ETHICA
INSTITUTE OF ISLAMIC FINANCE

# HANDBOOK OF ISLAMIC FINANCE

https://ethica.institute




Published by

Ethica Institute of Islamic Finance
651 North Broad St., Middletown, DE 19709, United States

https://ethica.institute
contact@ethica.institute



**Disclaimer:** Content in this e-book and available at https://ethica.institute is provided for education and informational purposes only, without any express or implied warranty of any kind, including warranties of accuracy, completeness, or fitness for any particular purpose. The information contained in or provided from or through all of Ethica's content is general in nature and not specific to you or anyone else and is not intended to be and does not constitute financial, legal, investment, trading or any other advice. You understand that you are using any and all information available on or through this and other Ethica content at your own risk.

If you are the owner of publishable content that you would like included in the next edition of Ethica's Handbook of Islamic Finance, please contact us at contact@ethicainstitute.com.

Cover photo: Copyright © Sohail Nakhooda

Ethica's Handbook of Islamic Finance is a free e-book designed for you to keep on your desktop as a handy reference. Permission is granted for non-commercial use only. We ask that the words be left as they are and the source be attributed and acknowledged.

Corruption has appeared in the land and sea, for that men's own hands have earned, that He may let them taste some part of that which they have done, that haply they may return.

Koran (30:41)

"All that we had borrowed up to 1985 or 1986 was around $5 billion and we have paid about $16 billion yet we are still being told that we owe about $28 billion. That $28 billion came about because of the injustice in the foreign creditors' interest rates. If you ask me what is the worst thing in the world, I will say it is compound interest."

President Obasanjo of Nigeria, G8 summit, Okinawa, 2000

# LETTER FROM A READER...

*I recently downloaded your Handbook of Islamic Finance and have just begun to read it. I am so pleased that my eyes have had the chance to read some of the words within it.*

*I have for many decades been part of the Western finance system and over the years I have become more and more aware of the greed and corruption that exists within it. For many years I have thought of the damage this greed and corruption has done to the lives of millions of innocent people.*

*Now I have started to educate myself on the fundamentals of Islamic finance and am quite excited to one day become part of the Islamic finance system that places the good of many above the greed and self interests of a few as Western finance has proven to do.*

*I firmly believe that if the Western banking system had been operating under the ethical guidelines of Islamic finance, then there would never have been a global financial crisis.*

*I am not a religious person, but I strongly believe in ethical outcomes, as my dear and now departed uncle Bert said to me not long before he died — "Whatever you do in life William — just do good, just do good." I believe I have now discovered a path that would have made my uncle Bert proud.*

*Once again, thank you for allowing me to read Ethica's Handbook.*

**William Lancaster**
Melbourne, Australia

# TABLE OF CONTENTS

# WE BELIEVE…

We believe that interest is the root cause of most of the world's problems.

If we did not have interest, we would not need endless growth. And if we did not need endless growth, we would not have most of the debt-induced poverty, resource-hungry wars, and runaway climate change we now see. All interest – whether simple interest or compound interest, whether at very low rates or very high rates – grows so fast that we simply cannot keep up. Interest is a cancer that grows faster than anything else. Faster than economies, faster than trees, faster than humans.

Need an example? Brazil is home to the beautiful Amazon rainforest. This lush wonder supplies us with a quarter of the world's oxygen. Unfortunately, this forest will vanish in our lifetimes. Why? So Brazil can pay off $200 billion of debt. How? With lumber.

Or take an example closer to home. Are you or someone you know crushed under growing personal debt? 43% of all American families now spend more than they earn each year. And this problem gets worse each year for millions of families around the world.

We believe there is a connection between interest and many of the world's problems. And we believe that Islamic finance can help solve some of these problems.

But for this to happen we need two things: the letter of the law and the spirit of the law. For the letter of the law to work, Islamic finance needs to follow some basic minimum standards. Standards that won't be taken seriously unless central banks start pulling some licenses.

The best standard in the industry - de facto in over 90% of the world's Islamic finance jurisdictions - is AAOIFI (pronounced "a-yo-fee"), which stands for the Accounting and Auditing Organization for Islamic Financial Institutions. AAOIFI brings together scholars from all over the world who agree on Shariah standards. And because AAOIFI provides minimum standards, if it isn't AAOIFI-compliant, it probably isn't Shariah-compliant. As one scholar put it, "The closest thing we have to ijma (scholarly consensus) in Islamic finance is AAOIFI." Ijma, as you know, is the highest evidentiary source after the Quran and hadith in traditional Islamic jurisprudence. We believe that following AAOIFI Shariah Standards - and questioning whether your bank, scholar, or trainer is following them - is a good starting point for following the letter of the law.

But we can't stop there. Islamic finance needs to follow the spirit of the law as well.

We need to promote equity-based structures like Musharakah and Mudarabah and reduce our dependence on expedient structures like Murabaha. We need to eliminate Tawarruq. And at a broader level, we need to address the larger problem of fractional debt-reserve banking. Why do banks get to lend money they don't have? And make money on money that doesn't exist? Does this make sense?

While the reality is that banks aren't going away anytime soon, a first step to challenging fractional debt-reserve banking is establishing a globally recognized gold-based currency. This immediately

forces the market to tie transactions to assets rather than base them on mere numbers inside computers.

So where do we start with promoting the law in letter and spirit? We believe it starts with you and me.

If you're a banker, you can start doing two things at your bank: 1) check that your bank's products comply with AAOIFI. The latest standards are available at www.aaoifi.com; and 2) start switching to Musharakah and Mudarabah for a variety of activities ranging from liquidity management to trade finance. And if your bank doesn't offer Islamic finance, start asking why.

If you're a regulator and Islamic finance is already practiced in your jurisdiction, pressure banks to follow AAOIFI or risk having their licenses suspended. At a broader level, support the Islamic microfinance industry. If Islamic finance hasn't yet reached your jurisdiction, promote awareness with training and educational initiatives.

If you're an entrepreneur, you probably have a skill the Islamic finance industry could use. Dream big: create a company, a community-based institution, a local currency, an ecologically-minded village, or an innovative product. In most countries, people still lack interest-free alternatives to home, education, and healthcare financing. Why is it easier to issue a billion dollar Sukuk than it is to raise a single penny for a Shariah-compliant education financing? How can we better operationalize Zakah? How do we build Waqf-based community-owned trust models? The recommended reading list for entrepreneurs later in this book gets you started with your idea.

If you're a student, learn Islamic finance. Think beyond the standard career path and seriously consider starting something on your own. Do what you love and success will follow.

And if you're an educator trying - like us - to change Islamic finance for the better, be patient. Lasting change takes years, often decades. Resist the temptation to "throw the baby out with the bathwater" and reject all Islamic finance. The industry is still a work in progress with a long way to go. Be part of this progress rather than embarking on a dazzling new theory of economics that leaves the average customer scratching his head wondering how to finance a small house for his family. Just promote Diminishing Musharakah instead, for instance. The deeper, structural environment that Islamic finance inherits - fractional debt-reserve banking, fiat currency - are not solved by replacing products. They are solved by replacing systems: gold-based currencies issued by Islamic central banks.

We believe this century - indeed, the coming years - will be like nothing before. Global heating will mean less food and water. Peak oil will mean less energy. And repeated financial crises will mean less certainty. We can throw our hands up and walk away in resignation. Or we can identify the root problems and do something about it. God only makes us responsible for our actions. He takes care of outcomes.

We believe that it's time to openly question the interest-based paradigm and promote interest-free finance as the proven alternative. The time has come. But the first step to questioning a paradigm and offering an alternative is to educate oneself.

Only then will you believe. Because if you believe, so will everyone else.


DOWNLOAD BROCHURE HERE >>


**MORE PEOPLE TRUST ETHICA FOR**
ISLAMIC FINANCE CERTIFICATION. PERIOD.

Ethica Institute of Islamic Finance is a Dubai-based training and certification institute.

Ethica has trained over 10,000 paying professionals in over **160 financial institutions across 65 countries**, winning numerous industry awards.

The 4-month Certified Islamic Finance Executive (CIFE) is a globally recognized certificate accredited by scholars to comply with AAOIFI, the world's leading Islamic finance standard. The award-winning CIFE is delivered 100% online or live at the bank.

3


ETHICA'S
GRADUATES
GET HIRED AND
PROMOTED
Islamic banks hire professionals strong in practical Islamic finance knowledge, not ones weighed down in theory. Using rigorous case studies, exercises, and examples, Ethica's CIFE emphasizes the practical execution experience that you need to enter the workplace.
4


Ethica's graduates now work
in over 160 financial institutions
in 65 countries around the world.
"I chose Ethica for its excellent market reputation. And now I understand why..."
Daniel Rasqui, CIFE Graduate
Director, SIX Financial
Luxembourg
5


ETHICA'S AWARDS
& RECOGNITIONS
GLOBAL ISLAMIC ECONOMY SUMMIT
Best Research and Education Company
Dubai, UAE
GLOBAL BANKING & FINANCE REVIEW AWARDS
Best Islamic Finance Training Institution MENA
Best Islamic Finance Education Provider MENA
Best Online Islamic Finance Program MENA
London, UK
INTERNATIONAL FINANCE
Best Online Islamic Finance Program
London, UK
GIFA
Best Islamic Finance Qualification
London, UK
Education Leadership Award
Dubai, UAE
EUROPEAN
Islamic Finance Education Provider of the Year
London, UK
6


ETHICA ALUMNI WORK
EVERYWHERE
HSBC
BARCLAYS
UBS
mashreq
المشرق
Emirates NBD
ADCB
Dubai Islamic Bank
ADIB
NOOR BANK
al hilal bank
FGB
QNB
pwc
KPMG
EY
Deloitte.
7

# THE FASTEST WAY **TO LEARN ISLAMIC FINANCE** GUARANTEED

In 4 months or less, Ethica's CIFE takes newcomers to an advanced level of knowledge about Islamic finance ...100% online or live at the bank.

Ethica has trained in 65 countries across the globe: from 1,000 bankers at Mashreqbank to the multi-country network of a giant British bank.

**1 ENROLL**

Pay your course fee (Visa/Mastercard or Bank Transfer).

**2 LOGIN**

Get instant access to the entire training curriculum. 100% online, 24 hours a day, 7 days a week for the next 4 months.

**3 TRAIN**

Play Ethica's award winning training videos. Play, pause, stop. Learn at your own pace. Anytime, anywhere.

"Ethica really delivers on its promise...the course content is very structured, clear as crystal..."
**Johan Serré, CIFE Graduate, Chief Internal Auditor Insurance, KBC Bank, Belgium**

8


**4 EXAMINATION**

Once you are ready, take the CIFE examination — 100% online or live at the bank.

**5 RECEIVE YOUR CERTIFICATE**

Beautifully-designed, custom-calligraphered and framed by hand, the CIFE certificate is couriered to your doorstep.

**6 GET AHEAD...**

Join the elite network of CIFE graduates across the world.

"At times you'd be forgiven for thinking you were listening to a live teacher. The only thing I regret about the course is that it ended!"
**Masen Abou-Zolof, CIFE Graduate, Financial Controller, Westpac Bank, Australia**

9


DOWNLOAD BROCHURE HERE >>

# SPEECH

# SPEECH:
# WHY ISLAMIC FINANCE?

**You are free to read all or part of this speech or play the video at conferences, training sessions, banks and universities.**


**PLAY NOW**

What do President Obasanjo of Nigeria, Nick the UK homebuyer, and Faisal the American college student all have in common? They're all trying to pay off loans that seem to increase every single day. What started off with a seemingly small interest rate ballooned into something completely unattainable. We'll look at each of their examples a little later.

First, let's answer the big question on everyone's mind: How is Islamic finance different from conventional finance? It looks the same. The result is often the same. What's the difference?

Well, the best way to find out is with a simple, real-world comparison. Let's take $10,000, for instance. And let's compare what a conventional bank can do with this $10,000 and what an Islamic bank can do.

First, the conventional bank.

The conventional bank finds a credit worthy customer and lends at 5% interest. The bank is not particularly concerned about what happens to this money other than that it gets repaid. The customer, on the other hand, has already found a borrower willing to pay 7%. This borrower runs a small credit co-op for students and lends at 10%. One of these students is enterprising enough to lend to his unemployed brother at 15%. Who has just discovered the power of compounding interest and now lends to street vendors at 25%. We could go on. But you get the idea.

As we speak, there are poor people paying upwards of 40%...per month! Now obviously we can't blame conventional banks for everything that happens after they've made the initial loan. But we can blame the power of compounded interest."

Interest, and the fact that you don't need actual cash to lend money means that the original $10,000 could keep passing hands until we pump out over $100,000 of artificial wealth. Artificial is right. How much actual cash is there? Only $10,000. With interest, we managed to turn $10,000 into much more.

Now what happens if the street vendors go out of business? Or the unemployed brother doesn't find his job? Or the credit co-op goes bankrupt?

That's right. Loans don't get repaid. And if enough people can't repay their loans, lenders get into all sorts of trouble. This vicious cycle sets off a domino effect of defaults.

And imagine that instead of a $10,000 personal loan, it's a million dollar business loan, or a billion dollar World Bank loan. Compounding interest grows so fast that borrowers are often unable to repay. People, economies, and the environment pay the price as we grow more desperate to meet rising debts.

So are we surprised when billions of dollars vanish into thin air?

Let's take the example of the Islamic bank. With this $10,000 the Islamic bank only invests in actual assets and services. It might buy machinery, lease out a car, or invest in a small business. But, throughout, the transaction is always tied to a real asset or service.

And this is the central point: we can't simply "compound" assets and services like we can compound interest-based loans. An asset or service can only have one buyer and one seller at any given time. Interest, on the other hand, allows cash to circulate and grow into enormous sums.

That's the difference between Islamic finance and conventional finance: the difference between buying and selling something real and borrowing and lending something fleeting.

In recent years we've witnessed the most dramatic global financial downturn seen in decades. What began as a housing bubble soon became a sub-prime credit crisis. And what many thought would remain a credit crisis soon spread into a global financial meltdown. It devastated every corner of the world.

And while these events affected most of us negatively, there was one silver lining: people finally gave a serious look at alternative forms of finance. And many people stopped believing that interest could solve all problems.

Understanding what caused these events serves as our starting point for understanding Islamic finance, and how it differs from conventional finance.

What conventional finance enables is the ability to sell money when there is no money. To sell assets before there are any underlying assets. And to allow debts to grow unchecked while borrowers become more desperate.

Interest creates an artificial money supply that isn't backed by real assets. The result? Increased inflation, heightened volatility, richer rich, and poorer poor.

Let's look at 3 practical examples that show just how Islamic finance is different from, and better than, conventional finance. And while Islamic finance parts ways with conventional finance on more than just being interest-free, we'll focus on interest in this talk.

We'll look at 3 people in 3 very different, real-world situations: the first is the leader of a developing country: President Obasanjo of Nigeria; the second is Nick, a homebuyer in the UK, and the third is Faisal, an American college student.

**Debt-Laden Country: Nigeria**

We begin by quoting President Obasanjo who said these words after the G8 summit in Okinawa in 2000: "All that we had borrowed up to 1985 or 1986 was around $5 billion and we have paid about $16 billion yet we are still being told that we owe about $28 billion. That $28 billion came about because of the injustice in the foreign creditors' interest rates. If you ask me what is the worst thing in the world, I will say it is compound interest."

It seems unbelievable but, sadly, it's typical. Developing countries start off with relatively small loans and remain saddled with huge amounts of growing debt for generations.
And remember, this could be Nigeria, or any other poor country. To give just one other example, during the years leading up to the 1997 Asian collapse, Indonesia's foreign debt as a percentage of GDP was over 60%. So Nigeria is certainly not an isolated example. There are countless more.

How did borrowing just $5 billion end up in having to pay $44 billion in total? Let's open up a spreadsheet and find out. For the sake of simplicity we'll just grow $5 billion into $44 billion between 1985 and 2000 and see what interest rate we get. It must've been a very high interest rate to get to $44 billion in such a short period of time. So let's start off with 40% per annum. No that's not right.

**Table 1: $5 billion growing at 40%**

| Year | Debt |
|---|---|
| 1985 | 5,000,000,000 |
| 1986 | 7,000,000,000 |
| 1987 | 9,800,000,000 |
| - | - |
| 1997 | 283,469,561,876 |
| 1998 | 396,857,386,627 |
| 1999 | 555,600,341,278 |
| 2000 | 777,840,477,789 |

Let's try 30%. That still gives us a very high number.

**Table 2: $5 billion growing at 30%**

| Year | Debt |
|---|---|
| 1985 | 5,000,000,000 |
| 1986 | 6,500,000,000 |
| 1987 | 8,450,000,000 |
| 1988 | 10,985,000,000 |
| - | - |
| 1997 | 116,490,425,612 |
| 1998 | 151,437,553,296 |
| 1999 | 196,868,819,285 |
| 2000 | 255,929,465,070 |

It turns out that to grow $5 billion into $44 billion takes an interest rate of only 15.6%. Now on the face of it around 15% doesn't sound exorbitant. It doesn't seem unfair, and technically it isn't even illegal according to international law. In fact, we personally know of banks that charge high-risk credits upwards of 30% interest rates. But every day numerous countries find themselves in the same predicament as Nigeria.

UNICEF estimates that over half a million children under the age of five die each year around the world as a result of the debt crisis. But as we've seen, it's not the debt that's the problem. It's the compounding interest.

Now how would Islamic finance handle things differently?

Using the $5 billion example, Islamic banks could provide $5 billion of financing for infrastructure, literacy, healthcare, or sanitation programs, to name a few.

- An Islamic bank could have arranged for the $4 billion construction of a natural gas pipeline and delivered it to Nigeria for $5 billion using an Istisna.
- Or taken an equity stake in a highway project and shared in profits and losses using Musharakah or Mudarabah.
- Or purchased commodities and sold them at a premium using a Murabaha.
- Or structured a project financing using an Ijarah Sukuk.

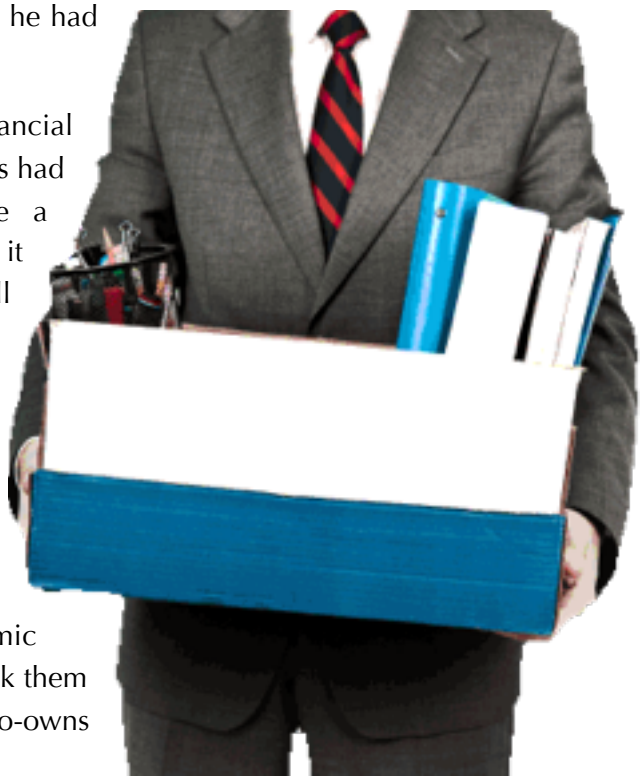
These names may sound new to you, but as we explain them in our training modules, they're much like conventional equity, trade, and lease-based instruments already familiar to most bankers. Islamic finance, after all, permits legitimate profit.

We're not asking that everything be changed. Just the harmful parts, and eliminating interest would be the first step.

In all of these cases the bank could not have charged more than the initial financing premium. So if the Islamic bank was owed $5 billion, that could never turn into $44 billion or even $6 billion. The debt would have to be fixed. Throughout our training modules we'll show you how these and other Islamic finance products operate.

Let's take another example of how Islamic finance is different from conventional finance. This time let's make it a little bit more relevant to our day-to-day lives.

**Nick The Homebuyer**



Nick has lost his job, his house, and all the money he had spent paying off his mortgage.

The property bubble that triggered the global financial meltdown could not have happened if the properties had been financed Islamically. Why? Because a conventional bank merely lends out cash. Legally, it can keep lending this cash over and over. Well above its actual cash reserves.

An Islamic bank, on the other hand, has to take direct ownership of an actual asset. Whether for a longer period in a lease or partnership, or a shorter period in a sale or trade, Islamic finance always limits the institution to an actual asset.

The next time anyone wonders whether Islamic banking is just dressed up conventional banking, ask them to show you a single major consumer bank that co-owns actual properties with their customers.

Of course, there's no excuse for Islamic banks that are Islamic in name only. But if the transaction complies with internationally recognized standards like AAOIFI, for instance, then there's no reason for it to have the many side effects associated with interest-based banking.

To provide just one example of how Islamic banks get directly involved in asset purchases, let's look at how a Diminishing Musharakah works. The word Musharakah refers to a partnership in Islamic finance.

And it's called a Diminishing Musharakah because the banks equity keeps decreasing throughout the tenure of the financing, while the client's ownership keeps increasing through a series of equity purchases. Eventually, the client becomes the sole owner.

If Nick had lost his job with a Diminishing Musharakah, at the very least he would still have an equity stake in an actual property that he could monetize.

Pay close attention to this example because this is something you may want to suggest to your own local bank. There's no reason why they can't do it.

We've kept all the numbers and calculations very simple and straightforward for illustration purposes.

Let's take a $220,000 house. And let's say the customer puts down $20,000 and finances the remaining $200,000 from the Islamic bank. Let's also say that the financing lasts 20 years and the bank sets a 5% profit rate. For the sake of simplicity, we'll make it 20 annual repayments.

In the first column (see Table 3) we have the year. In the second column we have the homebuyer's equity purchase, which is how much the buyer pays every year for buying the property's actual equity. It's his way of increasing his ownership in the property, while diminishing the bank's ownership, shown in the third column. The fourth column, called Rent, is what the homebuyer pays the bank for that portion of the property he doesn't yet own, a number that keeps decreasing as the bank's share also decreases. The final column shows what the homebuyer pays in total every year. Let's explain to you how we got these numbers, and how simple it is for most banks to put this together with just the will to take real ownership of an asset.

Let's go through each column one by one.

The homebuyer's equity purchase of $10,000 is a simple straight line calculation of the $200,000, divided by the number of years for the financing, 20 years. We subtract this $10,000 each year from the bank's total balance, to get the next column, the bank's ownership, which, as we see, keeps going down each year until the bank owns none of the property.

**Table 3: Nick's Diminishing Musharakah**

| Year | Homebuyer's Equity Purchase ($) | Bank's Ownership ($) | Rent ($) | Homebuyer's Payment ($) |
|---|---|---|---|---|
| 1 | 10,000 | 190,000 | 10,000 | 20,000 |
| 2 | 10,000 | 180,000 | 9,500 | 19,500 |
| 3 | 10,000 | 170,000 | 9,000 | 19,000 |
| 4 | 10,000 | 160,000 | 8,500 | 18,500 |
| 5 | - | - | - | - |
| 6 | - | - | - | - |
| 7 | - | - | - | - |
| 16 | 10,000 | 40,000 | 2,500 | 12,500 |
| 17 | 10,000 | 30,000 | 2,000 | 12,000 |
| 18 | 10,000 | 20,000 | 1,500 | 11,500 |
| 19 | 10,000 | 10,000 | 1,000 | 11,000 |
| 20 | 10,000 | - | 500 | 10,500 |

Next, we calculate the homebuyer's rent. This is equal to the bank's ownership for that period multiplied by the bank's profit rate. This number also keeps declining each year, because as the bank's ownership declines, so does the homebuyer's rent.

Lastly, we calculate the homebuyer's total annual payment. This is simply the homebuyer's equity purchase plus his rent. This number also keeps declining each year until the homebuyer eventually becomes the homeowner.

At no time does the homebuyer pay any interest. And, certainly, at no time does any payment compound. The homebuyer just pays for two things: the house, in small payments, little by little. And the rent, for the portion of the house he doesn't yet own.

This simple structure is something that just about any conventional bank can offer today. It takes a leap of faith for banks accustomed to interest-based lending to suddenly become direct stakeholders in property. But as the growth of Islamic banking shows, these concerns are misplaced. Call it Islamic finance, ethical finance, or conventional finance, when a bank takes real ownership of an asset, economies don't fall apart like a house of cards.

**Faisal The Student**

Now our final example. Talking about indebted countries and property bubbles may seem removed from our immediate predicament.

What are we talking about? That's right: personal debt. In the US alone, credit card holders have amassed over $1 trillion of personal debt. And that's just credit cards.

Let's take Faisal's student loan for example.

His education cost him about $30,000 a year for four years. That's $120,000. And Faisal had no savings to start off with. He got an interest rate of 10%, which is fairly typical for many students, and he began borrowing $30,000 at the beginning of each year. Three years after graduation he began paying off his student loans at the rate of $20,000 per year.

Can you guess how long it took Faisal to pay off his entire loan?

That's right. It'll take him over 25 years to pay off his loan.

And in the end he spends over $400,000 to pay for his $120,000 education. And that's assuming Faisal keeps his well-paying job. If he's unemployed, the debt just gets bigger.

An Islamic bank, on the other hand, could structure a service-based Ijarah to lease out the university's credit hours. Faisal ends up paying about 20% or 30% more; but with the interest-based loan, he pays about 400% more.

Islamic finance never can and never will be able to grow Faisal's debt once it's fixed.

**Principles of Islamic Finance**

Let's now step back for a moment and ask: so how *does* Islamic finance make any money?

Let's take a moment to compare banking in general with Islamic finance.

All banking products can largely be divided into the following 4 categories:

1. Equity
2. Trading
3. Leasing, and
4. Debt

Equity refers to direct ownership, trading refers to buying and selling, leasing refers to giving an asset or service out on rent, and debt refers to providing an interest-based loan.

Simply put, Islamic finance permits equity, trade, and lease-based transactions, but forbids debt.

And in many ways we're already familiar with these kinds of transactions. Here's most of Islamic finance in a nutshell:

- Mudarabah, Musharakah, and Sukuk are all equity based
- Murabaha, Salam, and Istisna are trade based
- And Ijarahs are lease based

Let's look at some of the basic principles that guide Islamic banks.

These are that transactions must:

1. Be interest free
2. Have risk sharing and asset and service backing
3. Have contractual certainty
4. And that all the elements of the transaction must, in and of themselves, be ethical

Let's look at each of these 4 guiding principles.

First, the transaction must be **free of interest.**

The Islamic ban on interest is not new. For centuries banned by Christians and Jews, the Shariah, or Islamic Law, prohibits paying or earning interest, irrespective of whether it is a soft, development loan or a monthly consumption loan.

In fact the Vatican itself has said, "The ethical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service."

The examples we've seen clearly show the harms of interest, not only to banks and governments but also to individuals. Islam is concerned with the well-being of society, sometimes at the immediate expense of the individual. A single interest-based loan may *seem* harmless, but an entire economy based on interest can have devastating consequences.

The second principle that governs Islamic finance transactions is the element of **risk sharing and asset and service backing**.

The central juristic principle in the Shariah that informs our concept of risk-sharing states: "al ghunm bil ghurm," meaning "there is no return without risk."

Bankers know that the concept of risk sharing is common to all equity-based transactions. Islamic finance is no different, where profit and loss distribution is commensurate with investment proportions.

Lending cash on interest is not the kind of risk sharing we're talking about. In a conventional loan the bank doesn't directly involve itself in how the cash is spent. Here's the cash. See you in a few months with some extra cash. That's all. Even with a secured loan, in which the bank takes security and gets more involved, there is still no direct equity position. The bank still doesn't own anything. An Islamic bank, on the other hand, actually takes a direct equity position, or buys a particular asset and charges a premium through a trade or a lease. It uses risk mitigants, but not without first taking ownership risk.

There must also be **contractual certainty**.

Contracts play a central role in Islam. And the uncertainty of whether a contractual condition will be fulfilled or not is unacceptable in the Shariah.

Contractual uncertainty happens when the basic prerequisite or integral of a contract is absent, such as the existence of the subject matter, the fixing of a delivery date, or the agreement on a price. Conventional insurance, interest, futures and options all contain an element of contractual uncertainty and are thus prohibited.

And lastly, Islamic finance transactions must be **ethical**, which means that there is no buying, selling, or trading in anything that is, in and of itself, impermissible according to the Shariah. Examples include dealing in conventional banking and insurance, alcohol, and tobacco.

With these basic principles in mind, we invite you to try our introductory training modules before progressing onto more advanced topics. At Ethica Institute you learn at your own pace. Play, pause, stop. Anytime, anywhere.

We blend live online training sessions and webinars with convenient e-learning modules, case studies, quizzes, and the world's largest database of Q&As available online. We bridge the gap between scholars and bankers by mixing theory with practical examples; by complementing authentic Shariah knowledge with real-world banking expertise. And we ensure that everything you learn complies with the Accounting and Auditing Organization of Islamic Financial Institution's, or AAOIFI's, latest Shariah Standards.

And best of all, we provide you with the only Islamic finance certificate available 100% online.

We look forward to you joining the Islamic finance community. We look forward to seeing you at EthicaInstitute.com.

# ARTICLES

# FIQH OR FICTION

## The primacy of a fatwa when accrediting an Islamic finance training program, and why Islamic finance scholars, not academic and professional bodies, should certify training programs for authenticity

A fatwa, or expert legal opinion of one or more Islamic scholars, is the highest level of accreditation granted a transaction, product, or institution in Islamic finance. Islamic banks esteem fatwas. And Islamic banking customers esteem fatwas. Yet Islamic finance training programs continue to turn to academic and professional bodies for Shariah accreditation. Why?

Whence this came one can only guess. Perhaps the word “accreditation” itself naturally harks one back to the leafy environs of one’s campus and conjures up images of stone pillars and gilded arches. After all, accreditation and academia have always gone hand in hand. Or perhaps it is the Islamic finance industry’s natural tendency to replicate the conventional finance industry, and thereby errantly impose upon the Islamic educational paradigm a western educator’s sensibility.

Whatever the origins of this mistake, Islamic finance is ultimately about Islam. And in Islam, accreditation is not about the sanctity of a particular hall of academia or the credentials of a professor; it is about the Islamic qualification of the accreditor — qualification proper to a particular Islamic science, in this case the application of Islamic commercial law, and qualification proper to the individual or institution issuing the opinion, in this case a fatwa.

After all, it was the Prophet Muhammad (Allah bless him and give him peace) who said, "Whoever is given a fatwa without knowledge, his sin is but upon the person who gave him the opinion" *(Abu Dawud)*.[1]

### What Does Standardized and Accredited Training Mean in Islamic Finance?

Of the many challenges now facing the Islamic financial industry, perhaps the greatest two are:

1. Accreditation by scholars, not academic and professional bodies: The importance of an Islamic finance scholar certifying a training program is paramount, and

2. Standardization in training: The importance of this scholar-certified training conforming to a widely accepted Islamic finance standard.

There is not a single industry in the world except that it enforces standards: banking, construction, transportation, food, and drug, to name but a few. And yet Islamic finance training, the very building

block of the industry, is conspicuous in its absence of standards. This is a root problem for all practitioners for which almost every other problem is but a symptom.

Lack of standardization is felt most acutely in the industry's face-to-face training sector, where just about anyone with passable product knowledge stands before an audience of eager bankers and waxes lyrical about the virtues of Islamic finance. Of course, it would be acceptable if this trainer merely repeated the positions of those qualified to speak on the matter.

But more often than not, this unqualified trainer, professor, or writer assigns the role of scholar unto himself, guessing through an answer here, issuing a pronouncement there, with little regard for established industry standards. Seemingly innocent at first. But these same audience members then go out into the marketplace and begin putting what they learn to practice. If they remember nothing else from the trainer, they rarely forget his casual attitude towards the high standards of the Shariah, or Islamic Sacred Law, and his ready willingness to issue his own "fatwas" — a willingness they soon adopt. Non-scholar trainers may convey legal positions, but they may not create them.

Accrediting academic bodies like universities, degree programs, professional bodies, and accrediting institutes have a place, no doubt, in ensuring high pedagogical standards. Delivery standards in Islamic finance training span the spectrum from excellent to illegal. But pedagogy is not the same thing as Islamic finance.

In Islamic finance, accredited training means training approved by a scholar who confirms that the content fully adheres to a particular standard. And not just any scholar. In order to be qualified to approve something in Islamic finance, one must first be a trained and experienced Islamic scholar who possesses, foremost, deep knowledge of the Shariah with, at minimum, demonstrated, peer-reviewed competence in at least one of the traditional schools of jurisprudence.

And second, he must bring practical working knowledge of banking and finance, complemented by actual practical experience in the contemporary marketplace. It is not enough for him to have read books — even AAOIFI's Standards — and passed tests. He has to know finance at the level he is answering questions about.

The least of what can be expected of a scholar with little or no practical experience in the area of finance he is speaking about is to first ask an experienced Islamic finance scholar. Every transaction is different. And, therefore, every transaction must be understood in its context. Like a pilot who only reads a flight manual but never flies with another more experienced pilot, he is limited by what he has read. Never having executed an Islamic finance transaction under the guidance of a more experienced scholar, he is limited to the narrow confines of his inexperience.

The result? Often hasty fatwas and costly mistakes.

**Standardized AAOIFI Based Training Promotes Shariah Harmonization**

In 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, pronounced "a-yo-fee") formed as an independent, non-profit, standard-setting body with a remit to promulgate Islamic finance standards for the entire industry. Thirty years on, AAOIFI is still widely regarded by banks and governments as the de facto industry standard for Islamic finance practitioners.[2] In fact, numerous central banks and financial services authorities now recommend the standards as a source of guidance for local banks.

AAOIFI's regularly updated texts have become the definitive reference work for those seeking a comprehensive rule book about Islamic financial products and practices. Its 100 standards cover everything from accounting and auditing to governance and product-specific Shariah standards. The 16 to 20 scholars — the number depending on the year — who sit on AAOIFI's Shariah Board are leading Islamic finance scholars who come from the Gulf, South Asia, South East Asia, Africa, and North America; each of them legally qualified to issue a fatwa and adjudicate on matters Islamic finance.[3] And for a religion that deeply values scholarly consensus, or *ijma*, as one of the main sources for legal derivation in Islamic jurisprudence, it is a relief to hear one scholar put it this way: "AAOIFI is the closest thing we have to *ijma* in Islamic finance."[4]

**Training Accreditation by Scholars, Not Academic and Professional Bodies**

According to AAOIFI's *"Stipulation and Ethics of Fatwa in the Institutional Framework"*[5] the standards for issuing a fatwa are, at minimum, knowledge of:

1. Islamic jurisprudence in financial transactions
2. How to derive rulings from primary sources
3. Islamic jurisprudential contributions of other scholars
4. Contemporary issues in the financial industry

Moreover, the individual should demonstrate discernment, scrupulousness, and peer-reviewed competence within the financial industry.(6)

In order to fully comprehend the complexity of the scholar's task, one should reflect upon the competing demands placed upon him when deriving a ruling from the Quran and hadith (prophetic traditions) corpus; hadith which number in the tens of thousands for those that are rigorously authenticated (sahih) and exceed one million when counted as separate chains of transmission.

As one scholar notes, knowledge of the primary texts consists in knowing, among many other things, "the *'amm*, a text of general applicability to many legal rulings, and its opposite; the *khass*, that which is applicable to only one ruling or type of ruling; the *mujmal*, that which requires other texts to be fully understood, and its opposite; the *mubayyan*, that which is plain without other texts; the *mutlaq*, that which is applicable without restriction, and its opposite; the *muqayyad*, that which has restrictions given in other texts; the *nasikh*, that which supersedes previous revealed rulings, and its opposite; the *mansukh*: that which is superseded; the *nass*: that which unequivocally decides a particular legal question, and its opposite; the *dhahir*: that which can bear more than one interpretation."(7)

This lengthy description of the minutiae facing the scholar in only one area of *ijtihad*, or personal legal reasoning, is particularly relevant in an age when pretenders to the task open the doors of scholarship unto themselves. Lest one decry that such high standards only complicate matters, and that God's word is divinely protected, we should have the humility to remind ourselves that divine protection relates to the *word* of God, not to our ability to derive rulings from it.

It is not lost on anyone the rareness of such individuals in present times. In a perfect world, such a scholar would be the trainer himself. But until there are enough scholars to go around, the best that we can do, and the least we must, is obtain their consent when accrediting a training program.

**"Fatwa Shopping" and the Harms of Less Than 100% Standardization**

When training content is anything less than 100% standardized to AAOIFI, discrepancies between the learner's knowledge and the market's practice abound. This rift widens into a chasm of confusion and leads to what can only be euphemistically described as the banker's penchant for "fatwa shopping": finding the right fatwa to fit your needs, rather than tempering your needs to comply with the fatwa. At best, this occasionally costs some banks and customers their money. At worst, this laxity costs the whole industry its credibility.

A number of Islamic finance trainers now work with guidebooks and other material that is merely "authored" by a scholar or "supervised" by a scholar. But what we often end up with is material that is 80% or 90% AAOIFI-based; "Shariah compliant" according to somebody, perhaps. But not uniformly Shariah-compliant according to any particular mainstream collectivity.

When trainers fail to conform their content 100% against a widely accepted standard, newcomers get confused: "Why is this guidebook telling me a product is unacceptable to most of the industry, but teaching it to me anyway?"[8] It is not always quite clear where the Shariah-compliant part of the guidebook ends and where the non-compliant part begins. What is a newcomer in Islamic finance supposed to do?

**Addressing Common Questions**

Shifting training certification away from conventional academic and professional bodies to Islamic finance scholars requires a paradigm shift in our collective thinking. Common questions and comments, and how to address them, include the following:

*Why follow a single standard when scholars cannot agree among themselves, and each bank has its own Shariah board? Does AAOIFI have an answer for everything?*

Standards should be specific enough to be of technical benefit to the practitioner, and general enough to be of practical benefit to the broader audience in a variety of situations. Most Islamic finance scholars already acknowledge that AAOIFI is the leading standard-setting body in the industry.

Differences in opinion *between* qualified scholars is a part of Islamic finance, indeed a part of Islam. But the operative word here is "qualified," and difference of opinion between laypersons is part of the problem.

Shariah harmonization in training has the immediate effect of getting all the stakeholders in the industry moving in one direction. The laborious work of *ijtihad* then returns to those qualified to adjudicate on the matter, far from the din of confusion now plaguing the lay audience. It is impossible for AAOIFI to anticipate every possible question on every possible matter. Operationalizing rulings is the work of the banks' Shariah advisors. However, for purposes of training, which is more general in nature, AAOIFI provides sufficient depth.

*Aren't academic and professional bodies necessary to ensure high standards?*

Pedagogical standards and Islamic finance standards are related but separate issues. Ideally, the industry's aim should be to deliver high pedagogical standards along with scholar-approved certification. Academic bodies serve an important role here. But this role must be treated as secondary to the more important matter of standardizing Shariah compliance. Mediocre learning that leads to a 100% scholar-standardized examination is far better for the industry than the best guidebook, trainer, or online course that is anything less than 100% Shariah standardized. Of course, it would be best if training institutes delivered both 100% standardization with the best pedagogical standards possible.

*Banks use scholars because bankers execute the products themselves in the marketplace. But students do not need scholar-approved certification because they are just trying to get a job and require only general knowledge of Islamic finance, not detailed knowledge of standards. Correct?*

Islamic banking students are future Islamic banking professionals. The same care that is taken by scholars working inside banks to ensure that products are Shariah-compliant must also be taken to ensure that training is Shariah-compliant. Newcomers to Islamic finance, even those who are still students, need standardized knowledge more than ever precisely because of their limited exposure to practical application.

*Who determines which individuals are considered Islamic scholars? Why do we need scholars when anyone who memorizes AAOIFI rulings can give certifications?*

It is not merely a matter of memorizing AAOIFI's rulings and parroting them to a captive audience. An individual must possess the ability to join between contemporary rulings and the classical texts in order to help bankers better navigate the uncharted waters not yet faced; new and detailed matters which necessarily give rise to new *ijtihad*.

The standards for scholarship vary by institution, but generally a student of Islamic Sacred Law reaches the rank of scholar through a system of prolonged study in the classical Islamic sciences, throughout receiving *ijazas*, or formal authorization to transmit a particular subject, from qualified individuals and institutions.

This is followed by a period of apprenticeship under scholars who are already qualified to issue fatwas, where at the culmination of as few as six years and as many as sixteen years of Shariah and general study one hopes to attain sufficient competence to reach the level of a scholar.

To give an idea of the specialness of such individuals and the loftiness of their rank, at the beginning of Islam and at the end of the Prophet's life (Allah bless him and give him peace), when there were estimated to be as many as one hundred thousand companions, only as few as seven individuals were at the level of scholarship to be able to perform *ijtihad* and issue fatwa independently. Today, the jurisprudence of these several individuals personally taught by the Prophet (Allah bless him and give him peace) have been distilled into the four traditional *madhhabs*, or schools of jurisprudence, by verifiable contiguous chains of transmission resulting in the schools well known to students of Sacred Law: the Hanafi, Shafi'i, Maliki, and Hanbali schools.[9]

There is not a classical scholar after the early Muslims except that he followed one of these schools: Bukhari, Muslim, Nawawi, Suyuti, and Subki, to name but a few, each of whom had memorized over 100,000 hadiths, sometimes as many as several hundred thousand, with their individual chains of transmission and each chains relative authenticity committed to memory. In order to put this feat into perspective, consider that a nine volume Sahih Bukhari contains just over 7,000 hadith.

All this is relevant to understanding the importance of upholding scholarship in the present age where opinions are bandied about with little regard for jurisprudential authority. The Prophet himself (Allah bless him and give him peace), the gentlest of mankind, responded to the ignorance of loose opinion in the strongest terms in a hadith that should give any thinking individual reason for pause:

> *We went on a journey, and a stone struck one of us and opened a gash in his head. When he later had a wet-dream in his sleep, he then asked his companions, "Do you find any dispensation for me to perform dry ablution (tayammum)?" [Meaning instead of a full purificatory bath (ghusl).] They told him, "We don't find any dispensation for*

> *you if you can use water." So he performed the purificatory bath and his wound opened and he died. When we came to the Prophet (Allah bless him and give him peace), he was told of this and he said: "They have killed him, may Allah kill them. Why did they not ask?—for they didn't know. The only cure for someone who does not know what to say is to ask." (Abu Dawud)*[10]

*How can we rely on a single fatwa? That is just one scholar's opinion.*

Reliance on a single fatwa is not being suggested - quite the opposite. The industry should rely on the opinions of many scholars - through their acceptance of *already agreed upon standards*. The purpose of the single fatwa is to assure users of a *particular* training program that these agreed upon standards are actually being followed. Think of the commercial pilot: he makes the final decisions, but his decisions are based upon an already agreed upon standard recognized by the mainstream aviation industry. Islamic finance training standards, on the other hand, abide by no such standard and are still very much up in the air.

*What about Islamic scholars who disagree with AAOIFI scholars?*

The Prophet (Allah bless him and give him peace) said "The hand of Allah is over the *jama'ah" (Tirmidhi)*[11] where the word *jama'ah* refers to the overwhelming majority of the Muslim collectivity, and in the context of *ijtihad*, the overwhelming majority of those qualified to independently derive rulings.

But where, one wonders, does difference of opinion come in when the opinion of an overwhelming majority prevails? The answer is that within the overwhelming majority, there is legal deference given to those permitted to make ijtihad, so that while one's own position is considered correct and the opposing position is considered incorrect, one accepts the possibility that one's own position might be incorrect and the opposing position might be correct. Within this framework of tolerance scholars accept valid difference of opinion.

For instance, scholars accept that Islamic finance practiced correctly is, in and of itself, legally valid; however, there is difference of opinion as to which products are valid and which ones are not. It is the task of AAOIFI, the world's largest collectivity of Islamic finance scholars, to organize these rulings and their application and determine validity here. If a divergent opinion is extreme to the extent that it does not accord with any mainstream collectivity (e.g. saying that commercial interest is permissible), whether this collectivity is in the majority or not, it is simply ignored.

The above is a necessary digression in order to understand the following: for scholars who disagree with an aspect of Islamic finance, the constructive response is to formally approach with one's disagreement the largest collectivity of those scholars who possess industry-specific knowledge and practical, day-to-day execution experience in Islamic finance. For this reason, each Shariah standard in AAOIFI is followed by an explanatory appendix describing the evidentiary bases for arriving at the rulings.

*Scholar-approved certification is only necessary for those who actually engage in product development and need to study Islamic finance in-depth for that purpose.*

From the customer-facing relationship manager who answers client questions all the way up to the boardroom executive who rarely sees the inside of a single product structuring exercise, everyone who works inside an Islamic bank should understand Islamic finance principles. At the bank, training is not about fiqh and fatwas, it is about product knowledge, and every individual working inside an Islamic bank needs some level of product knowledge, if nothing else, to understand how Islamic finance is different from - and better than - conventional finance.

*AAOIFI is just a standard-setting body. How can they certify so many training programs?*

AAOIFI does not certify training programs besides their own face-to-face programs as of this writing. It is the work of the scholars familiar with AAOIFI who are hired by training institutes to check that material conforms to their standards.

*What about the Malaysian standard in Islamic finance? How is it different from AAOIFI?*

The Malaysian standard in Islamic finance is accepted in few countries - Thailand and Indonesia are two that come to mind - of the more than 90% of the industry that is heading towards common AAOIFI convergence. In an exclusive interview with Ethica a few years ago, we had the privilege to speak with Malaysia's former Prime Minister, Dr. Mahathir Mohammad, who expressed his country's willingness to use products based on the buyback and debt trading structures in order to galvanize their then fledgling industry. However, because Bay al Inah and Bay al Dain are not acceptable to AAOIFI, it may be one of the reasons that there has not been much liquidity flowing from AAOIFI-based markets to Malaysian-based markets.[12]

**Next Steps: Promoting Shariah Harmonization in Training and the Role of Academic and Professional Bodies**

Face-to-face trainers, guidebook publishers, and online course providers now need to take a hard look at their content and decide whether they want to continue allocating resources to marketing and distribution, or finally step back and acknowledge that the market has changed, and so too have the needs of the customer. Bankers no longer want more theory and the confusion of multiple standards; they want to know the practical application of what is already widely accepted in the industry.

Ethica recommends the following steps:

> Step 1: Go to www.aaoifi.com[13] and order AAOIFI's latest "Shariah Standards."[14]
>
> Step 2: Bring bankers and scholars together in order to create training content around these standards.
>
> Step 3: Review and approve the certification examination by one or more third-party Islamic finance scholars who understand AAOIFI and confirm that the content, and certainly the examination, is consistent with these standards.

With common standards in training, the dividends to the industry are substantial. At the moment, Islamic finance faces a credibility problem. On the one hand, bankers are often not entirely convinced of their own products; not knowing the difference between what they used to execute as conventional bankers and what they now execute as Islamic bankers. And customers face a similar

crisis of confidence as they grapple with how Islamic banking is any different from conventional banking. Some level of informational asymmetry is to be expected in a young, burgeoning sector. But trainers, who are the fountainheads of much of the information streaming out into the industry, have no excuse for falling prey to this asymmetry.

Even so, it is a time of optimism and opportunity. Never before has the industry had a critical mass of so many Islamic bankers. And never before have we had a set of so many heavily refined standards agreed upon by the majority of the industry's scholars. And, most important, not once before have we had the opportunity to consolidate this critical mass into a standardized whole. With an entire industry working in unison towards a common purpose, Islamic finance will then truly embody the lofty ideals on which it was originated rather than be mired in the confusion that may one day hasten its undoing.

Notes:

1. Abu Dawud 3.321 Well-authenticated (hasan).
2. http://www.thefinancialexpress-bd.com/more.php?news_id=95274; http://www.philadelphia.edu.jo/courses/accountancy/Files/Accountancy/aa303.pdf; http://www.philadelphia.edu.jo/courses/accountancy/Files/Accountancy/0308910.txt; http://pakistantimes.net/pt/detail.php?newsId=7805; http://www.ibfim.com/v2/images/kmc/2011BookshoppeList/iaccount/56%20islamic%20accounting.pdf; https://www.zawya.com/story.cfm/sidZAWYA20100125122913/Islamic%20Bank%20leads%20on%20Sharia%20compliance%20with%20AAOIFI%20industry%20certification; http://www.islamicfinance.de/?q=node/1140; http://www.tradearabia.com/news/bank_190503.html; http://www.islamicfinance.de/?q=node/933;
3. Accounting and Auditing Organization for Islamic Financial Institutions, Shariah Standards: Intro., pp XI-XXVIII (Manama, Bahrain: Accounting and Auditing Organization for Islamic Financial Institutions, 2008).
4. Private study session, Darul Uloom, Karachi, Pakistan, 2005.
5. Accounting and Auditing Organization for Islamic Financial Institutions, Shariah Standards: "Stipulation and Ethics of Fatwa in the Institutional Framework," pp. 515-530 (Manama, Bahrain: Accounting and Auditing Organization for Islamic Financial Institutions, 2008).
6. State Bank of Pakistan, Islamic Banking Department, Fit and Proper Criteria for Shariah Advisors of Islamic Banking Institutions (Annexure-IV to IBD Circular No. 2 of 2004, revised vide IBD Circular 2) (Karachi, Pakistan: State Bank of Pakistan, 2004).
7. "Why Muslims Follow Madhhabs," Nuh Ha Mim Keller, accessed February 2011, http://www.masud.co.uk/ISLAM/nuh/madhhabstlk.htm.
8. Securities and Investment Institute (now Chartered Institute for Securities and Investment), "Islamic Finance Qualification (IFQ): Bay al Inah," pp. 75-76 (London, UK: Securities and Investment Institute, 2007).
9. Ahmad ibn Naqib al Misri, Reliance of the Traveller: A Classic Manual of Islamic Sacred Law, trans. Keller (Maryland: Amana Publications, 1999).
10. Abu Dawud 1.93, well-authenticated (hasan).
11. Tirmidhi, well-authenticated (hasan).
12. Dr. Mahathir Mohammad, interview by Ethica Institute of Islamic Finance, available as a podcast at www.EthicaInstitute.com, 2008.
13. "Shariah Standards," Accounting and Auditing Organization for Islamic Financial Institutions, accessed February 2011, http://www.aaoifi.com.
14. The present author neither works for nor is compensated by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) for endorsing their standards.

# COMMON QUESTIONS ABOUT ISLAMIC FINANCE

**Is Islamic banking truly Islamic, or is it just cosmetically-enhanced conventional banking?**

Islamic bankers, caught between scholar and layman, devote much of their time to educating an often skeptical public about the authenticity of their products. Time well spent. The purgative effects of ridding the Islamic financial sector of pretenders (and there are many) at the hands of an educated consumer are obvious. Too often, however, this educational process is long on theory and short on practical relevance.

Perhaps the easiest way to determine whether Islamic banking is true to Koran, sunna and customer is to see how it actually works in practice. The Islamic banking discussed here is the same one that earns consensual acceptance from the field's leading scholars of the traditional schools of jurisprudence. And while unscrupulous banks do exist, increasing market regulation and customer sophistication ensure that those Islamic banks that are truly Shariah-compliant lead the industry. By learning the basics about these banks, individuals will be better able to stand their ground when not-so-Islamic bankers push non-compliant instruments in the name of Islam.

At the outset, though, it is necessary to emphasize two important points. First, just because an Islamic product and a conventional product are identical does not render the Islamic product impermissible. As obvious as this seems, it is an argument detractors often use to discredit Islamic banking. The vast majority of Islamic financial instruments bear a strong resemblance to their conventional counterparts, particularly equity-based ones. What distinguishes them from conventional instruments is usually nothing more than a set of processes, which leads to the second point.

In Islam, the difference between whether something is forbidden, offensive, permissible, recommended or obligatory usually depends on a validating process. Two couples, one married the other unmarried, may look the same, but the agreement of a simple marriage contract makes the one Islamically valid and the other not. Two hamburgers, one using Islamically slaughtered meat the other not, may look the same, but a simple process makes one valid. So too, two financial products, one Islamic the other not, are differentiable by a set of steps: ostensibly cosmetic, Islamically defensible.

The following are among the most commonly asked questions by customers new to Islamic banking (ordered in increasing degree of complexity):

**There was no Islamic bank during the Prophet's (Allah bless him and give him peace) time, so how can there be Islamic banking now? Sounds like a bid'a.**

Microchips, potato chips and Islamic banks are examples of permissible things for which the Prophet (Allah bless him and give him peace) gave us no specific guidance. Rather, he forbade us from engaging in blameworthy innovations (bid'a) that would contravene the Islamic Sacred Law (Shariah), rather than from new things that possess no intrinsic blameworthiness. The bid'a is in the blameworthiness, not in the newness.

Admittedly, some Islamic banks do carry out impermissible transactions, but that implicates the entire field of Islamic banking no more than the sins of a few Muslims incriminate the entire Islamic community.

As for the claim that Islamic banking is just part of the "system" and is therefore best avoided, is to put one's head firmly into the sand; romantic anachronists need not apply. As long as Muslims, money and capital markets co-exist, there will always be a need for Muslims to put their money into some kind of a market (even a little money in a checking account circulates into global capital markets). The question Muslims should really be asking themselves is: what now? Whether they would not rather keep their money in the most Islamically acceptable manner available to them given the options. And while new customers might be forgiven some level of healthy skepticism, we should all understand the limits of our own unqualified ijtihads when declaring something a bid'a.

**Don't Islamic banks simply change labels, by replacing the word "interest" with "profit"?**

Some Islamic banks do just that. And here is the easiest way to find out the truth: ask them if the profit amount (not the percentage amount) is fixed, or if the customer profit is declared before the bank's actual profit is announced. If either of these is the case, their "profit" is just another kind of riba.

Interest, the additional charge over the loan principal, is the "cost" of using money, and is strictly forbidden in Islam, whether given or taken, at a low rate or a high one, to or from a Muslim or a

non-Muslim, whether in Muslim lands or not. The problem with exchanging one amount of money for a larger amount of money at a later date is that there is no underlying asset or service transacted.

Profit, rent and mark-up, on the other hand, are asset and service backed, and permissible in Islam. Profit is earned on the sale of goods and the provision of services. Rent is charged on the usufruct of property. Mark-ups are added to the cost of an asset. Among the most common financing products that an Islamic bank will use in order to earn profit are musharakas (partnership finance) and mudarabas (investment finance).

In a musharaka, two or more partners (even thousands of shareholders) commit risk capital and share profit based on an agreed upon percentage, enduring loss in proportion to their invested capital. Modern corporations, like those listed on the New York Stock Exchange, are a kind of musharaka.

In a mudaraba, an investing partner brings capital and a working partner brings time and effort to share in profits and losses agreed upon beforehand. Venture capital firms, such as the ones that financed much of Silicon Valley's growth, are a kind of mudaraba.

Unlike with interest, which is charged on a borrower whether the business succeeds or fails, in a musharaka and a mudaraba the investor profits only when the business profits and therefore the investor fully shares in the business risk. Some might argue that an interest-based lender also shares risk: the risk of whether his money will be returned or not. But this is not a business risk, it is a credit risk. The difference is substantial: a business risk only risks the business; a credit risk will risk both business and borrower (by forcing repayment, in extreme cases through personal bankruptcy).

**Why does Islam forbid interest when money is just another commodity that comes at a price?**

Unlike an actual commodity (like gold, which has traditionally been the standard of measure for currencies), money has no intrinsic value. It derives its value from something other than itself, namely, market demand. So interest actually creates nothing. By creating money from nothing, we bloat economies with asset-less, service-less pieces of paper. And we all know what happens when the supply of anything, even money, exceeds its demand. Its price drops. And when the "price" of money drops, we get inflation: the money in our pocket becomes worth less today than it was yesterday. However simplified and stylized this description, it accurately illustrates the macroeconomic debilitation of interest. Because interest serves the interest (coincidence?) of capital owners like banks, governments, "development" agencies, corporations and wealthy individuals, it is unlikely to go away.

The treatment of money as a commodity is partly responsible for burgeoning world poverty (by forcing poor countries to allocate increasing amounts of capital away from social services, like healthcare and education, toward debt servicing) and increased market volatility (by widening the gap between the supply of money and the creation of real assets). It is often asked how we would live in a world without interest. We might instead begin asking how we should be expected to live in a world with interest?

**Where should I keep my money? Islamic banking doesn't adequately address the inflation problem and you say interest banking is forbidden. If today's $1 is going to be worth 90 cents next year because of inflation, why can't I charge interest to compensate for the loss?**

The short answer: because interest is still haraam. Charging interest to compensate for inflation is analogous to terrorizing civilians to compensate for global injustice: two haraams do not make a halaal. Far too many Muslims, sincere practicing ones no less, have somehow reconciled the taking of interest with their personal definition of what the Koran and sunna say about the matter. But compensating for inflation is still no excuse for taking interest, no matter how noble one might feel at taking money from a conventional bank. In order to compensate for inflation, Islamic banks provide plenty of instruments that mimic the security and liquidity of an ordinary savings account while also providing a reasonable interest-free return (Meezan Bank's Monthly Musharaka Certificate is just one example, but all the major banks, including non-Muslim banks that sell permissible Islamic products, offer basic consumer accounts). If making a long-term personal loan, for instance, one might consider gold (e.g. an individual lends $100 in gold today and tells the borrower that he would like the equivalent gold back in 3 years).

**Stocks are like gambling, but Islam permits stocks and forbids gambling. Why?**

This returns to the basic principle of asset and service backing. Stocks invest in real assets (a company's property, plant and equipment) and actual services (a company's management expertise). Gambling invests in nothing. Even if a lottery funds charities or finances public works, the money with which it does so is still haraam. Stocks provide risk-based returns based on publicly available information. Gambling provides only uncertainty, and the distant prospect of huge gains based entirely on chance.

To the casual observer "buying low and selling high" resembles gambling, but because there is no Islamic stipulation on the price at which something is sold (barring artificial interventions like bidding up or hoarding) and the duration for which it is held, the primary concern relates to what is actually bought and sold. Provided the main business of the company is permissible, the company owns some illiquid assets, and the investor removes the proportion of his profits that correspond to the company's interest earnings, then purchasing the stock is permissible.

**What's the difference between an ordinary lease and an Islamic lease (ijarah)? They look the same.**

An ijarah lease, like a conventional lease, is an agreement to rent out property or services. In an ijarah lease the lessor (the person granting the lease) maintains ownership of the property or service while the lessee (the person to whom the lease is granted) gains use of the property and the resulting profit. In conventional financial leasing, the interest payments have to be made to the lessor whether the lessee gains benefit from the property or not. If the property is damaged through no fault of the lessee's, the interest payments are still payable. So the ownership risk does not entirely rest in the

owner's hands. Ijarahs, on the other hand, clearly distinguish between ownership and usufruct, or the use and profit of a thing, and stipulate that rental rates, unlike interest rates, be known and agreed upon beforehand.

The central component of a valid ijarah agreement is the appropriation of risk, specifically the ownership of risk. In an Islamic lease, risk associated with the leased property or service remains with the lessor, the beneficiary of the rental payments.

**If Islam forbids fixed-income interest, what's wrong with floating-rate interest? Doesn't it also rise and fall like profit?**

Islam does not forbid fixation. It is permissible to fix profits (in percentage, not absolute, terms), prices, rents and installment plans, to name a few measures. But it is forbidden to exchange money for a larger amount of money (unless the currency is different, in which case it is permissible at spot). The unlike exchange of like moneys creates riba. But exchanging assets or services for money and money for assets or services is entirely permissible. So the problem does not relate to whether an interest rate is fixed or floating, but to the interest itself.

**I don't have enough money to buy factory equipment (or a car, a home or pay for an education)? How do I avoid interest and still fulfill my short-term financing requirements?**

Murabaha (mark-up financing) is an example of an Islamic instrument that funds short-term capital requirements. Because it is the most easily confused with interest-based financing, it is worthwhile going through the basic steps in a murabaha execution:

A customer approaches an Islamic bank with a request to purchase an item, promising to pay at some later date. The bank assesses the product and the customer's collateral (collateral is an Islamically acceptable method of securing a financial obligation) and agrees by making the customer its agent. The customer goes to the market and selects the product. The bank pays the vendor, charges the customer a mark-up, and the customer takes the product agreeing to pay later.

This is analogous to a friend buying something on your behalf, charging a little extra for the time and effort, and selling it to you with an expectation that you will repay him at some later date. This is instead of giving you cash to buy it now, and asking for the cash at some later date, charging you interest in addition to the loan amount.

In a murabaha, the bank provides financial intermediation entirely free of interest, and because the bank buys and sells an asset, even if at a profit, the transaction is Islamically permissible. The difficulty people have in differentiating a murabaha from a simple short-term loan is by not appreciating the importance of the seemingly insignificant intermediate step of the bank owning the item by paying the vendor directly. What this does is satisfy the very basic Islamic requirement of backing the transaction with an asset. The mark-up is no different from the profit any business makes for having provided a legitimate service.

For home purchases, diminishing partnership schemes (or "diminishing musharakas") also provide the buyer with a financing alternative. In a diminishing partnership arrangement the buyer approaches the bank with a down payment. The bank pays for the rest of the property and the buyer begins living in the property while paying the bank rent. Over time, the buyer buys back the bank's equity in the house and reduces his monthly rent in proportion to his increased ownership of the house. Eventually, the buyer becomes the sole owner. The important point is that the Islamic bank participates in the customer's ownership risk.

**Is there a secondary market for Islamic instruments?**

A secondary market is a fancy name for any exchange where securities (like stocks) are bought and sold after their original issuance. Islamic leases, or ijarahs, are an example of a securitizable instrument.

Because lessors have the right to sell all or part of their leases to one or more third parties without affecting the continuity of the lease itself, ijarah certificates may be traded like securities under certain conditions. An ijarah certificate represents the third party's new ownership in the lease as well as the proportionate share in claiming rent and suffering loss. Ownership, not the right to claim rent, represents the tradable portion of the certificate. Islam permits the trading of assets, not of money, for profit, and a rental claim is a receivable that represents money. So trading rental claims without first transferring ownership is forbidden. But it is acceptable for buyers seeking ownership and sellers seeking profit to trade ijarah certificates like common securities in a capital market.

Islamic banks face an unusual set of competing demands today. On the one hand, the Islamic banking sector is growing at about four times the rate of the industry as a whole. But on the other hand, Islamic banks are forced to conform to a regulatory environment that has traditionally catered to a well-entrenched interest banking system. As a result, Islamic banks now inherit a customer base so accustomed to dealing in interest that to suggest an alternative, particularly one with a well-laden "Islamic" label attached, is to imagine the seemingly unimaginable. But in just the first few decades of consumer-level Islamic banking, a centuries-old conventional finance sector is beginning to acknowledge the importance of providing an Islamic alternative, evidenced most tellingly by the creation of Islamic subsidiaries within conventional Western banks. And because all banks, whether Islamic or not, are profit-motivated and demand-driven, it is important that the Islamic banking customer demands products that are compliant, for which the first step is self-education about what actually makes a financial product Islamic.

# RIBA AND MORTGAGES: 21 COMMONLY ASKED QUESTIONS

## We speak to bankers, both Islamic and conventional, and laymen, both sincere and cynical, and compile twenty-one of the most commonly asked questions about riba and mortgages

He's a good Muslim. He prays, he fasts, he pays zakat. He regularly performs voluntary acts of obedience. He's a caring family man and a respected member of the community. By every outward measure, he appears to be leading the life of an exemplary Muslim.

But, somewhere along the line, he reconciled his views on interest-based finance, particularly in relation to conventional mortgages, with his religious beliefs. He became convinced, like countless other Muslims, that Islam permits one to take a conventional mortgage to finance the purchase of a home.

The question is not whether riba is impermissible; the verses in the Quran are clear enough. The question for many is: "Is the riba in the Quran the same as the interest on my home loan?"

We spoke to bankers, both Islamic and conventional, and laymen, both sincere and skeptical, and compiled twenty-one of the most commonly asked questions related to conventional mortgages.

We confirmed the answers with qualified scholars who referred back to the Quran; sunna of the Prophet (Allah bless him and give him peace); the scholarly consensus of the traditional schools of jurisprudence; and the Shariah standards of the world's largest regulatory body governing Islamic banks, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

The following are *actual* questions posed by genuine Muslim homebuyers and industry practitioners:

***1. How is the riba Allah has forbidden the same as ordinary interest? I thought riba refers only to usury.***

The Quranic verses and hadith are clear on the prohibition of riba. What is not clear to some is the *meaning* of the word "riba."

Understanding this is particularly relevant to understanding the impermissibility of conventional mortgages.

The present answer seeks to show that differences in interpretation do not originate from a substantive change in the nature of the circumstances since the time of the Prophet (Allah bless him and give him peace), as some claim, but rather from a change in the common usages of the words "usury" and "interest." So while the original meaning of the word "usury" referred to any charge over the principal according to Old English Law[1], the modern meaning of the word underwent a process of evolution.

Essentially, a change in language, not a change in commerce.

Allah deems only two sins worthy of a war from Him: enmity with His friends and dealing in riba. Few Muslims doubt the enormity of dealing in riba, clear in Allah's words in the following verse:

**"Those who eat of riba shall not rise (on Judgment Day) except as those arise who are smitten by the Devil with madness—which is because they say that trade is but like riba, though Allah has made trade lawful and has forbidden riba. So whoever is reached by a warning from his Lord and desists may keep what was before (Allah forbade it), and his affair is with his Lord. But whosoever returns, those are the denizens of hell, abiding therein forever.**

**"Allah extirpates (all benefit from) riba, but makes charity bounteous, and Allah loves no sinful ingrate.**

**"Verily, those who believe and do righteous works, who perform the prayer and give zakat, they possess their wage with their Lord: no fear shall be upon them, nor shall they grieve.**

**"O you who believe, fear Allah, and give up whatever remains of riba, if you be believers.**

**"But if they do not, then be apprised of war from Allah and His messenger, though if you repent, you may keep your principal, neither wronging nor being wronged" (Quran 2:275-79)**

And the words of the Prophet (Allah bless him and give him peace) found in this and other rigorously authenticated (sahih) hadith:

**"The Messenger of Allah (Allah bless him and give him peace) cursed whoever eats of riba, feeds another with it, writes an agreement involving it, or acts as a witness to it." (Muslim)**

And the expert legal opinion (fatwa) of one of the world's leading Islamic finance scholars, Justice Mufti Muhammad Taqi Usmani, defining riba:

**"The concept of riba was widely recognized among the addressees of the Holy Quran, and it is that concept which is reflected in the legal definition provided for riba either in the hadith or in the later literature of Islamic jurisprudence. According to this definition, any transaction of loan where the payment of an additional amount on the principal is made conditional to the advance of such a loan is called riba."[2]**

Confusion, spread primarily by the more modernist readings of the Islamic Sacred Law in the first half of the 20th century, arose on whether riba refers to usurious levels of interest alone, or refers to commercial interest as well, the kind found in conventional mortgages.

Two issues are involved here: 1) the incorrect and widely-held belief that interest was, in previous times, only usuriously excessive by nature; and, 2) the popular notion that pre-modern forms of finance served primarily consumptive, not commercial, needs.

A brief look at history is instructive.

Commercial interest, as practiced today even at single digit rates, was well-known and widely-practiced among Abrahamic societies, even over four thousand years ago, mostly as a form of institutionalized agricultural finance, not just as a form of usurious consumption finance, borne out by substantial historical proof.[3] Later, even the concept of credit risk became well understood, with Byzantine traders contemporary to the Prophet (Allah bless him and give him peace) borrowing on standardized rates of interest, rates that varied by profession.[4]

The Prophet (Allah bless him and give him peace), his Companions, among whom many were previously moneylenders, and all those trading in the Arabian peninsula during the 7th century were thoroughly familiar with the widespread practice of commercial interest-based lending: charging for the use of money with an additional sum over the principal amount.

Modernist Islamic discourse on the inadequacies of an interest-free economy is highly reminiscent of the arguments favoring interest given by medieval Christian theologians. Three centuries before pro-interest Calvinism reached its full stride, the slippery-slope justifications that marked the beginning of the end of the Church's interest prohibitions began, most openly, in the 13th century with the introduction of a time-based penalty charge on an interest-free loan.

The charge was called "interesse."

About a hundred years later, this charge evolved into one that could be incorporated into the contract itself as part of the loan, not just as a penalty for late payment, but as a charge just for the use of the funds.[5]

The last stage of this recidivism came in 1920 when the Church itself issued the following statement: "…in lending a fungible thing, it is not itself illicit to contract for the payment of the profit allocated by law, unless it is clear that this is excessive, or even for a higher profit, if a just and adequate title be present…"[6]

Even the modern dictionary attests to the true origins of the word "usury": "1. the practice of lending `money at an exorbitant interest rate. 2. an exorbitant amount or rate of interest. 3. *Obs*. Interest paid for the use of money…"[7] The first two definitions are the norm, the third, the point. That it became obsolete (*"Obs."*) is testament to the fact that usury was once regarded as none other than non-exorbitant interest.

From the beginning of Islam to the present day, the overwhelming majority of Muslims, both scholars and laymen, have regarded riba, usury, and interest as but one in meaning. To follow this is to follow the words of the Prophet (Allah bless him and give him peace) to "adhere to the jama'a (overwhelming majority of Muslims)." (Ahmad)

***2. How does interest harm society? Isn't it a necessary part of every economy.***

Muslim societies are a living example of the debilitating effects of interest-based finance. Most sadly reflected in just about every Muslim country in the world, with daily-ballooning interest payments to the World Bank, International Monetary Fund, and other industrialized nations' agencies; notably, at low rates of interest. Interest payments that, quite unproductively, draw valuable funds away from healthcare, education, sanitation, infrastructure, and any number of other governmental responsibilities.

Debt creates dependence, and dependence provides the opportunity for control.

The following two passages are particularly relevant for those who claim that interest-based development actually works:

"According to UNICEF, over 500,000 children under the age of five died each year in Africa and Latin America in the late 1980s as a direct result of the debt crisis and its management under the International Monetary Fund's structural adjustment programs. These programs required the abolition of price supports on essential food-stuffs, steep reductions in spending on health, education, and other social services, and increases in taxes. The debt crisis has never been resolved for much of sub-Saharan Africa. Extrapolating from the UNICEF data, as many as 5,000,000 children and vulnerable adults may have lost their lives in this blighted continent as a result of the debt crunch."[8]

"Debt is an efficient tool. It ensures access to other peoples' raw materials and infrastructure on the cheapest possible terms. Dozens of countries must compete for shrinking export markets and can export only a limited range of products because of Northern protectionism and their lack of cash to invest in diversification. Market saturation ensues, reducing exporters' income to a bare minimum while the North enjoys huge savings.

The IMF cannot seem to understand that investing in…(a) healthy, well-fed, literate population…is the most intelligent economic choice a country can make."[9]

Further, price inflation and increased market volatility, the usual concomitants of a highly leveraged economy, affect poor and rich countries alike. To add to this, poorer, debtor countries typically find their currencies devaluing as they struggle to repay loans in their creditor's currency.

The realistic alternative to debt is the one already employed to good use in successful Western economies: equity, upon which most Islamic finance products are based. In comparison to debt, equity provides the most resilient and least damaging source of capital for individuals, businesses, and economies.

Besides the ravaging macroeconomic effects of debt, problems also appear at the level of the individual. A 2001 study at Bath and Exeter reveals that students who fear they may fall into debt are four times more likely to suffer from depression.[10] For those students who are *actually* in debt, the numbers may be worse.

The correlation between indebtedness and illness is particularly alarming given the widespread use and social acceptability of interest-based consumer finance, including home financing, which also offers the all too convenient option of multiple mortgages.

Debt finance expands the range of possibilities available to us, and for some, to unsustainable levels, making it possible to own things one cannot afford with money one may never have. Allah's command, after all, is not intended for His benefit, but for our own.

Islam recognizes that the choices we make as individuals affect all society, and that to support an interest-based institution, even with a seemingly benign conventional home loan, is to support the broader framework of banking institutions largely responsible for today's widespread global poverty.

***3. Does Islam permit conventional mortgages?***

A conventional mortgage is a loan of money on which interest is charged. It constitutes a cash loan advanced by a bank or mortgage agency to finance the purchase of a property. The homebuyer agrees to repay the principal in addition to making an interest payment, while nonpayment of either entitles the bank to seize title. Some money today for more money tomorrow.

The lender takes no equity position in the property. The lender provides no service. There is no usufruct of the lender's assets. The lender provides only some cash today for more cash tomorrow. Riba, no less, and forbidden.

***4. Aren't Islamic home financiers simply changing labels, replacing "interest" with "rent"? What's the difference between a conventional mortgage and an Islamic home financing?***

Shariah-compliant Islamic banks, which certainly does not represent all of them, use one of three forms of home financing: 1) Diminishing Musharakah (also called "declining partnership" or "declining balance"); 2) Ijarah; and, 3) Murabaha.

Very briefly, in a Diminishing Musharakah, the Islamic bank and the client purchase the property jointly. The client moves into the property and begins acquiring the bank's equity in the property while paying rent in proportion to the bank's remaining equity, with each successive rental payment "diminishing" to the extent of the bank's reduction in its share of the property.

In an Ijarah, or Islamic lease, the bank, acting as lessor, acquires a property and rents it out to the lessee client. Much later, as part of a separate agreement, the bank offers to sell the property to the client. In a Murabaha, or cost-plus financing, the client selects a property and the bank acquires it. The bank adds its profit and sells the asset to the client at an agreed upon price on a deferred, usually installment, basis.

No different from the shopkeeper who sells goods (not money) on credit. For the purposes of facilitating execution, it is permissible for the client to act as the bank's agent, provided the risk of ownership resulting from this agency role devolves back to the bank.

The key difference between a conventional mortgage and an Islamic home financing is that a conventional mortgage involves the loan of cash on interest, whereas an Islamic home financing is strictly the exchange of an asset. Each of the above transactions involves an asset and actual ownership by the bank. Ultimately, the bank must own some (Diminishing Musharakah) or all (Ijarah and Murabaha) of the asset for it to be Islamically acceptable.

Exacting conditions related to timing, usufruct, and the proper allocation of potential penalty charges (to a designated charity), among other things, govern these Islamic products. When things go wrong, the fact of the Islamic bank having undertaken the liabilities associated with asset ownership makes all the difference.

So while "changing labels" is, alas, true in the case of some "Islamic" banks, to make a blanket statement condemning the entire Islamic banking industry as fraudulent is simply inaccurate. If only to earn the reward for having tried, one should probe a bit further into a bank's dealings, at the very least, by asking a relied upon traditional scholar about the qualifications of the bank's Shariah board.

***5. Isn't home ownership an important step in establishing Muslim minorities in the West? Surely, that should make conventional mortgages permissible.***

As a general Shariah principle, avoiding harm takes precedence over seeking benefit.

Establishing Muslim communities is important, but not at the level of the obligation of avoiding the enormity of dealing in interest. With Islamic home finance options readily available in most areas where large Muslim populations reside, there is no need to resort to conventional mortgaging to build communities of Muslim homeowners.

***6. What about necessity (dharura)? Are there any situations in which conventional mortgages are permissible?***

In the words of the respected Damascene scholar Sheikh Muhammad Sa`id Ramadan al-Buti:

“The necessity which allows usurious loans is the same necessity which allows eating the meat of a dead animal, pig and the like, in which case the one necessitated is exposed to perish from hunger, nakedness or losing lodging. Such is the necessity, which makes such prohibitions lawful.”[11]

And in the words of another leading scholar, Sheikh Wahba Zuhayli:

"…only when there is absolute distress (dharura qaswa) in which all the conditions of genuine distress are fulfilled. In such situations, it would only be permitted to the extent of the distress, such as someone being unable to find a house through rental, for example, and if they don't take a mortgage they'll actually end up sleeping on the street or end up hungry such that they'll have genuine fear of death. This is the criteria for the genuine distress that would entail an exception."[12]

***7. Imam Abu Hanifa said that there is no riba in Dar al-Harb (lands where the rules of Islam do not exist), basing his opinion on a hadith[13]. Doesn’t this entitle me to take a conventional mortgage?***

The traditional schools of Islamic jurisprudence consist of rulings and methodologies that rely on the expertise of a body of scholars who base these rulings and methodologies on a specific socio-economic context. It is not simply a matter of lifting an opinion from a classical jurist and inserting it, decontextualized, into a modern framework. The job of today’s scholars is to apply the interpretive tools of their respective schools within this framework.

The position of the Hanafi school and the Hanafi scholars with whom we spoke, including several leading muftis specializing in Islamic finance, is that one is not permitted to deal in riba, whether in Muslims lands or non-Muslim lands, and whether with Muslims or non-Muslims.

***8. I don’t qualify for an Islamic home financing and I can’t afford to rent. But I do qualify for a conventional mortgage. Can I then enter into a conventional mortgage since this is my only reasonable option?***

As Sheikh Muhammad Sa`id Ramadan al-Buti’s states, quoted from above, “the necessity which allows usurious loans is the same necessity which allows eating the meat of a dead animal, pig and the like, in which case the one necessitated is exposed to perish from hunger, nakedness or losing lodging.”

In such a case one is expected to explore *all* possible alternatives, including the inconvenience of a longer commute, the prospect of a less desirable neighborhood (provided it is not clearly dangerous or harmful), or, in the longer term, seeking work in another city.

The monthly payments on a conventional mortgage, after adding principal and interest, property taxes, and the usual expenditures that go with home ownership, come to an amount similar to renting property, and in many localities, an amount greater. Often we impose a pre-conceived limit on the kinds of options available to us before we fully explore all of these options.

***9. Can I live in a conventionally mortgaged house that somebody else bought for me as a gift and is currently making payments on?***

Scholars have permitted one to live in such a house, though it is still best avoided. Of course, one is not permitted to assist in the decision-making process or transaction of obtaining the property through unlawful means.

***10. Why do Islamic banks charge more for a home financing than a conventional bank? How is that Islamic?***

Rates are a function of market dynamics. Not sincerity.

In more mature Islamic finance markets, it is cheaper to purchase property using Islamic finance than it is to borrow funds through a conventional bank.[14]

Growing market competitiveness, and the resulting growth in volumes, ensures that financing rates will continue to fall. Islamic banks in the West are catching up. On the supply side rates continue to fall as more Islamic home finance providers enter the market, while on the demand side a rapidly growing and increasingly sophisticated customer base asks for greater Shariah compliancy at competitive rates.

In relation to conventional mortgage transactions, which number in the millions each year in the US and UK, Islamic home finance transactions are but a fraction. But within only a few years, Islamic banks in the West have made considerable strides in lowering financing rates, with one Islamic home finance provider stating that their product is "no more expensive than a 30-year fixed-rate (conventional) product…"[15]

***11. Islamic banking is inherently less competitive because extra paperwork for Shariah-compliancy means higher costs.***

This returns to the above point about scale, and the need for greater volumes to bring rates down. Shariah compliance is less a matter of additional paperwork, though additional paperwork is often necessary, than a matter of properly executing existing paperwork. Even so, demonstrable costs associated with collapsing conventional banks and their associated products, most tellingly seen in the global financial crise, far outweigh any perceived or real costs associated with Islamic finance and the additional steps necessary to legitimize a contract.

***12. What about the moral hazard of Islamic banks using their own paid for Shariah boards?***

Shariah advisors are paid a fee for their services regardless of their legal opinions. These opinions are not commission-based, volume-based, or linked to the success of any given transaction. The Shariah advisor plays an auditory role, not a marketing role, so there is no financial incentive for the advisor to win hearts.

And given the relative simplicity of Islamic banking products, and the fact that industry-wide Shariah standards[16] are accessible to everyone, including customers, central bank regulators, and independent auditors, means that there is little room for advisors to exercise personal agendas.

Notwithstanding the handful of scholars whose fringe positions are well known to the industry, if there is a worldly motive that a Shariah advisor might aspire to, it is the need to preserve his reputation. And in an industry in which the number of institutions entering the market far outpaces the number of qualified scholars available to serve them, reputations are paramount.

The way that one ensures that an Islamic product is Shariah-compliant is to speak directly to the Islamic bank and then check their responses against the opinions of a qualified scholar.[17]

***13. In an Islamic home financing, the rent follows the rate of interest and is always a certain percentage above the base rate. Does this mean that the rent is simply replacing the interest to make it sound permissible?***

Interest is forbidden on the basis of it representing "rent" on the use of cash. The concept of benchmarking, on the other hand, in which rental rates are measured against a well-known benchmark, like the US Federal Funds Rate or LIBOR (London Inter-Bank Offered Rate), constitutes a *measurement*, not an actual interest charge. Scholars cite the example of selling wine: a Muslim vendor selling juice would be perfectly entitled to measure the price of his product against those of his wine-selling competitors in order to remain competitive.

The variation in rental rates after the contract is signed could be a potential source of uncertainty leading to dispute (gharar), but scholars provide two mitigants: 1) mutual agreement by both parties to benchmark against a well-known measure; and 2) flooring and capping of rate levels. While scholars permit benchmarking, they acknowledge that it is the less ideal (though still no less permissible) alternative to a truly Islamic measure such as an asset-based benchmark.

***14. Islamic banks use the word "interest" in their documentation. Is this permissible?***

In the absence of government documentation specific to Islamic home financing in most countries, Islamic banks are required by law to use conventional home mortgage contracts, including those that use the word "interest" in their documentation. Scholars state that this does not compromise the permissibility of the transaction, saying that the legal substance—and reality—of an Islamic home financing contract is not affected in this case by a third party's terminological usages.

***15. Islamic home financiers require clients to engage in insurance. Is this permissible?***

Given that property insurance is a legal requirement in most, if not all, localities in the West, and given that properly capitalized Islamic cooperative insurance (takaful) options do not exist in the West, scholars have allowed the use of conventional property insurance for homebuyers.

***16. Islamic banks use credit scores similar to the ones conventional banks use to check on the eligibility of a potential homebuyer. Is this permissible?***

Credit scoring, among other risk assessment measures, is only a measure. Just as one would check on the credentials of a business partner before entering into a partnership, so too, an Islamic bank checks on the customer before entering into what amounts to an actual partnership.

Credit scores provide institutions with a clearer understanding of a prospective customer's credit worthiness. In order to be sustainable and continue to provide Muslims with Shariah-compliant financial alternatives, Islamic banks must remain financially stable, and credit scores are an indispensable tool for promoting this stability.

***17. If I am not allowed to take a conventional mortgage, am I permitted to work in the conventional real estate business?***

The Prophet (Allah bless him and give him peace) said in a rigorously authenticated (sahih) hadith, reprinted from above:

**"The Messenger of Allah (Allah bless him and give him peace) cursed whoever eats of riba, feeds another with it, writes an agreement involving it, or acts as a witness to it." (Muslim)**

Assisting in an act of disobedience is an act of disobedience.

As it relates to the real estate business, one should not be involved in the solicitation, execution, or any form of assistance, of an interest-based conventional mortgage, though scholars have permitted accountants and others to make post-transaction records in financial statements and the like. Growing globally at an annual rate of 15-20%[18], and considerably faster in some countries, career opportunities in Islamic banking abound, particularly for those already familiar with conventional finance, as many real estate professionals are.

***18. How do some banks, claiming to be "Islamic", trick me?***

While there is no end to the possibility of indiscretion on the part of insincere "Islamic" bankers and lawyers, the customer's final line of defense, amid the paper shuffling, is a quiet read of the actual contract.

Whether in a Diminishing Musharakah, Ijarah, or Murabaha contract, if the financier never owns the property, one is not engaged in an Islamic home financing transaction.

One "Islamic" home finance provider in North America claims to "conceptually own the shares in its name as expressed as a lien on the property," while another provider, this time in Australia, "assumes an interest in the property ('rights') other than a right to possession."

According to scholarly consensus, neither of these represents actual ownership.

These banks effectively charge rent on a claim or a right (as opposed to the valid rent on an asset, service, or usufruct), a practice not acceptable to regulatory bodies. In the absence of a governing regulatory body that unifies and imposes global Shariah standards, customers are on their own. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is widely regarded as the industry's leading standard-setting body, and may one day provide the criteria for global licensing and auditing, but it currently only serves as a guide, not as a watchdog.

Even so, as one bank learned when it was stripped of its "Islamic" label by its government regulators, word gets around.

***19. The concept of ownership has changed since the classical jurists first formulated their rulings.***

Some have argued for a new theory of ownership, stating that, among other financial innovations, a lien represents a new form of conceptual ownership that did not exist when the classical jurists declared all forms of riba forbidden.

First, secured lending was not foreign to classical jurists. Second, a conventional mortgage is a lien against a property, not an interest in it. The liabilities associated with the property never return to the lender. Not convinced? Light a bonfire in your front lawn this weekend and see who the authorities fine, you or the lender.

On the other hand, look at the assets side of an Islamic bank's balance sheet and you will find actual home ownership[19], unimaginable to a conventional bank.

***20. Interest is now customary practice in most of the world. Don't rulings change in the Shariah when something becomes customarily acceptable?***

Customary practice ('urf) affects rulings related to the permissible, not the decisively prohibited.

As always, changes in rulings are subject to the agreement of qualified scholars, who must possess, among other things, a highly sophisticated understanding of the primary texts, classical Arabic, the rulings and methodologies of previous scholars in their respective schools, a thorough understanding of the needs of our time, and deep familiarity with the specific topic the ruling relates to, in this case, finance and economics.

***21. After much thought, I have decided to leave interest-based finance. What should I do now? What happens to the mortgage and the property?***

Allah says: "And those who, when they do an evil thing or wrong themselves, remember Allah and implore forgiveness for their sins - Who forgives sins save Allah only? - and will not knowingly repeat (the wrong) they did." (Quran 3:135)

The Prophet (Allah bless him and give him peace) said in a rigorously authenticated (sahih) hadith: "There is no one who commits a sin, goes and performs ritual ablutions, and then prays two rakats after which they seek Allah's forgiveness except that He forgives them." (Tirmidhi)

Imam Nawawi says in Riyad al-Salihin: "Sincere repentance consists of abstaining from the sin instantly, having a firm intention not to be involved in that sin again and being remorseful and regretful of one's actions."

One takes the means to extricate oneself from the mortgage: one would be religiously obligated to remove oneself from the situation, and when not reasonably possible, to repay the loan as quickly as possible by the most effective means available to one; most readily by reducing one's expenditure and, if possible, taking interest-free loans from friends and family. Ownership in the house itself and proceeds from its eventual sale are both considered lawful. A number of Islamic banks now offer refinancing options that convert one's conventional mortgage into its Shariah-compliant equivalent.

And Allah knows best.

**Notes**:

1 "Usury." Encyclopaedia Britannica. 2005.

2 Usmani, Muhammad Taqi (Justice Mufti). Contemporary Fatawa. Karachi: Idara-e-Islamiat, 2001. According to scholarly consensus, this ruling applies equally in a fiat currency environment. For further reading, Mufti Taqi Usmani's "Text of the Historic Judgment on Interest" provides excellent responses to common arguments in favor of commercial interest; the entire text is available at http://www.albalagh.net/Islamic_economics/

3 "Banks and Banking." Encyclopaedia Britannica. 2005.
4 Gibbon, Edward. The Decline and Fall of the Roman Empire. New York: Random House Everyman's Library, 1993.

5 El Diwany, Tarek. The Problem With Interest. London: Kreatoc, 2003.

6 Codex Iuris Canonici (Rome, 1920). This position contrasts sharply with the original Biblical prohibitions of interest: Exodus 22:25, Leviticus 25:36, Leviticus 25:37, Deuteronomy 23:19, Deuteronomy 23:20, Nehemiah 5:7, Nehemiah 5:10, Psalm 15:5, Proverbs 28:8, Isaiah 24:2, Jeremiah 15:10, Ezekiel 18:8, to name only a few.

7 Random House Dictionary (New York, 2001). Word entry: "usury."

8 Buckley, Ross, "The Rich Borrow and the Poor Repay: The Fatal Flaw in International Finance." World Policy Journal (2002/2003).

9 George, Susan. A Fate Worse Than Debt. New York: Grove Weidenfeld, 1990.

10 "Students Depressed by Debt Burden," BBC News, September 23, 2001: http://news.bbc.co.uk/1/hi/education/1559910.stm

11 "Shaykh Buti on Riba in the West," Sunnipath.com, May 16, 2003: http://qa.sunnipath.com/issue_view.asp?HD=1&ID=408&CATE=43

12 Zuhayli, Wahba, Al-Mu`amalat al-Maliyya al-Mu`asira. Damascus, 2002.

13 For a complete discussion, see section w43.0: Al-Misri, Ahmad ibn Naqib. Reliance of the Traveller. Maryland: Amana Publications, 1999.

14 Based on a survey of rates at Meezan Bank (Islamic) and Prime Bank (conventional), conducted by Fareed Agha (Pakistan, Summer 2005).

15 Norris, Kim. "Faith, finance forge new path." Detroit Free Press August 6, 2005.

16 See: Accounting and Auditing Organization for Islamic Financial Institutions (2005). Shariah Standards. Bahrain: AAOIFI

17 See: www.sunnipath.com for detailed and reliable answers to commonly asked questions answered by qualified scholars and those able to contact them directly.

18 Euromoney Books (2005). Islamic Retail Finance Handbook. London: Euromoney.

19 Under the line item "Financings," for instance, at Meezan Bank; Siddiqui, Ahmed Ali (Manager, Product Development and Shariah Compliance, Meezan Bank, Pakistan). Telephone interview. 7 November, 2005.

# IN YOUR INTEREST

## Is Islamic banking a viable alternative to interest-based conventional banking? Is it really any different from conventional finance? Does it offer a better way forward?

These and other questions face the next generation of Islamic bankers as they inherit an industry that, in just the last decade, grew from a niche market serving a largely Muslim population to a global phenomenon offered side-by-side its conventional counterpart. In the aftermath of the global financial crisis, it is now seen in a completely new light as not only an ethical form of finance, but also as a potentially superior one. First, however, we must understand what Islamic finance is and what it is not.

This article places special emphasis on equity-based Islamic finance because, while "good-enough" Shariah-compliant trade and lease based instruments currently predominate the market and manage to satisfy the letter of the law, stakeholders increasingly demand Shariah-based products that fulfill the original spirit of the law.

All banking is debt, equity, trade, or lease based. And all Islamic finance does is simply dispense with the debt. The same proven risk-oriented principles that benefited past generations of equity-based conventional bankers (more profitably than their interest-based counterparts) also ensures the success of future generations of Islamic financiers. The positive impact that Islamic-style equity has on both the profitability of a business and the well being of society contrasts sharply with the negative effects of interest-based instruments.

The demystification of Islamic banking requires an understanding of four basic points:

1. What is an Islamic bank?
2. How is an Islamic bank different from a conventional bank?
3. How is an Islamic bank similar to a conventional bank? and
4. How do the two compare in practice?

An Islamic bank is a financial intermediary that brings together the providers of capital with the users of capital in accordance with the principles of the Shariah (Islamic Sacred Law). Like conventional banks, a combination of products, services and customers loosely determines the type of banking the institution engages in: at a very basic level, investment bankers execute complex, investment-oriented transactions for large institutions; commercial bankers borrow, lease and lend; and retail bankers service consumer-oriented needs. Though increasingly there is considerable overlap across these industry specialties, with commercial banks offering investment banking expertise, investment banks providing retail operations, and retail banks evolving into full-service commercial banks, the burgeoning demand for Shariah compliant instruments at all levels of the banking value chain has Islamic banks repositioning themselves as one-stop financial shops rather than as specialist boutiques.

Islamic banks are unique in that their activities are regulated by rules derived from the Quran, sunna (Prophetic practice), and the traditional schools of scholarship. Certainly, there are banks that offer cosmetically-enhanced products that are Islamic in name only, but the increasing regulation of the industry, the improving sophistication of the customer base, and the genuine demand for authentic Shariah committees, limits the proliferation of these expedient, non-compliant banks.

An Islamic bank is distinguishable from its conventional counterpart by some basic principles, each of which is derived from the Quran, sunna, or both. While thousands of fiqh (Islamic jurisprudence) rulings operationalize specific injunctions from the primary texts, four basic principles govern at least 80% of all Islamic transactions:

**Riba-Free Transactions:** The Arabic word riba refers to “increase” or “addition”, and in the commercial context refers to any incremental increase, however great or small, above the original lent or exchanged amount. While riba is of many types, the most common kind is ordinary commercial interest, where the borrower compensates the lender with an interest payment for the right to use a sum of capital over a period of time.

Often riba is translated as usury, and because in modern times usury normally refers to exorbitant rates of interest, Muslims often mistakenly regard seemingly benign commercial rates of interest as something other than riba. In reality, however, riba refers to any increment above the principal amount, whether it is a soft, development loan charged at 1% annually or a usurious consumption loan charged at 10% monthly. So riba includes both usury and commercial interest.

**Risk Sharing:** The concept of risk sharing is common to all Islamic finance transactions, whether equity, trade, or lease based. A few additional conditions make Islamic finance transactions even more equitable in many cases; such as the ruling that silent partners receive profit no more than is proportionate to their investment, while they may receive less; and that working partners may enjoy more pre-agreed profit than is proportionate to their investment, reflecting an emphasis on reward for work rather than reward for merely possessing capital.

The popularity of debt-style, interest-free instruments like Murabaha (mark-up financing) reflects the infancy of the Islamic banking industry and the tendency to gravitate towards something that mimics interest. But even in Murabaha transactions, where the bank intermediates a purchase by buying the good and charging a mark-up in advance, the condition imposed by the Shariah, and absent in a conventional loan agreement, is that the Islamic bank assumes some of the risk as well by holding the good for a period of time. Few conventional banks will choose to own anything, even if only for a short period.

This distribution of risk is itself an equity-based principle. Such seemingly insignificant conditions are often lost in contractual minutiae, and often confuse the layman into thinking that there is no difference between a given Islamic product and its conventional counterpart, but when things go wrong, the details in an Islamic contract place particular emphasis on the equitable distribution of risk.

**Asset and Service Backing:** Because Islam restricts the treatment of money as a commodity by declaring unlawful any profit earned from the exchange of like currencies, regardless of the time value of money, transactions are backed by an asset or a service. Asset and service backing ensures that real assets and inventories are created, rather than pyramidic money-lending schemes where money simply creates money and market volatility increases unchecked. Even monetary losses due to inflation are overcome by denominating the exchange of money into an asset with intrinsic utility, such as gold.

Because Islamic banking relies on asset and service backing rather than interest payments, conventional bankers often point to Islamic banking's inability to service demand for short-term loans. This is less true now than ever before. Islamic banks have now gained the expertise and scale necessary to conduct a broader set of activities. Across the world, Islamic bankers now provide car and home loans, fund short-term working capital requirements, and offer a range of shelf-like instruments.

**Contractual Certainty:** Contracts play a central role in Islam. The uncertainty of whether a contractual condition will be fulfilled or not is unacceptable in the Shariah and creates gharar (ambiguity or uncertainty leading to dispute). Conventional insurance, interest, futures and options all contain an element of contractual uncertainty. This is distinct from commercial uncertainty, such as whether a business will be profitable or not, which is acceptable because there is an asset (such as property, plant and equipment) or a service (such as labor) underpinning the risk.

Some of the above mentioned differences between Islamic and conventional banking seem inconsequential, even trivial to some, but these ostensibly insignificant conditions spell the difference between financial dynamism and financial disaster, as will be shown later.

The similarities between Islamic banking and conventional banking far outnumber the dissimilarities, because the basic principles of finance remain the same. Companies still only raise cash in one of two ways, with the first method conforming to Islamic principles: 1) by issuing equity, or stocks, done by selling shares in a company, where the rise and fall of the share's value reflects the holder's share in profits and losses; and 2) by raising debt, or large IOUs called bonds, which obligate the company to repay the holder some fixed-income at some given maturity. Like conventional banking, Islamic banking enables the profit-motive, fosters a spirit of transparency and corporate responsibility, and ultimately seeks to promote shareholder value, all within the guidelines of the Shariah. Capitalism, if you will, without the after-taste.

So how do equity-based Islamic banking and interest-based commercial banking compare in practice? The question should be answered on three levels: 1) the profit impact; 2) the economic impact; and 3) the social impact. It is worth emphasizing that in the longer term these levels are inter-related. No company profits unfairly, or suffers adversely, without having a negative residual impact on the economy. And no economy suffers without some concomitant social cost:

**Profit Impact:** Comparing the profitability of equity and debt, history is quite telling. Between 1926 and 1999 in the United States:

$1 invested in small stocks would now be worth $5,117;

$1 in large stocks, $2,351;

$1 in corporate bonds, $61;

$1 in government bonds, $44; and,

$1 invested in an extremely safe Treasury bill would now be worth $15.

Out of 54 possible 20-year periods between 1926 and 1999, stocks outperformed bonds all 54 times. For the risk averse among us (i.e. bondholders), in bad times the highest returning bonds still managed worse than the lowest returning stocks. In the worst 20-year period for large stocks, $1 grew to $3.11, and for intermediate government bonds, $1 grew to $1.58 (Ibbotson Associates, 1999). We have to rethink our concept of risk. The perceived long-term safety of bond investing is as illusory as its profitability is real. Equity is not only historically more profitable but, as these numbers convincingly show, the safer long-term choice. Even risk-adjusted returns are higher for equity than they are for debt.

**Economic Impact:** The primary objective of most commercial banks is to increase profit by extending loans to creditworthy individuals at the highest possible rate while undertaking the least amount of risk. But this objective focuses both borrower and lender on repayment, not profit. Typically, the lender has little active interest in the borrower's business; only an interest in the

borrower's ability to repay, often at all costs, including the well being of the business and the borrower. Equity focuses on profit (and loss).

If the principal (lender) has an equity share in the business, he will have an almost exclusive focus on the profitability of the business. Knowing that a loss is possible, the principal will make every effort that the agent (borrower) succeeds.

In a debt transaction the borrower loses everything if the business fails, and is still left to repay. While in an equity transaction, the agent loses nothing if the business fails, besides time and effort, and has nothing to repay. Further, debt inhibits innovation by putting undue focus on repayment schedules while equity promotes innovation by focusing on the business itself. Small, growing businesses need to invest time and money to innovate before becoming profitable, a task made difficult by even the most lenient repayment schedules. Early repayment by the borrower precludes reinvestment into innovating the business, while delayed repayment increases subsequent payment sizes.

Too, the confrontational nature of interest-based lending debilitates business. In a debt transaction, the lender and borrower work in conflict, having to negotiate and renegotiate repayment schedules and lending rates. In an equity transaction, the principal and the agent work in concord to make more money.

From a distributive justice perspective, debt tends to centralize capital into larger corporations that are more able to match stable cash flows with repayment schedules. Equity, on the other hand, is more distributive in that it favors smaller companies that provide a greater profit potential. Speculative debt-based borrowing, including borrowing to finance equity purchases, triggered almost every major financial disaster in the modern capital market era. The negative effects are not merely money-deep; debt affects the collective consciousness of the business community, creating a demeaning and disempowered "borrower culture" rather than a vibrant and productive "investment culture."

**Social Impact:** As the Quran mentions in relation to wine and gambling, "In them is great sin, and some profit for men; but the sin is greater than the profit." (2:219) So too, interest has its share of convenient, short-term advantages, but like other evils, comes at the price of a broader social impact.

Real world examples are illustrative. The IMF and the World Bank aggressively disbursed loans for decades in the name of economic rehabilitation and poverty alleviation. Now recipients of their soft loans and structural adjustment programs are deeper in debt than ever before. Their non-usurious, low-interest loans compounded over time to create a situation where interest payments now exceed original principal amounts often by several orders of magnitude. The world's poor now pay several times more in interest payments than they do in all social services combined, leaving us with damning evidence that the debt-based sincerity of the IMF and the World Bank only served to spread world poverty.

At a commercial level, interest-based lending centralizes capital into fewer hands. The common man puts a higher proportion of his wealth into interest-based instruments than the wealthy man because he lacks the capital to make long-term investments and requires a ready source of liquidity, like a bank deposit, which returns a low rate. At the same time, the common man's lower disposable income requires him to continuously borrow capital for consumption purposes, like financing a car, a home or an education. For this, the same man earns a low interest rate and is charged a high borrowing rate.

The owners of capital, on the other hand, include high-worth, decision-making stakeholders of society, like banks, corporations, the government, institutional investors and wealthy individuals. By charging interest, they access the borrowers' and depositors' capital at relatively low rates and allocate them with other owners of capital (often in the form of equity-based investments) for significantly higher profits, which serve only to centralize capital among owners. This is neither conspiracy nor collusion. This is the nature of interest. The lines between borrower, depositor and owner are rarely well defined, but one fact remains: the nature of interest-based lending is such that the lower one's income, the higher one's borrowing rate and the lower one's return on deposits. Equity, on the other hand, levels the playing field, so that large and small investors share identical returns.

With global trends headed in the direction of equity (evidenced by the dramatic emergence in recent decades of the individual investor; the success of the mutual fund; the proliferation of new stock exchanges and equity indices; and an increase in global privatizations) there seems to be a collective acknowledgement that equity is the investment of choice. Debt continues to be a corporate mainstay as the cheaper source of financing, particularly among large, stable borrowers able to reduce their cost of capital by matching expected cash flows with future debt repayments. But to choose debt over equity has severe implications, not just for the business itself but also for society as a whole. Leaving Islamic banking as not only a viable and profitable choice, but also a responsible one.

# POVERTY TO PROFIT: USING ISLAMIC MICROFINANCE TO ALLEVIATE POVERTY

**Poverty alleviation has traditionally been the domain of the interest-based development agency, and profit generation has always been the mainstay of the corporation. Rarely have the two overlapped: corporate shareholders have no interest in giving money away and development banks have little to offer profit-oriented investors.**

*Note: Before implementing any Islamic finance product, including the structures described in this article, get the approval of a qualified Islamic finance scholar.*

Microfinance is a financing tool that sustainably provides very small loans to the working poor. A handful of borrowers, usually 5 to 20 individuals, assemble themselves into groups. The first set of loans are extended to an initial subset of individuals within the group, for instance 2 out of the group's 5 individuals, and once these loans are repaid, a second subset of individuals receive their loans. This continues through the entire group, circulating until a final loan is extended to a designated group leader.

Variations of this general theme abound but the basic underlying principle remains the same: a borrower is much more likely to repay on time if not doing so affects one's selected group partner,

usually an acquaintance. The fear of a faceless bank is replaced with the mercy for one's own neighbor. This non-traditional concept of "social collateral" banking allows the poor to break out of the poverty cycle: the provision of capital allows for greater business investment, which leads to increased income, resulting in higher household savings and eventual financial independence.

**The Origins of Conventional Microfinance**

Microfinance grew out of the failure of cooperative movements and government-sponsored initiatives for concessional individual lending. With some of these heavily subsidized programs yielding repayment rates as low as 40%, there is little wonder they were short-lived.

In the 1970s, Bangladesh's Grameen Bank revolutionized the development world by extending small, interest-based loans to the extreme poor, an economic group commercial banks refused to lend to and development banks found difficult to sustain acceptable repayment rates with. But by assembling individuals into self-selected borrowing groups, particularly in homogeneous settings, peer pressure and peer assistance lead to a form of informal monitoring that paved the way for continued success.

What began as a $26 loan to 42 village women is now a major industry in Bangladesh, with 4 million Grameen borrowers and over $4 billion in disbursed loans, of which over $300 million is currently outstanding. All collateral-free.

**…Its Problems…**

But critics of Grameen and other conventional microfinanciers cite Draconian interest rate levels as a major impediment to many borrowers becoming truly self-sufficient; an astronomical 22% interest rate charge at Grameen (measured on a declining basis), and as high as 50% elsewhere. Anathema to Muslims, for whom taking even the smallest amount of interest is forbidden, evidenced by a number of Quranic verses (2:275-279, 3:130, 4:160-161, 30:39), numerous rigorously authentic traditions of the Prophet (Allah bless him and give him peace), the consensus of the four schools of jurisprudence, and the ravaging effects of decades of low-interest development loans to poor countries.

The single biggest problem with conventional microfinance, and for that matter all interest-based finance, is that the borrower has to make his interest payments even if he is unable to meet them. If his business succeeds, he pays; if his business fails, he still pays.

At a time when a young business should be concerned with innovation and expansion, an interest payment looms unavoidably large at the end of the month. Putting it off only exacerbates the problem, as interest payments often become larger than the original loan principal with the passage of time. It makes little sense for small, undercapitalized microentrepreneurs with nothing to fall back on to assume debt instead of equity. In a protracted market downturn, when large groups of borrowers are unable to meet their repayment requirements, this precipitates heightened levels of market volatility. End game: debt forgiveness on the lender's part or increased impoverishment on the borrower's, meaning bonded labor in some countries.

Further, interest-based transactions tend to focus attentions on the process-oriented task of repayment rather than on the result-oriented task of increasing profit. And because no direct causality exists in an interest-based transaction between the size of the payout and the profitability of the business (since interest payments are already fixed), conventional microfinance requires additional technical intervention on the part of the lender in order to promote business efficiency. Equity-based investments, on the other hand, already assume an effort toward business efficiency because both the investor and the worker share the same goal: increasing profit.

**…And Its Islamic Alternative**

Islamic microfinance provides an innovative interest-free alternative to conventional microfinance. Perhaps not so innovative since interest-free, equity-based investing has already proven itself as the predominant corporate financing tool for decades, from Wall Street investment banks to Silicon Valley venture capitalists. And while the players may change, the transaction dynamics remain largely the same, whether the transaction is worth billions of euros or hundreds of rupees: an investor takes a stake in a business for a share of the business's profits, undertaking commensurate levels of risks.

Based primarily on the profit-sharing principles of equity-based finance, Islamic microfinance offers greater resilience than conventional microfinance. If a business fails, nothing is paid; if a business succeeds, profits are shared. Risks and rewards are always proportionate to equity shares. So while any return on capital in the form of interest is completely prohibited in Islam, there is no objection to getting a return on capital if the provider of capital enters into a partnership with a worker or entrepreneur and is prepared to share in the risks of the business.

The key dynamics of conventional microfinance arrangements are, however, still retained in Islamic microfinance, with small groups of self-selected individuals providing each other with emotional, technical, and financial support. By assembling themselves into their own groups, clients choose as partners only those individuals they trust most, filtering out to a large extent poorer credits.

**How Islamic Microfinance Works**

One Islamic microfinance arrangement is done using a mudarabah structure, a participative agreement in which one party provides capital (the principal) and the other (the worker) utilizes it for business purposes in which profit from the business is shared according to an agreed upon proportion, and loss, if any, unless caused by negligence or violation of contract by the worker, is borne by the principal. Some considerations include the following:

- The bank as the principal should not interfere in the routine transactions of the business of the worker, though the bank is permitted to provide general technical advice. The worker should provide regular periodical reports to the bank on the state of the business;
- The worker may choose to also employ his own capital in the mudarabah business, taking commensurate increases in profit and loss;

- Profit earned from a mudarabah business is distributed between principal and worker on the basis of proportions settled in advance;
- No fixed amount, whether as profit, wage, or commission, may be settled in favor of either party beforehand; Islam permits the fixing of profits in percentage terms (e.g. "share 10% of your profits with me every month"), but forbids fixing profits in absolute terms (e.g. "give me $100 of your profits every month"), the obvious difference being that the former is linked to the performance of the business, whereas the latter is linked to nothing;
- In a running business, losses may be offset by business earnings until the business comes to a close and accounts are settled;

A Shariah-compliant version of the Grameen model resembles the following, the particulars of which should be approved by a qualified AAOIFI-versed scholar:

1) A group of 5 clients approach an Islamic microfinance bank for investment capital for 5 separate projects;
2) After assessing feasibility for each of the 5 projects, the bank draws up separate contracts, explaining repayment schedules and profit-sharing percentages, and underscoring the possibility of larger investments in future depending on their individual performances;
3) The bank first invests in 2 individuals;
4) These first 2 individuals repay one-fourth of each of their original investments each week for four weeks (clawing profits back into the business each week) until at the end of the month the entire original investment is repaid, and 75% of all profits remain with the individual and 25% of profits return to the bank (primarily to fund the bank's future operations and growth); in the event of losses, only what remains of the investment is repaid;
5) In the second month, the bank then assesses the performance of these first 2 individuals and decides whether to reinvest; increasing investment sizes for those individuals with rates of return higher than 10%; maintaining existing investment sizes for those individuals with rates of return between 0% and 10%; and reducing investment sizes for loss-making individuals, where a second round of losses would disqualify them from any future investment, forcing the remaining group to find another group partner;
6) Also in the second month, the bank commences investment in the next 2 individuals, using the same repayment schedule and profit-sharing agreement as for the first 2 individuals;
7) In the third month, the bank assesses the performance of the existing 4 clients and decides whether to reinvest, using the same criteria as before;
8) Also in the third month, the bank invests in the fifth and final individual of the group, using the same repayment schedule and profit-sharing agreement as for the previous 4 individuals;

9) The bank continues this transaction cycle, using the same repayment schedule, profit-sharing agreement, and reinvestment criteria for all future investments;

These simple steps are as effective in a rural village in a Muslim country as they are in an urban ghetto in a non-Muslim one, whether the client is male or female, young or old, Muslim or not. Group sizes, repayment schedules, profitability targets, reinvestment criteria, investment duration, and other integrals of the transaction may be tailored to suit client needs as necessary.

It is critical that at the outset, clients are explained that profitability (and, implicitly, declaring profits honestly) translates into larger investments in future. Islamic Law does not permit parties to contractually condition future investment sizes on past investment performances, but parties are permitted to enter into unenforceable pledges whereby the investor agrees, as a matter of policy at his own discretion, to increase or decrease future investment sizes on the basis of historical performance, perhaps according to the investor's own internal investment matrix. The parallel subtext obviously being that theft only hurts the client. And because original investment sizes are sufficiently small, suiting only the extreme poor of the locality, the bank filters out free-riders and other untargeted individuals.

One might wonder why simply giving money away to the poor, as opposed to investing in their businesses, might not be the most effective poverty alleviation tool. Zakat and charity come to mind. But in Islam believers are also encouraged to keep their money circulating throughout the community, as zakat and charity indeed, but also complementarily as risk capital. Now more than ever, with large capital inflows entering the Islamic banking industry and the possibility of securitizing microfinance contracts a proven reality, we stand at the beginning of a second microfinance revolution, in which Islamic microfinanciers alleviate poverty with sustainable, replicable, and inexpensive transactions, without the problems associated with conventional microfinance.

# ONE AND A MILLION

**What you can do, starting right now, with $1 or a million**

Cash often speaks louder than words, and whatever your financial wherewithal, there is always an opportunity to make a difference. The following are some ideas that each of us can resolve to do with $1, $1,000, $100,000, or $1 million:

**$1**

Send a letter to your bank asking them to introduce Islamic banking to their product range, and if you currently use an Islamic bank, ask them to send proof of their Shari'a compliancy, perhaps also requesting copies of the actual documentation they use in their car, home, and business finance transactions.

Educated consumers and qualified scholars, not bankers, drive demand for high-quality, Shari'a-compliant Islamic banking products. It is imperative that during the current Islamic banking boom, individuals and institutions begin to understand the basics of Islamic banking and learn to address some of the misconceptions about its authenticity.

Banks are highly customer-driven organizations that will do just about anything to safeguard their reputation and satisfy unmet demand. But while over three hundred Islamic banks operate worldwide, and dozens more open each year, the U.S. and the U.K. are home to but a handful of Islamic banks, and even these few usually only provide plain-vanilla home financings.

The following are some sample letters Ethica permits you to reprint for the sake of promoting awareness among the banking community:

**SAMPLE LETTER TO A CONVENTIONAL BANK:**

*Dear Sir or Madam,*

*As a customer at Bank Conventional for some years now, I have wanted to do more than just hold a simple checking account. My home, car, and business financing requirements keep growing but, as a Muslim, I adhere to specific Islamic guidelines when making purchases, and your bank only offers interest-based alternatives.*

*Islamic banking is growing all over the world and a number of major non-Muslim banks have begun to offer Islamic products. Would Bank Conventional consider doing the same? A number of my friends and family members are also keen to join Bank Conventional if you were to introduce Islamic banking.*

*Just to give a few examples of some Islamic products at other banks:*

***Savings Accounts:*** *A number of Islamic banks offer savings accounts that provide monthly returns based on the equity prin- ciples of musharakah, or partnership financing.*

***Car Leases:*** *The substance of an Islamic lease, or ijarah, is quite similar to a conventional lease for car financings except for specific conditions relating to ownership, risk distribution and penalty clauses.*

***Home Financings:*** *The most common form of Islamic home financing is called a diminishing musharakah in which the bank and the buyer become joint partners in a property and the buyer purchases the bank' s equity while paying rent for what remains of the equity.*

***Asset Financings:*** *Growing numbers of Muslim businesses rely on a simple murabaha transaction to fulfill their short-term liquidity needs. In a murabaha, the customer selects an asset, for instance, machinery, which the bank buys on behalf of the customer and resells to the customer on a deferred basis at a profit, whether in installments or lump sum. This means that the sale of an asset takes place, creating a debt, rather than the sale of cash. If you would like, I am happy to send you more material describing Islamic banking. The principles of Islamic banking are very similar to those used in conventional equity-based banks and differ from interest-based banks primarily in matters of execution and ownership. The first and most important step in developing Islamic banking expertise is to contact a qualified Islamic scholar.*

*I look forward to hearing your thoughts on the possibility of introducing Islamic banking at Bank Conventional in the near future.*

*Regards, etc.*

**SAMPLE LETTER TO AN ISLAMIC BANK:**

*Dear Sir or Madam,*

*As a customer at Bank Islamic, I am inquiring about Shari'a compliancy at your bank.*

*While I hold your bank in the highest regard, certain industry practices among less scrupulous banks motivate me to do some of my own research. Could you please give me specific responses to the following queries:*

***Transparency:*** *Does your Shari'a advisory board have total visibility on all the contracts you use? Do they see exactly the same documents the customer sees? If so, please give me specific proof that this is the case.*

***Authenticity:*** *Do you use conventional contracts and simply replace the language with Islamic terminology or do you execute bona fide Islamic transactions? Kindly send me sample documents for each of your Islamic products.*

***Qualification:*** *The leading experts in the industry follow the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and have extensive training in the field. What are the backgrounds of the members of your Shari'a advisory board?*

*Additionally, I ask that you broaden your current product line. While I would like to continue to bank with Bank Islamic, my requirements keep increasing and currently you only offer (insert car, home, education, business, etc) financing. At the moment, I am in the market for (insert car, home, education, business, etc) financing.*

*Kindly address these concerns because, while I find it in- convenient to deal with Islamic banks abroad, I am willing to make the move if I am not satisfied with Shari'a compliancy at Bank Islamic.*

*I look forward to your earliest response.*

*Regards, etc.*

**$1,000**

This year diversify your zakat allocation to include debt relief for students. How often we find the budding scholar, the next big entrepreneur, or the talented writer, groaning under the burden of thousands of dollars of student loans, relinquishing his less pedestrian ambitions for something more sensible.

Provided one meets the conditions for a valid zakat payment, three additional points make the possibility of relieving debt burdens a practical reality: 1) one may pay zakat in advance, allowing for larger one-time payments to students; 2) the portion of the zakat payment made in advance may be paid in installments, giving the student the security of a future stream of cash without excessively burdening the one paying; 3) provided one makes the intention first, one may pay the zakat in the guise of a gift, avoiding the possible stigma attached to giving zakat to one's deserving relatives.

**$100,000**

Still on the drawing boards at some Islamic banks, education finance is a Shari'a-compliant possibility we should continue to explore. Among the structures recently proposed is one from Mufti Muhammad Imran Usmani, one of the world's leading Shari'a advisors on Islamic banking, in which a service-based ijarah (Islamic lease) is used to finance an education.

In such an arrangement a financier, such as a bank or angel investor, partners with an educational institution. The financier pays the educational institution the cost of the education and concurrently creates an educational package sold at a premium that includes tuition, room, board, books, and other expenses. The student enrolls and repays the financier in installments or as a lump sum at some future date.

The package is priced attractively enough for both financier and student, while the educational institution only signs the documentation necessary to create the partnership with the financier. The financier might also negotiate a discount with the institution for multiple packages, and pass some of the savings on to the student.

Obviously, it would be ideal to simply give the money away, but this poses the usual problem: limited institutional interest. In order for education finance to interest banks, Islamic or otherwise, and thereby achieve the scale necessary to reach everyone, there must be profits. But unlike conventional interest-based loans that compound mercilessly year-in and year-out after the student graduates, Islam does not permit simple or compounded interest or rollovers: rescheduling a debt is permissible, increasing it is not.

The market for Shari'a-compliant education financings is substantial enough to potentially rival the home financing market, and do so while offering shorter tenures. It is now a matter of a handful of intrepid individuals creating the grassroots awareness, and the institutional leverage, for interest-free education finance to become a ground reality. Until then, with the assistance of a qualified Islamic scholar, individuals should consider approaching banks independently.

## $1 MILLION

Islamic venture capital. Three words rarely found together, and yet the very essence of venture capital is thoroughly Islamic. Sadly, the single largest economic "community" in the world, the Muslims, have almost zero institutional equity-based capital organized for start-up businesses. Today, a Muslim entrepreneur seeking to raise cash to bring a distinctly Islamic product to market has no one to turn to except family, friends or the local interest-based bank.

In a post-9/11 environment of highly regulated capital flows, American and British Muslims are flush with capital that otherwise would have left the country as donations, remittances, or investments. There is no better time to conduct a funding round among these Muslim investors to raise capital for a venture fund that targets high-growth Muslim businesses, or a "social" venture capital fund that seeks economic uplift in addition to profitability.

The typical venture capitalist, sometimes a handful of cash-rich bankers and often a former entrepreneur-turned- angel-investor with a keen eye for picking potentially profitable companies, provides seed capital to a high-growth business in return for an equity share in the company. Most of the fund's capital invests in about a dozen companies, of which only about two or three are really expected to gene- rate significant returns.

Gone perhaps are the go-go dotcom days of two kids, a garage and a pre-revenue, pre-product business plan, scoring a multi-billion dollar financing. But if the successes of Intel, Apple, and Netscape are anything to go by, not to mention the continued interest for post-product bricks-and-mortar companies, venture capital is still the single most attractive form of Islamically acceptable start-up financing.

# ENTREPRENEURIAL LESSONS FROM ETHICA

## What Islamic Finance Entrepreneurs Can Learn from Ethica's Experiences

**THE VISION:** The vision of creating Ethica Institute of Islamic Finance, an organization that sought to bridge the gap between Islamic finance scholars and industry practitioners, was formed in 2002. The idea was to create a learning resource that was global, scalable, and replicable. Global that it might be equal to the task of reaching a growing audience of Islamic finance practitioners; scalable that the delivery mechanism be as effective in a classroom of twenty as it would in an institution of several thousand; and replicable that the training be deliverable repeatedly.

We went to work in 2002, later compiling content one-on-one with some of the world's leading Islamic finance scholars and bankers, designing the platform, refining the pedagogy, incorporating in 2007 in Dubai, and finally launching the platform in 2009. During our stealth design and development mode we conducted face-to-face training programs around the world and gained invaluable experience about the particular needs of practitioners, most notably that training not be too heavy on theory, a common refrain among attendees. Keeping the training practical became our

relentless focus. The use of practical case studies, examples, and quizzes slowed content development but made the end product that much more effective.

We were grateful for the timing of our launch, amid a crisis, because it inculcated in our team the habits of entrepreneurial efficiency that bode well later, spending wisely, hiring slowly, and relying on steady, consistent customer service.

For other entrepreneurs considering a launch, the lessons they can take from the Ethica experience are the following:

1. stay as small, not as big, as you possibly can;
2. grow slowly;
3. launch early;
4. focus on cash flow, not profitability.

**STAYING SMALL:** The once lauded advantages of large scale now often encumber the entrepreneur. With technologies for product and service execution changing so quickly for Ethica, having a team nimble enough to respond and retool quickly was more useful than the possible advantage of a large company. We were also grateful that by maintaining a small team we were able to weather the global financial crisis without asking anyone to leave the company.

**GROWING SLOWLY:** Steady, organic growth where you cultivate talent and give employees genuine ownership of their work is more satisfying to the individual and more beneficial to the customer. Moreover, with knowledge based companies like Ethica, the knowledge of the market always exceeds any amount of content you generate yourself, so there is a built-in skew in favor of outsourcing content generation. Even so, Ethica resisted this temptation to outsource everything: owning our own content had short-term costs that were eventually outweighed by the longer term benefit of quality control and Shariah compliance.

**LAUNCHING EARLY:** After working years in stealth mode, there is a tendency among entrepreneurs to anxiously hold on to the product or service for as long as possible. We saw the same tendency in ourselves and tried to resist it by launching as soon as the product was ready. Many things necessarily must evolve with the fullness of time. For instance, our partnership agreement began at a scant dozen pages and now runs to over three dozen with the experience that came with engaging partners from all over the world.

**FOCUSING ON CASH FLOW:** Young companies often focus on profitability, but unless there is a steady stream of cash flowing through the system, high growth companies often "grow themselves broke." We avoid debt, look at cash on a weekly basis, and configure our business model so that payments come in before services go out. We spend a great deal of our time and money on developing new content and allocating surplus funds to subsidizing developing countries rather than on advertising and business development.

**In terms of Islamic finance specifically, entrepreneurs often ask us how to break into the industry. Among the more common questions are the following:**

***What are the most lucrative sectors in Islamic finance for entrepreneurs to tap into?***

Islamic finance is a top-heavy industry: large and medium sized banks dominate the headlines while major gaps abound in other sectors of the industry. At Ethica we've seen that early stage venture capital, waqf finance, microfinance, research, training, advisory, and media are among the many under-served areas that offer substantial opportunity for entrepreneurs. In a market where major institutions are still not hiring at the pace they were several years ago, it is time to look beyond the standard banking job and explore start-up opportunities.

***How can Shariah-compliant financing benefit entrepreneurs in comparison to raising conventional financing?***

Entrepreneurs raise capital using debt or equity. Debt focuses both lender and borrower on the debt because the ultimate objective is repayment. Equity, on the other hand, focuses investor and issuer on the business: its viability, profitability, and, depending on the stage of investment, its short and long-term prospects. Shariah-compliant finance, where the financing is equity-based such as with a Musharakah or Mudarabah based structure, rather than a conventional financing or even an Islamic financing based on debt, such as with a Murabaha, Salam, or Istisna, accomplishes this.

***There are many Islamic financial hubs around the world. Which countries hold the most opportunities for entrepreneurs and why?***

Ethica currently serves professionals and students in 62 countries, so we have some sense of the relative strengths of different countries during this protracted financial crisis. Africa, South Asia, Central Asia, and outliers like Australia show continued promise and hold near-term opportunity for budding entrepreneurs. At a time when banks in the traditional Islamic financial hubs are downsizing or freezing their hiring, we see many countries in these regions launching their Islamic finance sectors and issuing licenses. It is during these early years of a country's Islamic finance industry that Islamic finance entrepreneurs have an opportune time to launch their companies.

***What advice would you give to an entrepreneur who is new to Islamic finance?***

First, regardless of what kind of business you decide to launch, you will need to know the basics about Islamic finance. Becoming conversant in Islamic finance means knowing the core products and how they work. At minimum, you should understand these products and their limitations according to the leading Islamic finance standard in the world, the de facto standard for 90% of the world's Islamic finance jurisdictions, AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions). Their Shariah Standards guide is available at www.aaoifi.com. If you cannot sit and learn directly from a scholar who has a working understanding of these products according to AAOIFI standards, you should learn from an educational institution, of which there are several currently in the market today. And finally, you should begin working on your idea today. The need to "get experience first" is highly overrated. Nothing prepares you better for succeeding in your future business than going ahead and launching your future business. Put pen to paper and start your business plan now.

# A CLIMATE OF CHANGE

## Four Initiatives Islamic Finance Must Undertake to Keep Itself Relevant in Changing Times

*An invasion of armies can be resisted, but not an idea whose time has come. (Victor Hugo)*

The coming years — faced with a confluence of factors ranging from climate change and peak oil to currency crisis and food and water shortage — offer an unprecedented opportunity for Islamic finance to rise to the occasion.

To do so, we respectfully call upon governments, regulators, and the scholars of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), to develop standards, products, and human capital to undertake four major initiatives:

1) Launch a gold-based currency

2) Develop Shariah standards for the environment

3) Support community-based finance

4) Regulate Shariah standards

But first, it is worth stepping back to assess the gravity of the problem before we consider the urgency of the response.

According to a growing number of climate scientists, in the next few decades — within the lifetimes of many of us and certainly those of our children — the world will undergo major upheaval, with widespread food and water shortage, energy insecurity, mass migration, and unprecedented weather patterns. All things we already see to varying degrees in different parts of the world. But today is just the harbinger. Many scientists, among whom "The Revenge of Gaia" author James Lovelock is most

notable, now predict that as many as 80% of the world's population will perish amid the cataclysms of the 21st century.

The consequence of global heating in our own lives will not be felt so much in the discomfort of extreme heat during summers or, as for some in coastal areas, rising sea levels, but in the extreme shortage of food, water, and energy, now already being felt across the developing world. While these may seem extreme predictions, a growing body of data shows that successive intergovernmental forecasts about the impact of carbon emissions on climate change fall far short of observable reality.

While the evidence has been around for some decades, with most of us only squirming in vague unease at the data, it is gaining mainstream following especially within the last decade, when the proverbial writing is now on the wall: friends without water, gas, and electricity back home; nasty sheets of ice blanketing cities causing power outages; entire countries facing submergence.

Despite this, mainstream corporate media earnestly repeats the growth mantra ("we must have growth for prosperity") and while it occasionally laments the rise of carbon emissions, the media conveniently manages to avoid asking the obvious "why?" question: why must we have unchecked growth when this is the very thing that causes all our problems?

The answer is becoming plainer for all to see, especially in the wake of the bailout debacle: banks.

In order for banks to survive, there must be compound interest, and in order to keep up with compound interest, you must have compound growth. However, as Margaret Atwood, author of "Payback: Debt and the Shadow Side of Wealth," notes, "Instead of thinking that nature is this huge bank that we can just keep drawing on, we have to think about the finite nature of this planet to keep it alive so that we too may remain alive. Unless we conserve the planet there isn't going to be any 'The Economy.'"

What can Islamic finance do? As it turns out, a great deal.

With conventional finance incapable of thinking outside an interest-based box ("the problem is sub-primes," "corporate bailouts," "actually, the problem is greed," "corporate lobbying needs reform"), the West appears condemned to repeat the mistakes it refuses to learn from. The problem of interest is now so systemic, so deeply rooted, that it may be too close for many to see. Even to this day searching "bank interest and global warming" on the Internet yields almost nothing (except Ethica's webinar "Interest-Based Finance and Global Warming - Making the Connection" from over three years ago).

What is needed is a paradigm shift in our approach to currency, the environment, the community, and Islamic banks.

**1. Launching a Gold-Based Currency**

An idea whose time has long since come — and was once a reality before the United States left the gold standard in 1971 — governments and regulators must develop a gold-based currency and begin circulating it globally. Short of this we are at the mercy of fiat currencies teetering on the brink of collapse. Moreover, there are serious Shariah implications for continuing to deal in currencies based on debt rather than on assets. For many, Islamic finance remains an empty claim as long as the very currency upon which it operates is itself predicated upon questionable standards.

Because the fractional reserve banking system enables banks to lend money they do not possess — often much more money — we are always caught in a precarious bubble of varying size and consequence. This bubble is based on the creation of 'wealth' without a commensurate creation of assets, enabling countries, companies, and individuals to demand more of the environment than it is naturally equipped to handle.

And lest our ambitions carry us away, we do not need a multi-country agreement to launch a globally recognized gold-based currency. Just one central bank. Dubai, with its stated ambition to become the capital of the Islamic economy, and Abu Dhabi, with the respect it commands regionally as a cash rich hydrocarbon center, would be well suited to jointly launch a parallel gold-based currency based on a gold dinar. Interests are far too deeply entrenched to ever expect fractional reserve banking to simply go away on its own. Rather, demand for a viable alternative may better hasten its undoing.

**2. Environmental Shariah Standards**

Scholars must develop Shariah standards for the environment. A detailed, more nuanced ijtihad that explains the environmental limits of transactions and products. What are the limits of consumption? What are the limits of production? Is the connection between a given product and its ultimate impact on the environment tenuous or direct?

Islamic finance now finds itself at a crossroads. On the one hand, it offers a world free of interest. Yet on the other hand, its often single-minded focus on economic growth seems anachronistic amid severe climate change.

As fiqh stands today, would it be permissible for an investment bank based in London to issue Sukuk to fund a rubber company that further destroys the Sumatran rainforest; or for an Islamic bank in Dubai to finance the construction of a dam in China that floods a fragile ecosystem; and so on?

Fiqh does bear upon the general interests of society and, increasingly with the planet's environment hanging in delicate balance, what happens in one part of the world affects all society.

The environment is a fiqh issue.

**3. Supporting Community-Based Finance**

Exxon is bigger than Thailand, Conoco Phillips is worth more than Pakistan, and Walmart's revenues now put it ahead of 157 of the world's 182 countries. Large companies grow larger as milquetoast public policy gives free rein to corporations with questionable environmental standards.

Governments, regulators, and scholars must support localized, small-scale, community-level finance. At the outset, this means developing Shariah standards for products that promote these efforts: microfinance, small-scale Musharakah and Mudarabah investment companies, Waqf-based finance, community land trusts, and the like. At the governmental level, supporting such efforts means providing a favorable legal, tax, and regulatory environment with incentives and disincentives that protect these efforts from large, institutional interference.

Case in point: when a Walmart or Carrefour superstore moves into a neighborhood, small and medium businesses in the area suffer. In fact, real estate prices actually drop because consumer demand is expected to decline as the larger business hollows out the spending power of the residents who have now lost their jobs. As our present scholarship stands, there is nothing wrong with providing Islamic finance to a Walmart or a Carrefour; it might even be heralded as a breakthrough. But a more thoughtful reading of it shows that putting a retail giant in the middle of a small economy has far reaching deleterious effects.

Similar other examples abound. This is the kind of thinking that governments, regulators, and scholars must now begin to make if we are to reverse some of the damage wrought by a blind growth economy.

For their part, activists, practitioners, and academics already advocating community-based finance should begin working with governments, regulators, and scholars to develop Shariah standards. As a starting point, Ethica proposes convening a meeting between a delegation of those already active in community-based finance and members of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the leading standard-setting body in the world and the de facto standard in ninety percent of the world's Islamic finance jurisdictions

**4. Regulating Shariah Standards**

Governments must now empower regulators to begin revoking Islamic banking licenses for Shariah non-compliance, just as they revoke Islamic banking licenses for violating conventional law. At the moment, in most jurisdictions around the world, for something to be labeled "Shariah-compliant," it merely has to be called that, regardless of the qualification of the one making the claim.

This is unacceptable.

Unless we are prepared to relive the phantasmagoric mess the financial crisis of 2008 left us, complete with paperless, assetless, fly-by-night projects vanishing overnight, and unless we understand that there is a connection between bad banking and environmental degradation, we would do well to put some teeth into Shariah regulation.

Despite its economic woes, Pakistan does an excellent job of fostering Shariah compliance in its burgeoning Islamic finance sector where the specter of license revocation looms ever large and has on occasion been used to good effect. To this end, AAOIFI's "Shariah Standards," a document compiling rulings agreed upon by some of the world's leading Islamic finance scholars, offers a minimum fiqh a product or practice must comply with and could be a good starting point for a given jurisdiction's financial services authority to deem mandatory.

**The End**

A once common problem with explaining environmental degradation to the common man was the abstractness of it: outwardly, everything seemed fine in the 1970s, 1980s, and into the 1990s to the casual observer even though closer inspection revealed otherwise. But by the turn of the 21st century, and especially in the last five years, events are unfolding at a pace that makes environmental problems hard to ignore.

To use examples from Ethica's own team, lifelong farmers we spoke with once predicted seasons down to the week. Now they have trouble timing harvests to the nearest month. Relatives who once enjoyed basic energy security throughout the year now regularly go days without gas and electricity. Forests we once played in as children have been wiped out forever by palm oil companies, and so on.

Given the inadequacy of the present world response to environmental degradation, it is unlikely that we will avert some of the more major disasters like global heating, which many climatologists already declare an inevitability even if we reduced carbon emissions to zero today. But better late than never. Some things are still very much in our control, and they do bear upon the shape of the world to come: currency, environmental standards, community-based finance, and the Shariah compliance of our institutions, to name just some of those mentioned in this article.

How can Islamic finance make a difference in the sweep of such global events? History is filled with examples of small tipping points making disproportionately large impacts. Though the Islamic finance industry accounts for only a fraction of global transactional volume, the real power of Islamic finance is in being able to galvanize the world's 1.5 billion Muslims by providing them and their non-Muslim brothers and sisters with real solutions.

***This article was approved by Mufti Ismail Ebrahim Desai.***

# THE SHARIAH COMPLIANCE REPORT

## Ethica sits down with Shariah department experts to identify industry best practices for Shariah compliance at the bank.

**Acknowledgements:** Ethica Institute of Islamic Finance wishes to extend a special thanks to Ahmed Ali Siddiqui and his colleagues at Meezan Bank for generously sharing their time and expertise to make this Shariah Compliance Report possible.

Ethica works with Islamic finance scholars, product developers, Shariah auditors, and bankers across the Islamic banking world and one theme consistently emerges: there are a broad range of opinions on what exactly constitutes 'Shariah compliance.' Shariah boards often frown on what they see as expedience on the part of bankers, while bankers bemoan what they see as over precise meddling on the part of Shariah boards. Are interests to remain mutually exclusive? What is the common ground between bankers and scholars where Shariah compliance matters? Does a strong Shariah compliance policy improve customer retention? What is the remit of the Shariah department?

The purpose of Ethica's Shariah Compliance Report is to answer some of these questions and identify industry best practices. We sat down with experts who bring experience working inside Shariah departments, have executed transactions with scholars and bankers, and are experts in AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) standards, the most widely followed standard-setting body in the industry, and discuss Shariah compliance issues facing Islamic banks around the world.

**OVERVIEW**

Islamic banks vary in their approach to Shariah compliance – most take a limited view where their Shariah department exists only to vet contract language alone. It has little real say over how they are implemented, how transactions are recorded, and whether or not employees are trained well enough. Moreover, product development at these banks is often a function completely independent of the Shariah department and causes business interest to prevail over Shariah compliance.

Most Islamic banks have very small – sometimes only two member – Shariah departments to oversee the workings of over one hundred branches. Shariah departments here are either excluded from the bank's main activities or lack the commitment or resources to get actively involved.

Generally bank management and stakeholders view Shariah departments as an expense that hinders progressive banking. They fear Shariah audits highlight banking errors and add unnecessary hurdles.

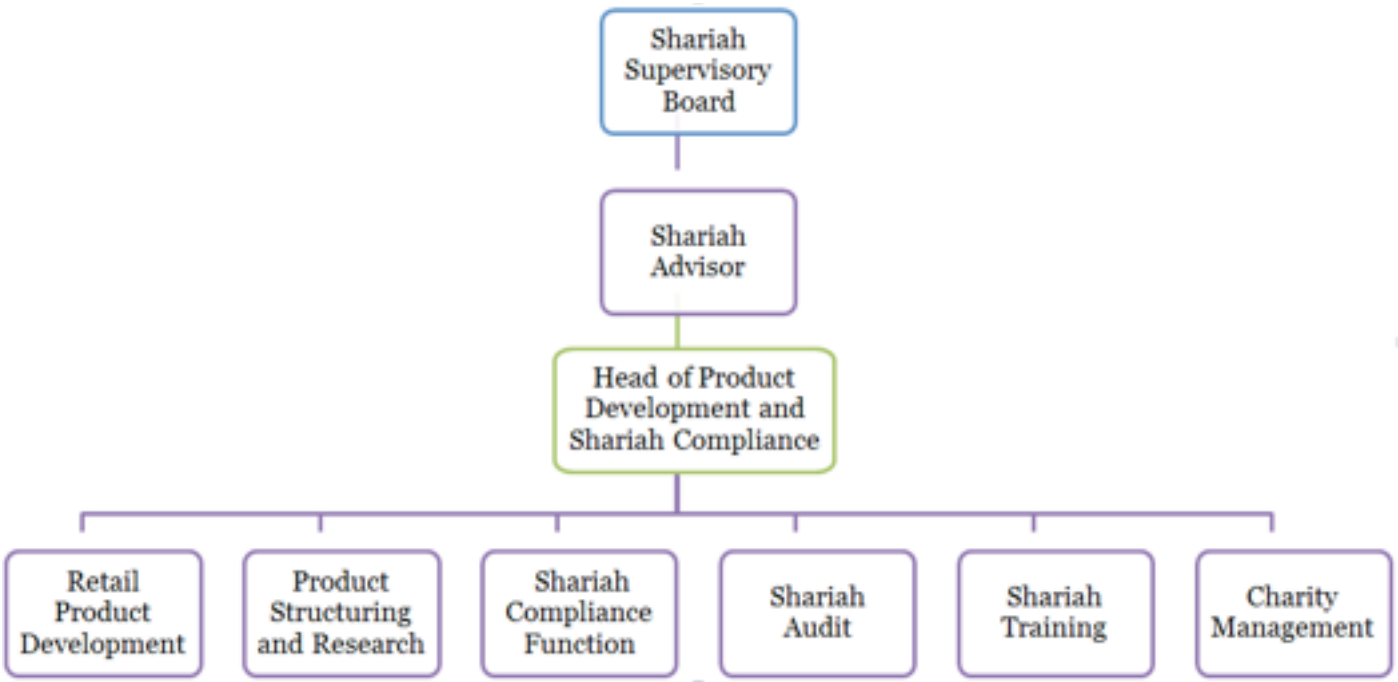
But talking to customers shows that a proactive Shariah department is what creates the solutions and goodwill for the bank and the resulting increase in business volume. When speaking of risk, risks such as liquidity risk, interest rate risk, and market risk are always highlighted, while the main risk an Islamic bank faces is the risk to its reputation.

When an Islamic bank launches or when a conventional bank decides to become Islamic, one of its first priorities must be to create a product development and Shariah compliance department. This function coordinates with the Shariah Advisor, the Shariah Supervisory Board, and Management to perform the key role of ensuring that all of the bank's functions are Shariah-compliant.

In an ideal Islamic bank, the department performs the following functions:

1. Product Development, Shariah Compliance and Research
2. Shariah Audit
3. Additional Services

**Sample Shariah Department Organizational Chart**




Source: Pages 63 and 64 of Meezan Bank Annual Report 2012 (Section: Operations Review)

**PRODUCT DEVELOPMENT AND RESEARCH**

This function includes all the product development activities for corporate, commercial, retail, investment banking, and treasury. The research team must visit corporate and SME clients, interact actively with them on a routine basis along with business teams to ascertain their requirements and design processes accordingly. It must identify the ideal Islamic banking solution and structure it to meet the client's need in a Shariah compliant manner.

Designing Shariah-compliant solutions for businesses entails analyzing certain crucial aspects of a client's business which includes but is not restricted to the following:

- The business cycle
- The tenure (short term or long term)
- The rate of financing (fixed or variable)
- Existing market alternatives
- Payment flexibility (possibility of early repayment)
- The mode and nature of assets
- Adherence to basic Shariah principles
- Tax concerns

- Accounting treatment
- Regulatory framework
- Risk mitigation procedures

Product Development and Research personnel must know the Shariah and product requirement and also possess accounting expertise to equip them to customize and implement adequate solutions.

The benefit of a joint Product Development and Shariah Compliance Department is that combining the two functions creates a synergy that facilitates the bank's overall operations and fulfillment of objectives. When product departments are independent, business teams review transactions and the clients from a business perspective alone, they come up with solutions on their own, and put them before the Shariah experts – more often than not, these solutions are not the best alternatives or even not Shariah-compliant since the business department is focused primarily on the commercial side of the transaction.

The wrong solutions mean numerous process cycles before the solutions are consistent with the client's demand and Shariah principles. On the other hand, when the product development team has a Shariah background in addition to product development expertise, it is in a much better position to customize solutions that are effective and fall within Shariah parameters. It also increases the time to market aspect of the solution to the customers.

Another limitation with business teams is that Shariah-compliant product development expertise never really thrives because of high employee turnover. Every few years an employee leaves the bank with all his learning and is replaced with a new individual usually from a conventional banking background who needs to be trained all over again. In order to ensure quicker turnaround times and quicker solutions a combined product development and Shariah compliance and research department is key. It allows solutions to be delivered in as little as two to three days whereas two separate departments using a hit and miss approach fail to adequately serve clients. The joint product development and Shariah compliance department ensures consistent Shariah-compliance because the team not only structures the products but also the process flows with the business team's help. These processes get documented as a step by step guide for future reference.

There is a general misconception that a Shariah department must only be represented by a Shariah scholar or group of scholars. The right approach is to include a variety of experts on the panel such as chartered accountants, business management specialists, and lawyers, to name a few, who work alongside the scholars to create and deliver effective solutions. These specialists must also be well versed in AAOIFI Standards and all the laws of sale and contracts in order to be strong supports to the business. Such a proactive approach means fewer errors and, therefore, fewer charity penalties post audit. It is a tried and tested method that promotes the bank's growth by turning around solutions in a matter of days.

The main concepts of all new products must be approved by the Shariah Board, an entity separate from the Product Development and Shariah Compliance Department. Thereafter, the Shariah Advisor is entitled to approving any other products based on an already approved theme. For existing products, the involvement of the Shariah Advisor and/or the Shariah Board depends on the level of change required. If the modification is a repetition or a change undertaken earlier, then the bank already has the approval in place to execute the transaction. If it is a minor change which does not affect the Shariah essence of a contract it need not be referred back to the Shariah Advisor or Shariah Board. For major changes, the Shariah Advisor must be referred to and upon his discretion the Shariah board may or may not be involved.

Importantly, neither the Shariah Advisor nor the Shariah Board are the bank's employees. The Shariah Advisor serves the bank in an advisory capacity only, however, he must visit the bank almost daily to ensure regular interaction. The Shariah Board should consist of at least three members with a senior scholar serving as its Chairman. The Shariah Board should ideally meet every quarter or at least twice a year to review overall matters related to the Shariah, approve new products and ideas, examine the issues highlighted during Shariah audits, and provide direction to the bank for enhancing Shariah compliance. The Product Development and Shariah Compliance Department must report to the Shariah Advisor and the Shariah Board to have continuous supervision.

In addition to monitoring specialized product design, the Shariah compliance team's role includes reviewing and monitoring the Islamic bank's:

- Pool Management and profit distribution procedures
- Investment banking transactions
- Funding, financing, investment and foreign exchange related activities

**SHARIAH AUDIT**

Shariah Audit is a periodic activity. It must be designed as a formal, structured process based on standard operating procedures and programs. It should involve a review of documents which entails going over a checklist to see whether or not documents are genuine and their entries are correct. The aim of the Shariah Audit is not to penalize for mistakes but in fact to ensure mistakes are learned from and improvements made accordingly.

The Shariah Audit must also include an evaluation of the bank's environment, customer reading material and staff dress-code to see if it all complies with the Shariah. It entails staff interviews, particularly the branch and operation manager's to determine their knowledge and understanding of Islamic banking. It must include a check on the methods of profit distribution and assigning weightages. At a financing branch the audit must determine the degree of Shariah compliance of financing transactions. At a deposit branch the audit should focus on branch environment and staff awareness. The audit team must also visit clients to determine whether or not proper procedures are in place.

Errors if any should be presented in the Shariah Advisor's Report. Errors must also be reported to the Product Development, Research and Shariah Compliance team which directs them to review post product approval process flows. If the Product Development team is not a part of the Shariah Department, then it is likely that the problem never may get communicated.

Once reported the error serves as a precedent to help avoid similar mistakes in the future and likewise informs other branches of the latest findings and measures to prevent them from repeating the same errors.

This is the synergy between the different teams within the department that enables the Islamic bank to function effectively as a whole – its perspective, objectives and activities directed to one goal – ensuring 100% Shariah compliance and ultimately 100% customer satisfaction.

As an industry best practice and as guideline given by top scholars in the field, it is strongly recommended that every year a Shariah Audit must be conducted for all the financing units, department or branches in a bank. Transactions within each unit must be checked via sampling. It is also recommended that a Shariah review is conducted at the time when the financing limits are renewed annually.

The Product Development and Shariah Compliance unit must also check sample transactions for each client to determine their conformity to Shariah rulings. This process of refinement exists to avoid mistakes that would otherwise show up in an audit.

***Post Audit Corrective Measures***

If the Shariah Audit discloses a serious error, the transaction should be stopped or put on hold and put before the Shariah Advisor and Product Development team. The transaction may be allowed to continue but only after the correction of error or with a revised process flow.

The cause of the error must be investigated to determine the appropriate course of action - was it the bank officer's mistake? Was the financing mode prescribed inappropriate?

If the transaction is impermissible, the corresponding income should be transferred to the charity account.  Disciplinary measures must be prescribed if the mistake is intentional. In case the error is the client's, it should be investigated whether it occurred out of a lack of awareness or the client's indifference to Shariah prescriptions.

***Disclosures & Annual Shariah Report***

All the major activities of the bank's Shariah department and the results of the Shariah audit must be disclosed in the Shariah Board's or Shariah Advisor's report published within the bank's Annual Report.

The Shariah Report must state the number of branches audited and the resultant findings. It should mention the amounts transferred to the charity account owed to flawed transactions and where the charity is distributed. Major errors too must be disclosed along with the actions recommended to rectify them. The Shariah Advisor should follow up on his recommendations in the subsequent year's report.

The report must also disclose the research undertaken, the new products developed, the number of employee and client training sessions conducted. It should disclose the scope of the audit; the transactions covered. It must include an overall branch assessment and a review of how profit was distributed and the employees' level of Islamic banking knowledge.

All these disclosures offer transparency and keep the bank's clients and shareholders informed of the bank's activities and the measures it takes to ensure continued Shariah-compliance.

Refer: Pages 75-79 and 83 of Meezan Bank Annual Report 2012 (Section: Report of the Board Audit Committee; Shariah Advisor's Report – 2012; Statement of Sources and Uses of Charity Fund)

**RATING**

As part of the industry best practice an Islamic bank must have two rating processes Shariah Audit rating and employee rating.

***Shariah Audit Rating***

The bank's branches/departments/functions must be rated after Shariah Audits using an efficient rating system, like a five tier rating system (e.g. Excellent, Above Average, Good, Below Average, Poor) and the result of the Shariah audits should be linked to the annual appraisal of the branch and concerned staff.

For instance if a unit is rated "Poor" it affects its appraisal, promotions and increments and if a unit is rated "Excellent" it earns some type of reward or other performance enhancement incentive.

A unit rated "Poor" is also given extra support to bring it up-to-date with the latest training and performance improving activities.

***Employee Rating***

Starting from the CEO to the cashier at the front desk, ensuring Shariah-compliance is everyone's job. And it is strongly suggested that in the employees' annual appraisals due weightage must be given to the Shariah compliance mindset, knowledge and commitment to Shariah compliance.

Institutionalizing a penalty and reward system is a must to ensure good performance at both the branch and employee level.

## ADDITIONAL SERVICES

### SHARIAH TRAINING

The Islamic bank must have two types of training in place – one mandatory Islamic banking orientation and concept training for all the staff of the bank and a second type of more advanced and specialized product trainings for different functional areas. Ideally, every new employee must go through a basic orientation session covering a list of mandatory modules on Islamic banking products. The bank should also run a number of specialized courses ranging from shorter courses to advance and longer duration expert level courses; deliver face-to-face training and video training – modules should be designed based on specific job requirements. For instance, apart from the general orientation course, the Relationship Manager's training should be different from the Branch Manager's.

It is also very important that the bank conduct customer training workshops and general awareness seminars to educate clients on Islamic banking products and procedures. So the bank's training arm undertakes internal as well as external training. The employees of the department must be up to date with all the latest products and how they work as they themselves are key resources in training new and existing staff. Team members must be assigned different training functions where it should be one group's responsibility to ensure training takes place.

### ADVISORY AND SUPPORT SERVICES

In order to promote Islamic banking, the bank may offer advisory and support services to other institutions as well. It can organize workshops and seminars to spread awareness of the Islamic financial system, offer alternative solutions and highlight common mistakes and the ways to avoid them. It could host forums for Shariah Advisors to update them of the latest research findings in the field.

### CORPORATE SOCIAL RESPONSIBILITY

The Shariah department can also contribute towards CSR activities. Some banks have created Waqf based trusts independent to the bank which efficiently manage the distribution of charity to reliable and deserving institutions.

Ideally the Shariah department should partner with other Islamic financial institutions to launch Islamic finance initiatives and publish research papers and articles on Islamic obligations and rites – all of this goes towards promoting public awareness of the ethos of the Islamic value system which in turn goes a long way in determining the direction of the overall economy.

Refer: Pages 69 and 70 of Meezan Bank Annual Report 2012 (Section: Corporate Social Responsibility)

## APPENDIX: SELECTIONS FROM THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTION'S (AAOIFI) GOVERNANCE STANDARD FOR ISLAMIC FINANCIAL INSTITUTIONS

### Governance Standard for Islamic Financial Institutions No.1

### Shari'a Supervisory Board: Appointment, Composition and Report

#### Introduction

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance on the definition, appointment, composition and report of the Sharia' supervisory board for ensuring compliance of the Islamic financial institution in all its dealings and transactions with Islamic Shari'a Rules and Principles.

#### Definition of Shari'a Supervisory Board

The Shari'a supervisory board is an independent body of specialized jurists in fiqh almua'malat (Islamic commercial jurisprudence). However, the Shari'a supervisory board may include a member other than those specialized in fiqh almua'malat, but who should be an expert in the field of Islamic financial institutions and with knowledge of fiqh almua'malat. The Shari'a supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Shari'a Rules and Principles. The fatwas and rulings of the Shari'a supervisory board shall be binding on the Islamic financial institution.

### Governance Standard for Islamic Financial Institutions No. 2

### Shari'a Review

#### Introduction

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance to assist Shari'a Supervisory Boards (SSB) of Islamic Financial Institutions (IFIs) in performing Shari'a reviews to ensure compliance with Islamic Shari'a Rules and Principles as reflected in the fatwas, rulings and guidelines issued by them. The appointment, composition and report of the SSB is dealt with in AAOIFI Governance Standards for Islamic Institutions No.1 Shari'a Supervisory Board: Appointment, Composition and Report.

This standard should be read in conjunction with ASIFI No.1: Objective and Principles of Auditing with particular reference to paragraph 7 and ASIFI No.2: The Auditors Report with particular reference to paragraph 17. It follows that the objective of this standard as well as those of ASIFIs No. 1 and No.2 requires close coordination between the SSB and the external auditor.

**Definition and Principles of Shari'a Review**

Shari'a review is an examination of the extent of an IFI's compliance, in all its activities, with the Shari'a. The examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars etc.

The SSB shall have complete and unhindered access to all records, transactions and information from all sources including professional advisers and the IFI employees.

**Governance Standard for Islamic Financial Institutions No. 3**

**Internal Shari'a Review**

**Introduction**

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards and provide guidance on the Internal Shari'a review in institutions which conduct business in conformity with Islamic Shari'a rules and principles. The standard covers:

- Objectives
- Internal Shari'a review
- Independence and objectivity
- Professional proficiency
- Scope of work
- Performance of the internal Shari'a review work
- Management of the internal Shari'a review
- Quality assurance and
- Elements of an effective internal Shari'a review control system

The standard also covers responsibility for its implementation

**Objectives**

The internal Shari'a review shall be carried out by an independent division/department or part of the internal audit department, depending on the size of the Islamic financial institution (IFI). It shall be established with an IFI to examine and evaluate the extent of compliance with Islamic Shari'a rules and principles, fatwas, guidelines and instructions issued by the IFI's Shari'a supervisory board (SSB), hereafter referred to as Sharia' rules and principles.

The primary objective of the internal Shari'a review is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shari'a rules and principles as determined by the IFI's SSB.

**Internal Shari'a Review**

The internal Shari'a review is an integral part of the organs of governance of the IFI and operates under the policies established by the IFI. It shall have a statement of purpose, authority and responsibility (charter). The charter shall be prepared by management and shall be consistent with Islamic Shari'a rules and principles. The charter shall be approved by the SSB of the IFI and issued by the board of directors. The charter shall be regularly reviewed.

**Governance Standard for Islamic Financial Institutions No. 4**

**Audit & Governance Committee for Islamic Financial Institutions**

**Introduction**

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to define the role and responsibilities of an Audit & Governance Committee (AGC) for an Islamic financial institution (IFI). The standard also highlights the requirements for establishing such a committee for an IFI and specifies the pre-requisites of an effective AGC.

**Importance of AGC**

The importance of the AGC (known internationally as the Audit Committee) for an IFI emanates from its role in:

(a) Achieving the fundamental objectives of an IFI by enhancing greater transparency and disclosure in financial reporting; and

(b) Enhancing the public's confidence of the IFI as genuine in its applications of Shari'a rules and principles.

**Functions of the AGC**

The AGC has gained widespread acceptance as a prerequisite for organizations seeking to demonstrate a commitment to higher standards of corporate governance. The AGC assists the board of directors in exercising independent and objective monitoring through the following functions:

(a) Preserving the integrity of the financial reporting process.

(b) Safeguarding the interests of shareholders, investors and other corporate stakeholders.

(c) Providing additional assurance on the reliability of financial information presented to the board of directors, if the AGC is to be considered effective.

(d) Acting as an independent link between the IFI's management and its stakeholders.

**Governance Standard for Islamic Financial Institutions No. 5**

**Independence of Shari'a Supervisory Board**

**Introduction**

The purpose of this standard is to provide guidance for members of Shari'a Supervisory Boards (SSBs) of Islamic Financial Institutions (IFIs) pertaining to its independence, monitoring of such independence and ways to resolve issues of independence.

**Independence**

Independence for the purpose of this standard is "an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests. It is achieved through organizational status and objectivity." The principle of objectivity imposes obligations on SSB members to be fair, intellectually honest and free of conflict of interests. (neutral)

**Importance of Independence of SSBs**

The importance of the independence of SSB members for an IFI emanates from its role in:

(a) Enhancing the public confidence in the IFI as compliant in its applications of Shari'a rules and principles.

(b) Achieving the fundamental objectives of an IFI by enhancing independence and objectivity.

SSB members have a responsibility to the public who rely on the services provided by them that require independence. The public includes clients, credit grantors, governments, employers, employees, investors and others who rely on the objectivity and integrity of SSB members to ensure Shari'a compliance with regard to activities.

**Governance Standard for Islamic Financial Institutions No. 6**

**Statement on Governance Principles for Islamic Financial Institutions**

**Introduction**

Governance practices play a vital role in ensuring that businesses are run in a prudent and sound manner. A loss of confidence in financial institutions has the potential to create severe economic dysfunction, adversely affecting the general community in which they operate.

Financial institutions are different from other types of businesses due to their public purpose. There are more stakeholders in banks and other financial services institutions than in other businesses.

Indeed, in an Islamic financial institution (IFI), the list of stakeholders is even wider. The interest of Rab al Maal and providers of other forms of capital are exposed to the risk of being prejudiced if government practices are focused on benefits to owners or equity-holders.

Those charged with governance of IFIs are held to the highest fiduciary standards since they are accountable not to the equity-holders who appointed them but also for the safety of all key stakeholders as well as the community the IFI serves.

Financial institutions that develop strong governance practices win public confidence and thereby promote trust amongst their equity-holders, investors and other parties dealing with them. In IFIs, governance practices are also expected to lead to enhanced Shari'a compliance structures.

**Rationale for establishment of the framework**

A Statement on Governance Principles for Islamic financial institutions is necessary in order to support the development of sound governance practices within its IFIs as well as establish the basis for standards setting by AAOIFI on individual aspects of governance.

This Statement on Governance principles represents the framework for governance in IFIs and forms part of the pronouncement of the AAOIFI.

The purpose of the Statement is as follows:

(a) To lay down the key principles and concepts relevant to governance in IFIs.

(b) To assist IFIs as well as their stakeholders to appreciate the respective roles of those charged with governance.

(c) To establish the foundation upon which the development of future governance or compliance standards will take place.

(d) To provide the necessary inter-linkage between the various current and future standards applicable to IFIs.

The Statement recognizes the complexity of the concept of governance structures and therefore focuses on the principles on which it should be based.

The governance principles are founded on the need for structures leading to enhance compliance, transparency, accountability, fairness and equitable treatment of stakeholders.

**Governance Standard for Islamic Financial Institutions No. 7**

**Corporate Social Responsibility**

**Conduct and Disclosure for Islamic Financial Institutions**

**Introduction**

The purpose of this Governance Standard for Islamic Financial Institutions (GSIFI) is to establish standards on the definition of Corporate Social Responsibility (CSR) for Islamic Financial Institutions, provide both mandatory and recommended standards to implement CSR in all aspects of the Islamic Financial Institution's (IFI) activities and provide guidance on disclosure of CSR information to the IFI's stakeholders.

**Definition of Corporate Social Responsibility for Islamic Financial Institutions**

Corporate Social Responsibility (CSR) for IFIs refers to all activities carried out by an IFI to fulfill its religious, economic, legal, ethical and discretionary responsibilities as financial intermediaries for individuals and institutions.

Religious responsibility refers to the overarching obligation of IFIs to obey the laws of Islam in all its dealings and operations. Economic responsibility refers to the obligation for Islamic banks to be financially viable, profitable and efficient. Legal responsibility refers to the obligation of IFIs to respect and obey the laws and regulations of the country of operation. Ethical responsibility refers to the obligation of the IFIS to respect the mass of societal, religious and customary norms which are not codified in law.

Discretionary responsibility refers to the expectation from the stakeholders that IFIs will perform a social role in implementing Islamic ideals over and above the religious, economic, legal and ethical responsibilities.

This standard does not focus on economic or legal responsibilities of IFIs as it is assumed that the management/accounting structure and other accounting and governance standards are designed to fulfill economic responsibilities, while legal responsibilities are codified and enforced by the state and its functions.

# AN INTRODUCTION TO ISLAMIC FINANCE

MUFTI MUHAMMAD TAQI USMANI

Reprinted with Permission

**Important Note**

Ethica has not changed the style, usage, or meanings contained in Mufti Taqi's book.

# CONTENTS

## Musharakah & Mudarabah as Modes of Financing

Project Financing

- Securitization of Musharakah
- Financing of a Single Transaction
- Financing of the Working Capital

Some Objections on Musharakah Financing

- Risk of Loss
- Dishonesty
- Secrecy of the Business
- Clients' Unwillingness to Share Profits

Diminishing Musharakah

- House Financing on the Basis of Diminishing Musharakah
- Diminishing Musharakah for Carrying Business of Services
- Diminishing Musharakah in Trade

## Murabahah

Introduction

- Some Basic Rules of Sale
- Bai' Mu'ajjal (Sale on Deferred Payment Basis)

Murabahah

- Murabahah as a Mode of Financing
- Basic Features of Murabahah Financing

Some issues involved in Murabahah

- Different Pricing for Cash and Credit Sales
- The Use of Interest-Rate as Benchmark
- Promise to Purchase

Securities against Murabahah Price

Guaranteeing the Murabahah

Penalty of Default

No Roll Over in Murabahah

Rebate on Earlier Payment

Calculation of Cost in Murabahah

Subject Matter of Murabahah

Rescheduling of Payments in Murabahah

Securitization of Murabahah

Some basic mistakes in Murabahah Financing

## Ijarah

Basic Rules of Leasing

Lease as a mode of Financing

1. The Commencement of Lease
2. Different Relations of the Parties
3. Expenses Consequent to Ownership
4. Liability of the Parties in Case of Loss to the Asset
5. Variable Rentals in Long Term Leases
6. Penalty for Late Payment of Rent
7. Termination of Lease
8. Insurance of the Assets
9. The Residual Value of the Leased Asset
10. Sub-Lease
11. Assigning of the Lease

Securitization of Ijarah

Head-Lease

## Salam and Istisna'

Salam

- Conditions of Salam
- Salam as a Mode of Financing
- Some Rules of Parallel Salam

Istisna'

- Difference Between Istisna' and Salam
- Difference Between Istisna' and Ijarah
- Time of Delivery
- Istisna' as a Mode of Financing

## Islamic Investment Funds

Equity Fund

- Conditions for Investment in Shares

Ijarah Fund

Commodity Fund

- Murabahah Fund
- Bai'-Al-Dain

Mixed Fund

## The Principle of Limited Liability

Waqf

Baitul-Maal

Joint Stock

Inheritance under debt

The limited liability of the master of a slave

## The Performance of the Islamic Banks — A Realistic Evaluation

# FOREWORD

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

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

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

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

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

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

Since last two decades, these modes of financing are being used by the Islamic banks and financial institutions. But all these instruments are not the substitutes of interest in the strict sense, and it will be wrong to presume that they may be used exactly in the same fashion as interest is used. They have their own set of principles, philosophy and conditions without which it is not allowed in Shari'ah to use them as modes of financing. Therefore the ignorance of their basic concept and relevant details may lead to confusing the Islamic financing with the conventional system based on interest.

The present book is a revised collection of my different articles that aimed at providing basic information about the principles and precepts of Islamic finance, with special reference to the modes of financing used by the Islamic banks and non-banking financial institutions. I have tried to explain the basic concept underlying these instruments, the necessary requirements for their

acceptability from the Shari'ah standpoint, and the correct method of their application. I have also dealt with the practical issues involved in the application of these instruments and their possible solutions in the light of Shari'ah.

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

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

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

# 1. SOME PRELIMINARY POINTS

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

## BELIEF IN DIVINE GUIDANCE

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

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

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

## THE BASIC DIFFERENCE BETWEEN CAPITALIST AND ISLAMIC ECONOMY

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

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

## ASSET-BACKED FINANCING

One of the most important characteristics of Islamic financing is that it is an asset-backed financing. The conventional / capitalist concept of financing is that the banks and financial institutions deal in money and monetary papers only. That is why they are forbidden, in most countries, from trading in goods and making inventories. Islam, on the other hand, does not recognize money as a subject-matter of trade, except in some special cases. Money has no intrinsic utility; it is only a medium of exchange; Each unit of money is 100% equal to another unit of the same denomination, therefore, there is no room for making profit through the exchange of these units inter se. Profit is generated when something having intrinsic utility is sold for money or when different currencies are exchanged, one for another. The profit earned through dealing in money (of the same currency) or the papers representing them is interest, hence prohibited. Therefore, unlike conventional financial institutions, financing in Islam is always based on illiquid assets which creates real assets and inventories.

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

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

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

1. In conventional financing, the financier gives money to his client as an interest-bearing loan, after which he has no concern as to how the money is used by the client. In the case of murabahah, on the contrary, no money is advanced by the financier. Instead, the financier himself purchases the commodity required by the client. Since this transaction cannot be completed unless the client assures the financier that he wishes to purchase a commodity, therefore, murabahah is not possible at all, unless the financier creates inventory. In this manner, financing is always backed by assets.

2. In the conventional financing system, loans may be advanced for any profitable purpose. A gambling casino can borrow money from a bank to develop its gambling business. A pornographic magazine or a company making nude films are as good customers of a conventional bank as a house-builder. Thus, conventional financing is not bound by any divine or religious restrictions. But the Islamic banks and financial institutions cannot remain indifferent about the nature of the activity for which the facility is required. They cannot effect murabahah for any purpose which is either prohibited in Shariʿah or is harmful to the moral health of the society.

3. It is one of the basic requirements for the validity of murabahah that the commodity is purchased by the financier which means that he assumes the risk of the commodity before selling it to the customer. The profit claimed by the financier is the reward of the risk he assumes. No such risk is assumed in an interest-based loan.

4. In an interest bearing loan, the amount to be repaid by the borrower keeps on increasing with the passage of time. In murabahah, on the other hand, a selling price once agreed becomes and remains fixed. As a result, even if the purchaser (client of the Bank) does not pay on time, the seller (Bank) cannot ask for a higher price, due to delay in settlement of dues. This is because in Shariʿah, there is no concept of time due of money.

5. In leasing too, financing is offered through providing an asset having usufruct. The risk of the leased property is assumed by the lessor / financier throughout the lease period in the sense that if the leased asset is totally destroyed without any misuse or negligence on the part of the lessee, it is the financier/lessor who will suffer the loss.

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

**CAPITAL AND ENTREPRENEUR**

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

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

**PRESENT PRACTICES OF ISLAMIC BANKS**

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

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

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

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

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

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

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

# 2. MUSHARAKAH

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

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

In the modern economic system, it is the banks which advance depositors' money as loans to industrialists and traders. If industrialists having only ten million of their own, acquire 90 million from the banks and embark on a huge profitable project, it means that 90% of the project has been created by the money of the depositors while only 10% has been created by their own capital. If this huge project brings enormous profits, only a small proportion i.e. 14 or 15% will go to the depositors through the bank, while all the rest will be gained by the industrialists whose real contribution to the project is not more than 10%. Even this small proportion of 14 or 15% is taken back by the industrialists, because this proportion is included by them in the cost of their production. The net result is that all the profit of the enterprise is earned by the persons whose own capital does not exceed 10% of the total investment, while the people owning 90% of the investment get no more than the fixed rate of interest which is often repaid by them through the increased prices of the products. On the contrary, if in an extreme situation, the industrialists go insolvent, their own loss is no more than 10%, while the rest of 90% is totally borne by the bank, and in some cases, by the depositors. In this way, the rate of interest is the main cause for imbalances in the system of distribution, which has a constant tendency in favor of the rich and against the interests of the poor.

Conversely, Islam has a clear cut principle for the financier. According to Islamic principles, a financier must determine whether he is advancing a loan to assist the debtor on humanitarian grounds or he desires to share his profits. If he wants to assist the debtor, he should resist from claiming any excess on the principal of his loan, because his aim is to assist him. However, if he wants to have a share in the profits of his debtor, it is necessary that he should also share him in his losses. Thus the returns of the financier in musharakah have been tied up with the actual profits accrued through the enterprise. The greater the profits of the enterprise, the higher the rate of return to the financier. If the enterprise earns enormous profits, all of it cannot be secured by the

industrialist exclusively, but they will be shared by the common people as depositors in the bank. In this way, musharakah has a tendency to favor the common people rather than the rich only.

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

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

## THE CONCEPT OF MUSHARAKAH

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

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

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

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

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

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

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

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

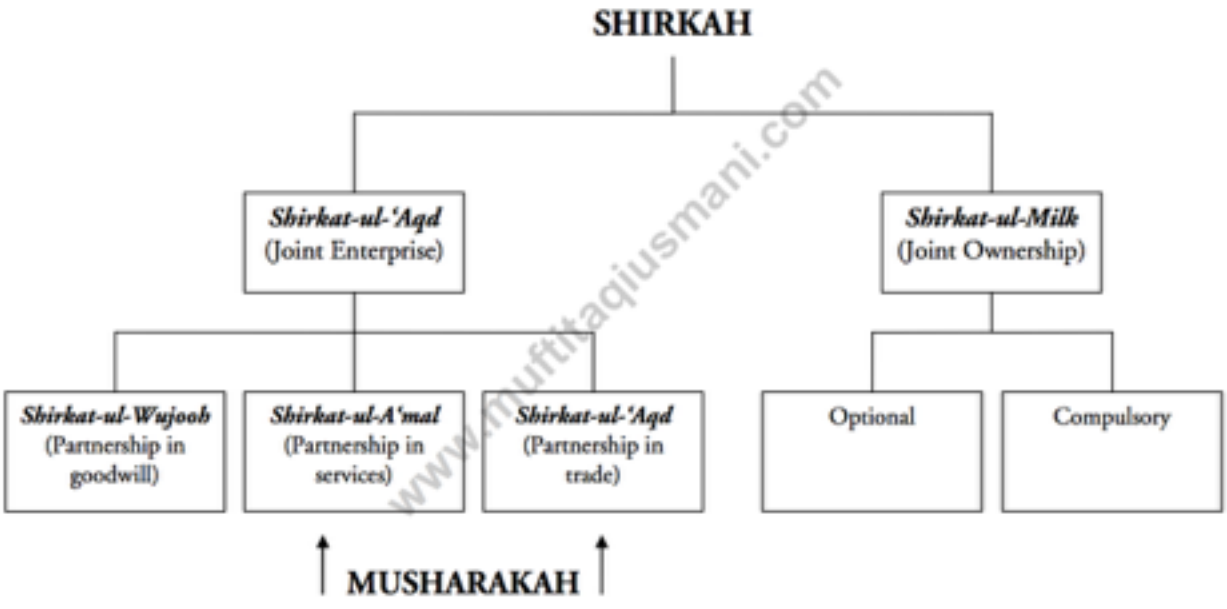
(iii) The third kind of Shirkat-ul-'aqd is Shirkat-ul-wujooh. Here the partners have no investment at all. All they do is that they purchase the commodities on a deferred price and sell them at spot. The profit so earned is distributed between them at an agreed ratio.

All these modes of "Sharing" or partnership are termed as "shirkah" in the terminology of Islamic Fiqh, while the term "musharakah" is not found in the books of Fiqh. This term (i.e. musharakah) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of "Shirkah", that is, the Shirkat-ul-amwal, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes Shirkat-ul-a'mal also where partnership takes place in the business of services.

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

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

Table 1



## THE BASIC RULES OF MUSHARAKAH

1. Musharakah or Shirkat-ul-amwal is a relationship established by the parties through a mutual contract. Therefore, it goes without saying that all the necessary ingredients of a valid contract must be present here also. For example, the parties should be capable of entering into a contract; the contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc.

But there are certain ingredients which are peculiar to the contract of "musharakah". They are summarized here:

## DISTRIBUTION OF PROFIT

2. The proportion of profit to be distributed between the partners must be agreed upon at the time of effecting the contract. If no such proportion has been determined, the contract is not valid in Shari'ah.

3. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in proportion to the capital invested by him. It is not allowed to fix a lump sum amount for any one of the partners, or any rate of profit tied up with his investment.

Therefore, if A and B enter into a partnership and it is agreed between them that A shall be given Rs 10,000/- per month as his share in the profit, and the rest will go to B, the partnership is invalid. Similarly, if it is agreed between them that A will get 15% of his investment, the contract is not valid. The correct basis for distribution would be an agreed percentage of the actual profit accrued to the business. If a lump sum amount or a certain percentage of the investment has been agreed for any one of the partners, it must be expressly mentioned in the agreement that it will be subject to the final settlement at the end of the term, meaning thereby that any amount so drawn by any partner shall be treated as 'on account payment' and will be adjusted to the actual profit he may deserve at the end of the term. But if no profit is actually earned or is less than anticipated, the amount drawn by the partner shall have to be returned.

## RATIO OF PROFIT

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

In the view of Imam Malik and Imam Shafi'i, it is necessary for the validity of musharakah that each partner gets the profit exactly in the proportion of his investment. Therefore, if A has invested 40% of the total capital, he must get 40% of the profit. Any agreement to the contrary which makes him entitled to get more or less than 40% will render the musharakah invalid in Shari'ah. On the contrary, the view of Imam Ahmad is that the ratio of profit may differ from the ratio of investment if it is agreed between the partners with their free consent. Therefore, it is permissible that a partner with 40% of investment gets 60% or 70% of the profit, while the other partner with 60% of investment gets only 40% or 30%.[1]

---

[1] Ibn Qudamah, *Al-Mughni*, (Beirut: Dar al-Kitab al-Arabi, 1972), 5:140.

The third view is presented by Imam Abu Hanifah which can be taken as a via media between the two opinions mentioned above. He says that the ratio of profit may differ from the ratio of investment in normal conditions. However, if a partner has put an express condition in the agreement that he will never work for the musharakah and will remain a sleeping partner throughout the term of musharakah, then his share of profit cannot be more than the ratio of his investment.[2]

## SHARING OF LOSS

But in the case of loss, all the Muslim jurists are unanimous on the point that each partner shall suffer the loss exactly according to the ratio of his investment. Therefore, if a partner has invested 40% of the capital, he must suffer 40% of the loss, not more, not less, and any condition to the contrary shall render the contract invalid. There is a complete consensus of jurists on this principle.[3] Therefore, according to Imam Shafi'i, the ratio of the share of a partner in profit and loss both must conform to the ratio of his investment. But according to Imam Abu Hanifah and Imam Ahmad, the ratio of the profit may differ from the ratio of investment according to the agreement of the partners, but the loss must be divided between them exactly in accordance with the ratio of capital invested by each one of them. It is this principle that has been mentioned in the famous maxim:

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

## THE NATURE OF THE CAPITAL

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

**1.** Imam Malik is of the view that the liquidity of capital is not a condition for the validity of musharakah, therefore, it is permissible that a partner contributes to the musharakah in kind, but his share shall be determined on the basis of evaluation according to the market price prevalent at the date of the contract. This view is also adopted by some Hanbali jurists.[4]

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

Firstly, they say that the commodities of each partner are always distinguishable from the commodities of the other. For example, if A has contributed one motor car to the business, and B has come with another motor car, each one of the two cars is the exclusive property of its original owner. Now, if the car of A is sold, its sale- proceeds should go to A. B has no right to claim a share in its price. Therefore, so far as the property of each partner is distinguished from the property of the other, no partnership can take place. On the contrary, if the capital invested by every partner is in the form of money, the share capital of each partner cannot be distinguished from that of the other, because the units of money are not distinguishable, therefore, they will be deemed to form a common pool, and thus the partnership comes into existence.[5]

---

[2] Al-Kasani, *Bada'i' al-Sana'i'*, 6:162–63.

[3] Ibn Qudamah, *Al-Mughni*, 5:147.

[4] Ibn Qudamah, *Al-Mughni*, 5:125.

[5] Al-Kasani, *Bada'i' al-Sana'i'*, 6:59.

Secondly, they say, there are a number of situations in a contract of musharakah where the partners have to resort to redistribution of the share-capital to each partner. If the share- capital was in the form of commodities, such redistribution cannot take place, because the commodities may have been sold at that time. If the capital is repaid on the basis of its value, the value may have increased, and there is a possibility that a partner gets all the profit of the business, because of the appreciation in the value of the commodities he has invested, leaving nothing for the other partner. Conversely, if the value of those commodities decreases, there is a possibility that one partner secures some part of the original price of the commodity of the other partner in addition to his own investment.[6]

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

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

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

Now, Imam al-Shafi'i says that the commodities of the first kind (i.e. dhawat-ul-amthal) may be contributed to the musharakah as the share of a partner in the capital, while the commodities of the second kind (i.e. the dhawat-ul-qeemah) cannot form part of the share capital.[7]

By this distinction between dhawat-ul-amthal and dhawat-ul- qeemah, Imam al-Shafi'i has met the second objection on 'participation by commodities' as was raised by Imam Ahmad. For in the case of dhawat-ul-amthal, redistribution of capital may take place by giving to each partner the similar commodities he had invested. However, the first objection remains still unanswered by Imam al-Shafi'i. In order to meet this objection also, Imam Abu Hanifah says that the commodities falling under the category of dhawat-ul- amthal can form part of the share capital only if the commodities contributed by each partner have been mixed together, in such a way that the commodity of one partner cannot be distinguished from that of the other.[8]

In short, if a partner wants to participate in a musharakah by contributing some commodities to it, he can do so according to Imam Malik without any restriction, and his share in the musharakah shall be determined on the basis of the current market value of the commodities, prevalent at the date of the commencement of musharakah. According to Imam al-Shafi'i, however, this can be done only if the commodity is from the category of dhawat-ul-amthal. According to Imam Abu Hanifah, if the commodities are dhawat-ul-amthal, this can be done by mixing the commodities of each partner together. And if the commodities are dhawat-ul- qeemah, then, they cannot form part of the share capital. It seems that the view of Imam Malik is more simple and reasonable and meets the needs of the modern business. Therefore, this view can be acted upon.[9]

---

[6] Ibn Qudamah, *Al-Mughni*, 5:124–25.

[7] Ibid., 125.

[8] Al-Kasani, op cit.

[9] Ashraf Ali Thanawi, *Imdad al-Fatawa*.

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

## MANAGEMENT OF MUSHARAKAH

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

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

## TERMINATION OF MUSHARAKAH

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

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

In this case, if the assets of the musharakah are in cash form, all of them will be distributed pro rata between the partners. But if the assets are not liquidated, the partners may agree either on the liquidation of the assets, or on their distribution or partition between the partners as they are. If there is a dispute between the partners in this matter i.e. one partner seeks liquidation while the other wants partition or distribution of the non-liquid assets themselves, the latter shall be preferred, because after the termination of musharakah, all the assets are in the joint ownership of the partners, and a co-owner has a right to seek partition or separation, and no one can compel him on liquidation. However, if the assets are such that they cannot be separated or partitioned, such as machinery, then they shall be sold and the sale-proceeds shall be distributed.[10]

**(2)** If any one of the partners dies during the currency of musharakah, the contract of musharakah with him stands terminated. His heirs in this case, will have the option either to draw the share of the deceased from the business, or to continue with the contract of musharakah.[11]

**(3)** If any one of the partners becomes insane or otherwise becomes incapable of effecting commercial transactions, the musharakah stands terminated.[12]

---

[10] Ibn Qudamah, *Al-Mughni*, 5:133–34.

[11] Ibid.

[12] Op cit.

## TERMINATION OF MUSHARAKAH WITHOUT CLOSING THE BUSINESS

If one of the partners wants termination of the musharakah, while the other partner or partners like to continue with the business, this purpose can be achieved by mutual agreement. The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership, because the termination of musharakah with one partner does not imply its termination between the other partners.[13]

However, in this case, the price of the share of the leaving partner must be determined by mutual consent, and if there is a dispute about the valuation of the share and the partners do not arrive at an agreed price, the leaving partner may compel other partners on the liquidation or on the distribution of the assets themselves. The question arises whether the partners can agree, while entering into the contract of the musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners, or the majority of them wants to do so, and that a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them on liquidation or separation.

Most of the traditional books of Islamic Fiqh seem to be silent on this question. However, it appears that there is no bar from the Shari'ah point of view if the partners agree to such a condition right at the beginning of the musharakah. This is expressly permitted by some Hanbali jurists.[14]

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

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

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

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

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

---

[13] See *al-Fatawa al-Hindiyyah*, 2:335–36.

[14] See al-Mardawi, al-Insaf (Beirut, 1400 AH), 5:423.

# 3. MUDARABAH

*"Mudarabah"* is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "rabb-ul- mal", while the management and work is an exclusive responsibility of the other, who is called *"mudarib"*.

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

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

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

**(3)** In musharakah all the partners share the loss to the extent of the ratio of their investment while in mudarabah the loss, if any, is suffered by the rabb-ul-mal only, because the mudarib does not invest anything. His loss is restricted to the fact that his labor has gone in vain and his work has not brought any fruit to him. However, this principle is subject to a condition that the mudarib has worked with due diligence which is normally required for the business of that type. If he has worked with negligence or has committed dishonesty, he shall be liable for the loss caused by his negligence or misconduct.

**(4)** The liability of the partners in musharakah is normally unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne pro rata by all the partners. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition. Contrary to this is the case of mudarabah. Here the liability of rabb-ul-mal is limited to his investment, unless he has permitted the mudarib to incur debts on his behalf.

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

The case of mudarabah is different. Here all the goods purchased by the mudarib are solely owned by the rabb-ul-mal, and the mudarib can earn his share in the profit only in case he sells the goods profitably. Therefore, he is not entitled to claim his share in the assets themselves, even if their value has increased.[1]

---

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

## BUSINESS OF THE MUDARABAH

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

A rabbul-mal can contract mudarabah with more than one person through a single transaction. It means that he can offer his money to A and B both, so that each one of them can act for him as mudarib and the capital of the mudarabah shall be utilized by both of them jointly, and the share of the mudarib shall be distributed between them according to the agreed proportion.[2] In this case both the mudaribs shall run the business as if they were partners inter se. The mudarib or mudaribs, as the case may be, are authorized to do anything which is normally done in the course of business. However, if they want to do an extraordinary work, which is beyond the normal routine of the traders, they cannot do so without express permission from the rabb-ul-mal.

## DISTRIBUTION OF THE PROFIT

It is necessary for the validity of mudarabah that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. No particular proportion has been prescribed by the Shari'ah; rather, it has been left to their mutual consent. They can share the profit in equal proportions, and they can also allocate different proportions for the rabb-ul-mal and the mudarib. However, they cannot allocate a lump sum amount of profit for any party, nor can they determine the share of any party at a specific rate tied up with the capital. For example, if the capital is Rs. 100000/- they cannot agree on a condition that Rs. 10000/- out of the profit shall be the share of the mudarib, nor can they say that 20% of the capital shall be given to rabb-ul-mal. However, they can agree on that 40% of the actual profit shall go to the mudarib and 60% to the rabb-ul-mal or vice versa. It is also allowed that different proportions are agreed in different situations. For example the rabbul-mal can say to mudarib, "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit". Similarly, he can say "If you do the business in your town, you will be entitled to 30% of the profit, and if you do it in another town, your share will be 50% of the profit." [3]

Apart from the agreed proportion of the profit, as determined in the above manner, the mudarib cannot claim any periodical salary or a fee or remuneration for the work done by him for the mudarabah.[4]

All the schools of Islamic Fiqh are unanimous on this point. However, Imam Ahmad has allowed for the mudarib to draw his daily expenses of food only from the mudarabah account.[5]

---

[2] Ibn Qudamah, *Al-Mughni,* 5:145.

[3] Al-Kasani, *Bada'i' al-Sana'i'*, 6:99.

[4] Al-Sarakhsi, *al-Mabsut*, 22:149–50.

[5] Ibn Qudamah, *Al-Mughni*, 5:186.

The Hanafi jurists restrict this right of the mudarib only to a situation when he is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc., but he is not entitled to get anything as daily allowances when he is in his own city.[6]

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, then the remainder, if any, shall be distributed between the parties according to the agreed ratio.[7]

**TERMINATION OF MUDARABAH**

The contract of mudarabah can be terminated at any time by either of the two parties. The only condition is to give a notice to the other party. If all the assets of the mudarabah are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of the mudarabah are not in the cash form, the mudarib shall be given an opportunity to sell and liquidate them, so that the actual profit may be determined.[8]

There is a difference of opinion among the Muslim jurists about the question whether the contract of mudarabah can be effected for a specified period after which it terminates automatically. The Hanafi and Hanbali schools are of the view that the mudarabah can be restricted to a particular term, like one year, six months, etc, after which it will come to an end without a notice. On the contrary, Shafi'i and Maliki schools are of the opinion that the mudarabah cannot be restricted to a particular time.[9]

However, this difference of opinion relates only to the maximum time-limit of the mudarabah. Can a minimum time-limit also be fixed by the parties before which mudarabah cannot be terminated? No express answer to this question is found in the books of Islamic Fiqh, but it appears from the general principles enumerated therein that no such limit can be fixed, and each party is at liberty to terminate the contract whenever he wishes. This unlimited power of the parties to terminate the mudarabah at their pleasure may create some difficulties in the context of the present circumstances, because most of the commercial enterprises today need time to bring fruits. They also demand constant and complex efforts. Therefore, it may be disastrous to the project, if the rabb-ul-mal terminates the mudarabah right in the beginning of the enterprise. Specially, it may bring a severe set-back to the mudarib who will earn nothing despite all his efforts.

Therefore, if the parties agree, when entering into the mudarabah, that no party shall terminate it during a specified period, except in specified circumstances, it does not seem to violate any principle of Shari'ah, particularly in the light of the famous hadith, already quoted, which says:

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

---

[6] Al-Kasani, *Bada'i' al-Sana'i',* 6:109.

[7] Ibn Qudamah, *Al-Mughni*, 5:168.

[8] Al-Kasani, *Bada'i' al-Sana'i'*, 6:109.

[9] Ibid., 6:99. See also Ibn Qudamah, *al-Mughni,* 5:185–86 and al-Sarakhsi, *al- Mabsut,* 22:133.

## COMBINATION OF MUSHARAKAH AND MUDARABAH

A contract of mudarabah normally presumes that the mudarib has not invested anything to the mudarabah. He is responsible for the management only, while all the investment comes from rabb-ul- mal. But there may be situations where mudarib also wants to invest some of his money into the business of mudarabah. In such cases, musharakah and mudarabah are combined together. For example, A gave to B Rs. 100000/- in a contract of mudarabah. B added Rs. 50000/- from his own pocket with the permission of A. This type of partnership will be treated as a combination of musharakah and mudarabah. Here the mudarib may allocate for himself a certain percentage of profit on account of his investment as a sharik, and at the same time he may allocate another percentage for his management and work as a mudarib. The normal basis for allocation of the profit in the above example would be that B shall secure one third of the actual profit on account of his investment, and the remaining two thirds of the profit shall be distributed between them equally. However, the parties may agree on any other proportion. The only condition is that the sleeping partner should not get more percentage than the proportion of his investment.

Therefore, in the aforesaid example, A cannot allocate for himself more than two thirds of the total profit, because he has not invested more than two thirds of the total capital. Short of that, they can agree on any proportion. If they have agreed on that the total profit will be distributed equally, it means that one third of the profit shall go to B as an investor, while one fourth of the remaining two thirds will go to him as a mudarib. The rest will be given to A as "rabb-ul-mal."[10]

[10] See Ibn Qudamah, *al-Mughni,* 5:136–37; and al-Kasani, *Bada'i' al-Sana'i'*.

# 4. MUSHARAKAH AND MUDARABAH AS MODES OF FINANCING

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

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

However, it does not mean that the concept of musharakah and mudarabah cannot be used for financing a running business. The concept of musharakah and mudarabah is based on some basic

principles. As long as these principles are fully complied with, the details of their application may vary from time to time. Let us have a look at these basic principles before entering the details:

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

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

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

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

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

**PROJECT FINANCING**

In the case of project financing, the traditional method of musharakah or mudarabah can be easily adopted. If the financier wants to finance the whole project, the form of mudarabah can come into operation. If investment comes from both sides, the form of musharakah can be adopted. In this

case, if the management is the sole responsibility of one party, while the investment comes from both, a combination of musharakah and mudarabah can be brought into play according to the rules already discussed.

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

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

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

**SECURITIZATION OF MUSHARAKAH**

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

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

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

In most cases, the assets of the project are a mixture of liquid and non-liquid assets. This comes to happen when the working partner has converted a part of the subscribed money into fixed assets or raw material, while rest of money is still liquid. Or, the project, after converting all its money into non-liquid assets may have sold some of them and has acquired their sale proceeds in the form of money. In some cases the price of its sales may have become due on its customers but may have not yet been received. These receivable amounts, being a debt, are also treated as liquid money. The question arises about the rule of Shari'ah in a situation where the assets of the project are a mixture of liquid and non-liquid assets, whether the musharakah certificates of such a project can be traded in? The opinions of the contemporary Muslim jurists are different on this point. According to the traditional Shafi'i school, this type of certificate cannot be sold. Their classic view is that whenever there is a combination of liquid and non-liquid assets, it cannot be sold unless the non-liquid part of the business is separated and is sold independently.[1]

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

Suppose, the musharakah project contains 40% non-liquid assets i.e. machinery, fixtures etc. and 60% liquid assets, i.e. cash and receivables. Now, each musharakah certificate having the face value of Rs. 100/- represents Rs. 60/- worth of liquid assets, and Rs. 40/- worth of non-liquid assets. This certificate may be sold at any price more than Rs. 60. If it is sold at Rs. 110/- it will mean that Rs. 60 of the price are against Rs. 60/- contained in the certificate and Rs. 50/- is against the proportionate share in the non-liquid assets. But it will never be allowed to sell the certificate for a price of Rs. 60/- or less, because in the case of Rs. 60/- it will not set off the amount of Rs. 60, let alone the other assets.

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

---

[1] This view is based on the famous principle of "mudd al-'ajwah" explained in the traditional books of Islamic fiqh. See for example, al-Khattabi, *Ma'alim al-Sunan*, 5:23.

However, most of the contemporary scholars, including those of Shafi'i school, have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50%. Therefore, for a valid trading of the musharakah certificates acceptable to all schools, it is necessary that the portfolio of musharakah consists of non-liquid assets valuing more than 50% of its total worth. However, if Hanafi view is adopted, trading will be allowed even if the non-liquid assets are less than 50%, but the size of the non- liquid assets should not be negligible.

**FINANCING OF A SINGLE TRANSACTION**

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

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

Similarly, musharakah will be even easier in the case of export financing. The exporter has a specific order from abroad. The price on which the goods will be exported is well-known before hand, and the financier can easily calculate the expected profit. He may finance him on the basis of musharakah or mudarabah, and may share the amount of export bill on a pre-agreed percentage. In order to secure himself from any negligence on the part of the exporter, the financier may put a condition that it will be the responsibility of the exporter to export the goods in full conformity with the conditions of the L/C. In this case, if some discrepancies are found, the exporter alone shall be responsible, and the financier shall be immune from any loss due to such discrepancies, because it is caused by the negligence of the exporter. However, being a partner of the exporter, the financier will be liable to bear any loss which may be caused due to any reason other than the negligence or misconduct of the exporter.

**FINANCING OF THE WORKING CAPITAL**

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

**(1)** The capital of the running business may be evaluated with mutual consent. It is already mentioned while discussing the traditional concept of musharakah that it is not necessary, according to Imam Malik, that the capital of musharakah is contributed in cash form. Non-liquid assets can also form part of the capital on the basis of evaluation. This view can be adopted here. In this way, the value of the business can be treated as the investment of the person who seeks finance, while the

amount given by the financier can be treated as his share of investment. The musharakah may be effected for a particular period, like one year or six months or less. Both the parties agree on a certain percentage of the profit to be given to the financier, which should not exceed the percentage of his investment, because he shall not work for the business. On the expiry of the term, all liquid and non-liquid assets of the business are again evaluated, and the profit may be distributed on the basis of this evaluation.

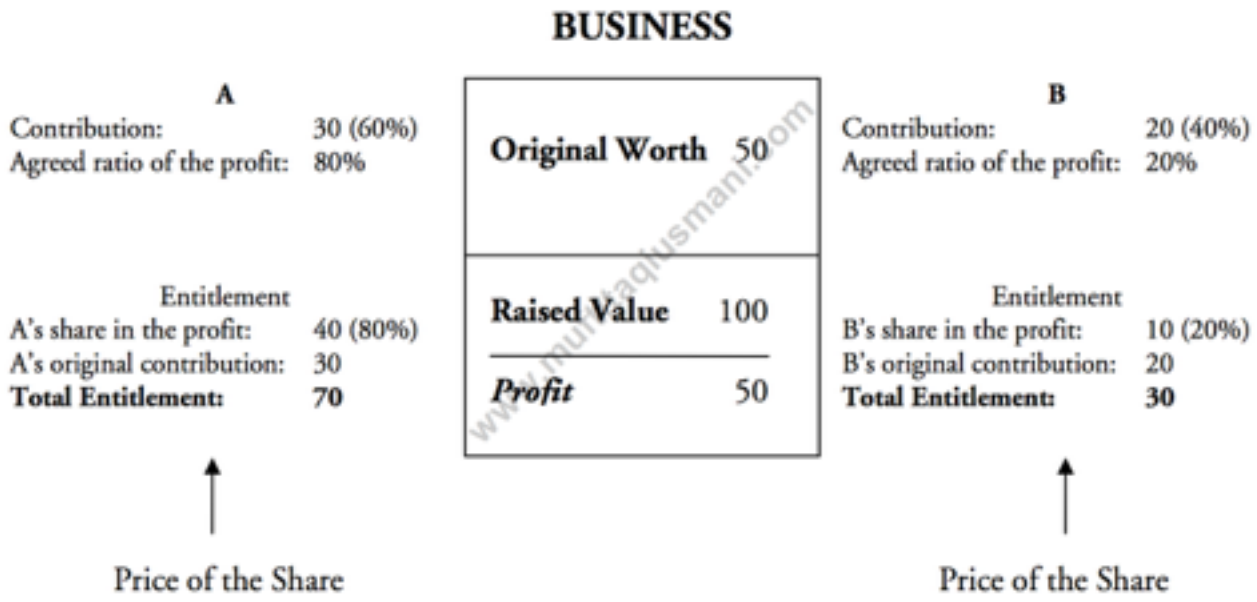
Although, according to the traditional concept, the profit cannot be determined unless all the assets of the business are liquidated, yet the valuation of the assets can be treated as "constructive liquidation" with mutual consent of the parties, because there is no specific prohibition in Shari'ah against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

For example, the total value of the business of A is 30 units. B finances another 20 units, raising the total worth to 50 units; 40% having been contributed by B, and 60% by A. It is agreed that B shall get 20% of the actual profit. At the end of the term, the total worth of the business has increased to 100 units. Now, if the share of B is purchased by A, he should have paid to him 40 units,

because he owns 40% of the assets of the business. But in order to reflect the agreed ratio of profit in the price of his share, the formula of pricing will be different. Any increase in the value of the business shall be divided between the parties in the ratio of 20% and 80%, because this ratio was determined in the contract for the purpose of distribution of profit. Since the increase in the value of the business is 50 units, these 50 units are divided at the ratio of 20-80, meaning thereby that 10 units will have been earned by B. These 10 units will be added to his original 20 units, and the price of his share will be 30 units.

In the case of loss, however, any decrease in the total value of the assets should be divided between them exactly in the ratio of their investment, i.e., in the ratio of 40/60. Therefore, if the value of the business has decreased, in the above example, by 10 units reducing the total number of units to 40, the loss of 4 units shall be borne by B (being 40% of the loss). These 4 units shall be deducted from his original 20 units, and the price of his share shall be determined as 16 units.

Figure 2



**SHARING IN THE GROSS PROFIT ONLY**

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

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

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

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

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

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

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

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

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

**RUNNING MUSHARAKAH ACCOUNT ON THE BASIS OF DAILY PRODUCTS**

3. Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the process of debit and credit goes on up to the date of maturity, and the interest is calculated on the basis of daily products.

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

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

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

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

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

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

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

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

that period. Conversely, the business may have suffered a great loss during a period when a particular investor had huge amounts invested in it. Still, he will pass on some of his loss to other investors who had no investment in that period or their size of investment was negligible.

This argument can be refuted on the ground that it is not necessary in a musharakah that a partner should earn profit on his own money only. Once a musharakah pool comes into existence, the profits accruing to the joint pool are earned by all the participants, regardless of whether their money is or is not utilized in a particular transaction. This is particularly true of the Hanafi School which does not deem it necessary for a valid musharakah that the monetary contributions of the partners are mixed up together. It means that if A has entered into a musharakah contract with B, but has not yet disbursed his money into the joint pool, he will still be entitled to a share in the profit of the transactions effected by B for the musharakah through his own money.[1]

Although his entitlement to a share in the profit will be subject to the disbursement of money undertaken by him, yet the fact remains that the profit of this particular transaction did not accrue to his money, because the money disbursed by him at a later stage may be used for another transaction. Suppose, A and B entered into a musharakah to conduct a business of Rs. 100,000/-

They agreed that each one of them shall contribute Rs. 50,000/- and the profits will be distributed by them equally. A did not yet invest his Rs. 50,000/- into the joint pool. B found a profitable deal and purchased two air-conditions for the musharakah for Rs. 50,000/- contributed by himself and sold them for Rs. 60,000/-, thus earning a profit of Rs. 10000/-. A contributed his share of Rs. 50,000/- after this deal. The partners purchased two refrigerators through this contribution which could not be sold at a greater price than Rs. 48000/- meaning thereby that this deal resulted in a loss of Rs. 2000/- Although the transaction effected by A's money brought loss of Rs. 2000/- while the profitable deal of air-conditions was financed entirely by B's money in which A had no contribution, yet A will be entitled to a share in the profit of the first deal. The loss of Rs. 2000/- in the second deal will be set off from the profit of the first deal reducing the aggregate profit to Rs. 8000/-. This profit of Rs. 8000/- will be shared by both partners equally. It means that A will get Rs. 4000/-, even though the transaction effected by his money has suffered loss.

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

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

---

[1] See al-Kasani, *Bada'i' al-Sana'i',* 6:54, 60.

The Hanafi scholars are unanimous on the point that it is not a pre- condition. Al-Kasani, the famous Hanafi jurist, writes:

> ***According to our Hanafi School, it is not a condition for the validity of musharakah that the amount of capital is known, while it is a condition according to Imam Shafi'i. Our argument is that jahalah (uncertainty) in itself does not render a contract invalid, unless it leads to disputes. And the uncertainty in the capital at the time of musharakah does not lead to disputes, because it is generally known when the commodities are purchased for the musharakah, therefore it does not lead to uncertainty in the profit at the time of distribution.***[2]

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

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

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

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

---

[2] Al-Kasani, *Bada'i' al-Sana'i'*, 6:63.

## SOME OBJECTIONS ON MUSHARAKAH FINANCING

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

### RISK OF LOSS

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

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

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

Apart from this, 'an Islamic economy must create a mentality which believes that any profit earned on money is the reward of bearing risks of the business. This risk may be minimized through expertise and diversifying the portfolio where it becomes a hypothetical or theoretical risk only. But there is no way to eliminate this risk totally. The one who wants to earn profit, must accept this minimal risk. Since this understanding is already there in the case of normal joint stock companies, nobody has ever raised the objection that the money of the shareholders is exposed to loss. The problem is created by the system which separates the banking and financing from the normal trade activities, and which has compelled the people to believe that banks and financial institutions deal in money and papers only, and that they have nothing to do with the actual results emerging in trade and industry. Therefore, it is argued that they deserve a fixed return in any case. This separation of

financing sector from the sector of trade and industry has brought great harms to the economy at macro-level. Obviously, when we speak of Islamic banking, we never mean that it will follow this conventional system in each and every respect. Islam has its own values and principles which do not believe in separation of financing from trade and industry. Once this Islamic system is understood, the people will invest in the financing sector, despite the theoretical risk of loss, more readily than they invest in the profitable joint stock companies.

**DISHONESTY**

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

It is, no doubt, a valid apprehension, especially in societies where corruption is the order of the day. However, solution to this problem is not as difficult as is generally believed or exaggerated.

If all the banks in a country are run on pure Islamic pattern with a careful support from the Central Bank and the government, the problem of dishonesty is not hard to overcome. First of all, a well-designed system of auditing should be implemented whereby the accounts of all the clients are fully maintained and properly controlled. It is already discussed that the profits may be calculated to the basis of gross margins only. It will reduce the possibility of disputes and misappropriation. However, if any misconduct, dishonesty or negligence is established against a client, he will be subjected to punitive steps, and may be deprived of availing any facility from any bank in the country, at least for a specified period.

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

Undoubtedly, the apprehension of dishonesty is more severe for the Islamic Banks and Financial institutions working in isolation from the main stream of conventional banks. They have not much support from their respective governments and central Banks. They cannot change the system, nor can they impose their own laws and regulations. However, they should not forget that they are not just commercial institutions. They have been established to introduce a new system of banking which has its own philosophy. They are duty bound to promote this new system, even if they apprehend that it will reduce the size of their profits to some extent. Therefore, they should start using the instrument of musharakah, at least on a selective basis. Each and every bank has a number of clients whose integrity is beyond all doubts. The Islamic banks should, at least, start financing them on the basis of true musharakah. It will help setting good precedents in the market and induce others to follow suit. Moreover, there are some sectors of financing where musharakah can be used easily. For example, the use of musharakah instrument in financing exports has not much room for

dishonesty. The exporter has a specific order from abroad. The prices are agreed. The cost is not difficult to determine. Payments are normally secured by a letter of credit. The payments are made through the bank itself. There is no reason in such cases why the musharakah arrangement should not be adopted. Similarly, financing of imports may also be designed on the basis of musharakah with some precautions, as explained earlier in this chapter.

**SECRECY OF THE BUSINESS**

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

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

**CLIENTS' UNWILLINGNESS TO SHARE PROFITS**

Many a time, it is mentioned that the clients are not willing to share with the Banks the actual profits of their business. The reluctance is based on two reasons:

1. They think that the bank has no right to share in the actual profit, which may be substantial, because the bank has nothing to do with the management or running of the business and why should they (the clients) share the fruit of their labour with the Bank who merely provides funds. The Clients also argue that conventional banks are content with a meagre rate of interest and so should be the Islamic Banks.

2. Even if the above was not a factor, the Clients are afraid to reveal their true profits to the Banks, lest the information is also passed on to the tax authorities and Clients' tax liability increases.

The solution to the first part, though not easy, is not difficult or impossible either. Such Clients need to be convinced and persuaded that borrowing on interest is a cardinal sin, unless there is a dire necessity for such borrowing. Mere expansion of business is not a dire need, by any stretch of imagination. By making a legitimate arrangement for obtaining funds for their business, by way of musharakah, not only do they earn Allah's pleasure but also a legitimate return for themselves, as well as for the Islamic Banks.

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

## DIMINISHING MUSHARAKAH

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

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

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

   This arrangement allows the financier to claim rent according to his proportion of ownership in the property and at the same time allows him periodical return of a part of his principal through purchases of the units of his share.

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

3. 'A' wishes to start the business of ready-made garments but lacks the required funds for that business. 'B' agrees to participate with him for a specified period, say two years. 40% of the investment is contributed by 'A' and 60% by 'B'. Both start the business on the basis of musharakah. The proportion of profit allocated for each one of them is expressly agreed upon.

   But at the same time 'B's share in the business is divided to six equal units and 'A' keeps purchasing these units on gradual basis until after the end of two years 'B' comes out of the business, leaving its exclusive ownership to 'A'. Apart from periodical profits earned by 'B', he gains the price of the units of his share which, in practical terms, tend to repay to him the original amount invested by him.

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

**HOUSE FINANCING ON THE BASIS OF DIMINISHING MUSHARAKAH**

The proposed arrangement is composed of the following transactions:

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

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

i) The first step in the above arrangement is to create a joint ownership in the property. It has already been explained in the beginning of this chapter that 'Shirkat-al-Milk' (joint ownership) can come into existence in different ways including joint purchase by the parties. This has been expressly allowed by all schools of Islamic jurisprudence.[3]

Therefore no objection can be raised against creating this joint ownership.

ii) The second part of the arrangement is that the financier leases his share in the house to his client and charges rent from him.

This arrangement is also above board because there is no difference of opinion among the Muslim jurists in the permissibility of leasing one's undivided share in a property to his partner. If the undivided share is leased out to a third party its permissibility is a point of difference between the Muslim jurists. Imam Abu Hanifah and Imam Zufar are of the view that the undivided share cannot be leased out to a third party, while Imam Malik and Imam Shafi'i, Abu Yusuf and Muhammad Ibn Hasan hold that the undivided share can be leased out to any person. But so far as the property is leased to the partner himself, all of them are unanimous on the validity of 'ijarah'.[4]

---

[3] See for example *Radd al-Muhtar*, 3:364–365.

[4] See Ibn Qudamah, *Al-Mughni,* 6:137; and *Radd al-Muhtar*, 6:47, 48.

iii) The third step in the aforesaid arrangement is that the client purchases different units of the undivided share of the financier. This transaction is also allowed. If the undivided share relates to both land and building, the sale of both is allowed according to all the Islamic schools. Similarly if the undivided share of the building is intended to be sold to the partner, it is also allowed unanimously by all the Muslim jurists. However, there is a difference of opinion if it is sold to the third party.[5]

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

iv) It is generally believed that a promise to do something creates only a moral obligation on the promisor which cannot be enforced through courts of law. However, there are a number of

Muslim jurists who opine that promises are enforceable, and the court of law can compel the promisor to fulfil his promise, especially, in the context of commercial activities. Some Maliki and Hanafi jurists can be cited, in particular, who have declared that the promises can be enforced through courts of law in cases of need. The Hanafi jurists have adopted this view with regard to a particular sale called 'bai-bilwafa'. This bai-bilwafa is a special arrangement of sale of a house whereby the buyer promises to the seller that whenever the latter gives him back the price of the house, he will resell the house to him. This arrangement was in vogue in countries of central Asia, and the Hanafi jurists have opined that if the resale of the house to the original seller is made a condition for the initial sale, it is not allowed. However, if the first sale is effected without any condition, but after effecting the sale, the buyer promises to resell the house whenever the seller offers to him the same price, this promise is acceptable and it creates not only a moral obligation, but also an enforceable right of the original seller. The Muslim jurists allowing this arrangement have based their view on the principle that "قد تجعل المواعيد لازمة لحاجة الناس" (the promise can be made enforceable at the time of need). Even if the promise has been made before effecting the first sale, after which the sale has been effected without a condition, it is also allowed by certain Hanafi jurists.[6]

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

---

[5] See *Radd al-Muhtar*, 3:365.

[6] See *Jami' al-Fusulain*, 2:237 and *Radd al-Muhtar*, 4:135.

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

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

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

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

a) The agreement of joint purchase, leasing and selling different units of the share of the financier should not be tied-up together in one single contract. However, the joint purchase and the contract of lease may be joined in one document whereby the financier agrees to lease his share, after joint purchase, to the client. This is allowed because, as explained in the relevant chapter, ijarah can be effected for a future date. At the same time the client may sign one-sided promise to purchase different units of the share of the financier periodically and the financier may undertake that when the client will purchase a unit of his share, the rent of the remaining units will be reduced accordingly.

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

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

**DIMINISHING MUSHARAKAH FOR CARRYING BUSINESS OF SERVICES**

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

i) Creating joint ownership in a taxi in the form of Shirkah al- Milk. As already stated this is allowed in Shari'ah.

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

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

**DIMINISHING MUSHARAKA IN TRADE**

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

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

2) Purchase of different units of the share of the financier by the client. This may be in the form of a separate and independent promise by the client. The requirements of Shari'ah regarding this promise are the same as explained in the case of House financing with one very important difference. Here the price of units of the financier cannot be fixed in the promise to purchase, because if the price is fixed before hand at the time of entering into musharakah, it will practically mean that the client has ensured the principal invested by the financier with or without profit, which is strictly prohibited in the case of musharakah. Therefore, there are two options for the financier about fixing the price of his units to be purchased by the client. One option is that he agrees to sell the units on the basis of valuation of the business at the time of the purchase of each unit. If the value of the business has increased, the price will be higher and if it has decreased the price will be less. Such valuation may be carried out in accordance with the recognized principles through the experts, whose identity may be agreed upon between the parties when the promise is signed. The second option is that the financier allows the client to sell these units to any body else at whatever price he can, but at the same time he offers a specific price to the client, meaning thereby that if he finds a purchaser of that unit at a higher price, he may sell it to him, but if he wants to sell it to the financier, the latter will be agreeable to purchase it at the price fixed by him before hand.

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

# 5. MURABAHAH

## INTRODUCTION

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

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

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

Murabahah, in its original Islamic connotation, is simply a sale. The only feature distinguishing it from other kinds of sale is that the seller in murabahah expressly tells the purchaser how much cost

he has incurred and how much profit he is going to charge in addition to the cost.

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

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

In order to understand these conditions correctly, one should, in the first instance, appreciate that murabahah is a sale with all its implications, and that all the basic ingredients of a valid sale should be present in murabahah also. Therefore, this discussion will start with some fundamental rules of sale without which a sale cannot be held as valid in Shari'ah. Then, we shall discuss some special rules governing the sale of murabahah in particular, and in the end the correct procedure for using the murabahah as an acceptable mode of financing will be explained.

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

**SOME BASIC RULES OF SALE**

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

**Rule 1. The subject of sale must be existing at the time of sale.**

Thus, a thing which has not yet come into existence cannot be sold. If a non-existent thing has been sold, though by mutual consent, the sale is void according to Shari'ah.

**Example:** A sells the unborn calf of his cow to B. The sale is void.

**Rule 2. The subject of sale must be in the ownership of the seller at the time of sale.**

Thus, what is not owned by the seller cannot be sold. If he sells something before acquiring its ownership, the sale is void.

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

**Rule 3. The subject of sale must be in the physical or constructive possession of the seller when he sells it to another person.**

"Constructive possession" means a situation where the possessor has not taken the physical delivery of the commodity, yet the commodity has come into his control, and all the rights and liabilities of the commodity are passed on to him, including the risk of its destruction.

**Examples:**
(i) A has purchased a car from B. B has not yet delivered it to A or to his agent. A cannot sell the car to C. If he sells it before taking its delivery from B, the sale is void.
(ii) A has purchased a car from B. B, after identifying the Car has placed it in a garage to which A has free access and B has allowed him to take the delivery from that place whenever he wishes. Thus the risk of the Car has passed on to A.. The car is in the constructive possession of A. If A sells the car to C without acquiring physical possession, the sale is valid.

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

(a) It has come into existence.
(b) It is owned by the seller.
(c) It is in the physical or constructive possession of the seller.

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

**Exception:**
The rules mentioned in paragraphs 1 to 3 are relaxed with respect to two types of sale, namely:
(a) Bai' Salam
(b) Istisna'

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

**Rule 4. The sale must be instant and absolute.**

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

**Examples:**
(a) A says to B on the first of January: "I sell my car to you on the first of February". The sale is void, because it is attributed to a future date.
(b) A says to B, "If party X wins the elections, my car stands sold to you". The sale is void, because it is contingent on a future event.

**Rule 5. The subject of sale must be a property of value.**

Thus, a thing having no value according to the usage of trade cannot be sold or purchased.

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

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

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

---

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

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

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

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

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

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

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

**Examples:**
(1) A buys a car from B with a condition that B will employ his son in his firm. The sale is conditional, hence invalid.
(2) A buys a refrigerator from B, with a condition that B undertakes its free service for 2 years. The condition, being recognized as a part of the transaction, is valid and the sale is lawful.

## BAI' MU'AJJAL (SALE ON DEFERRED PAYMENT BASIS)

1. A sale in which the parties agree that the payment of price shall be deferred is called a "Bai' Mu'ajjal".

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

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

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

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

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

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

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

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

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

**MURABAHAH**

1. Murabahah is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit or mark-up thereon.

2. The profit in murabahah can be determined by mutual consent, either in lump sum or through an agreed ratio of profit to be charged over the cost.

3. All the expenses incurred by the seller in acquiring the commodity like freight, custom duty etc. shall be included in the cost price and the mark-up can be applied on the aggregate cost. However, recurring expenses of the business like salaries of the staff, the rent of the premises etc. cannot be included in the cost of an individual transaction. In fact, the profit claimed over the cost takes care of these expenses.

4. Murabahah is valid only where the exact cost of a commodity can be ascertained. If the exact cost cannot be ascertained, the commodity cannot be sold on murabahah basis. In this case the commodity must be sold on musawamah (bargaining) basis i.e. without any reference to the cost or to the ratio of profit / mark-up. The price of the commodity in such cases shall be determined in lump sum by mutual consent.

**Example (1)** A purchased a pair of shoes for Rs. 100/-. He wants to sell it on murabahah with 10% mark-up. The exact cost is known. The murabahah sale is valid.

**Example (2)** A purchased a ready - made suit with a pair of shoes in a single transaction, for a lump sum price of Rs. 500/-. A can sell the suit including shoes on murabahah. But he cannot sell the shoes separately on murabahah, because the individual cost of the shoes is unknown. If he wants to sell the shoes separately, he must sell it at a lump sum price without reference to the cost or to the mark-up.

**MURABAHAH AS A MODE OF FINANCING**

Originally, murabahah is a particular type of sale and not a mode of financing. The ideal mode of financing according to Shari'ah is mudarabah or musharakah which have been discussed in the first chapter. However, in the perspective of the current economic set up, there are certain practical difficulties in using mudarabah and musharakah instruments in some areas of financing. Therefore, the contemporary Shari'ah experts have allowed, subject to certain conditions, the use of the murabahah on deferred payment basis as a mode of financing. But there are two essential points which must be fully understood in this respect:

1. It should never be overlooked that, originally, murabahah is not a mode of financing. It is only a device to escape from "interest" and not an ideal instrument for carrying out the real economic

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

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

## BASIC FEATURES OF MURABAHAH FINANCING

**1.** Murabahah is not a loan given on interest. It is the sale of a commodity for a deferred price which includes an agreed profit added to the cost.

**2.** Being a sale, and not a loan, the murabahah should fulfil all the conditions necessary for a valid sale, especially those enumerated earlier in this chapter.

**3.** Murabahah cannot be used as a mode of financing except where the client needs funds to actually purchase some commodities. For example, if he wants funds to purchase cotton as a raw material for his ginning factory, the Bank can sell him the cotton on the basis of murabahah. But where the funds are required for some other purposes, like paying the price of commodities already purchased by him, or the bills of electricity or other utilities or for paying the salaries of his staff, murabahah cannot be effected, because murabahah requires a real sale of some commodities, and not merely advancing a loan.

**4.** The financier must have owned the commodity before he sells it to his client.

**5.** The commodity must come into the possession of the financier, whether physical or constructive, in the sense that the commodity must be in his risk, though for a short period.

**6.** The best way for murabahah, according to Shari'ah, is that the financier himself purchases the commodity and keeps it in his own possession, or purchases the commodity through a third person appointed by him as agent, before he sells it to the customer. However, in exceptional cases, where direct purchase from the supplier is not practicable for some reason, it is also allowed that he makes the customer himself his agent to buy the commodity on his behalf. In this case the client first purchases the commodity on behalf of his financier and takes its possession as such. Thereafter, he purchases the commodity from the financier for a deferred price.

His possession over the commodity in the first instance is in the capacity of an agent of his financier. In this capacity he is only a trustee, while the ownership vests in the financier and the risk of the commodity is also borne by him as a logical consequence of the ownership. But when the client purchases the commodity from his financier, the ownership, as well as the risk, is transferred to the client.

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

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

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

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

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

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

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

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

**The most essential element of the transaction is that the commodity must remain in the risk of the institution during the period between the third and the fifth stage.** This is the only feature of murabahah which can distinguish it from an interest-based transaction. Therefore, it must be observed with due diligence at all costs, otherwise the murabahah transaction becomes invalid according to Shari'ah.

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

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

**(a)** At the first stage, the institution and the client promise to sell and purchase a commodity in future. This is not an actual sale. It is just a promise to effect a sale in future on murabahah basis. Thus at this stage the relation between the institution and the client is that of a promisor and a promise.
**(b)** At the second stage, the relation between the parties is that of a principal and an agent.
**(c)** At the third stage, the relation between the institution and the supplier is that of a buyer and seller.

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

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

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

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

## SOME ISSUES INVOLVED IN MURABAHAH

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

## DIFFERENT PRICING FOR CASH AND CREDIT SALES

The first and foremost question about murabahah is that, when used as a mode of financing, it is always effected on the basis of deferred payment. The financier purchases the commodity on cash payment and sells it to the client on credit. While selling the commodity on credit, he takes into account the period in which the price is to be paid by the client and increases the price accordingly. The longer the maturity of the murabahah payment, the higher the price. Therefore the price in a murabahah transaction, as practiced by the Islamic banks, is always higher than the market price. If the client is able to purchase the same commodity from the market on cash payment, he will have to pay much less than he has to pay in a murabahah transaction on deferred payment basis. The question arises as to whether the price of a commodity in a credit sale may be increased from the price of a cash sale. Some people argue that the increase of price in a credit sale, being in consideration of the time given to the purchaser, should be treated analogous to the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment. On this basis they argue that the murabahah transactions, as practiced in the Islamic banks, are not different in essence from the interest-based loans advanced by the conventional banks.

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

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

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

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

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

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

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

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

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

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

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

These and similar other considerations play their role in charging a higher price from the customer. In the same way, if a seller increases the price because he allows credit to his client, it is not prohibited by Shari'ah if there is no cheating and the purchaser accepts it with open eyes, because whatever the reason of increase, the whole price is against a commodity and not against money. It is true that, while increasing the price of the commodity, the seller has kept in view the time of its payment, but once the price is fixed, it relates to the commodity, and not to the time. That is why if the purchaser fails to pay at the stipulated time, the price will remain the same and can never be increased by the seller. Had it been against time, it might have been increased, if the seller allows him more time after the maturity.

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

The upshot of this discussion is that when money is exchanged for money, no excess is allowed, neither in cash transaction, nor in credit, but where a commodity is sold for money, the price agreed

upon by the parties may be higher than the market price, both in cash and credit transactions. Time of payment may act as an ancillary factor to determine the price of a commodity, but it cannot act as an exclusive basis for and the sole consideration of an excess claimed in exchange of money for money.

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

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

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

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

---

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

## THE USE OF INTEREST RATE AS BENCHMARK

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

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

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

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

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

**PROMISE TO PURCHASE**

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

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

This solution is subjected to the objection that a unilateral promise creates a moral obligation but it cannot be enforced, according to Shari'ah, by the courts of law. This leads us to the question whether or not a one-sided promise is enforceable in Shari'ah. The general impression is that it is not, but before accepting this impression at its face value, we will have to examine it in the light of the original sources of Shari'ah.

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

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

2. A number of the Muslim jurists are of the view that fulfilling a promise is mandatory and a promisor is under moral as well as legal obligation to fulfil his promise. According to them, promise can be enforced through courts of law. This view is ascribed to Samurah ibn Jundub (May Allah be well pleased with him) the well known companion of the Holy Prophet صلى الله عليه وسلم, Umar ibn Abd al-Aziz, Hasan al-Basri, Sa'id ibn al- Ashwa', Ishaq ibn Rahwaih and Imam al-Bukhari.[4]

---

[3] See *Umdat al-Qari*, 12:121; *Mirqat al-Mafatih*, 4:653; *al-Adhkar al-Nawawi,* 282; *Fat-h al-'Ali al-Malik*, 1:254.

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

The same is the view of some Maliki jurists, and it is preferred by Ibn al-'Arabi and Ibn al-Shat, and endorsed by al-Ghazzali, the famous Shafi'i jurist, who says the promise is binding, if it is made in absolute terms. The same is the view of Ibn Shubrumah.[5] The third view is presented by some Maliki jurists. They say that in normal conditions, promise is not binding, but if the promisor has caused the promise to incur some expenses or undertake some labor or liability on the basis of promise, it is mandatory on him to fulfil his promise for which he may be compelled by the courts.[6]

Some contemporary scholars have claimed that the jurists who have accepted the binding nature of a promise have done so only with regard to unilateral gifts or other voluntary payments, but none of them has accepted the binding nature of a promise to effect a bilateral commercial or monetary transaction. However, based on a close study, this notion does not seem to be correct, because the Maliki and Hanafi jurists have allowed '*Bai' bil wafa'* on the basis of binding promise. Bai' bil wafa' is a special kind of sale whereby the purchaser of an immovable property undertakes that whenever the seller will give him the price back, he will resell the house to him. The question of validity of 'Bai'bil wafa' has already been discussed in detail in the first chapter while explaining the concept of house financing on the basis of 'diminishing musharakah'. The gist of the discussion is that if repurchase by the seller is made a condition for the original sale, it is not a valid transaction, but if the parties have entered into the original sale unconditionally, but the seller has signed a separate and independent promise to repurchase the sold property, this promise will be binding on the promisor and enforceable through the courts. The binding nature of the promise in this case has been admitted by both Maliki and Hanafi jurists.[7]

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

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

> ***And fulfill the covenant. Surely, the covenant will be asked about (in the Hereafter) (Bani Isra'il: 34)***
>
> ***O those who believe, why do you say what you not do. It invites Allah's anger that you say what you not do. (al-Saf:2 to 3)***

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

---

[5] Al-Qurtubi, *Al-Jami' li-Ahkam al-Qur'an*, 18:29; *Hashiyah ibn al-Shãt 'ala Furuq al-Qarafi*, 4:24; Al-Ghazzali, I*hya Ulum al-Din*, 3:133; Ibn Hazm, *al-Muhalla*, 8:28.

[6] *Al-Furuq al-Qarafi,* 4:25; *Fat-h al-'Ali al-Malik*, 1:254.

[7] Al-Hattab, *Tahrir al-Kalam* (Beirut, 1404 AH), 239.

[8] Al-Jassas, *Ahkam al-Qur'an*, 3:420.

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

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

This is only an example. There is a large number of injunctions in the ahadith of the Holy Prophet صلى الله عليه وسلم where it is ordained to fulfil the promises and it is clearly prohibited to back out, except for a valid reason. Therefore, it is evident from these injunctions that fulfilling promise is obligatory. However, the question whether or not a promise is enforceable in courts depends on the nature of the promise. There are certainly some sorts of promises which cannot be enforced through courts. For example, at the time of engagement the parties promise to go through the marriage. These promises create a moral obligation, but obviously they cannot be enforced through courts of law. But in commercial dealings, where a party has given an absolute promise to sell or purchase something and the other party has incurred liabilities on that basis, there is no reason why such a promise should not be enforced. Therefore, on the basis of the clear injunctions of Islam, if the parties have agreed that this particular promise will be binding on the promisor, it will be enforceable.

This is not a question pertaining to murabahah alone. If promises are not enforceable in the commercial transactions, it may seriously jeopardize commercial activities. If somebody orders a trader to bring for him a certain commodity and promises to purchase it from him, on the basis of which the trader imports it from abroad by incurring huge expenses, how can it be allowed for the former to refuse to purchase it? There is nothing in the Holy Qur'an or Sunnah which prohibits the making of such promises enforceable. It is on these grounds that the Islamic Fiqh Academy Jeddah has made the promises in commercial dealings binding on the promisor with the following conditions:

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

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

---

[9] *Sahih al-Bukhari*, Kitab al-Iman.

[10] Resolution no. 2 and 3, Fifth Conference of the Islamic Fiqh Academy held in Kuwait, 1409 AH. See the academy's journal no. 5, 2:1599.

**SECURITIES AGAINST MURABAHAH PRICE**

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

1. The security can be claimed rightfully where the transaction has created a liability or a debt. No security can be asked from a person who has not incurred a liability or debt. As explained earlier, the procedure of murabahah financing comprises of different transactions carried out at different stages. In the earlier stages of the procedure, the client does not incur a debt. It is only after the commodity is sold to him by the financier on credit that the relationship of a creditor and debtor comes into existence. Therefore, the proper way in a transaction of murabahah would be that the financier asks for a security after he has actually sold the commodity to the client and the price has become due on him, because at this stage the client incurs a debt. However, it is also permissible that the client furnishes a security at earlier stages, but after the murabahah price is determined. In this case, if the security is possessed by the financier, it will remain at his risk, meaning thereby that if it is destroyed before the actual sale to the client, he will have either to pay the market price of the mortgaged asset, and cancel the agreement of murabahah, or sell the commodity required by the client and deduct the market price of the mortgaged asset from the price of the sold property. [11]

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

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

---

[11] Ibn Nujaym writes, وإنما يصح الرهن بدين ولو موعودا . . . ولو أخذ الرهن بشرط أن يقرضه كذا ، فهلك في يده قبل أن يقرضه هلك بالأقل من قيمته ومما سمى له من القرض )البحر الرائق 8:450 طبع مكة

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

Therefore, if the market price of the car was 450,000/- he can claim only the remaining part of the agreed sale price (i.e. Rs. 50,000/- in the above example). If the market price of the car is Rs. 500,000/- or higher, nothing can be claimed from the purchaser.

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

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

**GUARANTEEING THE MURABAHAH**

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

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

Suppose, A has borrowed 100 US dollars from B who asked him to produce a guarantor. C says to A, "I pay off your debt to B right now, but you will have to pay me 110 dollars at a later date." Obviously 10 dollars charged from A are not allowed, being interest. Then D comes to A and says, "I stand as a guarantor to you, but you will have to pay me 10 dollars for this service." If we allow to charge a fee for guarantee, it will mean that C cannot charge 10 dollars, despite the fact that he has actually paid the amount, and D can charge 10 dollars, despite the fact that he has merely committed himself to pay only when A fails to pay. This being unfair apparently, the classical Muslim jurists have forbidden the charging of a fee for guarantee, so that both C and D, in the above example, may stand on equal footing.

---

[13] See Ibn Qudamah, *Al-Mughni*, 4:442; al-Ghazzali, *al-Wasit,* 3:509; Ibn 'Abidin, *Radd al-Muhtar*, 5:341.

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

**PENALTY OF DEFAULT**

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

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

In order to solve this problem, some contemporary scholars have suggested that the dishonest clients who default in payment deliberately should be made liable to pay compensation to the Islamic bank for the loss it may have suffered on account of default. They suggest that the amount of this compensation may be equal to the profit given by that bank to its depositors during the period of default. For example, the defaulter has paid the price three months after the due date. If the bank has given to its depositors a profit at the rate of 5%, the client has to pay 5% more as compensation for the loss of the bank. However, the scholars who allow this compensation make it subject to the following conditions:

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

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

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

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

This concept of compensation, however, is not accepted by the majority of the present day scholars. (including the author). It is the considered opinion of such scholars that this suggestion neither conforms to the principles of Shari'ah nor is it able to solve the problem of default. First of all, any additional amount charged from a debtor is riba. In the days of Jahiliyyah (before Islam) the people used to charge additional amounts from their debtors when they were not able to pay at the due date. They used to say,

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

The aforementioned suggestion of paying compensation to the creditor/seller resembles the same attitude. It can be argued that the above suggestion is theoretically different from the practice of jahiliyyah in that the suggestion is to grant the debtor a grace period of one month to make sure that he is avoiding payment without a valid cause and to exempt him from compensation if it appears that his non-payment is due to poverty or a hardship. But in practical application of the concept, these conditions are hardly fulfilled, because every debtor may claim that his default is due to his financial inability at the due date, and it is very difficult for a financial institution to hold an inquiry about the financial position of each client and to verify whether or not he was able to pay. What the banks normally do is that they presume that every client was able to pay unless he has been declared as bankrupt or insolvent. It means that the concession allowed in the suggestion can be enjoyed only by the insolvent people. Obviously, insolvency is a rare phenomenon, and in this rare situation, even the interest- based banks cannot normally recover interest from the borrower. Therefore, the suggestion leaves no practical and meaningful difference between an interest based financing and an Islamic financing.

So far as grace period is concerned, it is a minor concession which is sometimes given by the conventional banks as well. Once again, in practical terms, there is no material difference between interest and the late payment charged as compensation. It is argued in favor of charging compensation that the Holy Prophet صلى الله عليه وسلم has condemned the person who delays the payment of his dues without a valid cause. According to the well-known hadith he has said,

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

---

[14] *Sahih al-Bukhari*, hadith no. 2400, with *Fath al-Bari,* 5:62.

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

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

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

Another point is worth attention. The one who defaults in payment of debt is, at the most, like a thief or a usurper. But the study of the rules prescribed for theft and usurpation would show that a thief has been subjected to very severe punishment of amputating his hands, but he was never asked to pay an additional mount to compensate the victim of theft. Similarly, if a person has usurped the money of another person, he may be punished by way of ta'zir, but no Muslim jurist has ever imposed on him a financial penalty to compensate the owner.

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

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

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

All this discussion relates to the impermissibility of the proposed compensation in Shari'ah. Now it is to be noted that this proposal does not solve the problem of default at all. To the contrary, it may encourage the debtors to commit as much default as they wish.

---

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

[16] Al-Shirazi, *al-Muhadh-dhab*, 1:370.

[17] Resolution no. 53, Vth Annual Session of the Islamic Fiqh Academy, Jeddah, Journal no. 6, 1:447.

The reason is that, according to this suggestion, the defaulter is asked to pay compensation equal to the return earned by the depositors during the period of default. It is evident that the rate of return earned by the depositors is always less than the rate of profit paid by the customer in a murabahah transaction. Therefore, the customer will be paying after default, much less than he was paying before the default. Therefore, he would willingly accept to pay this amount and not pay the amount of price which he will invest in a more profitable activity. Suppose the rate of profit agreed in a murabahah transaction of six moths is 15% p.a. and the rate of profit declared to the depositors is 10%. p.a. It means that if the client withholds the price of murabahah after its maturity date and keeps it for another six months, he will have to pay the compensation at the rate of 10% p.a. which is much less than the rate of original murabahah (i.e. 15%). As such he will default and enjoy another facility for the next six months at a lesser rate.

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

**THE ALTERNATIVE SUGGESTION**

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

We have already mentioned that the real solution to this problem is to develop a system where the defaulters are duly punished by depriving them from enjoying a financial facility in future. However, as commented earlier, this may be only where the whole banking system is based on Islamic principles, or the Islamic banks are given due protection against defaulters. Therefore, up to a time when this goal is reached, we may need some other alternative.

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

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

---

[18] Al-Hattab, *Tahrir al-Kalam* (Beirut, 1404 AH), 176.

**1.** The proposal is meant only to pressurize the debtors on paying their dues promptly and not to increase the income of the creditor / financier, nor to compensate him for his opportunity cost. Therefore, it must be ensured that no part of the penalty forms part of the income of the bank in any case, nor can it be used to pay taxes or to set-off any liability of the financier.

**2.** Since the amount of penalty is not deserved by the financier as his income, but it goes to charity, it may be any amount willfully undertaken by the debtor. It can also be determined on per cent per annum basis. Therefore, it may serve as a real deterrent against deliberate default, unlike the former suggestion of compensation which, as explained earlier, may tend to encourage the defaults.

**3.** Since the penalty undertaken by the client is originally a self- undertaken vow, and not penalty charged by the financier, the agreement should reflect this concept. Therefore, the proper wording of the penalty clause would be on the following pattern,

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

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

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

## NO ROLL OVER IN MURABAHAH

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

Some Islamic banks or financial institutions, who misunderstood the concept of murabahah and took it as merely a mode of financing analogous to an interest-based loan, started using the concept of roll-over to murabahah also. If the client requests them to extend the maturity date of murabahah, they roll it over and extend the period of payment on an additional mark-up charged from the client which practically means that another separate murabahah is booked on the same commodity. This practice is totally against the well-settled principles of Shari'ah. It should be clearly understood that murabahah is not a loan. It is the sale of a commodity the price of which is deferred to a specific date. Once the commodity is sold, its ownership is passed on to the client. It is no more a property

of the seller. What the seller can legitimately claim is the agreed price which has become a debt payable by the buyer. Therefore, there is no question of effecting another sale on the same commodity between the same parties. The roll-over in murabahah is nothing but interest pure and simple because it is an agreement to charge an additional amount on the debt created by the murabahah sale.

**REBATE ON EARLIER PAYMENT**

Sometimes the debtor wants to pay earlier than the specified date. In this case he wants to earn a discount on the agreed deferred price. Is it permissible to allow him a rebate for his earlier payment? This question has been discussed by the classical jurists in detail. The issue is known in the Islamic legal literature as "ضـــع وتعجـــل" (Give discount and receive soon). Some earlier jurists have held this arrangement as permissible, but the majority of the Muslim jurists, including the four recognized schools of Islamic jurisprudence do not allow it, if the discount is held to be a condition for earlier payment.[19]

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

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

The majority of the Muslim jurists, however, does not accept this hadith as authentic. Even Imam al-Baihaqi, who has reported this hadith in his book, has expressly admitted that this is a weak narration. Even if the hadith is held to be authentic, the exile of Banu Nadir was in the second year after hijrah, when riba was not yet prohibited.

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

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

---

[19] Ibn Qudamah, *Al-Mughni*, 4:174–75. For a full discussion, see my Arabic book "Bahuth fi Qadaya Fiqhiyyah Mu'asirah", 25

[20] Al-Bayhaqi, al-Sunan al-Ku bra, 6:28.

[21] Al-Waqidi, *al-Maghazi*, 1:374.

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

It means that in a murabahah transaction effected by an Islamic bank or financial institution, no such rebate can be stipulated in the agreement, nor can the client claim it as his right. However, if the bank or a financial institution gives him a rebate on its own, it is not objectionable, especially where the client is a needy person. For example, if a poor farmer has purchased a tractor or agricultural inputs on the basis of murabahah, the bank should give him a voluntary discount.

**CALCULATION OF COST IN MURABAHAH**

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

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

However, in the case of international trade, it may be difficult to base both purchases on the same currency. If the commodity intended to be sold to the customer is imported from a foreign country, while the ultimate purchaser is in Pakistan, the price of the original sale has to be paid in a foreign currency and the price of the second sale will be determined in Pak. Rupees. This situation may be met with in two ways. Firstly, if the ultimate purchaser agrees and the laws of the country allow, the price of the second sale may also be determined in dollars.

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

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

---

[22] Resolution no. 66, VIth Session of Islamic Fiqh Academy, Jeddah, Journal no. 7, 2:217.

Such uncertainty continues upto a date after three months when the buyer actually pays the price to the supplier. Such uncertainty renders the transaction invalid. Therefore, there are following options open to the bank in this issue:

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

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

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

**SUBJECT MATTER OF MURABAHAH**

All commodities which may be subject matter of sale with profit can be subject matter of murabahah, because it is a particular kind of sale. Therefore, the shares of a lawful company may be sold or purchased on murabahah basis, because according to the Islamic principles, the shares of a company represent the holder's proportionate ownership in the assets of the company. If the assets of a company can be sold with profit, its shares can also be sold by way of murabahah. But it goes without saying that the transaction must fulfil all the basic conditions, already discussed, for the validity of a murabahah transaction. Therefore, the seller must first acquire the possession of the shares with all their rights and obligations, then sell them to his client. A buy back arrangement or selling the shares without taking their possession is not allowed at all. Conversely, no murabahah can be effected on things which cannot be subject - matter of sale, For example murabahah is not possible in exchange of currencies, because it must be spontaneous or, if deferred, on the market rate prevalent on the date of the transaction.[23] Similarly, the commercial papers representing a debt receivable by the holder cannot be sold or purchased except at par value, and therefore no murabahah can be effected in respect of such papers. Similarly, any paper entitling the holder to receive a specified amount of money from the issuer cannot be negotiated. The only way of its sale is to transfer if for its face value. Therefore, they cannot be sold on murabahah basis.

**RESCHEDULING OF PAYMENTS IN MURABAHAH**

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

---

[23] For detailed discussion on the subject, see my Arabic treatise *Ahkam al-Awraq al-Naqdiyyah*

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

## SECURITIZATION OF MURABAHA

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

## SOME BASIC MISTAKES IN MURABAHAH FINANCING

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

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

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

---

[24] NBFI: Non-Bank Financial Institution.

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

**(a)** Instead of giving funds to the customer, the purchase price should be paid directly to the supplier.

**(b)** If it becomes necessary that the client is entrusted with funds to purchase the commodity on behalf of the financier, his purchase should be evidenced by invoices or similar other documents which he should present to the financier.

**(c)** Where either one of the above two requirements is not possible to be fulfilled, the financing institution should arrange for physical inspection of the purchased commodities.

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

**3.** In some cases, sale of commodity to the client is effected before the commodity is acquired from the supplier. This mistake is invariably committed in transactions where all the documents of murabahah are signed at one time without taking into account various stages of the murabahah. Some institutions have only one murabahah agreement which is signed at the time of disbursement of money, or in some cases, at the time of approving the facility. This is totally against the basic principles of murabahah. It has already been explained in this article that the murabahah arrangement practiced by the banks is a package of different contracts which come into play one after another at their respective stages. These stages have been fully highlighted earlier while discussing the concept of murabahah financing. Without observing this basic feature of murabahah financing, the whole transaction turns into an interest-bearing loan. Merely changing the nomenclature does not make it lawful in the eyes of Shari'ah.

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

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

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

## CONCLUSIONS

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

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

2. While approving a murabahah facility, the sanctioning authority must make sure that the client really intends to purchase commodities which may be subject-matter of murabahah. It should never be taken as merely a paper-work having no genuine basis.

3. No murabahah can be effected for overhead expenses, paying the bills or settling the debts of the client, nor can it be effected for purchase of currencies.

4. It is the foremost condition for the validity of murabahah that the commodity comes in the ownership and physical or constructive possession of the financier before he sells it to the customer on murabahah basis. There should be a time in which the risk of the commodity is borne by the financier. Without having its ownership or assuming the risk of the commodity, though for a short while, the transaction is not acceptable to Shari'ah and the profit accruing therefrom is not halal.

5. The best way to effect murabahah is that the financier himself purchases the commodity directly from the supplier and after taking its delivery sells it to the client on murabahah basis. Making the client agent to purchase on behalf of the financier renders the arrangement dubious. For this very reason some Shari'ah Boards have forbidden this technique, except in cases where direct purchase is not possible at all. Therefore, the agency concept should be avoided as far as possible.

6. If in cases of genuine need, the financier appoints the client his agent to purchase the commodity on his behalf, his different capacities (i.e. as agent and as ultimate purchaser) should be clearly distinguished. As an agent, he is a trustee, and unless he commits negligence or fraud, he is not liable to any loss so far as the commodity is in his possession as agent of the financier. After he purchases the commodity in his capacity as agent, he must inform the financier that, in

fulfilling his obligation as his agent, he has taken delivery of the purchased commodity and now he extends his offer to purchase it from him. When, in response to this offer, the financier conveys his acceptance to this offer, the sale will be deemed to be complete, and the risk of the property will be passed on to the client as purchaser. At this point, he will become a debtor and the consequences of indebtedness will follow. These are the necessary requirements of murabahah financing which can never be dispensed with. While describing the concept of "murabahah as a mode of financing" we have already identified five stages of murabahah under agency agreement. Each and every step out of these five is necessary in its own right and neglecting any one of them renders the whole arrangement unacceptable.

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

7. Two different prices for cash and credit sales are allowed on condition that either of the two options is specifically elected by the customer. Once the price is fixed, it can neither be increased because of late payment, nor decreased on earlier payment.

8. In order to assure that the purchaser will pay the price promptly, he may undertake that in case of default, he will pay a certain amount to the charitable fund maintained by the financing institution. This amount may be based on per cent per annum concept, but it must invariably be spent for purely charitable purposes and should in no case form part of the income of the institution.

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

# 6. IJARAH

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

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

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

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

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

Therefore, it can easily be seen that 'ijarah' is not a mode of financing in its origin. It is a normal business activity like sale. However, due to certain reasons, and in particular, due to some tax concessions it may carry, this transaction is being used in the Western countries for the purpose of financing also. Instead of giving a simple interest - bearing loan, some financial institutions started leasing some equipment's to their customers. While fixing the rent of these equipment, they calculate the total cost they have incurred in the purchase of these assets and add the stipulated interest they could have claimed on such an amount during the lease period. The aggregate amount so calculated is divided on the total months of the lease period, and the monthly rent is fixed on that basis.

The question whether or not the transaction of leasing can be used as a mode of financing in Shari'ah depends on the terms and conditions of the contract. As mentioned earlier, leasing is a normal business transaction and not a mode of financing. Therefore, the lease transaction is always

governed by the rules of Shari'ah prescribed for ijarah. Let us, therefore, discuss the basic rules governing the lease transactions, as enumerated in the Islamic Fiqh. After the study of these rules, we will be able to understand under what conditions the ijarah may be used for the purpose of financing. Although the principles of ijarah are so numerous that a separate volume is required for their full discussion, we will attempt in this chapter to summarize those basic principles only which are necessary for the proper understanding of the nature of the transaction and are generally needed in the context of modern economic practice. These principles are recorded here in the form of brief notes, so that the readers may use them for quick reference.

**BASIC RULES OF LEASING**

**1.** Leasing is a contract whereby the owner of something transfers its usufruct to another person for an agreed period, at an agreed consideration.

**2.** The subject of lease must have a valuable use. Therefore, things having no usufruct at all cannot be leased.

**3.** It is necessary for a valid contract of lease that the corpus of the leased property remains in the ownership of the seller, and only its usufruct is transferred to the lessee. Thus, anything which cannot be used without consuming cannot be leased out. Therefore, the lease cannot be effected in respect of money, eatables, fuel and ammunition etc. because their use is not possible unless they are consumed. If anything of this nature is leased out, it will be deemed to be a loan and all the rules concerning the transaction of loan shall accordingly apply. Any rent charged on this invalid lease shall be an interest charged on a loan.

**4.** As the corpus of the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor, but the liabilities referable to the use of the property shall be borne by the lessee.

> **Example:**
> A has leased his house to B. The taxes referable to the property shall be borne by A, while the water tax, electricity bills and all expenses referable to the use of the house shall be borne by B, the lessee.

**5.** The period of lease must be determined in clear terms.

**6.** The lessee cannot use the leased asset for any purpose other than the purpose specified in the lease agreement. If no such purpose is specified in the agreement, the lessee can use it for whatever purpose it is used in the normal course. However if he wishes to use it for an abnormal purpose, he cannot do so unless the lessor allows him in express terms.

**7.** The lessee is liable to compensate the lessor for every harm to the leased asset caused by any misuse or negligence on the part of the lessee.

**8.** The leased asset shall remain in the risk of the lessor throughout the lease period in the sense that any harm or loss caused by the factors beyond the control of the lessee shall be borne by the lessor.

**9.** A property jointly owned by two or more persons can be leased out, and the rental shall be distributed between all the joint owners according to the proportion of their respective shares in the property.

**10.** A joint owner of a property can lease his proportionate share to his co-sharer only, and not to any other person.[1]

**11.** It is necessary for a valid lease that the leased asset is fully identified by the parties.

> **Example:**
> A said to B. "I lease you one of my two shops." B agreed. The lease is void, unless the leased shop is clearly determined and identified.

**12.** The rental must be determined at the time of contract for the whole period of lease.

It is permissible that different amounts of rent are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of effecting a lease. If the rent for a subsequent phase of the lease period has not been determined or has been left at the option of the lessor, the lease is not valid.

> **Example (1):** A leases his house to B for a total period of 5 years. The rent for the first year is fixed as Rs. 2000/- per month and it is agreed that the rent of every subsequent year shall be 10% more than the previous one. The lease is valid.
>
> **Example (2):** In the above example, A puts a condition in the agreement that the rent of Rs. 2000/- per month is fixed for the first year only. The rent for the subsequent years shall be fixed each year at the option of the lessor. The lease is void, because the rent is uncertain.
>
> The determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor, as normally done in financial leases, is not against the rules of Shari'ah, if both parties agree to it, provided that all other conditions of a valid lease prescribed by the Shari'ah are fully adhered to.

**14.** The lessor cannot increase the rent unilaterally, and any agreement to to this effect is void.

**15.** The rent or any part thereof may be payable in advance before the delivery of the asset to the lessee, but the amount so collected by the lessor shall remain with him as 'on account' payment and shall be adjusted towards the rent after its being due.

**16.** The lease period shall commence from the date on which the leased asset has been delivered to the lessee, no matter whether the lessee has started using it or not.

**17.** If the leased asset has totally lost the function for which it was leased, and no repair is possible, the lease shall terminate on the day on which such loss has been caused. However, if the loss is caused by the misuse or by the negligence of the lessee, he will be liable to compensate the lessor for the depreciated value of the asset as, it was immediately before the loss.

---

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

## LEASE AS A MODE OF FINANCING

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

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

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

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

### 1. THE COMMENCEMENT OF LEASE

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

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

---

[2] See Ibn 'Abidin, *Radd al-Muhtar,* 4:64.

## 2. DIFFERENT RELATIONS OF THE PARTIES

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

The second stage begins from the date when the client takes delivery from the supplier. At this stage, the relation of lessor and lessee comes to play its role. These two capacities of the parties should not be mixed up or confused with each other. During the first stage, the client cannot be held liable for the obligations of a lessee. In this period, he is responsible to carry out the functions of an agent only. But when the asset is delivered to him, he is liable to discharge his obligations as a lessee.

However, there is a point of difference between murabahah and leasing. In murabahah, as mentioned earlier, actual sale should take place after the client takes delivery from the supplier, and the previous agreement of murabahah is not enough for effecting the actual sale. Therefore, after taking possession of the asset as an agent, he is bound to give intimation to the institution, and make an offer for the purchase from him. The sale takes place after the institution accepts the offer.

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

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

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

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

### 3. EXPENSES CONSEQUENT TO OWNERSHIP

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

### 4. LIABILITY OF THE PARTIES IN CASE OF LOSS TO THE ASSET

As mentioned in the basic principles of leasing, the lessee is responsible for any loss caused to the asset by his misuse or negligence. He can also be made liable to the wear and tear which normally occurs during its use. But he cannot be made liable to a loss caused by the factors beyond his control. The agreements of the traditional 'financial lease' generally do not differentiate between the two situations. In a lease based on the Islamic principles, both the situations should be dealt with separately.

### 5. VARIABLE RENTALS IN LONG TERM LEASES

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

In this case the lessor has two options:

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

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

These two options are available to the lessor according to the classical rules of Islamic Fiqh. However, some contemporary scholars have allowed, in long-term leases, to tie up the rental amount with a variable benchmark which is so well-known and well-defined that it does not leave room for any dispute. For example, it is permissible according to them to provide in the lease contract that in case of any increase in the taxes imposed by the government on the lessor, the rent will be increased to the extent of same amount. Similarly it is allowed by them that the annual increase in the rent is tied up with the rate of inflation. Therefore if there is an increase of 5% in the rate of inflation, it will result in an increase of 5% in the rent as well. Based on the same principle, some Islamic banks use the rate of interest as a benchmark to determine the rental amounts. They want to earn the same profit through leasing as is earned by the conventional banks through advancing loans on the basis of interest. Therefore, they want to tie up the rentals with the rate of interest and instead of fixing a definite amount of rental, they calculate the cost of purchasing the lease assets and want to earn through rentals an amount equal to the rate of interest. Therefore, the agreement provides that the rental will be equal to the rate of interest or to the rate of interest plus something. Since the rate of interest is variable, it cannot be determined for the whole lease period.

Therefore, these contracts use the interest rate of a particular country (like LIBOR) as a benchmark for determining the periodical increase in the rent.

This arrangement has been criticized on two grounds:

The first objection raised against it is that, by subjecting the rental payments to the rate of interest, the transaction is rendered akin to an interest based financing. This objection can be overcome by saying that, as fully discussed in the case of murabahah, the rate of interest is used as a benchmark only. So far as other requirements of Shari'ah for a valid lease are properly fulfilled, the contract may use any benchmark for determining the amount of rental. The basic difference between an interest - based financing and a valid lease does not lie in the amount to be paid to the financier or the lessor. The basic difference is that in the case of lease, the lessor assumes the full risk of the corpus of the leased asset. If the asset is destroyed during the lease period, the lessor will suffer the loss. Similarly, if the leased asset looses its usufruct without any misuse or negligence on the part of the lessee, the lessor cannot claim the rent, while in the case of an interest-based financing, the financier is entitled to receive interest, even if the debtor did not at all benefit from the money borrowed. So far as this basic difference is maintained, (i.e. the lessor assumes the risk of the leased asset) the transaction cannot be categorised as an interest-bearing transaction, even though the amount of rent claimed from the lessee is equal to the rate of interest.

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

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

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

The second reason for the prohibition of jahalah is that it renders the parties susceptible to an unforeseen loss. It is possible that the rate of interest, in a particular period, zooms up to an unexpected level in which case the lessee will suffer. It is equally possible that the rate of interest zooms down to an unexpected level, in which case the lessor may suffer. In order to meet the risks involved in such possibilities, it is suggested by some contemporary scholars that the relation between rent and the rate of interest is subjected to a limit or ceiling. For example, it may be provided in the base contract that the rental amount after a given period, will be changed according

to the change in the rate of interest, but it will in no case be higher than 15% or lower than 5% of the previous monthly rent. It will mean that if the increase in the rate of interest is more than 15% the rent will be increased only up to 15%. Conversely, if the decrease in the rate of interest is more than 5% the rent will not be decreased to more than 5%. In our opinion, this is the moderate view which takes care of all the aspects involved in the issue.

**6. PENALTY FOR LATE PAYMENT OR RENT**

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

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

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

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

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

**7. TERMINATION OF LEASE**

If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there

is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent. In some agreements of the 'financial lease' it has been noticed that the lessor has been given an unrestricted power to terminate the lease unilaterally whenever he wishes, according to his sole judgment. This is again contrary to the principles of Shari'ah.

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

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

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

**8. INSURANCE OF THE ASSETS**

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

**9. THE RESIDUAL VALUE OF THE LEASED ASSET**

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

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

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

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

But after the lease period expires, and the lessor wants to give the asset to the lessee as a gift or to sell it to him, he can do so by his free will. However, some contemporary scholars, keeping in view the needs of the Islamic financial institutions have come up with an alternative. They say that the

agreement of ijarah itself should not contain a condition of gift or sale at the end of the lease period. However, the lessor may enter into a unilateral promise to sell the leased asset to the lessee at the end of the lease period. This promise will be binding on the lessor only. The principle, according to them, is that a unilateral promise to enter into a contract at a future date is allowed whereby the promisor is bound to fulfil the promise, but the promisee is not bound to enter into that contract . It means that he has an option to purchase which he may or may not exercise. However, if he wants to exercise his option to purchase, the promisor cannot refuse it because he is bound by his promise.

Therefore, these scholars suggest that the lessor, after entering into the lease agreement, can sign a separate unilateral promise whereby he undertakes that if the lessee has paid all the amounts of rentals and wants to purchase the asset at a specified mutually acceptable price, he will sell the leased asset to him for that price.

Once this promise is signed by the lessor, he is bound to fulfil it and the lessee may exercise his option to purchase at the end of the period, if he has fully paid the amounts of rent according to the agreement of lease. Similarly, it is also allowed by these scholars that, instead of sale, the lessor signs a separate promise to gift the leased asset to the lessee at the end of the lease period, subject to his payment of all amounts of rent. This arrangement is called 'ijarah wa iqtina'. It has been allowed by a large number of contemporary scholars and is widely acted upon by the Islamic banks and financial institutions. The validity of this arrangement is subject to two basic conditions:

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

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

**10. SUB-LEASE**

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

---

[3] See Ibn Qudamah, *Al-Mughni* (Riyadh, 1981), 5:475; Ibn 'Abidin, *Radd al- Muhtar,* 5:20.

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

**11. ASSIGNING OF THE LEASE**

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

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

**SECURITIZATION OF IJARAH**

The arrangement of ijarah has a good potential of securitization which may help create a secondary market for the financiers on the basis of ijarah. Since the lessor in ijarah owns the leased assets, he can sell the asset, in whole or in part, to a third party who may purchase it and may replace the seller in the rights and obligations of the lessor with regard to the purchased part of the asset.[4]

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

---

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

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

**HEAD-LEASE**

Another concept developed in the modern leasing business is that of 'head-leasing.' In this arrangement a lessee sub-leases the property to a number of sub-lessees. Then, he invites others to participate in his business by making them share the rentals received by his sub- lessees. For making them participate in receiving rentals, he charges a specified amount from them. This arrangement is not in accordance with the principles of Shari'ah. The reason is obvious. The lessee does not own the property. He is entitled to benefit from its usufruct only. That usufruct he has passed on to his sub-lessees by contracting a sub-lease with them. Now he does not own anything, neither the corpus of the property, nor its usufruct. What he has is the right to receive rent only.

Therefore, he assigns a part of this right to other persons. It is already explained in detail that this right cannot be traded in, because it amounts to selling a receivable debt at a discount which is one of the forms of riba prohibited by the Holy Qur'an and Sunnah. Therefore, this concept is not acceptable.

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

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

# 7. SALAM AND ISTISNA

It is one of the basic conditions for the validity of a sale in Shari'ah that the commodity (intended to be sold) must be in the physical or constructive possession of the seller. This condition has three ingredients:

**Firstly,** the commodity must be existing; therefore, a commodity which does not exist at the time of sale cannot be sold.

**Secondly,** the seller should have acquired the ownership of that commodity. Therefore, if the commodity is existing, but the seller does not own it, he cannot sell it to anybody.

**Thirdly,** mere ownership is not enough. It should have come in to the possession of the seller, either physically or constructively. If the seller owns a commodity, but he has not taken its delivery himself or through an agent, he cannot sell it.

There are only two exceptions to this general principle in Shari'ah. One is salam and the other is istisna'. Both are sales of a special nature, and in the present chapter the concept of these two kinds of sale and the extent to which they can be used for the purpose of financing will be explained.

**SALAM**

Salam is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot.

Here the price is cash, but the supply of the purchased goods is deferred. The buyer is called *"rabb-us-salam"*, the seller is *"muslam ilaih"*, the cash price is *"ra's-ul-mal"* and the purchased commodity is termed as *"muslam fih"*, but for the purpose of simplicity, I shall use the English synonyms of these terms.

Salam was allowed by the Holy Prophet صلى الله عليه وسلم subject to certain conditions. The basic purpose of this sale was to meet the needs of the small farmers who needed money to grow their crops and to feed their family upto the time of harvest. After the prohibition of riba they could not take usurious loans. Therefore, it was allowed for them to sell the agricultural products in advance.

Similarly, the traders of Arabia used to export goods to other places and to import some other goods to their homeland. They needed money to undertake this type of business. They could not borrow from the usurers after the prohibition of riba. It was, therefore, allowed for them that they sell the goods in advance. After receiving their cash price, they could easily undertake the aforesaid business.

Salam was beneficial to the seller, because he received the price in advance, and it was beneficial to the buyer also, because normally, the price in salam used to be lower than the price in spot sales. The permissibility of salam was an exception to the general rule that prohibits the forward sales, and therefore, it was subjected to some strict conditions. These conditions are summarized below:

## CONDITIONS OF SALAM

**1.** First of all, it is necessary for the validity of salam that the buyer pays the price in full to the seller at the time of effecting the sale. It is necessary because in the absence of full payment by the buyer, it will be tantamount to sale of a debt against a debt, which is

expressly prohibited by the Holy Prophet صلى الله عليه وسلم. Moreover, the basic wisdom behind the permissibility of salam is to fulfill the instant needs of the seller. If the price is not paid to him in full, the basic purpose of the transaction will be defeated. Therefore, all the Muslim jurists are unanimous on the point that full payment of the price is necessary in salam. However, Imam Malik is of the view that the seller may give a concession of two or three days to the buyers, but this concession should not form part of the agreement.[1]

**2.** Salam can be effected in those commodities only the quality and quantity of which can be specified exactly. The things whose quality or quantity is not determined by specification cannot be sold through the contract of salam. For example, precious stones cannot be sold on the basis of salam, because every piece of precious stones is normally different from the other either in its quality or in its size or weight and their exact specification is not generally possible.

**3.** Salam cannot be effected on a particular commodity or on a product of a particular field or farm. For example, if the seller undertakes to supply the wheat of a particular field, or the fruit of a particular tree, the salam will not be valid, because there is a possibility that the crop of that particular field or the fruit of that tree is destroyed before delivery, and, given such possibility, the delivery remains uncertain. The same rule is applicable to every commodity the supply of which is not certain.[2]

**4.** It is necessary that the quality of the commodity (intended to be purchased through salam) is fully specified leaving no ambiguity which may lead to a dispute. All the possible details in this respect must be expressly mentioned.

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

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

**7.** Salam cannot be effected in respect of things which must be delivered at spot. For example, if gold is purchased in exchange of silver, it is necessary, according to Shari'ah, that the delivery of both be simultaneous. Here, salam cannot work. Similarly, if wheat is bartered for barley, the simultaneous delivery of both is necessary for the validity of sale. Therefore the contract of salam in this case is not allowed.

---

[1] Ibn Qudamah, *Al-Mughni*, 4:328.

[2] See Ibn Qudamah, *Al-Mughni* (Riyadh, 1981), 4:325.

All the Muslim jurists are unanimous on the principle that salam will not be valid unless all these conditions are fully observed, because they are based on the express ahadith of the Holy Prophet صلى الله عليه وسلم. The most famous hadith in this context is the one in which the Holy Prophet صلى الله عليه وسلم has said:

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

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

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

However, the other three schools of Fiqh (i.e. Shafi'i, Maliki, and Hanbali) are of the view that the availability of the commodity at the time of the contract is not a condition for the validity of salam. What is necessary, according to them, is that it should be available at the time of delivery.[5]

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

(2) It is necessary, according to the Hanafi and Hanbali schools that the time of delivery is, at least, one month from the date of agreement. If the time of delivery is fixed earlier than one month, salam is not valid. Their argument is that salam has been allowed for the needs of small farmers and traders and therefore, they should be given enough opportunity to acquire the commodity. They may not be able to supply the commodity before one month. Moreover, the price in salam is normally lower than the price in spot sales. This concession in the price may be justified only when the commodities are delivered after a period which has a reasonable bearing on the prices. A period of less than one month does not normally affect the prices. Therefore, the minimum time of delivery should not be less than one month.[7]

Imam Malik supports the view that there should be a minimum period for the contract of salam. However, he is of the opinion that it should not be less than fifteen days, because the rates of the market may change within a fortnight.[8]

This view is, however, opposed by some other jurists, like Imam Shafi'i and some Hanafi jurists also[9]

---

[3] This hadith is reported by all the six famous books of hadith (see Ibn al- Hummam, *Fat-h al-Qadir*, 6:205).

[4] Al-Kasani, *Bada'i' al-Sana'i'*, 5:211.

[5] Ibn Qudamah, *Al-Mughni,* 4:326.

[6] Ashraf 'Ali Thanawi, *Imdad al-Fatawa*, Vol. 3.

[7] Ibn Qudamah, *Al-Mughni,* 4:323.

[8] Al-Dardir, *Al-Sharh al-Saghir*, 3:275; *al-Khurashi*, 3:20.

[9] Ibn al-Hummam, *Fat-h al Qadir,* 6:219.

They say that the Holy Prophet صلى الله عليه وسلم has not specified a minimum period for the validity of salam. The only condition, according to the Hadith, is that the time of delivery must be clearly defined. Therefore, no minimum period can be prescribed. The parties may fix any date for delivery with mutual consent.

This view seems to be preferable in the present circumstances, because the Holy Prophet صلى الله عليه وسلم has not prescribed a minimum period. The jurists have prescribed different periods which range between one day to one month. It is obvious that they have done so on the basis of expedience and keeping in view the interest of the poor sellers. But the expediency may differ from time to time and from place to place. Likewise, sometimes it is more in the interest of the seller to fix an earlier date. As far as the price is concerned, it is not a necessary ingredient of salam that the price is always lower than the market price on that day. The seller himself is the best judge of his interest, and if he accepts an earlier date of delivery with his free will and consent, there is no reason why he should be forbidden from doing so. Certain contemporary jurists have adopted this view being more suitable for the modern transactions.[10]

**SALAM AS A MODE OF FINANCING**

It is evident from the foregoing discussion that salam was allowed by Shari'ah to fulfill the needs of farmers and traders. Therefore, it is basically a mode of financing for small farmers and traders. This mode of financing can be used by the modern banks and financial institutions, especially to finance the agricultural sector. As pointed out earlier, the price in salam may be fixed at a lower rate than the price of those commodities delivered at spot. In this way, the difference between the two prices may be a valid profit for the banks or financial institutions. In order to ensure that the seller shall deliver the commodity on the agreed date, they can also ask him to furnish a security, which may be in the form of a guarantee or in the form of mortgage or hypothecation.[11] In the case of default in delivery, the guarantor may be asked to deliver the same commodity, and if there is a mortgage, the buyer / the financier can sell the mortgaged property and the sale proceeds can be used either to realize the required commodity by purchasing it from the market, or to recover the price advanced by him.

The only problem in salam which may agitate the modern banks and financial institutions is that they will receive certain commodities from their clients, and will not receive money. Being conversant with dealing in money only, it seems to be cumbersome for them to receive different commodities from different clients and to sell them in the market. They cannot sell those commodities before they are actually delivered to them, because it is prohibited in Shari'ah.

But whenever we talk about the Islamic modes of financing, one basic point should never be ignored. The point is that the concept of the financial institutions dealing in money only is foreign to Islamic Shari'ah. If these institutions want to earn a halal profit, they shall have to deal in commodities in one way or the other, because no profit is allowed in Shari'ah on advancing loans only. Therefore, the establishment of an Islamic economy requires a basic change in the approach and in the outlook of the financial institutions. They shall have to establish a special cell for dealing in commodities. If such a special cell is established, it should not be difficult to purchase commodities through salam and to sell them in the spot markets.

---

[10] Ashraf 'Ali Thanawi, *Imdad al-Fatawa*, Vol. 3.

[11] Ashraf 'Ali Thanawi, *Imdad al-Fatawa*, Vol. 3.

However, there are two other ways of benefiting from the contract of salam.

**Firstly,** after purchasing a commodity by way of salam, the financial institutions may sell it through a parallel contract of salam for the same date of delivery. The period of salam in the second (parallel) transaction being shorter, the price may be a little higher than the price of the first transaction, and the difference between the two prices shall be the profit earned by the institution. The shorter the period of salam, the higher the price, and the greater the profit. In this way the institutions may manage their short term financing portfolios.

**Secondly,** if a parallel contract of salam is not feasible for one reason or another, they can obtain a promise to purchase from a third party. This promise should be unilateral from the expected buyer. Being merely a promise, and not the actual sale, their buyers will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the commodity is received by the institution, it will be sold to the third party at a pre-agreed price, according to the terms of the promise.

A third option is sometimes proposed that, at the date of delivery, the commodity is sold back to the seller at a higher price. But this suggestion is not in line with the dictates of Shari'ah. It is never permitted by the Shari'ah that the purchased commodity is sold back to the seller before the buyer takes its delivery, and if it is done at a higher price it will be tantamount to riba which is totally prohibited. Even if it is sold back to the seller after taking delivery from him, it cannot be pre-arranged at the time of original sale. Therefore, this proposal is not acceptable at all.

## SOME RULES OF PARALLEL SALAM

Since the modern Islamic Banks and Financial Institutions are using the instrument of parallel salam, some rules for the validity of this arrangement are necessary to observe:

**1.** In an arrangement of parallel salam, the bank enters into two different contracts. In one of them, the bank is the buyer and in the second one the bank is the seller. Each one of these contracts must be independent of the other. They cannot be tied up in a manner that the rights and obligations of one contract are dependant on the rights and obligations of the parallel contract. Each contract should have its own force and its performance should not be contingent on the other.

**For example,** if A has purchased from B 1000 bags of wheat by way of salam to be delivered on 31 December, A can contract a parallel salam with C to deliver to him 1000 bags of wheat on 31 December. But while contracting parallel salam with C, the delivery of wheat to C cannot be conditioned with taking delivery from B. Therefore, even if B did not deliver wheat on 31 December, A is duty bound to deliver 1000 bags of wheat to C. He can seek whatever recourse he has against B, but he cannot rid himself from his liability to deliver wheat to C.

Similarly, if B has delivered defective goods which do not conform with the agreed specifications, A is still obligated to deliver the goods to C according to the specifications agreed with him.

**2.** Parallel salam is allowed with a third party only. The seller in the first contract cannot be made purchaser in the parallel contract of salam, because it will be a buy-back contract, which is not permissible in Shari'ah. Even if the purchaser in the second contract is a separate legal entity, but it is fully owned by the seller in the first contract the arrangement will not be allowed, because in practical terms it will amount to 'buy-back' arrangement. For example A has purchased 1000 bags of wheat by way of salam from B, a joint stock company. B has a subsidiary C, which is a separate legal entity but is fully owned by B. A cannot contract the parallel salam with C.

However, if C is not wholly owned by B, A can contract parallel salam with it, even if some shareholders are common between B and C.

**ISTISNA'**

*'Istisna''* is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him with material from the manufacturer, the transaction of istisna' comes into existence. But it is necessary for the validity of istisna' that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

The contract of istisna' creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving a notice to the other.[12] However after the manufacturer has started the work, the contract cannot be cancelled unilaterally.

**DIFFERENCE BETWEEN ISTISNA' AND SALAM**

Keeping in view this nature of istisna' there are several points of difference between istisna' and salam which are summarized below:

**(i)** The subject of istisna' is always a thing which needs manufacturing, while salam can be effected on any thing, no matter whether it needs manufacturing or not.

**(ii)** It is necessary for salam that the price is paid in full in advance, while it is not necessary in istisna'.

**(iii)** The contract of salam, once effected, cannot be cancelled unilaterally, while the contract of istisna' can be cancelled before the manufacturer starts the work.

**(iv)** The time of delivery is an essential part of the sale in salam while it is not necessary in istisna' that the time of delivery is fixed.[13]

**DIFFERENCE BETWEEN ISTISNA' AND IJARAH**

It should also be kept in mind that the manufacturer, in istisna', undertakes to make the required goods with his own material. Therefore, this transaction implies that the manufacturer shall obtain the material, if it is not already with him, and shall undertake the work required for making the ordered goods with it. If the material is provided by the customer, and the manufacturer is required to use his labor and skill only, the transaction is not istisna'. In this case it will be a transaction of ijarah whereby the services of a person are hired for a specified fee paid to him.[14]

---

[12] Ibn 'Abidin, *Radd al-Muhtar,* 5:223.

[13] Ibid., 5:225.

[14] Khalid al-Atasi, *Sharh al-Majallah*, 2:403.

When the required goods have been manufactured by the seller, he should present them to the purchaser. But there is a difference of opinion among the Muslim jurists whether or not the purchaser has a right to reject the goods at this stage. Imam Abu Hanifah is of the view that he can exercise his 'option of seeing' (khiyar-ur-ru'yah) after seeing the goods, because istisna' is a sale and if somebody purchases a thing which is not seen by him, he has the option to cancel the sale after seeing it. The same principle is also applicable to istisna'.

However, Imam Abu Yusuf says that if the commodity conforms to the specifications agreed upon between the parties at the time of the contract, the purchaser is bound to accept the goods and he cannot exercise the option of seeing. This view has been preferred by the jurists of the Ottoman Empire, and the Hanafi law has been codified according to this view, because it is damaging in the context of modern trade and industry that after the manufacturer has used all his resources to prepare the required goods, the purchaser cancels the sale without assigning any reason, even though the goods are in full conformity with the required specifications.[15]

**TIME OF DELIVERY**

As pointed out earlier, it is not necessary in istisna' that the time of delivery is fixed. However, the purchaser may fix a maximum time for delivery which means that if the manufacturer delays the delivery after the appointed time, he will not be bound to accept the goods and to pay the price.[16]

In order to ensure that the goods will be delivered within the specified period, some modern agreements of this nature contain a penal clause to the effect that in case the manufacturer delays the delivery after the appointed time, he shall be liable to a penalty which shall be calculated on daily basis. Can such a penal clause be inserted in a contract of istisna' according to Shari'ah? Although the classical jurists seem to be silent about this question while they discuss the contract of istisna', yet they have allowed a similar condition in the case of ijarah. They say that if a person hires the services of a person to tailor his clothes, the fee may be variable according to the time of delivery. The hirer may say that he will pay Rs. 100/- in case the tailor prepares the clothes within one day and Rs. 80/- in case he prepares them after two days.[17] On the same analogy, the price in istisna' may be tied up with the time of delivery, and it will be permissible if it is agreed between the parties that in the case of delay in delivery, the price shall be reduced by a specified amount per day.

**ISTISNA' AS A MODE OF FINANCING**

Istisna' can be used for providing the facility of financing in certain transactions, especially in the house finance sector. If the client has his own land and he seeks financing for the construction of a house, the financier may undertake to construct the house at that open land, on the basis of istisna', and if the client has no land and he wants to purchase the land also, the financier may undertake to provide him a constructed house on a specified piece of land. Since it is not necessary in istisna' that the price is paid in advance, nor is it necessary that it is paid at the time of delivery, (it may be deferred to any time according to the agreement of the parties)[18], therefore, the time of payment may be fixed in whatever manner they wish. The payment may also be in installments.

---

[15] See *Majallah*, sec. 392 and the introduction.

[16] Ibn 'Abidin, *Radd al-Muhtar,* 5:225.

[17] Ibid., 3:311.

[18] Al-Atasi, Sharh al-Majallah, 2:406.

On the other hand, it is not necessary that the financier himself constructs the house. He can enter into a parallel contract of istisna' with a third party, or may hire the services of a contractor (other than the client). In both cases, he can calculate his cost and fix the price of istisna' with his client in a manner which may give him a reasonable profit over his cost. The payment of installments by the client may start, in this case, right from the day when the contract of istisna' is signed by the parties, and may continue during the construction of the house and after it is handed over to the client. In order to secure the payment of the installments, the title deeds of the house or land, or any other property of the client may be kept by the financier as a security, until the last installment is paid by the client.

The financier, in this case, will be responsible for the construction of the house in full conformity with the specifications detailed in the agreement. In the case of any discrepancy, the financier will undertake such alteration at his own cost as may be necessary for bringing it in harmony with the terms of the contract.

The instrument of istisna' may also be used for project financing on similar lines. If a client wants to install an air-conditioning plant in his factory, and the plant needs to be manufactured, the financier may undertake to prepare the plant through the contract of istisna' according to the aforesaid procedure. Similarly, the contract of istisna' can be used for building a bridge or a highway. The modern BOT (Buy, Operate and Transfer) agreements may also be formalized on the basis of istisna'. If a government wants to construct a highway, it may enter into a contract of istisna' with a builder. The price of istisna', in this case, may be the right of the builder to operate the highway and collect tolls for a specified period.

# 8. ISLAMIC INVESTMENT FUNDS

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

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

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

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

**EQUITY FUND**

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

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

Similarly the contemporary Shari'ah experts are almost unanimous on the point that if all the transactions of a company are in full conformity with Shari'ah, which includes that the company neither borrows money on interest nor keeps its surplus in an interest bearing account, its shares can be purchased, held and sold without any hindrance from the Shari'ah side. But evidently, such companies are very rare in the contemporary stock markets. Almost all the companies quoted in the present stock markets are in some way involved in an activity which violates the injunctions of Shari'ah. Even if the main business of a company is halâl, its borrowings are based on interest'. On the other hand, they keep their surplus money in an interest bearing account or purchase interest-bearing bonds or securities.

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

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

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

Therefore, if a company is engaged in a halâl business, but also keeps its surplus money in an interest-bearing account, wherefrom a small incidental income of interest is received, it does not render all the business of the company unlawful. Now, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own benefit, how can it be said that he has approved the transaction of interest and how can that transaction be attributed to him?

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

Moreover, even though according to the principles of Islamic jurisprudence, borrowing on interest is a grave and sinful act, for which the borrower is responsible in the Hereafter; but, this sinful act does not render the whole business of the borrower as harâm or impermissible.

The borrowed amount being recognized as owned by the borrower, anything purchased in exchange for that money is not unlawful. Therefore, the responsibility of committing a sinful act of borrowing on interest rests with the person who willfully indulged in a transaction of interest, but this fact does render the whole business of a company as unlawful

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

**CONDITIONS FOR INVESTMENT IN SHARES**

**1.** The main business of the company is not violative of Shari'ah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shari'ah, such as companies manufacturing, selling or offering liquors, pork, harâm meat, or involved in gambling, night club activities, pornography etc.

**2.** If the main business of the companies is halâl, like automobiles, textile, etc. but they deposit their surplus amounts in an interest-bearing account or borrow money on interest, the share holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.

**3.** If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given in charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity.

**4.** The shares of a company are negotiable only if the company owns some illiquid assets. If all the assets of a company are in liquid form, i.e. in the form of money they cannot be purchased or sold except at par value, because in this case the share represents money only and the money cannot be traded in except at par.

What should be the exact proportion of illquid assets of a company for warranting the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of illiquid assets must be 51% in the least. They argue that if such assets are less than 50%, then most of the assets are in liquid form, and therefore, all its assets should be treated as liquid on the basis of the juristic principle:

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

Some other scholars have opined that even if the illiquid asset of a company are 33%, its shares can be treated as negotiable.

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

**Firstly,** the illiquid part of the combination must not be in ignore-able quantity. It means that it should be in a considerable proportion.

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

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

The Shari'ah scholars have different views about whether the 'purification' is necessary where the profits are made through capital gains (i.e. by purchasing the shares at a lower price and selling them at a higher price). Some scholars are of the view that even in the case of capital gains, the process of 'purification' is necessary, because the market price of the share may reflect an element of interest included in the assets of the company. The other view is that no purification is required if the share is sold, even if it results in a capital gain. The reason is that no specific amount of the price can be allocated for the interest received by the company. It is obvious that if all the above requirements of the halâl shares are observed, then most of the assets of the company are halâl, and a very small proportion of its assets may have been created by the income of interest. This small proportion is not only unknown, but also ignore-able as compared to bulk of the assets of the company. Therefore, the price of the share, in fact, is against bulk of the assets, and not against such a small proportion. The whole price of the share therefore, may be taken as the price of the halâl assets only.

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

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

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

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

However, it is necessary in Shari'ah to determine any one of the aforesaid methods before the launch of the fund. The practical way for this would be to disclose in the prospectus of the fund the basis on which the fees of the management will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon by all the subscribers.

**IJARAH FUND**

Another type of Islamic Fund may be an ijârah fund. Ijârah means leasing the detailed rules of which have already been discussed in the third chapter of this book. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund which is distributed pro rata to the subscribers.

Each subscriber is given a certificate to evidence his proportionate ownership in the leased assets and to ensure his entitlement to the pro rata share in the income. These certificates may preferably be called *'sukûk'*— a term recognized in the traditional Islamic jurisprudence. Since these sukûk represent the pro rata ownership of their holders in the tangible assets of the fund, and not the liquid amounts or debts, they are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these sukûk replaces the sellers in the pro rata ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him. The price of these sukûk will be determined on the basis of market forces, and are normally based on their profitability.

---

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

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

**1.** The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.

**2.** The leased assets must be of a nature that their halâl (permissible) use is possible.

**3.** The lessor must undertake all the responsibilities consequent to the ownership of the assets.

**4.** The rental must be fixed and known to the parties right at the beginning of the contract.

In this type of the fund the management should act as an agent of the subscribers and should be paid a fee for its services. The management fee may be a fixed amount or a proportion of the rentals received. Most of the Muslim jurists are of the view that such a fund cannot be created on the basis of mudârabah, because mudârabah, according to them, is restricted to the sale of commodities and does not extend to the business of services and leases. However, in the Hanbali school, mudârabah can be effected in services and leases also. This view has been preferred by a number of contemporary scholars.

## COMMODITY FUND

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

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

**1.** The commodity must be owned by the seller at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in Shari'ah.

**2.** Forward sales are not allowed except in the case of salam and istisnâ' (For their full details the previous chapter of this book may be consulted).

**3.** The commodities must be halâl. Therefore, it is not allowed to deal in wines, pork or other prohibited materials.

**4.** The seller must have physical or constructive possession over the commodity he wants to sell. (Constructive possession includes any act by which the risk of the commodity is passed on to the purchaser).

**5.** The price of the commodity must be fixed and known to the parties. Any price which is uncertain or is tied up with an uncertain event renders the sale invalid.

In view of the above and similar other conditions, more fully described in the second chapter of this book, it may easily be understood that the transactions prevalent in the contemporary commodity markets, specially in the futures commodity markets do not comply with these conditions. Therefore, an Islamic Commodity Fund cannot enter into such transactions. However, if there are genuine

commodity transactions observing all the requirements of Shari'ah, including the above conditions, a commodity fund may well be established. The units of such a fund can also be traded in with the condition that the portfolio owns some commodities at all times.

**MURABAHAH FUND**

*Murabahah* is a specific kind of sale where the commodities are sold on a cost-plus basis. This kind of sale has been adopted by the contemporary Islamic banks and financial institutions as a mode of financing. They purchase the commodity for the benefit of their clients, then sell it to them on the basis of deferred payment at an agreed margin of profit added to the cost. If a fund is created to undertake this kind of sale, it should be a closed-end fund and its units cannot be negotiable in a secondary market. The reason is that in the case of murabahah, as undertaken by the present financial institutions, the commodities are sold to the clients immediately after their purchase from the original supplier, while the price being on deferred payment basis becomes a debt payable by the client. Therefore, the portfolio of murabahah does not own any tangible assets. It comprises either cash or the receivable debts, Therefore, the units of the fund represent either the money or the receivable debts, and both these things are not negotiable, as explained earlier. If they are exchanged for money, it must be at par value.

**BAI'-AL-DAIN**

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

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

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

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

**MIXED FUND**

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

# 9. THE PRINCIPLE OF LIMITED LIABILITY

The concept of 'limited liability' has now become an inseparable ingredient of the large scale enterprises of trade and industry throughout the modern world, including the Muslim countries. The present chapter aims to explain this concept and evaluate it from the Shari'ah point of view in order to know whether or not this principle is acceptable in a pure Islamic economy. The limited liability' in the modern economic and legal terminology is a condition under which a partner or a shareholder of a business secures himself from bearing a loss greater than the amount he has invested in a company or partner-ship with limited liability. If the business incurs a loss, the maximum a shareholder can suffer, is that he may lose his entire original investment. But the loss cannot extend to his personal assets, and if the assets of the company are not sufficient to discharge all its liabilities, the creditors cannot claim the remaining part of their receivables from the personal assets of the shareholders.

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

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

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

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

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

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

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

Now, if we accept that a company, in its capacity of a juridical person, has the rights and obligations similar to those of a natural person, the same principle will apply to an insolvent company. A company, after becoming insolvent, is bound to be liquidated: and the liquidation of a company corresponds to the death of a person, because a company after its liquidation, cannot exist any more. If the creditors of a real person can suffer, when he dies insolvent, the creditors of a juridical person may suffer too, when its legal life comes to an end by its liquidation. Therefore, the basic question is whether or not the concept of 'juridical person' is acceptable to Shari'ah. Although the idea of a juridical person, as envisaged by the modern economic and legal systems has not been dealt with in the Islamic Fiqh, yet there are certain prcedents wherefrom the basic concept of a juridical person may be derived by inference.

**WAQF**

The first precedent is that of a *Waqf*. The Waqf is a legal and religious institution wherein a person dedicates some of his properties for a religious or a charitable purpose. The properties, after being declared as Waqf, no longer remain in the ownership of the donor. The beneficiaries of a Waqf can benefit from the corpus or the proceeds of the dedicated property, but they are not its owners. Its ownership vests in Allah Almighty alone. It seems that the Muslim jurists have treated the Waqf as a separate legal entity and have ascribed to it some characteristics similar to those of a natural person. This will be clear from two rulings given by the fuqaha' (Muslim jurists) in respect of Waqf.

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

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

---

[1] *Al-Fatawa al-Hindiyyah*, Waqf, Ch. 5, 2:417.

[2] Ibid., 3:240. See also I*'lã' al-Sunan*, 13:198.

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

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

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

**BAITUL-MAL**

Another example of 'juridical person' found in our classic literature of Fiqh is that of the *Baitul-mal* (the exchequer of an Islamic state).

Being public property, all the citizens of an Islamic state have some beneficial right over the Baitul-mal, yet, nobody can claim to be its owner. Still, the Baitul-mal has some rights and obligations. Imam Al-Sarakhsi, the well-known Hanafi jurist, says in his work "Al- Mabsut":

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

At another place the same author says:

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

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

---

[3] See al-Khurashi's commentary on *Mukhtasar al-Khalil*, 7:80.

[4] Al-Sarakhsi, *al-Mabsut*, 14:33.

[5] Ibid., 3:18.

**JOINT STOCK**

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

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

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

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

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

**INHERITANCE UNDER DEBT**

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

According to the jurists, this property is neither owned by the deceased, because he is no more alive, nor is it owned by his heirs, for the debts on the deceased have a preferential right over the property as compared to the rights of the heirs. It is not even owned by the creditors, because the settlement has not yet taken place.

They have their claims over it, but it is not their property unless it is actually divided between them. Being property of nobody, it has its own existence and it can be termed a legal entity. The heirs of the deceased or his nominated executor will look after the property as managers, but they are not the owners. If the process of the settlement of debt requires some expenses, the same will be met by the property itself.

Looked at from this angle, this 'inheritance under debt' has its own entity which may sell and purchase, becomes debtor and creditor, and has the characteristics very much similar to those of a 'juridical person.' Not only this, the liability of this 'juridical person' is certainly limited to its

existing assets. If the assets do not suffice to settle all the debts, there is no remedy left with its creditors to sue anybody, including the heirs of the deceased, for the rest of their claims.

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

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

**THE LIMITED LIABILITY OF THE MASTER OF A SLAVE**

Here I would like to cite another example with advantage, which is the closest example to the limited liability of a joint-stock company. The example relates to a period of our past history when slavery was in vogue, and the slaves were treated as the property of their masters and were freely traded in. Although the institution of slavery with reference to our age is something past and closed, yet the legal principles laid down by our jurists while dealing with various questions pertaining to the trade of slaves are still beneficial to a student of Islamic jurisprudence, and we can avail of those principles while seeking solutions to our modern problems and in this respect, it is believed that this example is the most relevant to the question at issue. The slaves in those days were of two kinds. The first kind was of those who were not permitted by their masters to enter into any commercial transaction. A slave of this kind was called *'qinn'*. But there was another kind of slaves who were allowed العبد المأذون. by their masters to trade. A slave of this kind was called

The initial capital for the purpose of trade was given to such a slave by his master, but he was free to enter into all the commercial transactions. The capital invested by him totally belonged to his master. The income would also vest in him, and whatever the slave earned would go to the master as his exclusive property. If in the course of trade, the slave incurred debts, the same would be set off by the cash and the stock present in the hands of the slave. But if the amount of such cash and stock would not be sufficient to set off the debts, the creditors had a right to sell the slave and settle their claims out of his price. However, if their claims would not be satisfied even after selling the slave, and the slave would die in that state of indebtedness, the creditors could not approach his master for the rest of their claims.

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

This is the nearest example found in the Islamic Fiqh which is very much similar to the limited liability of the share holders of a company, which can be justified on the same analogy. On the basis of these five precedents, it seems that the concepts of a juridical person and that of limited liability

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

As for the private companies or the partnerships, the concept of limited liability should not be applied to them, because, practically, each one of their shareholders and partners can easily acquire a knowledge of the day-to-day affairs of the business and should be held responsible for all its liabilities. There may be an exception for the sleeping partners or the shareholders of a private company who do not take part in the business practically and their liability may be limited as per agreement between the partners. If the sleeping partners have a limited liability under this agreement, it means, in terms of Islamic jurisprudence, that they have not allowed the working partners to incur debts exceeding the value of the assets of the business. In this case, if the debts of the business increase from the specified limit, it will be the sole responsibility of the working partners who have exceeded the limit.

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

At the end, we should again recall what has been pointed out at the outset. The issue of limited liability, being a modern issue which requires a collective effort to find out its solution in the light of Shari'ah, the above discussion should not be deemed to be a final verdict on the subject. This is only the outcome of an initial thinking which always remains subject to further study and research.

# 10. THE PERFORMANCE OF THE ISLAMIC BANKS - A REALISTIC EVALUATION

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

Once during a press conference in Malaysia, this author was asked the question about the contribution of the Islamic Banks in promoting the Islamic economy. My reply to the question was apparently contradictory, I said it he has contributed a lot and they have contributed nothing. In the present chapter an attempt has been made to elaborate upon this reply. When it was said that they have contributed a lot, what was meant is that it was a remarkable achievement of the Islamic banks that they have made a great break- through in the present banking system by establishing Islamic financial institutions meant to follow Shari'ah. It was a cherished dream of the Muslim Ummah to have an interest-free economy, but the concept of Islamic banking was merely a theory discussed in research papers, having no practical example. It was the Islamic banks and financial institutions which translated the theory into practice and presented a living and practical example for the theoretical concept in an environment where it was claimed that no financial institution can work without interest. It was indeed a courageous step on the part of the Islamic banks to come forward with a firm resolution that all their transactions will conform to Shari'ah and all their activities will be free from all transactions involving interest.

Another major contribution of the Islamic banks is that, being under supervision of their respective Shari'ah Boards they presented a wide spectrum of questions relating to modern business, to the Shari'ah scholars, thus providing them with an opportunity not only to understand the contemporary practice of business and trade but also to evaluate it in the light of Shari'ah and to find out other alternatives which may be acceptable according to the Islamic principles.

It must be understood that when we claim that Islam has a satisfactory solution for every problem emerging in any situation in all times to come, we do not mean that the Holy Qur'an or the

Sunnah of the Holy Prophet صلى الله عليه وسلم or the rulings of the Islamic scholars provide a specific answer to each and every minute detail of our socio-economic life. What we mean is that the Holy Qur'an and the Holy Sunnah of the Prophet صلى الله عليه وسلم have laid down broad principles in the

light of which the scholars of every time have deduced specific answers to the new situation arising in their age. Therefore, in order to reach a definite answer about a new situation the scholars of Shari'ah have to play a very important role. They have to analyze every new question in the light of the principles laid down by the Holy Qur'an and Sunnah as well as in the light of the standards set by the earlier jurists, enumerated in the books of Islamic jurisprudence. This exercise is called istinbat or ijtihad. It is this exercise which has enriched the Islamic jurisprudence with a wealth of knowledge and wisdom for which no parallel is found in any other religion. In a society where the Shari'ah is implemented in its full sway the ongoing process of istinbat keeps injecting new ideas, concepts and rulings into the heritage of Islamic jurisprudence which makes it easier to find out specific answer to almost every situation in the books of Islamic jurisprudence. But during the past few centuries the political decline of the Muslims stopped this process to a considerable extent. Most of the Islamic countries were captured by non-Muslim rulers who by enforcing with power the secular system of government, deprived the socio- economic life from the guidance provided by the Shari'ah, and the Islamic teachings were restricted to a limited sphere of worship, religious education and in some countries to the matter of marriage, divorce and inheritance only. So far as the political and economic activities are concerned the governance of Shari'ah was totally rejected.

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

It is a major contribution of the Islamic banks that, because of their entry into the field of large scale business, the wheel of evolution of Islamic legal system has re-started. Most of the Islamic banks are working under the supervision of their Shari'ah Boards. They bring their day to day problems before the Shari'ah scholars who examine them in the light of Islamic rules and principles and give specific rulings about them. This procedure not only makes Shari'ah scholars more familiar with the new market situation but also through their exercise of istinbat contributes to the evolution of Islamic jurisprudence. Thus, if a practice is held to be un-Islamic by the Shari'ah scholars a suitable alternative is also sought by the joint efforts of the Shari'ah scholars and the management of the Islamic banks. The resolutions of the Shari'ah Boards have by now produced dozens of volumes—a contribution which can never be under-rated.

Another major contribution of the Islamic banks is that they have now asserted themselves in the international market, and Islamic banking as distinguished from conventional banking is being gradually recognized throughout the world. This is how I explain my comment that they have contributed a lot. On the other hand there are a number of deficiencies in the working of the present Islamic banks which should be analyzed with all seriousness.

First of all, the concept of Islamic banking was based on an economic philosophy underlying the rules and principles of Shari'ah. In the context of interest-free banking this philosophy aimed at establishing distributive justice free from all sorts of exploitation. As I have explained in a number of articles, the instrument of interest has a constant tendency in favor of the rich and against the

interests of the common people. The rich industrialists by borrowing huge amounts from the bank utilize the money of the depositors in their huge profitable projects. After they earn profits, they do not let the depositors share these profits except to the extent of a meager rate of interest and this is also taken by them by adding it to the cost of their products. Therefore, looked at from macro level, they pay nothing to the depositors. While in the extreme cases of losses which lead to their bankruptcy and the consequent bankruptcy of the bank itself, the whole loss is suffered by the depositors. This is how interest creates inequity and imbalance in the distribution of wealth.

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

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

**Firstly,** the basic philosophy of Islamic banking seems to be totally neglected.

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

**Thirdly,** when people realize that income from in the transactions undertaken by Islamic banks is dubious akin to the transactions of conventional banks, they become skeptical towards the functioning of Islamic banks.

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

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

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

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

In some cases the client himself is made an agent for the bank to purchase a commodity and to sell it to himself immediately after acquiring the commodity. This is not in accordance with the basic conditions of the permissibility of murabahah. If the client himself is made an agent to purchase the commodity, his capacity as an agent must be distinguished from his capacity as a buyer which means that after purchasing commodity on behalf of the bank he must inform the bank that he has effected the purchase on its behalf and then the commodity should be sold to him by the bank through a proper offer and acceptance which may be effected through the exchange of telexes or faxes.

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

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

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

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

The case of Islamic banking cannot be advanced unless a strong system of inter-bank transactions based on Islamic principles is developed. The lack of such a system forces the Islamic banks to turn to the conventional banks for their short term needs of liquidity which the conventional banks do not provide without either an open or camouflaged interest. The creation of an inter- bank relationship based on Islamic principles should no longer be deemed difficult. The number of Islamic financial institutions today has reached around two hundred. They can create a fund with a mixture of murabahah and ijarah instruments the units of which can be used even for overnight transactions. If they develop such a fund it may solve a number of problems.

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

The purpose of this discussion, as clarified at the outset, is by no means to discourage the Islamic Banks or to find faults with them.

The only purpose is to persuade them to evaluate their own performance from the Shari'ah point of view and to adopt a realistic approach while designing their procedure and determining their policies.

# ISLAMIC FINANCE CONTRACTS

**Reprinted with permission of the State Bank of Pakistan**

**DISCLAIMER:** These contracts are provided for sample purposes only. They should not be duplicated without the consideration of a particular situation. One should always seek the expert legal opinion of, at minimum, a qualified Islamic finance scholar and a registered legal counsel for the relevant jurisdiction. Laws vary by jurisdiction and certain provisions in this sample contract may not be enforceable in some jurisdictions. These sample contracts are for illustrative purposes only and its user indemnifies the sender for any wrongdoing.

# MODEL MUSAWAMAH FACILITY AGREEMENT

**Document 1**

**THIS MUSAWAMA FACILITY AGREEMENT**

**(this "Agreement") is made at_____ on _____ day of _____ by and**

**BETWEEN**

_____, (hereinafter referred to as the "Client" which expression shall where the context so permits mean and include its successors in interest and permitted assigns) of the one part

**AND**

_____, (hereinafter referred to as the "Institution" which expression shall where the context so permits mean and include its successors in interest and assigns) of the other part.

**IT IS AGREED BY THE PARTIES** as follows:

**1. PURPOSE AND DEFINITIONS**

**1.01** This Agreement sets out the terms and conditions upon and subject to which the Institution has agreed to purchase the Goods from time to time from the Suppliers and upon which the Institution has agreed to sell the same to the Client from time to time by way of Musawamah facility.

**1.02** In this Agreement, unless the context otherwise requires:

**"Act"** means the Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997 or any statutory modification or re-promulgation thereof;

**"Agent"** means the person appointed under the terms of the Agency Agreement;

**"Agency Agreement"** means the Agency Agreement between the Institution and the person appointed as Agent (which may be the Client) as provided in the Musawamah Document # 2;

**"Business Day"** means a day on which banks are open for normal business in Pakistan;

**"Cost Price"** means the amount which may be incurred by and/or on behalf of the Institution for the acquisition of Goods plus all costs, duties, taxes and charges incidental to and connected with acquisition of Goods;

**"Contract Price"** means the price payable by the Client to the Institution for Goods as stipulated in Part-III of the Declaration (Musawamah Document # 5) to be issued by the Institution from time to time;

**"Declaration"** means Declaration as set out in Musawamah Document # 5;

**"Event of Default"** means any of the events or circumstances described in Clause 9 hereto;

**"Goods"** means the Goods as may be specified in the Purchase Requisition(s) to be issued by the Client from time to time;

**"Indebtedness"** means any obligation of the Client for the payment or any sum of money due or, payable under this Agreement;

**"License"** means any license, permission, authorization, registration, consent or approval granted to the Client for the purpose of or relating to the conduct of its business;

**"Lien"** shall mean any mortgage, charge, pledge, hypothecation, security interest, lien, right of set-off, contractual restriction (such as negative covenants) and any other encumbrance;

**"Payment Date"** or "Payment Dates" means the respective dates for the payment of the installments of the Contract Price or part thereof by the Client to the Institution as specified in Musawamah Document # 6 hereto, or, if such respective due date is not a Business Day, the next Business Day;

**"Profit"** means any part of the Contract Price which is not a part of the Cost Price;

**"Parties"** mean the parties to this Agreement;

**"Principal Documents"** means this Agreement, the Agency Agreement; and the Security Documents;

**"Promissory Note"** is defined in Clause 3.02 and is negotiable only at the face value, if required;

**"Prudential Regulations"** means Prudential Regulations or other regulations as are notified from time to time by State Bank of Pakistan;
**"Purchase Requisition"** means a request from time to time by the Client to the Institution as per Musawama Document # 3/1;

**"Security Documents"** and "Security" is defined in Clause 3;

**"Supplier"** means the supplier from whom the Institution acquires Title to the Goods;

**"Secured Assets"** means (insert description of assets in respect of which charge/mortgage may be created) offered as security by the Client;

**"Receipt"** means a confirmation by the Agent of the Institution, of receipt of funds by the Supplier for the supply of Goods Musawamah Document # 4.

**"Rupees"** or "Rs." means the lawful currency of Pakistan;

**"State Bank of Pakistan"** means the State Bank of Pakistan;

**"Title"** means such title or other interest in the Goods as the Institution receives from the Supplier;

**"Taxes"** includes all present and future taxes (including central excise duty and sales tax), levies, imposts, duties, stamp duties, penalties, fees or charges of whatever nature together with delayed payment charges thereon and penalties in respect thereof and "Taxation" shall be construed accordingly;

**"Value Date"** means the date on which the Cost Price will be disbursed by the Institution as stated in the Purchase Requisition.

**1.03** Clause headings and the table of contents are inserted for convenience of reference only and shall be ignored in the interpretation of this Agreement. In this Agreement, unless the context otherwise requires, references to Clauses and Musawamah Documents are to be construed as references to the clauses of, and Musawamah Documents to, this Agreement and references to this Agreement include its Musawamah Documents; words importing the plural shall include the singular and vice versa and reference to a person shall be construed as including references to an individual, firm, Institution, corporation, unincorporated body of persons or any state or any Agency thereof.

**1.04** The recitals herein above and Musawamah Documents to this Agreement shall form an integral part of this Agreement.

**2. SALE AND PURCHASE OF THE GOODS**

**2.01** The Institution agrees to sell the Goods to the Client to a maximum amount of Rs_____ and the Client agrees to purchase the Goods from the Institution from time to time at the Contract Price. Upon receipt by the Institution of the Client's Purchase Requisition advising the Institution to purchase the Goods and make payment therefor, the Institution shall acquire the Goods either directly or through the Agent, the payment for which shall be made by the institution to the Supplier. The Receipt for such payment shall be acknowledged by the Client in his capacity as an Agent to the Institution, should he be so appointed as an Agent of the Institution. The said Receipt shall be substantially in a form given in Musawamah Document # 4.

**2.02.1** After the purchase of Goods by the Institution, the Client shall offer to purchase the Goods from the Institution at the Contract Price in the manner provided in the Part-II of the Declaration.

**2.03** The Client shall purchase the Goods from the Institution after the Institution has beneficially acquired the Goods. The Musawamah purchase of the Client from the Institution shall be effected by the exchange of an offer and acceptance between the Client and the Institution. The Goods shall remain at the risk of the Institution until such time the client has accepted the offer made by the Institution as set out in the Appendix C of this Agreement, immediately after which, all risks in respect of the Goods shall be passed on to the Client.

OR (to be applicable if sale is being made from inventory of the institution)

**2.04** The Institution has agreed to sell the Goods to the Client and the Client has agreed to purchase the Goods from the Institution for the Contract Price. Upon receipt by the Institution of the Client's Purchase Requisition advising the Institution of its requirements, the Institution shall deliver the Goods to the client. The title of Goods shall stand transferred to the Client as per agreed terms of delivery

**3. SECURITY**

**3.01** As security for the indebtedness of the Client under this Agreement, the Client shall:-

**(a)** Furnish to the Institution collateral(s)/security(ies), substantially in the form and substance attached hereto as Musawamah Document # 7;

**(b)** Execute such further deeds and documents as may from time to time be required by the Institution for the purpose of more fully securing and or perfecting the security created in favour of the Institution; and

**(c)** Create such other securities to secure the Client's obligations under the Principal Documents as the parties hereto, may by mutual consent agree from time to time.

(The above are hereinafter collectively referred to as the "Security").

**3.02** In addition to above, the Client shall execute a demand promissory note in favour of the Institution for the amount of the Contract Price (the "Promissory Note");

(The Security and the Promissory Note are hereinafter collectively referred to as the "Security Documents").

**4. FEES AND EXPENSES**

The Client shall pay to the Institution on demand within 15 days of such demand being made, all expenses (including legal and other ancillary expenses) incurred by the Institution in connection with the negotiation, preparation and execution of the Principal Documents and of amendment or extension of or the granting of any waiver or consent under the Principal Documents.

**5. PAYMENT OF CONTRACT PRICE**

**5.01** All payments to be made by the Client under this Agreement shall be made in full, without any set-off, roll over or counterclaim whatsoever, on the due date and when the due date is not a Business Day, the following Business Day and save as provided in Clause 5.02, free and clear of any deductions or withholdings, to a current account of the Institution as may be notified from time to time, and the Client will only be released from its payment obligations hereunder by paying sums due into the aforementioned account.

**5.02** If at any time the Client is required to make any non refundable and non-adjustable deduction or withholding in respect of Taxes from any payment due to the Institution under this Agreement, the sum due from the Client in respect of such payment shall be increased to the extent necessary to ensure that, after the making of such deduction or withholding, the Institution receives on the Payment Date, a net sum equal to the sum which it would have received had no such deduction or withholding been required to be made and the Client shall indemnify the Institution against any losses or costs incurred by the Institution by reason of any failure of the Client to make any such deduction or withholding. The Client shall promptly deliver to the Institution any receipts, certificates or other proof evidencing the amounts (if any) paid or payable in respect of any deduction or withholding as aforesaid.

**6. REPRESENTATIONS AND WARRANTIES**

The Client warrants and represents to the Institution that:

**a.** The execution, delivery and performance of the Principal Documents by the Client will not

**(i)** contravene any existing law, regulations or authorization to which the Client is subject
**(ii)** result in any breach of or default under any agreement or other instrument to which the Client is a party or is subject to, or

**(iii)** contravene any provision of the constitutive documents of the Client or any resolutions adopted by the board of directors or members of the Client;

**b.** The financial statements submitted together with the notes to the accounts and all contingent liabilities and assets that are disclosed therein represent a true and fair financial position of the business and to the best of the knowledge of the client, its directors and principal officers, there are no material omissions and/or mis-representations;

**c.** All requisite corporate and regulatory approvals required to be obtained by the Client in order to enter into the Principal Documents are in full force and effect and such approvals permit the Client, inter alia, to obtain financial facilities under this Agreement and perform its obligations hereunder and that the execution of the Principal Documents by the Client and the exercise of its rights and performance of its obligations hereunder, constitute private and commercial acts done for private and commercial purposes;

**d.** No material litigation, arbitration or administrative proceedings is pending or threatened against the Client or any of its assets;

**e.** It shall inform the Institution within ____ business days of an event or happening which may have an adverse effect on the financial position of the company, whether such an event is recorded in the financial statements or not as per applicable International Accounting Standards.

**7. UNDERTAKING**

The Client covenants to and undertakes with the Institution that so long as the Client is indebted to the Institution in terms of this Agreement:

**a)** It shall inform the Institution of any Event of Default or any event, which with the giving of notice or lapse of time or both would constitute an Event of Default forthwith upon becoming aware thereof;

**b)** It shall provide to the Institution, upon written request, copies of all contracts, agreements and documentation relating to the purchase of the Goods;

**c)** The Client shall do all such things and execute all such documents which in the judgment of the Institution may be necessary to;

**(i)** enable the Institution to assign or otherwise transfer the liability of the Client in respect of the Contract Price to any creditor of the Institution or to any third party as the Institution may deem fit at its absolute discretion;

**(ii)** create and perfect the Security;

**(iii)** maintain the Security in full force and effect at all times including the priority thereof;

**(iv)** maintain, insure and pay all Taxes assessed in respect of the Secured Assets and protect and enforce its rights and title, and the rights of the Institution in respect of the Secured Assets, and;

**(v)** preserve and protect the Secured Assets. The Client shall at its own expense cause to be delivered to the Institution such other documentation and legal opinion(s) as the Institution may reasonably require from time to time in respect of the foregoing;

**d)** It will satisfactorily insure all its insurable assets with reputable companies offering protection under the Islamic concept of Takaful. The Secured Assets shall be comprehensively insured (with a reputable insurance company to the satisfaction of the Institution) against all insurable risks, which may include fire, arson, theft, accidents, collision, body and engine damage, vandalism, riots and acts of terrorism, and to assign all policies of insurance in favour of the Institution to the extent of the amount from time to time due under this Agreement, and to cause the notice of the interest of the Institution to be noted on the policies of insurance, and to punctually pay the premium due for such insurances and to contemporaneously therewith deliver the premium receipts to the Institution. Should the Client fail to insure or keep insured the Secured Assets and/or to deliver such policies and premium receipts to the Institution, then it shall be lawful for the Institution, but not obligatory, to pay such premia and to keep the Secured Assets so insured and all cost charges and expenses incurred by it for the purpose shall be charged to and paid by the Client as if the same were part of the Indebtedness. The Client expressly agrees that the Institution shall be entitled to adjust, settle or compromise any dispute with the insurance company(ies) and the insurance arising under or in connection with the policies of insurance and such adjustments/compromises or settlements shall be binding on the Client and the Institution shall be entitled to appropriate and adjust the amount, if any received, under the aforesaid policy or policies towards part or full satisfaction of the Client's indebtedness arising out of the above arrangements and the Client shall not raise any question or objection that larger sums might or should have been received under the aforesaid policy nor the Client shall dispute its liability(ies) for the balance remaining due after such payment/adjustment;

**e)** Except as required in the normal operation of its business, the Client shall not, without the written consent of the Institution, sell, transfer, lease or otherwise dispose of all or a sizeable part of its assets, or undertake or permit any merger, consolidation, dismantling or re organization which would materially affect the Client’s ability to perform its obligations under any of the Principal Documents;

**f)** The Client shall not (and shall not agree to), except with the written consent of the Institution, create, incur, assume or suffer to exist any Lien whatsoever upon or with respect to the Secured Assets and any other assets and properties owned by the Client which may rank superior, pari passu or inferior to the security created or to be created in favour of the Institution pursuant to the Principal Documents;

**g)** It shall forthwith inform the Institution of:

**i)** event or factor, any litigation or proceedings pending or threatened against the Client which could materially and adversely affect or be likely to materially and adversely affect:

**(a)** the financial condition of the Client;
**(b)** business or operations of the Client; and
**(c)** the Client's ability to meet its obligations when due under any of the Principal Documents;

**ii)** Any change in the directors of the Client;

**iii)** Any actual or proposed termination, rescission, discharge (otherwise than by performance), amendment or waiver or indulgence under any material provision of any of the Principal Documents;

**iv)** Any material notice or correspondence received or initiated by the Client relating to the License, consent or authorization necessary for the performance by the Client of its obligations under any of the Principal Documents

**8. CONDITIONS PRECEDENT**

**8.01** The obligation of the Institution to pay the Cost Price shall be subject to the receipt by the Institution (in form and substance acceptable to the Institution) at least ___ Business Days prior to the Value Date of:

a) Documentary evidence that:

**i)** This Agreement and the Agency Agreement (should the Institution appoint the Client as its Agent) have been executed and delivered by the Client;

**ii)** The Client's representatives are duly empowered to sign the Principal Documents for and on behalf of the Client and to enter into the covenants and undertakings set out herein or which arise as a consequence of the Client entering into the Principal Documents;

**iii)** The Client has taken all necessary steps and executed all documents required under or pursuant to the Principal Documents or any documents creating or evidencing the Security in favour of the Institution and has perfected the Security as required by the Institution.

**b)** Certified copy of the Memorandum and Articles of Association of the Client.

**c)** Certified copies of the Client's audited financial statements for the last ____ years

**d)** The Purchase Requisition.

**8.02** The obligation of the Institution to pay the Cost Price on the Value Date shall be further subject to the fulfillment of the following conditions (as shall be determined by the Institution in its sole discretion):

**a)** The payment of Cost Price by the Institution to the Supplier on the Value Date shall not result in any breach of any law or existing agreement;

**b)** The Security has been validly created, perfected and is subsisting in terms of this Agreement;

**c)** The Institution has received such other documents as it may reasonably require in respect of the payment of the Cost Price;

**d)** No event or circumstance which constitutes or which with the giving of notice or lapse of time or both, would constitute an Event of Default shall have occurred and be continuing or is likely to occur and that the payment of the Cost Price shall not result in the occurrence of any Event of Default;

**e)** Delivery by the Client to the Institution of a true and complete extract of all relevant parts of the minutes of a duly convened meeting of its Board of Directors approving the Principal Documents and granting the necessary authorizations for entering into, execution and delivery of the Principal Documents which shall be duly signed and certified by the person authorised by the Board for this purpose;

**f)** All fees, commission, expenses required to be paid by the Client to the Institution have been received by the Institution.

**8.03** Any condition precedent set forth in this Clause 8 may be waived and or modified by the mutual written consent of the parties hereto.

**9. EVENTS OF DEFAULT**

**9.01** There shall be an Event of Default if in the opinion of the Institution

**(a)** Any representation or warranty made or deemed to be made or repeated by the Client in or pursuant to the Principal Documents or in any document delivered under this Agreement is found to be incorrect;

**(b)** Any Indebtedness of the Client to the Institution in excess of Rs._____ (Rupees _____only) is not paid when due or becomes due or capable of being declared due prior to its stated maturity;

**9.02** Notwithstanding anything contained herein, the Institution may without prejudice to any of its other rights, at any time after the happening of an Event of Default by notice to the Client declare that entire amount by which the Client is indebted to the Institution shall forthwith become due and payable.

**10. PENALTY**

**10.1** Where any amount is required to be paid by the Client under the Principal Documents on a specified date and is not paid by that date, or an extension thereof, permitted by the Institution without any increase in the Contract Price, the Client hereby undertakes to pay directly to the Charity Fund, constituted by the Institution, a sum calculated @ ------% per annum for the entire period of default, calculated on the total amount of the obligations remaining un-discharged. The Charity Fund shall be used at the absolute discretion of the Institution, exclusively for the purposes of approved charity.

**10.2** In case

**(i)** any amount(s) referred to in clause 10.01 above, including the amount undertaken to be paid directly to the Charity Fund, by the Client, is not paid by him, or

**(ii)** the Client delays the payment of any amount due under the Principal Documents and/ or the payment of amount to the Charity Fund as envisaged under Clause 10.01 above, as a result of which any direct or indirect costs are incurred by the Institution, the Institution shall have the right to approach a competent Court

**(i)** for recovery of any amounts remaining unpaid as well as

**(ii)** for imposing of a penalty on the Client. In this regard the Client is aware and acknowledges that notwithstanding the amount paid by the Client to the Charity Fund of the Institution, the Court has the power to impose penalty, at its discretion, and from the amount of such penalty, a smaller or bigger part, depending upon the circumstances, can be awarded as solatium to the Institution, determined on the basis of direct and indirect costs incurred, other than the opportunity cost.

**11. INDEMNITIES**

The Client shall indemnify the Institution against any expense which the Institution shall prove as rightly incurred by it as a consequence of:

**(i)** the occurrence of any Event of Default,
**(ii)** the purchase and sale of Goods or any part thereof by the Client or the ownership thereof, and
**(iii)** any mis-representation.

**12. SET-OFF**

The Client authorizes the Institution to apply any credit balance to which the Client is entitled or any amount which is payable by the Institution to the Client at any time in or towards partial or total satisfaction of any sum which may be due or payable from the Client to the Institution under this Agreement.

**13. ASSIGNMENT**

**13.01** This Agreement shall be binding upon and inure to the benefit of and be enforceable by the Institution, the Client, and respective successors permitted assigns and transferees of the parties hereto, provided that the Client shall not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Institution. The Institution may assign all or any part of its rights or transfer all or any part of its obligations and/or commitments under this Agreement to any Institution, or other person. The Client shall not be liable for the costs of the assignment and/or transfer of commitments hereunder by the Institution. If the Institution assigns all or any part of its rights or transfers all or any part of its obligations and commitments as provided in this Clause, all relevant references in this Agreement to the Institution shall thereafter be construed as a reference to the Institution and/or its assignee(s) or transferee(s) (as the case may be) to the extent of their respective interests.

**13.02** The Institution may disclose to a potential assignee or transferee or to any other person who may propose entering into contractual relations with the Institution in relation to this Agreement such information about the Client as the Institution shall consider appropriate.

**14. FORCE MAJEURE**

Any delays in or failure by a Party hereto in the performance hereunder if and to the extent it is caused by the occurrences or circumstances beyond such Party's reasonable control, including but not limited to, acts of God, fire, strikes or other labor disturbances, riots, civil commotion, war (declared or not) sabotage, any other causes, similar to those herein specified which cannot be controlled by such Party.

The Party affected by such events shall promptly inform the other Party of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall consult each other to decide whether to terminate this Agreement or to discharge part of the obligations of the affected Party or extend its obligations on a best effort and on an arm's length basis.

**15. GENERAL**

**15.01** No failure or delay on the part of the Institution to exercise any power, right or remedy under this Agreement shall operate as a waiver thereof nor a partial exercise by the Institution of any power, right or remedy preclude any other or further exercise thereof or the exercise of any other power right or remedy. The remedies provided in this Agreement are cumulative and are not exclusive of any remedies provided by law;

**15.02** This Agreement represents the entire agreement and understanding between the Parties in relation to the subject matter and no amendment or modification to this Agreement will be effective or binding unless it is in writing, signed by both Parties and refers to this Agreement;

**15.03** This Agreement is governed by and shall be construed in accordance with Pakistan law. All competent courts at _____ shall have the non-exclusive jurisdiction to hear and determine any action, claim or proceedings arising out of or in connection with this Agreement.

**15.04** Nothing contained herein shall prejudice or otherwise affect the rights and remedies that may otherwise be available under law to the parties.

**15.05** Any reconstruction, division, re-organization or change in the constitution of the Institution or its absorption in or amalgamation with any other person or the acquisition of all or part of its undertaking by any other person shall not in any way prejudice or affect its rights hereunder.

**15.06** The two parties agree that any notice or communication required or permitted by this agreement shall be deemed to have been given to the other party seven days after the same has been posted by registered mail or the next Business Day if given by a fascimile message to telex or by any other electronic means, or the next Business Day as counted from the date of delivery if delivered by courier mail;

**IN WITNESS WHEREOF**, the Parties to this Agreement have caused this Agreement to be duly executed on the date and year first aforementioned.

| | **WITNESSES:** | For and on behalf of [insert name of the Institution] |
|---|---|---|
| 1 | _____ | _____ |
| 2 | _____ | _____ |
| | | For and on behalf of |
| 1 | _____ | _____ |
| 2 | _____ | _____ |

**Document 2**

**AGENCY AGREEMENT**
**(If Required)**

With reference to the Musawamah Facility Agreement dated _____ , we hereby confirm our agreement to appoint you as our Agent to acquire for our account and benefit goods of the description to be specified in the purchase requisition which shall be issued from time to time, under the following terms and conditions;

**1.** As an Agent of the Institution, you will be responsible to receive the Goods directly from the Supplier (s) from time to time in terms of Purchase Requisition(s) to be duly endorsed by the Institution and provide us a declaration confirming acquisition thereof, alongwith a statement containing relevant details including place of storage.

**2.** At your request, we will effect payment(s) directly to the Supplier(s) nominated by you, for the Goods to be specified in the Purchase Requisition. All Purchase Requisitions shall be accompanied by quotation(s) from the Supplier(s). All payments to Supplier(s) shall be evidenced by a Receipt to be signed by you, in your capacity as an Agent of the Institution.

**3.** In case of failure on your part to:-

**a)** acquire goods in terms of this agreement and to refund, in consequence, the amount paid by us (the Institution) therefore, and/or

**b)** repay the amount, if any, due from you upon a notice of revocation, if any, served by you in the manner provided hereunder;

You shall become liable to pay a penalty to the institution by credit to a special Account, separately maintained by the institution, an amount which shall be 5% over the rate announced by State Bank of Pakistan for providing short term accommodation to commercial banks, as on the date of such default by you.

This amount will be calculated on the entire amount due from you, under this Agency Agreement and for the entire period for which the default subsists. The amount of such penalty shall be utilized by the institution only for the purposes of charity, in its absolute discretion.

**4.** The Institution shall have the authority, in its absolute discretion to refuse the disbursement of funds or to revoke this Agency Agreement at any time., subject to a notice in writing served given at least 07 days prior to revocation.

**5.** You may revoke this Agency Agreement by giving a notice in writing of at least 07 days prior to the date of intended revocation, provided that any amount due by you to the Institution shall become payable immediately and until such time that any such amount due from you has been discharged in full, this agreement shall not be deemed to have been revoked.

**6.** This Agency Agreement shall remain in force until revoked and shall be governed by the prevailing laws of Pakistan and the Musawamah Facility Agreement dated _____. Any dispute between the parties shall be submitted to a Court/Tribunal of competent jurisdiction in _____.

Kindly signify your acceptance of the foregoing terms and conditions by signing the duplicate.

For and on behalf of (insert name of the Institution)

_____

**AUTHORISED SIGNATORY OF THE INSTITUTION**

**AGREED AND ACCEPTED**

For and on behalf of [insert name]

_____

**AUTHORISED SIGNATORY OF THE AGENT**

| | **WITNESSES:** |
|---|---|
| | |
| 1 | _____ |
| 2 | _____ |
| | |
| | |

**Document 3.1**

**PURCHASE REQUISITION**

S. No. _____
Date: _____

To:
_____ [Insert name and address of the Institution]
_____
_____

Dear Sirs,

**PURCHASE REQUISITION FOR PURCHASE OF THE GOODS**
**MUSAWAMAH FACILITY AGREEMENT DATED_____**

**(1)** Please refer to the Musawamah Facility Agreement dated [_____] (the "**Agreement**") between [insert name of the Client] (the "**Client**") (of the first part) and [insert name of the Institution] (the "**Institution**") (of the second part).

**(2)** All terms defined in the Agreement bear the same meanings herein.

**(3)** The Client hereby requests you to purchase the Goods from the Suppliers as per the provisions of the Agreement as follows:

**(a)** Goods as detailed in Musawamah Document # 3/2:

**(b)** Value Date: _____

**(4)** Please make arrangements to pay the Cost Price to the account of _____on the Value Date in immediately available funds.

**(5)** All the terms and conditions of the Agreement shall form an integral part of this Requisition.

Yours faithfully,

For and on Behalf of the Client

_____

**Institution's instructions**

No. _____
Date: _____

Dear Sir,

You are hereby instructed to execute the aforesaid Purchase Requisition for and on our behalf in the manner, to the extent and for the Goods stipulated therein.

For and on Behalf of

_____
(Insert Institution's name)

**Document 3.2**

**DETAILS OF GOODS TO BE PURCHASED**
**(To be attached to Purchase Requisition)**

Name of Supplier: _____ Date:_____

Address: _____

| Sr. No. | Specifications of Goods | Quantity Requisitioned | Cost | Quantity Received | Cost |
|---|---|---|---|---|---|

**Document 4**

**R E C E I P T**

Received with thanks from _____branch, a sum of Rs. _____(Rupees _____only) for the purchase of goods in respect of which a Quotation dated _____has been issued by M/s. _____

In the event of failure on the part of the Supplier to supply the said goods within the period specified in the Purchase Requisition, I/We undertake and agree to refund/reimburse _____the full amount of Rs._____ and all cost and consequences under and in terms of the Agency Agreement.

For and on behalf of
[Insert name of the Agent)

_____
Authorized Signatory
Date: _____

**Document 5**

**DECLARATION**

**(Part-I)**
**CONFIRMATION OF GOODS PURCHASED**

Date: _____

Messrs. _____
_____

With reference to the Agency Agreement dated _____ and the Institution's instructions contained in Musawamah Document # 3/1, we hereby declare and certify that acting as your Agent, we have used the sum of Rs. _____ paid by your good selves to M/s _____ and purchased on your behalf the Goods as detailed in Musawamah Document # 3/2).

A sum of Rs._____ has been incurred for the purchase of the Goods, which are in my/ our possession at the following address:
_____.

Copies of bill/cash memo/invoice issued in your name by M/s. _____ are attached.

For and on behalf of [insert Agent's name]

_____
**AUTHORISED SIGNATORY**

**(Part-II)**

**OFFER TO PURCHASE**

I/We offer to purchase the above Goods from you for a Contract Price of Rs._____ (Rupees _____only).

I/We undertake to pay the Contract Price referred to above in lump sum on , or in _____ installments, if agreed by the Institution, as per the attached schedule (Musawamah Document # 6).

For and on behalf of [Insert Agent's name]

_____
**AUTHORISED SIGNATORY**

Date: _____

**(Part-III)**

**INSTITUTION'S ACCEPTANCE**

We have accepted your offer and have sold the above mentioned Goods to you on the following terms and conditions.

1) The Contract Price is Pak Rs._____ (Rupees _____only) inclusive of Sales Tax Rs._____.

2) The Contract Price stated above shall be payable in lump sum on _____ or in ___installments, as per the attached schedule (Musawamah Document # 6).

For and on behalf of [Insert name of the Institution]

| **AUTHORISED SIGNATORY** | **AUTHORISED SIGNATORY** |
|---|---|
| Date:_____ | Date:_____ |

**Document 6**

**SCHEDULE OF PAYMENTS OF CONTRACT PRICE**

| **Payment Date** | **Installment Amount** |
|---|---|
| | |
| | |

**Document 7**

**SCHEDULE OF SECURITY**

| **Description of Security** | **Nature of Charge** |
|---|---|
| | |
| | |

# MODEL MUSHARAKAH INVESTMENT AGREEMENT

**THIS AGREEMENT IS MADE**

AT_____ this _____ day of _____ 20XX

**BETWEEN**

_____Limited, a duly incorporated company having its registered office at _____hereinafter referred to as "the Client" (which expression shall wherever the context so requires or permits mean and include its successors-in-interest and assigns) of the ONE PART

**AND**

_____Institution (or financial institution), a duly incorporated banking company (or financial institution) having its registered office at _____ hereinafter referred to as "the Institution" (which expression shall wherever the context so requires or permits mean and include its successors-in-interest and assigns) of the OTHER PART:

WHEREAS the parties hereto have agreed that the Institution shall provide finance to the Client on profit and loss sharing basis on the terms and conditions hereinafter appearing.

**NOW, THEREFORE, THIS AGREEMENT WITNESSETH AS UNDER: -**

1. PURPOSE AND DEFINITIONS

This Agreement sets out the terms and conditions upon and subject to which the Institution has agreed to finance the Client by way of Musharaka investment.

**1.02** In this Agreement, unless the context otherwise requires:

**"Business Day"** means a day, on which Banks are open for normal business in Pakistan,

**"Client's Investment"** mean is defined in clause 4 (ii),

**“Financial Statements”** shall mean the client’s Balance Sheet, Profit & Loss Account, Cash Flow statement and statement of changes in equity.

**“Institution’s Investment”** is defined in Clause 2,

**“License"** means any license, permission, authorization, registration, consent or approval granted to the Client for the purpose of or relating to the conduct of its business,

**"Lien"** shall mean any mortgage, charge, pledge, hypothecation, security interest, lien, right of set-off, contractual restriction (such as negative covenants) and any other encumbrance,

**“Musharaka Capital”** means the sum of Client’s Investment, Institution’s Investment and the other PLS Funds, if any;

**“NBFIs”** means non-banking financial institutions as notified from time to time by State Bank of Pakistan or SECP

**“Other PLS Funds”** is defined in clause 4(iii)

**"Parties"** means the parties to this Agreement,

**"Principal Documents"** means this Agreement, and the Security Documents,

**"Prudential Regulations"** means Prudential Regulations or other regulations as are notified from time to time by the concerned regulatory authorities for banks or NBFIs.

**"Security Documents"** means such deeds and documents as the Institution may require the Client to furnish or execute under this Agreement.

**"Security"** is defined in Clause 15.

**"Secured Assets"** means all the Client's (insert description of the proposed securities)

**"Rupees"** or **"Rs."** means the lawful currency of Pakistan

**"State Bank of Pakistan"** means the State Bank of Pakistan,

**“SEC”** means the Securities and Exchange Commission of Pakistan established under the Securities & Exchange Commission of Pakistan Act, 1997 and includes any successors thereto;

**"Written Request"** means request by the Client to the Institution.

**2.** The Institution hereby agrees at written request of the Client to provide financing up to a sum of Rs. _____ (Rupees _____ only) on the terms and conditions hereinafter contained (which financing is hereinafter referred to as "Institution's Investment").

**3.** This Agreement shall be valid for a period of _____ years from the date of first disbursement of the Institution's Investment.

**4.** The Client and the Institution hereby mutually agree and covenant as under:

**i)** The Institution's Investment shall be used only for [insert description of purpose of the Musharaka Investment] and shall not be used and / or diverted for any other purpose.

**ii)** The investment of the Client for the purpose of this Agreement aggregate to Rs._____ (Rupees _____only) as on _____ as per details given in Annexure 'A' to this Agreement (**Client's Investment**).

**iii)** The Client has obtained following funds from various sources on Profit and Loss Sharing basis all of which are hereinafter referred to as "other PLS Funds".

_____ _____ _____ _____
_____ _____ _____ _____

**iv)** The Client shall not make any change in its paid up capital, accumulated reserves or un-appropriated profits, except on the basis of annual audited accounts, and shall also not, without prior written consent of the Institution (which consent shall not be unreasonably withheld) make any additional borrowing or accept any further funds on Profit and Loss Sharing basis either for short term or long term from any source. The Client shall also not, without the prior written consent of the Institution, repay, earlier than the repayment schedule already agreed to, any other PLS Funds

**v)** The Client shall not declare any dividend without the prior consent in writing of the Institution

**vi)** The Client hereby covenants with the Institution that on the basis of past experience, data available with the Client and reasonable and prudent expectations about future plans of the Client, it is expected that after adding the Institution's Investment to the Client's investment, the projected pre-tax annual profit of the Client hereafter shall be _____ % p.a. (_____ percent per annum) of the total of investments of (a) the Client, (b) the Institution and (c) other PLS Funds. The aforesaid profit percentage is hereinafter referred to as the "Projected Rate of Return" of the Client.

**vii)** It is hereby expressly agreed that the Client may avail the Institution's Investment as and when required, provided the outstanding amount of the Institution's Investment at any time shall not exceed the amount specified in clause 2 hereof.

**viii)** The Client shall perform all acts and fulfill all legal requirements, which may at any time and from time to time be necessary to implement this Agreement. The Client shall also execute all documents and furnish all information which the Institution may at any time require from the Client.

**ix)** The Client shall furnish to the Institution within one month of the end of each quarter of its accounting year, a report of its operations and statements of financial affairs and any other information in such form as may be devised by the Institution from time to time.

**x)** Based on the Projected Rate of Return the Client shall pay at the end of each quarter of its accounting year to the Institution its share of profit worked out in accordance with the formula specified in **Annexure-I.**

**xi)** Payments under sub clause (x) above shall be treated as provisional to be adjusted on final accounts being prepared for the whole accounting year in accordance with clause 5.

**5.**

**i)** At the end of each accounting year of the Client, Financial Statements shall be prepared based on accounting policies consistently applied, in accordance with International Accounting Standards as applicable in Pakistan. Any change in accounting policies of the Client shall require prior written approval of the Institution.

**ii)** Upon finalization of the annual Financial Statements in the manner provided in clause (i) above, the pre-tax net profits for that year shall be allocated among the Institution, Other PLS Funds and the Client on the basis of ratio of profit sharing stipulated in Annexure-II and subject to such conditions as contained therein. The amount so allocated is and shall be deemed to be the due share of profit of the Institution. All quarterly payments made by the Client to the Institution shall be deducted from the final payment to be made to the Institution.

**iii)** In the event of annual Financial Statements of the Client, showing a loss the same shall be shares by the Institution, the Client and other PLS funds in proportion to their respective shares in the Musharaka Capital. The amount of such loss shall be either paid by the respective parties into the Musharaka Capital or shall be deducted from the Musharaka Capital at the option of the respective party.

**6.** The Client shall submit to the Institution its audited Financial Statements within four months from the end of its accounting year duly audited by a firm of auditors approved by the Institution.

**7.** At the expiry of this Musharaka Agreement or its earlier termination as provided for in this Agreement, the Client shall redeem the Institution's Investment and any unpaid share of Institution's

profit.

**8.** Where the Musharaka under this Agreement is for a period of _____ years, the Institution shall have the right to convert into the shares of the Client the full amount of its investment outstanding at the time of such conversion. Such conversion shall, be at the Market* Value of the shares of the Client. Where Institution's entitlement under the above valuation results in a fraction of a share, fractions of half or more shall be taken as one and fractions of less than half shall be ignored.
Provided that the Institution shall exercise its right under this clause only if the Client has achieved, during any three previous years of the currency of this Agreement, an average profit of less than 2/3rd of the mutually agreed Projected Rate of Profit.
Provided further that whenever the Institution decides to sell the shares acquired by it under this clause, the existing shareholders of the Client (other than the Institution), shall have the first right of refusal to purchase the same at a price at which the Institution wishes to sell them.

**9.** The Client shall issue the letters of allotment of shares as mentioned hereinabove within thirty days of demand by the Institution and these shares may be of any class of shares of the Client as mutually agreed and the Institution shall have equal rights as enjoyed by other share holders holding shares of the same class including right of voting, transferring, subscription for right issue, bonus issue, dividends etc., under the law governing joint stock companies.

**10.** Subject only to the express terms of this Agreement, management and control shall primarily vested in the Client and the Client shall be responsible for the management and control of the business except when option under clause 8 or 9 above has been exercised. Provided that the Institution shall have the option in its sole discretion to nominate one or more persons on the Board of Directors of the Client.

**11.** This Agreement shall not be deemed to create a partnership or company and in no event has the Client any authority to bind the Institution. In no event shall the Institution be liable for the debts and obligations of the Client incurred for other purposes, except as stipulated in this Agreement.

**12.** In the event of the Client making default in:

**i)** Payment of due share of profit,

**ii)** Redemption of Institution's investment on the expiry/termination of the Musharaka, or

**iii)** Performance of any of the covenants under this Agreement provided such default remains un-rectified for a period of ____days from the date of notice served by the Institution,
the Institution shall have the right to dispose of the securities defined in clause 16 hereto and adjust the sale proceeds thereof towards the amounts receivable by it.

**13. PENALTY**

**i)** Where any amount is required to be paid by the Client under the Principal Documents on a specified date and is not paid by that date, or an extension thereof, permitted by the Institution without any increase in the amount payable, the Client hereby undertakes to pay directly to the Charity Fund, constituted by the Institution, a sum calculated @ ------% per annum for the entire period of default, calculated on the total amount of the obligations remaining un-discharged. The Charity Fund shall be used at the absolute discretion of the Institution, exclusively for the purposes of approved charity.

**ii)** In case

**(a)** any amount(s) referred to in clause 10.01 above, including the amount undertaken to be paid directly to the Charity Fund, by the Client, is not paid by him, or

**(b)** the Client delays the payment of any amount due under the Principal Documents and/ or the payment of amount to the Charity Fund as envisaged under Clause 10.01 above, as a result of which any direct or indirect costs are incurred by the Institution, the Institution shall have the right to approach a competent Court

**(c)** for recovery of any amounts remaining unpaid as well as

**(d)** for imposing of a penalty on the Client. In this regard the Client is aware and acknowledges that notwithstanding the amount paid by the Client to the Charity Fund of the Institution, the Court has the power to impose penalty, at its discretion, and from the amount of such penalty, a smaller or bigger part, depending upon the circumstances, can be awarded as solatium to the Institution, determined on the basis of direct and indirect costs incurred, other than the opportunity cost.

**14. ASSIGNMENT**

**i)** This Agreement shall be binding upon and inure to the benefit of and be enforceable by the Institution, the Client and respective successors permitted assigns and transferees of the parties hereto, provided that the Client shall not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Institution. The Institution may assign all or any part of its obligations and/or commitments under this Agreement to any bank, financial institution or other person. The Client shall not be liable for the costs of the assignment and/or transfer of commitments hereunder by the Institution. If the Institution assigns all or any part of its rights or transfers all or any part of its obligations and commitments as provided in this Clause, all relevant references in this Agreement to the Institution shall thereafter be construed as a reference to the Institution an/or its assignee's or transferee's (as the case may be) to the extent of their respective interests.

**ii)** The Institution may disclose to a potential assignee or transferee or to any other person who may propose entering into contractual relations with the Institution in relation to this Agreement such information about the Client as the Institution shall consider appropriate.

**15. FORCE MAJEURE**

Any delays in or failure by a Party hereto in the performance hereunder if and to the extent it is caused by the occurrences or circumstances beyond such Party's reasonable control, including but not limited to, acts of God, fire, strikes or other labor disturbances, riots, civil commotion, war (declared or not) sabotage, any other causes, similar to those herein specified which cannot be controlled by such Party. The Party affected by such events shall promptly inform the other Party of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall consult each other to decide whether to terminate this Agreement or to discharge part of the obligations of the affected Party or extend its obligations on a best effort and on an arm's length basis.

**16. SECURITY**

**i)** The Institution shall, with mutual consent of the parties hereto, obtain security for redemption of the Institution's Investment together with profit and / or all other sums receivable by the Institution as aforesaid after adjustment of losses (if any). The Client hereby agrees and undertakes to give the following security, the terms and conditions of which shall be such as the Institution may determine to secure its priority over other creditors of the Client:

**i)** Mortgage
**ii)** Hypothecation
**iii)** Pledge
and / or such other securities as the Institution may require.

**ii)** In case any other creditor of the Client claims or secures or attempts to secure lowering of the Institution's priority over the security or in case of defalcation by the Client, the Institution shall have a right to terminate the Agreement forthwith. The securities obtained by the Institution will be kept fully insured at the Client's cost and expenses through a reputable company offering protection under the Islamic concept of Takaful. Until Islamic concept of insurance is available, the secured assets shall be comprehensively insured with a reputable insurance company to the satisfaction of the Institution against all insurable risks.

**17. GENERAL**

**i)** No failure or delay on the part of the Institution to exercise any power, right or remedy under this

Agreement shall operate as a waiver thereof nor a partial exercise by the Institution of any power, right or remedy preclude any other or further exercise thereof or the exercise of any other power right or remedy.

The remedies provided in this Agreement are cumulative and are not exclusive of any remedies provided by law;

**ii)** This Agreement represents the entire agreement and understanding between the Parties in relation to the subject matter and no amendment or modification to this Agreement will be effective or binding unless it is in writing, signed by both Parties and refers to this Agreement;

**iii)** This Agreement is governed by and shall be construed in accordance with Pakistan law. All competent courts at _____ shall have the non-exclusive jurisdiction to hear and determine any action, claim or proceedings arising out of or in connection with this Agreement.

**iv)** Nothing contained herein shall prejudice or otherwise affect the rights and remedies that may otherwise be available under law to the parties.

**v)** Any reconstruction, division, re-organization or change in the constitution of the Institution or its absorption in or amalgamation with any other person or the acquisition of all or part of its undertaking by any other person shall not in any way prejudice or affect its rights hereunder.

**vi)** The two parties agree that any notice or communication required or permitted by this agreement shall be deemed to have been given to the other party seven days after the same has been posted by registered mail or the next Business Day if given by a facsimile message or telex or by any other electronic means, or the next Business Day as counted from the date of delivery if delivered by courier mail;

* In the case of an unquoted company, it shall be the higher of the break-up or face value.

**IN WITNESS WHEREOF** the Client and the Institution have executed this Agreement on the day, month and year hereinabove mentioned.

| **WITNESSES** | **SIGNATURES** |
|---|---|
| 1. Signature _____<br>Name _____<br>Address _____<br>NIC No. _____ | 1. _____<br>2. _____<br>(Authorized signatures)<br>Common Seal for and on behalf of |

| **WITNESSES** | **SIGNATURES** |
|---|---|

| | |
|---|---|
| 1. Signature _____<br>Name _____<br>Address _____<br>NIC No. _____ | 1. _____<br>2. _____<br>(Authorized signatures)<br>Common Seal for and on behalf of |

**Annexure I**

| | | **Agreed Ratio For Profit Sharing** | **Rupees** |
|---|---|---|---|
| **A)** | Client's investment | 70% | Rs. 100 |
| **B)** | Institution's investment | 30% | Rs. 100 |
| **C)** | Total Investment (A+B) | | Rs. 200 |
| **D)** | Agreed Projected Rate of Return on Total Investment | 60% | |
| **E)** | Projected amount of Profit on total investment | | Rs. 120 |
| **F)** | Allocation of Projected Profit in mutually agreed profit sharing | | |
| | | | |
| | **Ratio of:** | | |
| | Client | 70% | Rs. 84 |
| | Institution | 30% | Rs. 36 |
| | | | Rs. 120 |
| **G)** | Quarterly provisional payment of projected Profit 36/4 = Rs. 9 per quarter | | |
| **H)** | Allocation of actual net profit of Rs. 160 on year end: | | |
| | Client | | Rs. 112 |
| | Institution | | Rs. 48 |
| | | | Rs. 160 |
| **I)** | Therefore, final net payment to the Institution will be Rs. 12 (Rs. 48 - Rs. 36) | | |

**<> Based on the projected rate of Return stipulated in Clause 4(vi)**

**Annexure 2**

**PARAMETERS AGREED**

**I)** Ratio of sharing of Profit (Ratios indicative only)

| | |
|---|---|
| Institution | 18% |
| Client | 70% |
| Other PLS Funds | 12% |

**II)** Other Conditions, if any

(For example, relating to valuation of inventories, depreciation policies, agreed level or quantum of admissible costs etc.)

# MODEL MUDARABAH FINANCING AGREEMENT

**THIS AGREEMENT FOR FINANCING ON THE BASIS OF MUDARABA**

is made on the _____day of _____2001

**Between**

[Name of the Client], _____, **having its place of business at / resident of**_____ hereinafter referred to as the Client (which expression shall, where the context admits, mean and include its successors in interest and assigns) acting as Mudarib of the ONE PART;

**And**

[Name of the financial institution], a banking company incorporated under the laws of Pakistan, having its Registered Office at _____, hereinafter referred to as the Institution, (which expression shall, where the context admits, mean and include its successors in interest and assigns) acting as Rab Al-Maal of the OTHER PART.

**PREAMBLE**

**WHEREAS** the Client and the Institution wish to enter into a Modaraba in conformity with the Islamic Shariah for the purpose of carrying out the Project described in **Exhibit A.**

**AND WHEREAS** the Client has presented to the Institution an application to finance the Project described in **Exhibit A** and has satisfied conditions precedent and other formalities to avail of such financing;

**NOW THEREFORE THIS AGREEMENT WITNESSES AND IT IS HEREBY AGREED BY AND BETWEEN THE PARTIES AS UNDER:**

**1. DEFINITIONS**

The parties agree that the following terms used in this agreement shall have the following meanings:

**Account** means an account opened with the Institution in the name of the Client

**Client Asset Finance** means the sum estimated by the Client as necessary to acquire the assets required for the Project as disclosed on the Project Information Form Exhibit A and as reflected in the Cash Flow and Revenue Projection.

**Cash Flow and Revenue Projection** means the financial projections for the project prepared by the client and annexed as **Exhibit B**.

**Management Services** means the technical management and supervision services, required to ensure the success of the Project described in **Exhibit B** hereto.

**Profit** means the amount of gross profit available for distribution after deduction of permissible expenses as may be agreed between the client and the Institution in terms of Schedule of Expenses hereto attached (**Exhibit C**).

**Client Information Form** means **Exhibit D** prepared by the Client, disclosing certain information regarding the Client.

**Client Financials** means the Balance Sheet and Profit and Loss Statement of the Client for the last three years, prepared by the Client and audited by an independent accountant.

**Draw Down Dates** means the dates specified in **Exhibit E** at which the Institution is obliged to provide funds by credit to the Account

**Project Assets** means all Asset Finance and all things acquired with such finance and the proceeds and profits thereof until distributed to the client and the Institution in accordance with the terms and conditions of this Agreement

**Termination Date** is the date on which this Agreement shall terminate as herein provided.

The following exhibits shall form part of this Agreement:

**1. Exhibit A: Project Information Form being a narrative description of the Project**

**2. Exhibit B: Cash Flow and Revenue Projection for Project, and Management Services**

**3. Exhibit C: Schedule of Expenses**

**4. Exhibit D: Client Information Form**

**5. Exhibit E: Draw Down Dates**

**6. Exhibit F: Authorized Signatories.**

**2. INVESTMENT**

The parties agree that a sum of Rs. [ ] by way of finance required for the Project as estimated by the Client in the Project Information Form shall be supplied by the Institution for a period of _____ months hereof and deposited in the Account.

**3. ACCOUNT**

**a)** The authorized signatories on the Account shall be as specified in Exhibit F.

**b)** All funds for the purpose of the project shall be disbursed only through the Account by cheque or transfer against proper supporting invoices maintained by the Client but available for inspection by the Institution or its agents.

**c)** All receivables from third parties arising from the Project or the transfer of Project Assets shall be collected only through the Account.

**d)** The Institution shall have the right to refrain from the payment of any cheque or transfers from the Account if it reasonably appears to the Institution that such amounts are not included in the Cash Flow and Revenue Projections and do not directly or indirectly relate to the Project.

**4. REPRESENTATIONS OF THE CLIENT**

The Client represents to the Institution that:

**a)** The Client possesses all necessary powers and licenses to conduct its present business and the Project.

**b)** The Client Information Form is true and correct.

**c)** The Client is experienced and knowledgeable in all business matters relating to the Project.

**d)** The Client has prepared with all due care the Project Information Form and the Cash Flow and Revenue Projection based on his experience and knowledge and has completed all reasonable investigation to assure that such are true and correct and disclose all factors relevant to the Institution's evaluation of the Project.

**e)** The Client Financials are true and correct according to generally accepted accounting principles consistently applied accurately representing the Client's financial status on the dates and the profit

and loss for the periods indicated, an no liabilities, fixed or contingent exist at the indicated dates other than as appear in the Client Financials.

**f)** The Client has suffered no material adverse change in business operation or financial position since the date of the most recent Client Financials supplied to the Institution.

**5. REPRESENTATION OF THE INSTITUTION**

The Institution represents to the Client that on the date of this Agreement:

The Institution is a corporation organised under the laws of ……. and possesses all necessary powers and licenses to conduct its business and to finance the Project as provided by this Agreement.

**6. GENERAL COVENANTS OF THE CLIENT**

The Client undertakes to the Institution that the Client shall:

**a)** promptly give notice to the Institution of any change in the information disclosed on the Client Information Form.

**b)** render the Management Services with due care and all reasonable commercial diligence expected of an experienced businessman to ensure the success of the Project according to the description of the Project Information Form and the Cash Flow and Revenue Projection.

**c)** tutilize the Project assets exclusively for purposes of the Project as specified in the Cash Flow and Revenue Projection.

**d)** disburse all funds for the purpose of the Project only through the Account by cheque or transfer against proper supporting invoices maintained by the Client but available for inspection by the Institution or its agents.

**e)** collect all receivables from third parties arising from the Project or the transfer of Project assets or other documents requiring payment from third parties directly to the Account.

**f)** maintain all Project assets in the name of the Client, but physically segregated from other assets of the Client and free and clear of all liens and encumbrances except those in favour of the Institution.

**g)** submit the following to the Institution, prepared according to the instructions of the Institution:

**(i)** A cash flow and revenue statement of the Project for the previous quarter, with a clear explanation of each variation from the Cash Flow and Revenue Projection, within 30 days of the close of each quarter.

**(ii)** A balance sheet and income statement of the Client prepared in accordance with principles utilized in the Client Financials consistently applied. The annual balance sheet and income statement shall be audited by an independent firm of accountants approved by the Institution, and audited documents shall be presented to the Institution within 120 days of the close of the Client's accounting year.

**h)** maintain true and correct books of account relating to the Project together with all invoices, records contracts and all other documentation.

**i)** supply to the Institution any information, material or document relating to the Project or to Client's financial status, and grant access to the Institution or its agents to all books and relating to the Project and to the Client's financial statements.

**j)** immediately disclose in writing to the Institution any business factors of which the Client becomes aware and which might adversely affect the success of the Project.

**k)** not effect directly or indirectly any transaction on behalf of the Project in which the Client or any family member of the Client or any shareholder of the Client, if a corporation, is interested directly or indirectly without consent of the Institution.

**l)** consult with the Institution in any matter, including but not limited to insurance of the assets Modaraba with a view to determining the policy to be followed in order to ensure the proper implementation of this Agreement, but without any obligation of the Client to compromise rights of the Client hereunder.

**m)** under its sole responsibility, conduct the Project in conformity with all applicable civil and criminal laws.

**n)** conduct the Project without violation of the principles of the Islamic Shariah.

**o)** it will satisfactorily insure all its insurable assets of the Project with reputable companies offering protection under the Islamic concept of Takaful. Until the Islamic concept of Takaful is not available the such assets shall be comprehensively insured (with a reputable insurance company to the satisfaction of the Institution) against all insurable risks, which may include fire, arson, theft, accidents, collision, body and engine damage, vandalism, riots and acts of terrorism, and to assign all policies of insurance in favour of the Institution to the extent of the amount from time to time due under this Agreement, and to cause the notice of the interest of the Institution to be noted on the policies of insurance, and to punctually pay the premium due for such insurance's and to contemporaneously therewith deliver the premium receipts to the Institution.

Should the Client fail to insure or keep insured the aforesaid and/or to deliver such policies and premium receipts to the Institution, then it shall be lawful for the Institution but not obligatory to pay such premia and to keep the Secured Assets so insured and all cost charges and expenses incurred by it for the purpose shall be charged to and paid by the Client as if the same were part of the monies due. The Client expressly agrees that the Institution shall be entitled to adjust, settle or compromise any dispute with the insurance company(ies) and the insurance arising under or in connection with the policies of insurance and such adjustments/compromises or settlements shall be binding on the Client and the Institution shall be entitled to appropriate and adjust the amount, if any received, under the aforesaid policy or policies towards part or full satisfaction of the Client's indebtedness arising out of the above arrangements and the Client shall not raise any question or objection that larger sums might or should have been received under the aforesaid policy nor the Client shall dispute its liability(ies) for the balance remaining due after such payment/adjustment;

**7. GENERAL COVENANTS OF THE INSTITUTION**

The Institution undertakes to the Client that it shall:

**a)** make all payments of Finance required of the Institution under this Agreement to the Account on the Draw-Down Dates.

**b)** whenever the circumstances so require consult with the Client in any matter with a view to determining the policy to be followed in order to ensure the proper implementation of this Agreement, but without any obligation of the Institution to compromise its right, hereunder.

**c)** perform its obligations under this Agreement without violation of the principles of Islamic Shariah.

**8. PARTICIPATION IN PROFIT**

**a)** The participation in profit will be in accordance with the following ratio:

**(i)** [ ] % of the profit will be for the Management Services and payable to the Client.

**(ii)** [ ] % of the profit will be payable to the Institution.

**b)** On Termination Date, the accounts of the Modaraba shall be drawn up in accordance with accepted accounting principles, and the profit if any due to the Client and the Institution shall be worked out and paid in the proportion specified above, subject to adjustment of any provisional payments made, (plus the amount paid by the Institution after deducting loss if any).

**c)** At the sole discretion of the Institution, the Client may become entitled to receive a Good Performance Bonus at a rate to be determined by the Institution.

**9. LOSSES**

**a)**

**(i)** 100% of the loss in the Project will be borne by the Institution

**(ii)** The client will receive no compensation for his Management Services, and will be liable for the loss if it is proven that he has breached his obligations or is proven to be failing in the discharge of his obligations under this Agreement.

**b)** In the event of the Project showing losses during the currency of this Agreement the client shall forthwith give notice of such losses to the Institution together with all accounts and details pertaining thereto and such other information and records as may be required by the Institution. Notwithstanding the above, the Institution shall only be liable for the losses in the manner specified if the said losses have not been caused due to misconduct on the part of the Client in out the Project's business and operations or as a result of his negligence or inefficiency, including non-compliance with the terms and conditions of this Agreement

**10. TAXATION**

On behalf of the Project, the Client shall be liable for and shall punctually and regularly pay all taxes, duties, cesses and other charges relating to the Project's business and operations.

**11. TERMINATION**

**a)** Subject to other provisions of this Agreement, it is agreed that upon full payment on Termination Date or earlier, if proceeds have been received, the Modaraba shall stand redeemed.

**b)** While the amount invested by the Institution must be repaid on the due date, mentioned above, the accounts of the Modaraba will be drawn up within 7 days thereof and the agreed share the Institution's profit will be promptly paid.

**12. MANAGEMENT AND CONTROL**

Subject only to the express terms of this Agreement, complete management and control of the Project is exclusively vested in the Client and the Client shall be solely responsible for the management and control of the Project.

**13. ASSUMPTION OF MANAGEMENT OF THE PROJECT BY THE INSTITUTION**

The Institution shall have the right to terminate by notice the powers of the Client to manage the Project and assume the same if the Client violates any obligation hereunder, or if for any cause the results of the Project depart in a material adverse manner from those projected by the Client in the

Cash Flow and Revenue Projections. In such event:

**a)** The Client shall be entitled to receive his share of the profit, if any, until the date of termination stated in the notice. Thereafter, the Institution shall be entitled to the whole profit.

**b)** The assumption of management by the Institution shall not discharge the Client of any obligation hereunder other than the obligation to render the Management Services.

**c)** The assumption of management by the Institution with respect to the Project shall in no event be deemed to affect the liability of the Client to the Institution, with respect to any other facilities granted under any other agreement between the Client and the Institution whether or not the proceeds of such were employed in connection with the Project.

**d)** On assumption of management of the Project by the Institution, the Client will, on the written demand of the Institution, deliver to it all Project Asset, all books, records, contracts and other documents relating to the Project.

**14. CIVIL LAW STRUCTURE AND INTERPRETATION**

In all relations with third parties and this Agreement be construed under the laws of Islamic Republic of Pakistan. This Agreement shall not create a partnership or company and in no event has the Client any authority to bind the Institution. The Client shall contract the Project in the name of the Client and in no event shall the Institution be liable for the debts and obligations of the Client incurred for the Project or other purposes, except as stipulated in this Agreement and its Exhibits.

**15. SET OFF**

The Institution may set-off against any obligation of the Client hereunder, or any other obligation of the Client, the balances of any account maintained by the Client with it.

**16. GENERAL**

The parties agree that:

**a)** Any notice or other communication required or permitted by this Agreement shall be deemed to have been given to the other party seven days after the day on which the same is posted by registered mail, addressed to the address mentioned in this Agreement or any other address given in writing to the other party, or one day after actual delivery at such address, whichever is earlier.

**b)** This Agreement may be amended or any term or condition waived only in writing, executed by persons duly authorized.

**c)** The Exhibits of this Agreement shall be considered an integral part thereof.

**d)** This Agreement has been executed in two original counterparts. Each page of this Agreement and each Exhibit have been initialed for identification.

**IN WITNESS WHEREOF** this Agreement is executed on the date above mentioned by the parties.

**Witnessed**

_____
The Institution

_____
The Client

**Witnessed**

1. Name: _____

2. Name: _____

# MODEL LEASE AGREEMENT

**THIS LEASE AGREEMENT**

(the "Agreement") is made at _____ on _____ day of _____ by and

**BETWEEN**

_____, **(hereinafter referred to as the "Lessee" which expression shall where the context so permits mean and include its successors in interest and permitted assigns) of the one part**

**AND**

_____, (hereinafter referred to as the "**Lessor**" which expression shall where the context so permits mean and include its successors in interest and assigns) of the other part.

**IT IS AGREED BY THE PARTIES** as follows:

**1. PURPOSE AND DEFINITIONS**

**1.01** This Agreement sets out the terms and conditions upon and subject to which the Lessor has, acting on the Written Request of the Lessee which is attached as Lease Document # __ of this Agreement, acquired/beneficially acquired the requested assets and have agreed to Lease the same to the Lessee;

**1.02** In this Agreement, unless the context otherwise requires:

**"Business Day"** means a day on which the Banks are open for normal business in Pakistan;

**"Due Date(s)"** means the respective dates for the payment of the lease rentals as stated in the Appendices or if such respective due date is not a Business Day, the next Business Day;

**"Event of Default"** means any of the events or circumstances described in Clause 14 hereto;

**"Indebtedness"** means any obligation of the Lessee for the payment or any sum of money due or, payable under this Agreement;

**"Leased Assets"** means Assets that are subject to Lease under this Agreement, more particularly described in Lease Document # __;

**"Lessee"** means the Client and is defined in the preamble;

**"Lessor"** means the Institution and is defined in the preamble;

**"License"** means any license, permission, authorization, registration, consent or approval granted to the Lessee for the purpose of or relating to the conduct of its business;

**"Lien"** shall mean any mortgage, charge, pledge, hypothecation, security interest, lien, right of set-off, contractual restriction (such as negative covenants) and any other encumbrance;

**"Parties"** mean parties to this Agreement;

**"Principal Documents"** means this Agreement and the Security Documents;

**"Promissory Note"** is defined in Clause 4.01(b);

**"Prudential Regulations"** means Prudential Regulations or other regulations as are notified from time to time by State Bank of Pakistan and SECP;

**"Rupees" or "**Rs." Means the lawful currency of Pakistan;

**"State Bank of Pakistan"** means the State Bank of Pakistan established under the State Bank of Pakistan Act, 1956 and includes any successors thereto;

**"SECP"** means the Securities and Exchange Commission of Pakistan established under the Securities & Exchange Commission of Pakistan Act, 1997 and includes any successors thereto;

**"Security Documents"**
and "**Security"** is defined in Clause 4.01;

**"Secured Assets"** means all the Lessee's [insert description of assets in respect of which charge/ mortgage may be created];

**"Specified Location"** shall mean _____ or such other location as the Lessor may agree in writing;

**"Supplier"** means the Supplier from whom the Lessor acquires Title of the Assets for onward lease to the Lessee;

**"Taxes"** includes all present and future taxes (including central excise duty and sales tax), levies, imposts, duties, stamp duties, penalties, fees or charges of whatever nature together with delayed payment charges thereon and penalties in respect thereof and "Taxation" shall be construed accordingly;

**"Title"** means such title or other interest in the Assets subject to Lease under this Agreement;

**"Total Loss"** shall have the same meaning assigned to it in the policy of insurance where under the Leased Assets are insured and shall include such other terms in such policy that have a meaning analogous to the term Total Loss as generally understood;

**"Value Date"** means the date on which the Lease commences under this Agreement and is given in the Lease Document # __;

**1.03** Clause headings and the table of contents are inserted for convenience of reference only and shall be ignored in the interpretation of this Agreement. In this Agreement, unless the context otherwise requires, references to Clauses and Appendices are to be construed as references to the clauses of, and Appendices to, this Agreement and references to this Agreement include its appendices; words importing the plural shall include the singular and vice versa and reference to a person shall be construed as including references to an individual, firm, Institution, corporation, unincorporated body of persons or any state or any agency thereof.

**1.04** The recitals herein above and Appendices to this Agreement shall form an integral part of this Agreement.

**2. LEASE**

**2.01** The Lessor hereby leases to the Lessee and the Lessee hereby agrees to take on lease from the Lessor, the Leased Assets for the period stated herein upon the terms and conditions herein set forth.

**2.02** The Lessee covenants and agrees to pay the amount of Rs.[-------] to the Lessor on execution of this Agreement as a security deposit to be applied in the absolute discretion of the Lessor in respect of any rent in default under this Lease at any time or from time to time. The Lessee shall have no right of set off against such security deposit, but shall be entitled to the return of the said deposit after deduction of any costs, charges or expenses at the end of the term of this Lease.

**3. TERMS AND PERIOD OF LEASE**

**3.01** The term of the Lease and the charges payable hereunder (hereinafter referred to as lease rental) with respect to the Leased Assets shall be as set-forth in the aforementioned Lease Document # __ attached hereto. The lease rental shall be payable monthly/quarterly/semi-annually in advance/ arrears on the day mentioned in the Lease Document # __ during the term of the Lease.

**3.02** This Agreement or the lease hereunder in respect of the Leased Assets can be terminated only with the mutual consent of the parties hereto. Such termination shall take effect after ------- days from the date of parties' consent. This Agreement and all its terms and conditions shall, notwithstanding the termination of lease, continue in full force and effect until all obligations of the Lessee under this Agreement are discharged (including the obligation to return the Leased Assets to the Lessor in good operating condition in accordance with the provisions of this Agreement) and the payment of all sums due hereunder to the satisfaction of the Lessor.

**4. SECURITY**

**4.01** As security for the payment of the lease rentals as well as any other amount due under this Agreement and use of the Leased Assets as per conditions set out in this Agreement, the Lessee shall:

**(a)** Furnish to the Lessor a collateral(s), substantially in the form and substance attached hereto as Lease Document #
____ (the "_____");

**(b)** Execute such further deeds and documents as may from time to time be required by the Lessor for the purpose of more fully securing and or perfecting the security created in favour of the Lessor; and

**(c)** Create such other securities to secure the Lessee's obligations under the Principal Documents as the parties, hereto, may by mutual consent agree from time to time.

(The above are hereinafter collectively referred to as the "**Security**").

**4.02** In addition to above, the Lessee shall execute a demand promissory note in favour of the Lessor for the entire amount of the lease rentals (the "Promissory Note");
(The Security and the Promissory Note are hereinafter collectively referred to as the "Security Documents")

**5. FEES AND EXPENSES**

The Lessee shall pay to the Lessor on demand within 15 days of such demand being made, legal and other ancillary expenses incurred by the Lessor in connection with the negotiation, preparation and execution of the Principal Documents and of amendment or extension of or the granting of any waiver or consent under the Principal Documents.

**6. PAYMENT AND ACCOUNTS**

**6.01** All payments to be made by the Lessee under this Agreement shall be made in full, without any set-off or counter claim whatsoever, on the due date and when the due date is not a Business Day, the next Business Day and save as provided in Clause 6.02, free and clear of any deductions or

withholdings, to an account of the Lessor as may be notified from time to time, and the Lessee will only be released from its payment obligations hereunder by paying sums due into the aforementioned account;

**6.02** If at any time the Lessee is required to make any non refundable and non-adjustable deduction or withholding in respect of Taxes from any payment due to the Lessor under this Agreement, the sum due from the Lessee in respect of such payment shall be increased to the extent necessary to ensure that, after the making of such deduction or withholding, the Lessor receives on the Payment Date, a net sum equal to the sum which it would have received had no such deduction or withholding been required to be made and the Lessee shall indemnify the Lessor against any losses or costs incurred by the Lessor by reason of any failure of the Lessee to make any such deduction or withholding. The Lessee shall promptly deliver to the Lessor original or copies of any receipts, certificates or other proof evidencing the amounts (if any) paid or payable in respect of any deduction or withholding as aforesaid.

**7. DELIVERY**

**7.01** The Leased Assets as set out in the Lease Document # __ attached hereto shall be delivered by the Lessor to the place stated in the Lease Document # __. All costs incurred in connection with delivery of the Leased Assets up to the point of delivery as stated in the Lease Document # __ shall be borne by the Lessor. Further, the Lessee shall notify the Lessor in writing of the place at which such Leased Assets are to be installed, located, used or operated and thereafter the Lessee shall not remove or shift the Leased Assets to any other place without the prior written consent of the Lessor.

**7.02** Upon delivery of the Leased Assets to the Lessee, the Lessee shall execute and deliver to the Lessor a receipt or acceptance thereof in the form annexed hereto as Lease Document # __. By such acceptance, the Lessee agrees and covenants that such Leased Assets are in good working order, condition and appearance and in all respects satisfactory to the Lessee and complete in all respects.

**8. USE OF LEASED ASSETS**

**8.01** The Lessee hereby agrees and undertakes that:

**a)** Lessee shall at all times store, house, use and operate the Leased Assets carefully and strictly in conformity with the instructions and directions of the manufacturers and/or Suppliers thereof (including those relating to the environmental conditions, if any, under which the Leased Assets is to be transported, stored, housed, used or operated), whether such instructions and directions are contained in the operational manuals or are otherwise provided with or before or after the delivery of the Leased Assets by the manufacturer and/or Suppliers thereof:

**b)** The Leased Assets shall be handled, used and operated by authorized and suitably trained persons and shall not be handled, used or operated by unauthorized or untrained persons;

**c)** The Lessee shall not do or omit to do any act or thing by which the warranties and performance guarantees given by the Suppliers and/or manufacturers of the Leased Assets would or could become invalidated or unenforceable, whether wholly or in part;

**d)** Each item of Leased Assets shall be used for the normal and usual purpose of the business of the Lessee for the time being, and, except with the prior permissions of the Lessor, for no other purpose whatsoever;

**e)** The Lessee shall store, house, install, use and operate the Leased Assets in compliance with all relevant laws, rules, regulations, orders and direction, whether of the Federal or any Provincial government or of any Municipal or Local Authority or of any court, tribunal or other competent authority or officer;

**f)** The Lessee shall not sell, transfer, assign or otherwise dispose off, loan, give on license, or part with the possession of, or in any way mortgage, hypothecate, pledge, charge or otherwise encumber, the Leased Assets and except with the permission of the Lessor in writing, sublease or let for hire.

**g)** In the event the Leased Assets have been acquired by the Lessor from the Lessee prior to or simultaneous with the execution of this Lease, the Lessee represents and warrants, as of the date of such acquisition, that (i) the Leased Assets are free and clear of all liens, encumbrances or other charges of whatsoever nature; (ii) the transfer of Lease Assets to the Lessor does not violate any contract to which the Lessee is a party or by which it may be bound and (iii) the Lessee has the necessary corporate power and authority to transfer or sell the Leased Assets to the Lessor.

**8.02** The Lessee shall not, without the prior written consent of the Lessor, make any alteration, addition, or improvement to the Leased Assets or change the condition thereof; In the event of any component or accessory being affixed or added to the leased asset in the process of alteration or improvement of any kind, such component or accessory shall and be deemed to be the property of the Lessee. Accordingly, the Lessee shall have the right to retrieve by detachment or removal such accessories or components from the Leased Assets, upon termination of lease (or earlier) provided that such detachment or removal shall neither tend to damage the appearance nor impair the working of Leased Assets.

**8.03** Nothing contained in this article shall release the Lessee from its liability for any storage, handling, use or operation of the Leased Assets or any of them in breach of any of the terms and conditions contained herein or in a manner contrary to any provisions or requirements of the insurance policy or policies intended to cover the Lessor's liability as owner of the Leased Assets or in contravention of any law, rule, regulation, order or direction, whether of the Federal or any Provincial government or of any Municipal or Local Authority or of any court, tribunal or other competent authority or officer;

**8.04** The Lessee hereby agrees to indemnify and save harmless the Lessor from and against all claims and demands made and all fines or penalties levied or imposed in respect of or arising out of the storage, handling, use or operation of the Leased Assets or any of them;

**8.05** Lessee will immediately notify Lessor of any change of place of permanent location of the Leased Assets.

**9. MAINTENANCE OF LEASED ASSETS**

**9.01** The Lessee agrees to maintain each item of Leased Assets in reasonable condition satisfactory to the Lessor. All maintenance works shall be carried out strictly in accordance with the maintenance manuals or other instructions and directions of the manufacturers and/or Suppliers of the Leased Assets, or where no such manuals instructions or directions are provided, in accordance with the best practice in the industry;

**9.02** The Lessee agrees to be solely responsible for all maintenance and operating costs and expenses which shall include but shall not be limited to such as fuel, oil and lubricants, repairs, replacement of components and/or parts, periodic and preventive maintenance and repair costs, incurred in connection with or in any way referable to storage, handling, use and operation of each item of the Leased Assets;

**9.03** The Lessee also agrees to be responsible for and forthwith to pay all fees, taxes, fines or penalties of operational nature by and to whosoever payable and relating to the transportation, storage, handling, use and operation of the Leased Assets, except the income tax of the Lessor;

**9.04** In the event of normal maintenance or operation costs and expenses as aforesaid or fees, taxes, fines and penalties or any other charges not being paid by the Lessee as herein required, the Lessor may, but shall not be obligated, pay such cost, expenses, fees, taxes, fines, penalties and charges and the Lessee shall forthwith upon demand reimburse the Lessor therefore. The Lessor shall always receive a fixed amount herein provided for as rent on the Leased Assets leased hereunder, and any other charges, such as those specified above shall be in addition to the rent payable by the Lessee to the Lessor.

**10. INSURANCE, ACCIDENTS, INJURIES AND INDEMNIFICATION**

**10.01** The Lessor shall procure insurance coverage from reputable companies offering protection under the Islamic concept of Takaful. Until the Islamic insurance concept of Takaful is available the Leased Assets shall be comprehensively insured (with a reputable insurance company) against all insurable risks, which shall include, but not limited to fire, theft, accidents, collision, body and engine damage, vandalism, riots and acts of terrorism.

**10.02** The Lessee, its agents and employees shall comply with all the terms and conditions of the said insurance policy, including the immediate reporting of accidents or damage to the Lessor and the insurance company and shall do all the things necessary or proper to protect or preserve the Leased Assets in accordance with the appropriate clause as mentioned in the Insurance policy. The Lessee shall also provide all assistance to the insurance company and the Lessor for a prompt settlement of any claim and shall take all such actions and steps as may be necessary in that regard;

**10.03** The Lessee shall be responsible for and keep the Lessor indemnified against accidents and injuries, whether fatal or otherwise, damages and losses occurring to any person or property which may result from or be traceable to the storage, handling, use or operation of the Leased Assets by the Lessee, its contractors, its and/or their respective employees or agents, or any failure on the part of the Lessee to observe and perform any of the obligations under this Agreement or the instructions contained in the manufacturer's and/or the Supplier's maintenance and operation manual or any other instructions of the manufacturers and/or Suppliers and the Lessor. If the Lessor shall have to pay any money in respect of any claim or demand for which the Lessee is responsible hereunder, or incurs any costs, charges or expenses (including attorney's fees) in connection with any such claim or demand, the amount so paid and the costs, charges and expenses incurred by the Lessor shall be paid by the Lessee to the Lessor in full upon demand;

**10.04** The parties hereto agree that notwithstanding anything contained in this Agreement, the Lessor shall also not be responsible in any way whatsoever for the products derived from or through the use or operation of the Leased Assets by the Lessee or anybody else nor also as to their efficacy or merchantability or otherwise, and the Lessee shall indemnify and keep indemnified the Lessor against any and all actions, proceedings, liabilities, claims, losses, damages, costs and expenses relating to or arising out of the storage, sale, use or consumption of any product derived there from which may be instituted against or suffered or incurred by the Lessor or by any other person or party;

**10.05** The Lessee further indemnifies the Lessor against any loss or expense which the Lessor shall certify as rightly incurred by it as a consequence of : (i) the occurrence of any Event of Default, other than those stipulated in sub clauses (b), (c) & (i) of Clause 14 of this Agreement and (ii) arising out of any misrepresentation.

**10.06** All proceeds of insurance, whether consisting of Total Loss Proceeds or otherwise, shall be applied at the option of Lessor towards:

**(a)** The replacement restoration or repair of the Leased Asset if the same may be reasonably possible.
**(b)** The payment obligations of the Lessee to the Lessor hereunder.

**10.07** If any event covered by the insurance occurs, the Lessee shall forthwith notify the Lessor regarding the same in writing and shall immediately take all steps as may be required for ensuring that the insurance claim is properly lodged, and for said purpose, the Lessee shall sign all such documents as may be required and allow full opportunity to the insurance company and its nominee for carrying out inspection test, investigation and examination.

**10.08** The Lessee agrees to pay the Lessor the cost of repairing or replacing any damage arising out of misuse to the Leased Assets;

**11. REGISTRATION AND TITLE**

**11.01** The Leased Assets shall, where applicable, be registered in the name of Lessor under the Federal/ Provincial/Municipal laws pertaining to registration of such assets. Title, ownership and right of property in and to the Leased Assets leased hereunder shall at all times remain vested in Lessor and the Lessee covenants and agrees not to do or perform any act prejudicial thereto. Notwithstanding such registration, it is understood and agreed between the parties hereto that Lessor shall not be liable or responsible for the infraction of or noncompliance with any Federal/Provincial/ Municipal statute, law, ordinance, rule or regulation whatsoever relating to the operation or use of Leased Assets;

**11.02** Payment of all taxes incidental to usage and ownership including the Road Tax, if applicable, shall be the sole responsibility of the Lessee, and it is understood this payment has been factored in the Lease Rentals. Further provided that if Lessee is not in default under this Lease, the Lessor will, upon request, furnish the Lessee a letter of authority for this purpose;

**11.03** The Lessee shall affix a plate or label or other mark on the Leased Assets indicating that it has been leased from the Lessor and the Lessee shall ensure that such plates, labels or marks are not covered up, obliterated, defaced or removed. The detailed specifications and wordings of such plates, labels and marks shall be provided by the Lessor to the Lessee and the Lessee shall affix the plates, labels and marks on the leased assets in conformity with said specifications and wordings;

**11.04** As between the Lessor and the Lessee, the Leased Assets shall remain personal or moveable property and shall continue in the ownership of the Lessor notwithstanding that the same may have been affixed to any land or building. The Lessee shall be responsible for any damage caused to any such land or building by the affixing to or removal there from of the Leased Assets, whether affixed or removed by the Lessee or the Lessor, and the Lessee shall indemnify and save harmless the Lessor from and against any and all claims made in respect of such damage.

**12. RETURN OF LEASED ASSETS**

**12.01** Return of the Leased Assets shall be at the Lessor's place of business or as specified in Lease Document # __ hereto attached. Any structural alteration, special equipment or material alteration hereinafter required by the Lessee shall be added only with approval of the Lessor and shall, subject to the provisions of Clause 8.02, be removed at the Lessee's expense prior to the end of the term of the lease hereby granted. The Lessor shall be entitled to label the Leased Assets as having been leased from the Lessor;

**12.02** The Lessee agrees to return the Leased Assets at the end of the term of the lease hereby granted or any extension thereof or earlier upon termination of the lease, in good operating condition and working order, free from any physical damage. In general, normal wear and tear proportionate to the usage is to be expected. The Lessee and the Lessor or their respective Agents shall inspect and provide a jointly signed report on the condition of the Leased Assets. However, any condition as a result of neglect or abuse is the sole responsibility of the Lessee;

**13. LIMITATION OF LIABILITY**

**13.01** It is understood and agreed that Lessor shall not be liable or accountable to the Lessee for any loss, damage, claim, demand, liability, cost or expense of any nature or kind sustained by the Lessee directly or indirectly resulting from any inadequacy for any purpose, or any defect therein, from loss or interruption of use thereof, or any loss of business, profits consequential or any other damage of any nature;

**13.02** Parties hereto shall not be required to carry out any of the terms of this Agreement if prevented from so doing by Acts of God, or the State's enemies or any other circumstances beyond their control and shall not be liable for any loss or damages sustained by any party resulting there from;

**13.03** If the Leased Asset should be damaged without any fault on the part of the Lessee, but be capable of being repaired and if the applicable insurance proceeds be insufficient to pay the full cost of repairing the same, the Lessee may arrange repair and the difference between the actual cost of repairs and the amount of insurance claim received for it from the insurance company shall be payable by the Lessor. However, if the Leased Asset is completely lost or incapable of repair the proceeds of insurance shall be payable to the Lessor and this Agreement shall stand terminated;

**13.04** All repairs, replacements or substitution of the parts or component of the Leased Assets necessitated due to normal usage shall be at the Lessee's expense;

**13.05** The Lessor has not made and does not hereby make any representation as to merchantability, condition or suitability of the Leased Assets for the purpose of the Lessee or any other representation, with respect thereto.

The Lessee agrees that its obligation hereunder to pay rentals herein provided for shall not in any way be affected by any such defect or failure of performance of the Leased Assets once it has accepted the delivery of the same;

**13.06** Whenever they fall due, the Lessee shall be liable to forthwith pay all fees, central excise duties, taxes, levies and penalties, under any statute or enactment for the time being in forced as may relate to or charged upon or otherwise payable in respect of the Leased Assets or any services in relation to leasing or any transaction or activities under this Agreement. In the event any fees, duties, taxes, levies and penalties or any maintenance or operating costs are levied and paid by the Lessor, the Lessee shall be responsible to reimburse the Lessor for the amount so paid. The Lessee

recognizes that the Lessor has no liability whatsoever to make any payment whatsoever in respect of above stated account and the amount receivable under this Lease Agreement as Lease rental shall be net and not reducible in value on any account whatsoever.

**14. DEFAULT AND TERMINATION**

**14.01** There shall be an Event of Default if in the opinion of the Lessor:

**(a)** Any representation or warranty made or deemed to be made or repeated by the Lessee in or pursuant to the Principal Documents or in any document delivered under this Agreement is found to be incorrect;

**(b)** The lease rentals payable under this Agreement remain outstanding for a period of more than [Insert period];

**(c)** Any Indebtedness, including lease rentals outstanding under this Agreement, of the Lessee in excess of Rs._____ (Rupees _____only) is not paid when due or becomes due or capable of being declared due prior to its stated maturity;

**(d)** In the event of the Lessee making an assignment for the benefit of its creditors;

**(e)** In the event of the Lessee (A) voluntarily or involuntarily becoming the subject of proceedings under the Bankruptcy or insolvency law, or procedure for the relief of financially distressed debtors. (B) Has been unable or has admitted in writing its inability to pay his debts as they mature to the Lessor or to another party or the financial Lessor, (C) taken or suffered any action for its reorganization, liquidation or dissolution, or (D) had a receiver or liquidator appointed for all or any part of its assets or business

**(f)** Any authority of or registration with governmental or public bodies or courts required by the Lessee in connection with the execution, delivery, performance, validity, enforceability or admissibility in evidence of the Principal Documents are modified in a manner unacceptable to the Lessor or is not granted or is revoked or otherwise ceases to be in full force and effect;

**(g)** The total interruption or cessation of the business activities of the Lessee;

**(h)** In the Leased Assets are used unreasonably or in an abusive manner;

**(I)** Any costs, charges and expenses under the Principal Documents shall remain unpaid for a period of ___ days after notice of demand in that behalf has been received by the Lessee from the Lessor;
**(m)** If there is any change in the majority ownership and/or senior management of the Lessee without the consent of the Lessor.

**14.02** In the event that Lessor shall, by reason of the breach of any of the terms of this Agreement or the termination of this Lease becomes entitled to the return of the Leased Assets, then notwithstanding any terms or conditions herein contained, Lessor at its sole discretion in addition to any other remedy open to it and without obtaining a judgment, decree or other order from a court, may at any time without notice take possession of the said Leased Assets, and the Lessee hereby authorizes and empowers Lessor, its servants, agents, or other representatives to enter on any of the Lessee's lands or premises, or any other place or places where the said Leased Assets may be found, for the purpose of taking possession thereof, and on the happening of such an event or events the Lessee hereby irrevocably appoints Lessor or any of its officers, agents, or representatives as the Lessee's true and lawful attorneys to execute such document as may be necessary for the purpose of regaining possession of the said Leased Assets and the accessories attached thereto. The Lessee shall pay the costs of such repossession including transportation and storage charges.

**15. INSPECTION**

The Lessee shall permit, during the currency of the Lease Agreement, persons authorized by the Lessor to inspect and examine the condition of the Leased Assets and, for the said purpose, shall permit such persons to enter upon the premises where the Leased Assets are situated, even where, in default of custody, control, and use, the Leased Assets are not situated at the Specified Location.

**16. PRUDENTIAL REGULATIONS**

The Lessee shall comply with the Prudential Regulations and or other regulations issued by any Government regulatory body including the State Bank of Pakistan and the SECP to Non-Banking Financial Institutions or banking companies as if such regulations are applicable and binding on the Lessee.

**17. REPORT OF BUSINESS**

The Lessee shall furnish its latest audited and un-audited financial reports, statements or other documents relating to the financial status of the Lessee to the Lessor within ten (10) calendar days of the Lessor requesting the same.

**18. REPRESENTATIONS AND WARRANTIES**

The Lessee hereby represents and confirms that:

**(a)** The Lessee has not defaulted in respect of any payment obligation (whether relating to loan, finance or otherwise) or any other type of obligation owed to any bank or financial institution; and
**(b)** The Lessee has not defaulted in payment of any taxes or other dues owed to the government or any local authority.

**19. LEASE KEY MONEY/SECURITY DEPOSIT**

The Lessor shall not be liable to mark-up, interest or other charges to the Lessee in respect of the Lease Key Money/Security Deposit, whether or not the same or any part thereof, is actually returned to the Lessee.

**20. PENALTY**

**20.1**. Where any amount is required to be paid by the Lessee under the Principal Documents on a specified date and is not paid by that date, or an extension thereof, permitted by the Institution without any increase in the Lease Rentals, the Lessee hereby undertakes to pay directly to the Charity Fund, constituted by the Institution, a sum calculated @ ------% per annum for the entire period of default, calculated on the total amount of the obligations remaining un-discharged. The Charity Fund shall be used at the absolute discretion of the Institution, exclusively for the purposes of approved charity.

**20.2**. In case

**(i)** any amount(s) referred to in clause 20.01 above, including the amount undertaken to be paid directly to the Charity Fund, by the Lessee, is not paid by him, or

**(ii)** the Lessee delays the payment of any amount due under the Principal Documents and/ or the payment of amount to the Charity Fund as envisaged under Clause 20.01 above, as a result of which any direct or indirect costs are incurred by the Institution, the Institution shall have the right to approach a competent Court

**(a)** for recovery of any amounts remaining unpaid as well as

**(b)** for imposing of a penalty on the Lessee. In this regard the Lessee is aware and acknowledges that notwithstanding the amount paid by the Lessee to the Charity Fund of the Institution, the Court has the power to impose penalty, at its discretion, and from the amount of such penalty, a smaller or bigger part, depending upon the circumstances, can be awarded as solatium to the Institution, determined on the basis of direct and indirect costs incurred, other than the opportunity cost.

**21. ASSIGNMENT**

**21.01** This Agreement shall be binding upon and inure to the benefit of and be enforceable by the Lessor, the Lessee and respective successors' permitted assigns and transferees of the parties hereto, provided that the Lessee shall not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Lessor. The Lessor may assign all or any part of its rights or transfer all or any part of its obligations and/or commitments under this Agreement to any Lessor, or other person.

The Lessee shall not be liable for the costs of the assignment and/or transfer of commitments hereunder by the Lessor. If the Lessor assigns all or any part of its rights or transfers all or any part of its obligations and commitments as provided in this Clause, all relevant references in this Agreement to the Lessor shall thereafter be construed as a reference to the Lessor and/or its assignee(s) or transferee(s) (as the case may be) to the extent of their respective interests.

**21.02** The Lessor may disclose to a potential assignee or transferee or to any other person who may propose entering into contractual relations with the Lessor in relation to this Agreement such information about the Lessee as the Lessor shall consider appropriate.

**22. FORCE MAJEURE**

Any delays in or failure by a Party hereto in the performance hereunder if and to the extent it is caused by the occurrences or circumstances beyond such Party's reasonable control, including but not limited to, acts of God, fire, strikes or other labor disturbances, riots, civil commotion, war (declared or not) sabotage, any other causes, similar to those herein specified which cannot be controlled by such Party. The Party affected by such events shall promptly inform the other Party of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall consult each other to decide whether to terminate this Agreement or to discharge part of the obligations of the affected Party or extend its obligations on a best effort and on an arm's length basis.

**23. GENERAL**

No failure or delay on the part of the Lessor to exercise any power, right or remedy under this Agreement shall operate as a waiver thereof nor shall or a partial exercise by the Lessor of any power right or remedy preclude any other or further exercise thereof or the exercise of any other power right or remedy.

The remedies provided in this Agreement are cumulative and are not exclusive of any remedies provided by law;

**23.02** This Agreement represents the entire Agreement and understanding between the Parties in relation to the subject matter and no amendment or modification to this Agreement will be effective or binding unless it is in writing, signed by both Parties and refers to this Agreement;

**23.03** This Agreement is governed by and shall be construed in accordance with the Pakistani law. All competent courts at _____ shall have the non-exclusive jurisdiction to hear and determine any action, claim or proceedings arising out of or in connection with this Agreement.

**23.04** Nothing contained herein shall prejudice or otherwise affect the rights and remedies that may otherwise be available under law to the parties.

**23.05** Any reconstruction, division, reorganization or change in the constitution of the Lessor or its absorption in or amalgamation with any other person or the acquisition of all or part of its undertaking by any other person shall not in any way prejudice or affect its rights hereunder.

**23.06** The two parties agree that any notice or communication required or permitted by this Agreement shall be deemed to have been given to the other party seven days after the same has been posted by registered mail or the next Business Day if given by a facsimile message or telex or by any other electronic means, or the next Business Day as counted from the date of delivery if delivered by courier mail.

**IN WITNESS WHEREOF**, the Parties to this Agreement have caused this Agreement to be duly executed on the date and year first aforementioned.

| | |
|---|---|
| For and on behalf of the Lessee | For and on behalf of [insert name of the Lessor] |

**WITNESSES:**

1. _____
2. _____

**Document 1**

**WRITTEN REQUEST**

[Date]_____

To: _____
[Insert name and address of the Lessor]
_____

Dear Sirs,

**WRITTEN REQUEST FOR PURCHASE OF ASSETS**

**(1)** We request you to kindly procure the Assets described below to be leased to us under a separate Agreement:

| Sr. No. | Specification of Assets | Amount |
|---|---|---|
| | | |

**(2)** We further request you to deliver the Assets as follows:-

**(a)** Assets:
**(b)** Terms of delivery:
**(c)** Place of delivery:

**(3)** We hereby certify that the Lease of the Assets by you to us shall not result in a breach of our organizational documents, any provision of any document to which we are a party or by which we are bound, or any applicable law, rule or regulation, whether directly or indirectly.

Yours faithfully,

For and on behalf of [Insert name of the Lessee]
_____

**Document 2**

**SCHEDULE**

This Schedule shall be attached to and form an integral part of the Lease Agreement Between M/s (Lessor)_____and (Lessee) _____.

The Lessee authorizes the Lessor to procure the under noted asset(s), to be leased in terms of the Agreement between the parties, and at the rate and for the term herein specified.

| Sr. No. | Specification of Assets | Amount | Term of Lease |
|---|---|---|---|
| | | | |

The **Lessor** shall maintain comprehensive insurance during entire period of lease.

Registration, CVT, Income Tax, and Road Tax shall be paid by Lessee.

Place of delivery and return of the Leased Assets shall be at the Head Office of Lessor or as agreed between the Parties.

Commencement date of Lease: _____
Duly authorized by the Lessees:_____

The amount of Security Deposit Rs. _____ shall be adjusted towardsResidual Value at the end of lease period

**OR**

The amount of Residual Value Rs. _____ shall be payable by the Lessee at the end of Lease Period.

**Document 3**

**RECEIPT OF LEASED ASSETS**

**AGREEMENT NO[----------] DATED [----------]**

Description of the Assets: ----------
---
---

The Assets described above are received complete in all respect and in perfect working order and condition.

Delivery dated_____

**1.** Signature_____
Full Name_____
S/o.D/o.W/o._____
Res.Address_____
_____
NIC No._____
Designation_____

**2.** Signature_____
Full Name_____
S/o.D/o.W/o._____
Res.Address_____
_____
NIC No._____
Designation_____

Stamp _____

**SIGNED for and on behalf of the Lessor by:**

---

Dated:_____

**Document 4**

**UNDERTAKING**

_____

**[Name & Address of the Lessor]**

_____

Dear Sirs

In consideration of your entering into the Lease Agreement dated ..... (**Lease Agreement**), we hereby agree and undertake that if you desire to terminate this Lease on account of any of the grounds mentioned in the Lease Agreement during the currency of the Lease, we shall be obliged to purchase the Leased Assets at the Purchase Price mentioned **below** against the date immediately preceding the date of termination of the Lease (**Purchase Date**). In any such event, all our rights under the Lease Agreement and in the Leased Assets covered by this Lease Agreement shall forthwith terminate and, if we fail to pay the Purchase Price on or before the date specified by you, you shall have the right to take immediate possession of the Leased Assets and we shall immediately deliver to you the Leased Assets together with the registration certificate, permit or other documents pertaining thereto;

| Purchase Date | Purchase Price |
|---|---|

Yours faithfully,

# MODEL SALAM AGREEMENT

**THIS SALAM AGREEMENT**

(the "Agreement") is made at_____ on _____ day of _____ by and

**BETWEEN**

_____, (hereinafter referred to as the "**Supplier**" which expression shall where the context so permits mean and include its successors in interest and permitted assigns) of the one part

**AND**

_____, (hereinafter referred to as the "**Institution**" which expression shall where the context so permits mean and include its successors in interest and assigns) of the other part.

**IT IS AGREED BY THE PARTIES** as follows:

**1. PURPOSE AND DEFINITIONS**

**1.02** This Agreement sets out the terms and conditions upon and subject to which the Institution has agreed to purchase the Goods from the Supplier:

**1.03** In this Agreement, unless the context otherwise requires:

**"Business Day"** means a day on which banks are open for normal business in Pakistan;

**"Contract Price"** means Rs._____, paid by the Institution to the Supplier or such other sum as may mutually be agreed in writing between the parties hereto as the price of the Goods purchased in accordance with the terms of this Agreement;

**"Event of Default"** means any of the events or circumstances described in Clause 09 hereto;

**"Goods"** means the Goods described in Salam Document # __;

**"Goods Receiving Note"** means confirmation of receipt of Goods as set out in Salam Document # ;

**"Indebtedness"** means any obligation of the Supplier for delivery of the Goods or for payment of any sum of money due or, payable under this Agreement;

**"License"** means any license, permission, authorization, registration, consent or approval granted to the Supplier for the purpose of or relating to the conduct of its business;

**"Lien"** shall mean any mortgage, charge, pledge, hypothecation, security interest, lien, right of set-off, contractual restriction (such as negative covenants) and any other encumbrance;

**"Parties"** means parties to this Agreement;

**"Notice of Delivery"** means the Notice of Delivery given by the Supplier to the Institution as set out in Salam Document # __

**"Principal Documents"** means this Agreement and the Security Documents;

**"Promissory Note"** is defined in Clause 3.01(b);

**"Prudential Regulations"** means Prudential Regulations or other regulations as are notified from time to time by State Bank of Pakistan or SECP;

**"Security Documents"**
and "**Security**" is defined in Clause 3.01;

**"Secured Assets"** means the following assets of the Supplier [insert description of assets in respect of which charge/mortgage may be created];

**"Rupees"** or "Rs." means the lawful currency of Pakistan;

**"State Bank of Pakistan"** means the State Bank of Pakistan established under the State Bank of Pakistan Act, 1956 and includes any successors thereto;

**"SECP"** means the Securities and Exchange Commission of Pakistan established under the Securities & Exchange Commission of Pakistan Act, 1997 and includes any successors thereto;

**"Taxes"** includes all present and future taxes (including central excise duty and sales tax), levies, imposts, duties, stamp duties, penalties, fees or charges of whatever nature together with delayed payment charges thereon and penalties in respect thereof and **"Taxation"** shall be construed accordingly;

**“Written Offer”** means the Offer made by the Supplier to the Institution as per Salam Document # __ .

**1.04** Clause headings and the table of contents are inserted for convenience of reference only and shall be ignored in the interpretation of this Agreement. In this Agreement, unless the context otherwise requires, references to Clauses and Appendices are to be construed as references to the clauses of, and Appendices to, this Agreement and references to this Agreement include its appendices; words importing the plural shall include the singular and vice versa and reference to a person shall be construed as including references to an individual, firm, institution, corporation, unincorporated body of persons or any state or any agency thereof.

**1.05** The recitals herein above and Appendices to this Agreement shall form an integral part of this Agreement.

**2. SUPPLY OF THE GOODS PURCHASED**

**2.01** The Supplier has agreed to supply the Goods to the Institution pursuant to the Written Offer for the Contract Price. Upon receipt by the Institution of the Supplier’s Notice of Delivery, which shall be date] or such other date as may be mutually agreed between the parties hereto, hereinafter referred to as Delivery Date, advising the Institution to take delivery of the Goods, the Institution shall receive or cause to receive the Goods at the designated point of delivery.;

**2.02** The Goods shall remain at the risk of the Supplier until they are delivered to the point of delivery and have been inspected and accepted by the Institution, immediately after which, all risks in respect of the Goods shall be passed on to the Institution;

**3. SECURITY**

**3.01** As security for the performance of this Agreement by the Supplier under this Agreement, the Supplier shall:

**(a)** Furnish to the Institution a collateral(s), substantially in the form and substance attached hereto as Salam Document # __ ;

**(b)** Execute such further deeds and documents as may from time to time be required by the Institution for the purpose of more fully securing and or perfecting the security created in favour of the Institution; and

**(c)** Create such other securities to secure the Supplier’s obligations under the Principal Documents as the parties, hereto, may by mutual consent agree from time to time.
(The above are hereinafter collectively referred to as the "**Security**").

**3.02** In addition to above, the Supplier shall execute a demand promissory note in favour of the Institution for the amount of the Contract Price (the "Promissory Note");
(The Security and the Promissory Note are hereinafter collectively referred to as the "Security Documents").

**4. FEES AND EXPENSES**

It is understood that each party shall bear the fees and expenses incurred from its own account in connection with the negotiation, preparation and execution of the Principal Documents and of amendment or extension of or the granting of any waiver or consent under the Principal Documents.

**5. PAYMENT OF CONTRACT PRICE**

Payment to the Supplier under this Agreement has been made of such withholding taxes that the institutions is required to deduct under various laws in force. The Institution shall promptly deliver to the Supplier copies or originals of any receipts, certificates or other proof evidencing the amounts (if any) paid or payable in respect of any deduction or withholding as aforesaid.

**6. REPRESENTATIONS AND WARRANTIES**

**6.01** The Supplier warrants and represents to the Institution that:

**a.** The execution, delivery and performance of the Principal Documents by the Supplier will not (i) contravene any existing law, regulation or authorization, which the supplier is subject to, (ii) result in any breach of or default under any agreement or other instrument to which the Supplier is a party or is subject to, or (iii) contravene any provision of the constitutive documents of the Supplier or any resolution adopted by the board of directors or members of the Supplier;

**b.** The financial statements together with the notes to the accounts and all contingent liabilities and assets that are disclosed therein represent a true and fair financial position of the business of the Supplier and to the best of the knowledge of the Supplier there are no material omissions and or misrepresentations.

**c.** All requisite corporate and regulatory approvals required to be obtained by the Supplier in order to enter into the Principal Documents are in full force and effect and such approvals permit the Supplier, inter alia, to obtain the entire sales price in advance under this Agreement and perform its obligations hereunder and that the execution of the Principal Documents by the Supplier and the exercise of its rights and performance of its obligations hereunder, constitute private and commercial acts done for private and commercial purposes;

**d.** No material litigation, arbitration or administrative proceedings is pending or threatened against the Supplier or any of its assets;

**e.** It shall inform the Institution within ------- Business Days of an event or happening which may have an adverse effect on the financial position of the Supplier, whether such an event is recorded in the financial statements or not as per applicable International Accounting Standards, as applicable in Pakistan.

**7. UNDERTAKING**

**7.01** The Supplier covenants and undertakes that so long as it remains obliged under this Agreement:

**a.** It shall inform the Institution of any Event of Default or any event, which with the giving of notice or lapse of time or both would constitute an Event of Default forthwith upon becoming aware thereof;

**b.** It shall do all such things and execute all such documents which in the opinion of the Institution may be necessary to;

**(i)** enable the Institution to assign or otherwise transfer the right of the Institution to enable any creditor of the Institution or to any third party to receive the delivery of the Goods as the Institution may deem fit at its entire discretion;

**(ii)** create and perfect the Security;

**(iii)** maintain the Security in full force and effect at all times including the priority thereof;

**(iv)** maintain, insure and pay all Taxes assessed in respect of the Secured Assets and protect and enforce its rights and title, and the rights of the Institution in respect of the Secured Assets, and;

**(v)** preserve and protect the Secured Assets. The Supplier shall at its own expense cause to be delivered to the Institution such other documentation and legal opinion(s) as the Institution may reasonably require from time to time in respect of the foregoing;

**c.** It will satisfactorily insure all Secured Assets with reputable companies offering protection under the Islamic concept of Takaful. The Secured Assets shall be comprehensively insured (with a reputable insurance company to the satisfaction of the Institution) against all insurable risks, which may include fire, arson, theft, accidents, collision, body and engine damage, vandalism, riots and acts of terrorism, and to assign all policies of insurance in favour of the Institution to the extent of the amount from time to time due under this Agreement, and to cause the notice of the interest of the Institution to be noted on the policies of insurance, and to punctually pay the premium due for such insurance's and to contemporaneously therewith deliver the premium receipts to the Institution.

Should the Supplier fail to insure or keep insured the Secured Assets and/or to deliver such policies and premium receipts to the Institution, then it shall be lawful for the Institution but not obligatory to pay such premia and to keep the Secured Assets so insured and all cost charges and expenses incurred by it for the purpose shall be charged to and paid by the Supplier as if the same were part of the monies due. The Supplier expressly agrees that the Institution shall be entitled to adjust, settle or compromise any dispute with the insurance company (ies) and the insurance arising under or in connection with the policies of insurance and such adjustments/compromises or settlements shall be binding on the Supplier and the Institution shall be entitled to appropriate and adjust the amount, if any received, under the aforesaid policy or policies towards part or full satisfaction of the Supplier's indebtedness arising out of the above arrangements and the Supplier shall not raise any question or objection that larger sums might or should have been received under the aforesaid policy nor the Supplier shall dispute its liability(ies) for the balance remaining due after such payment/adjustment;

**d.** Except as required in the normal operation of its business, the Supplier shall not, without the written consent of the Institution, sell, transfer, lease or otherwise dispose of all or a sizeable part of its assets, or undertake or permit any merger, consolidation, dismantling or re organization which would materially affect the Supplier's ability to perform its obligations under any of the Principal Documents;

**e.** It shall not (and shall not agree to), except with the written consent of the Institution, create, incur, assume or suffer to exist any Lien whatsoever upon or with respect to the Secured Assets and any other assets and properties owned by the Supplier which may rank superior, pari passu or inferior to the security created or to be created in favour of the Institution pursuant to the Principal Documents;

**f.** It shall forthwith inform the Institution of:

**(i)** Any event or factor, any litigation or proceedings pending or threatened against the Supplier which could materially and adversely affect or be likely to materially and adversely affect:

**(a)** the financial condition of the Supplier;

**(b)** business or operations of the Supplier; and

**(c)** the Supplier's ability to meet its obligations when due under any of the Principal Documents,

**(d)** expiry or cancellation of a material patent, copy right or license,

**(e)** loss of a key executive or trade Agreement;

**(ii)** Any change in the directors or management of the Supplier;

**(iii)** Any actual or proposed termination, rescission, discharge (otherwise than by performance), amendment or waiver or indulgence under any material provision of any of the Principal Documents;

**(iv)** Any material notice or correspondence received or initiated by the Supplier relating to the License, consent or authorization necessary for the performance by the Supplier of its obligations under any of the Principal Documents;

**g.** The Supplier shall indemnify and hold the Institution and its officers and employees harmless against any claims on account of quality, merchantability, fitness for use, any latent or patent defects in the Goods and any matters pertaining to intellectual property rights in respect of such Goods.

**8. EVENTS OF DEFAULT AND TERMINATION**

**8.1** There shall be an Event of Default if in the opinion of the Institution:

**(a)** The Supplier fails to deliver the Goods contracted to be delivered under this Agreement on the Delivery Date at [insert Place of Delivery];

**(b)** Any representation or warranty made or deemed to be made or repeated by the Supplier in or pursuant to the principal Documents or in any document delivered under this Agreement is found to be incorrect;

**(c)** Any Indebtedness of the Supplier in excess of Rs._____ (Rupees _____only) is not paid when due or becomes due or capable of being declared due in terms of this Agreement;

**(d)** Any authority of or registration with governmental or public bodies or courts required by the Supplier in connection with the execution, delivery, performance, validity, enforceability or admissibility in evidence of the Principal Documents are modified in a manner unacceptable to the Institution or is not granted or is revoked or otherwise ceases to be in full force and effect;

**(e)** The total interruption or cessation of the business activities of the Supplier;

**(f)** Any costs, charges and expenses under the Principal Documents shall remain unpaid for a period of _____ days after notice of demand in that behalf has been received by the Supplier from the Institution;

**8.02** Notwithstanding anything contained herein, the Institution may without prejudice to any of its other rights, at any time after the happening of an Event of Default by notice to the Supplier declare that:

**(a)** The obligation of the Institution to take delivery of the Goods from the Supplier shall be terminated, forthwith; and/or

**(b)** The entire outstanding amount of the Contract Price and any other amounts paid to the Supplier under this Agreement along with all other costs, charges, and expenses incurred or actual loss sustained by the Institution shall forthwith become due and refundable.

**9. PENALTY**

**9.01** Where any amount is required to be paid by the Supplier under the Principal Documents on a specified date and is not paid by that date, or an extension thereof, permitted by the Institution without any decrease in the Contract Price, the Supplier hereby undertakes to pay directly to the Charity Fund, constituted by the Institution, a sum calculated @ ------% per annum for the entire period of default, calculated on the total amount of the obligations remaining un-discharged. The Charity Fund shall be used at the absolute discretion of the Institution, exclusively for the purposes of approved charity.

**9.02** In case

**(i)** any amount(s) referred to in clause 9.01 above, including the amount undertaken to be paid directly to the Charity Fund, by the Supplier, is not paid by him, or

**(ii)** the Supplier delays the payment of any amount due under the Principal Documents and/ or the payment of amount to the Charity Fund as envisaged under Clause 10.01 above, as a result of which any direct or indirect costs are incurred by the Institution, the Institution shall have the right to approach a competent Court

**(i)** for recovery of any amounts remaining unpaid as well as

**(ii)** for imposing of a penalty on the Supplier. In this regard the Supplier is aware and acknowledges that notwithstanding the amount paid by the Supplier to the Charity Fund of the Institution, the Court has the power to impose penalty, at its discretion, and from the amount of such penalty, a smaller or bigger part, depending upon the circumstances, can be awarded as solatium to the Institution, determined on the basis of direct and indirect costs incurred, other than the opportunity cost.

**10. INDEMNITIES**

The Supplier shall indemnify the Institution against any expense, which the Institution shall prove as rightly incurred by it as a consequence of

**(i)** any default in performance of any obligations under the Principal Documents,

**(ii)** the occurrence of any Event of Default, and

**(iii)** arising out of any misrepresentation

**11. INCREASED COSTS**

If any law or regulation or any order of any court, tribunal or authority has the effect of subjecting the Supplier to Taxes or changes the basis or rate of Taxation with respect to any payment or other obligation under this Agreement (other than Taxes or Taxation on the overall income of the Institution), the same shall be borne by the Supplier. No additional amount will be demanded or become payable by Institution;

**12. SET-OFF**

The Supplier authorizes the Institution to apply any credit balance to which the Supplier is entitled or any amount which is payable by the Institution to the Supplier at any time in or towards partial or total satisfaction of any sum which may be due from or payable by the Supplier to the Institution under this Agreement including the Contract Price upon occurrence of any event of the Supplier failing to meet the delivery.

**13. ASSIGNMENT**

This Agreement shall be binding upon and inure to the benefit of and be enforceable by the Institution, the Supplier and respective successors, assigns and transferees of the parties hereto, provided that the Supplier shall not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Institution. The Institution may assign all or any part of its rights or transfer all or any part of its obligations and/or commitments under this Agreement to any financial institution or other person without any consent of the Supplier. The Supplier shall not be liable for the costs of the assignment and/or transfer of commitments hereunder by the Institution. If the Institution assigns all or any part of its rights or transfers all or any part of its obligations and commitments as provided in this Clause, all relevant references in this Agreement to the Institution shall thereafter be construed as a reference to the Institution and/or its assignee(s) or transferee(s) (as the case may be) to the extent of their respective interests.

**14. FORCE MAJEURE**

Any delays in or failure by a Party hereto in the performance hereunder if and to the extent it is caused by the occurrences or circumstances beyond such Party's reasonable control, including but not limited to, acts of God, fire, strikes or other labor disturbances, riots, civil commotion, war (declared or not) sabotage, any other causes, similar to those herein specified which cannot be controlled by such Party. The Party affected by such events shall promptly inform the other Party of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall consult each other to decide

whether to terminate this Agreement or to discharge part of the obligations of the affected Party or extend its obligations on a best efforts and an on arm's length basis.

**15. GENERAL**

**15.01** No failure or delay on the part of the Institution to exercise any power, right or remedy under this Agreement shall operate as a waiver thereof nor shall a partial exercise by the Institution of any power right or remedy preclude any other or further exercise thereof or the exercise of any other power right or remedy. The remedies provided in this Agreement are cumulative and are not exclusive of any remedies provided by law;

**15.02** This Agreement represents the entire Agreement and understanding between the parties in relation to the subject matter and no amendment or modification to this Agreement will be effective or binding unless it is in writing, signed by both parties and refers to this Agreement;

**15.03** This Agreement is governed by and shall be construed in accordance with the Pakistani law. All competent courts at _____ shall have the non-exclusive jurisdiction to hear and determine any action, claim or proceedings arising out of or in connection with this Agreement.

**15.04** Nothing contained herein shall prejudice or otherwise affect the rights and remedies that may otherwise be available under law to the parties.

**15.05** Any reconstruction, division, reorganization or change in the constitution of the Institution or its absorption in or amalgamation with any other person or the acquisition of all or part of its undertaking by any other person shall not in any way prejudice or affect its rights hereunder.

**15.06** The two parties agree that any notice or communication required or permitted by this Agreement shall be deemed to have been given to the other party seven days after the same has been posted by registered mail or the next Business Day if given by a facsimile message to telex or by any other electronic means, or the next Business Day as counted from the date of delivery if delivered by courier mail;

**IN WITNESS WHEREOF, the Parties to this Agreement have caused this Agreement to be duly executed on the date and year first aforementioned.**

| | **WITNESSES:** | For and on behalf of [insert name of the Institution] |
|---|---|---|
| 1 | _____ | _____ |
| 2 | _____ | _____ |
| | | For and on behalf of |
| 1 | _____ | _____ |
| 2 | _____ | _____ |

**Document 1**

**WRITTEN OFFER**

Date: _____

To:

_____
[Insert name and address of the Institution]
_____

Dear Sirs,

**Written offer for Sale of Goods [insert descriptions]**

**(1)** Please refer to your recent inquiry for the sale of the above referred Goods. In this regard, we are pleased to offer the Goods as per following terms and conditions:

**(a)** Description of the Goods:

| Sr. No. | Specification of Goods | Quantity | Sale Price |
|---|---|---|---|
| | | | |

**(b)** Validity of the Offer:

**(c)** Delivery Date:

**(d)** Terms of delivery:

**(e)** Place of delivery:

**(2)** We certify that:

**(a)** There are no circumstances (i) that would materially and adversely affect the carrying on of our business, operations or prospects or financial position, or (ii) which has made the fulfillment of our obligations unlikely;

**(b)** The delivery of the Goods by us to you shall not result in a breach of our organizational documents, any provision of any document to which the we are a party or by which we are bound, or any applicable law, rule or regulation whether directly or indirectly.

Yours faithfully,

For and on Behalf of

_____

**Document 2**

Date:_____

To: _____

_____

[Insert name and address of the Institution]

Dear Sirs,

**Notice of Delivery of Goods [insert descriptions]**

Reference to the above we are pleased to inform you that we are ready to deliver the Goods under the above-referred agreement as per the following details:

**a)** Delivery Date:
**b)** Place of delivery:
**c)** Description of the Goods:

| Sr. No. | Specification of Goods | Quantity | Sale Price |
|---|---|---|---|
| | | | |

**d)** Additional remarks (if any):

Yours faithfully,

For and on Behalf of (Supplier)

_____

**GOODS RECEIVNG NOTE**

Date:_____

No. _____

To:_____

_____

[Insert name and address of the Supplier]

Dear Sirs,

**(1)** We acknowledge having received the Goods as detailed in the Notice of Delivery aforesaid:

**a)** Date of Receipt:
**b)** Time:
**c)** Place of Delivery:
**d)** Description of Goods delivered:

| Sr. No. | Specification of Goods | Quantity | Sale Price |
|---|---|---|---|

**e)** Additional remarks (if any):

**(2)** Subject to 1(e), we hereby confirm that there are no claims or liabilities against you.

Yours faithfully,
For and on Behalf of (Institution)
_____

# MODEL ISTISNA AGREEMENT

**THIS ISTISNA AGREEMENT**

(the "Agreement") is made at_____ on _____ day of _____ by and

**BETWEEN**

_____,(hereinafter referred to as the "**Manufacturer/Supplier**" which expression shall where the context so permits mean and include its successors in interest and permitted assigns) of the one part

**AND**

_____,(hereinafter referred to as the "**Institution**" which expression shall where the context so permits mean and include its successors in interest and assigns) of the other part

**IT IS AGREED BY THE PARTIES** as follows:

**1. PURPOSE AND DEFINITIONS**

**1.01** This Agreement sets out the terms and conditions upon and subject to which the Institution has agreed to have the Specified Goods manufactured from the Manufacturer/Supplier subject to the following terms and conditions:

**1.02** In this Agreement, unless the context otherwise requires:

**"Business Day"** means a day on which Institutions are open for normal business in Pakistan;

**"Contract Price"** means Rs._____, being the sum payable by the Institution to the Manufacturer/Supplier as price of the Goods to be manufactured by the Manufacturer/Supplier;

**"Event of Default"** means any of the events or circumstances described in Clause 09 hereto;

**"Goods"** means the Goods described in the clause 2.01 and the Appendix "A";

**"Goods Receiving Note"** means confirmation of receipt of Goods as set out in the Appendix **"B";**

**"Indebtedness"** means any obligation of the Supplier for delivery of the Goods or for payment of any sum of money due or, payable under this Agreement;

**"License"** means any license, permission, authorization, registration, consent or approval granted to the Manufacturer/Supplier for the purpose of or relating to the conduct of its business;

**"Lien"** shall mean any mortgage, charge, pledge, hypothecation, security interest, lien, right of set-off, contractual restriction (such as negative covenants) and any other encumbrance;

**“Parties”** mean parties to this Agreement;

**"Principal Documents"** means this Agreement and the Security Documents;

**"Promissory Note"** is defined in Clause 3.01(b);

**"Prudential Regulations"** means Prudential Regulations or other regulations as are notified from time to time by State Bank of Pakistan;

**"Security Documents”** and “**Security**" is defined in Clause 3.01;

**"Secured Assets"** means the following assets of the Manufacturer/Supplier; [insert description of assets in respect of which charge/mortgage may be created];

**"Rupees"** or "Rs." means the lawful currency of Pakistan;

**"State Bank of Pakistan"** means the State Bank of Pakistan;

**"Title"** means such title or other interest in the Goods as the Institution receives from the Manufacturer/Supplier;

**"Taxes"** includes all present and future taxes (including central excise duty and sales tax), levies, imposts, duties, stamp duties, penalties, fees or charges of whatever nature together with delayed payment charges thereon and penalties in respect thereof and "Taxation" shall be construed accordingly;

**"Written Offer"** means the Offer made by the Manufacturer/Supplier to the Institution as per Appendix**"A"**.

**1.03** Clause headings and the table of contents are inserted for convenience of reference only and shall be ignored in the interpretation of this Agreement. In this Agreement, unless the context otherwise requires, references to Clauses and Appendices are to be construed as references to the clauses of, and Appendices to, this Agreement and references to this Agreement include its

appendices; words importing the plural shall include the singular and vice versa and reference to a person shall be construed as including references to an individual, firm, institution, corporation, unincorporated body of persons or any state or any agency thereof.

**1.04** The Appendices to this Agreement shall form an integral part of this Agreement.

**2. MANUFACTURE OF GOODS**

**2.01** The Manufacturer/Supplier hereby agrees to manufacture or cause to manufacture the Goods described below on Istisna for the Institution to be delivered as per schedule set out in clause 2.04:

[Insert description of the Goods with specifications, quantity quality and respective contract price]

**2.02** The Contract Price shall subject to the provisions of clause 5 hereof, be paid by the Institution as per the following schedule:

| | |
|---|---|
| Within ____ days of signing this Agreement | Rs. [insert amount] |
| On [insert date] | ---------- |
| On [insert date] | ---------- |
| On [insert date] | ---------- |
| On delivery | ---------- |
| TOTAL | |

**2.03** The Manufacturer/Supplier agrees that the Contract Price is fixed at the amount stated in clause 2.02 and shall not be revised except by mutual consent, in writing, of the parties hereto due to any reason whatsoever including the Force Majeure events, if any;

**2.04** The delivery of the Goods shall be according to the following schedule:

| **Description of Goods** | **Date:** | **Quantity** |
|---|---|---|

**2.05** The Goods shall remain at the risk of the Manufacturer/Supplier until they are delivered to the point of delivery and have been inspected and accepted by the Institution, immediately after which, all risks in respect of the Goods shall be passed on to the Institution:

**3. SECURITY**

**3.01** As security for the performance of this Agreement by the Manufacturer/Supplier under this Agreement, the Manufacturer/Supplier shall:

**(a)** Furnish to the Institution a collateral (s), substantially in the form and substance attached hereto as _____, (the "_____");

**(b)** Execute such further deeds and documents as may from time to time be required by the Institution for the purpose of more fully securing and or perfecting the security created in favour of

the Institution; and

**(c)** Create such other securities to secure the Manufacturer's/Supplier's obligations under the Principal Documents as the parties, hereto, may by mutual consent agree from time to time.
**(The above are hereinafter collectively referred to as the "Security").**

**3.02** In addition to above, the Manufacturer/Supplier shall execute a demand promissory note in favour of the Institution for the amount of the Contract Price (the "Promissory Note");
(The Security and the Promissory Note are hereinafter collectively referred to as the**"Security Documents")**

**4. FEES AND EXPENSES**

It is understood each party shall bear the fees and expenses incurred from its own account:

**(i)** in connection with the negotiation, preparation and execution of the Principal Documents and of amendment or extension of or the granting of any waiver or consent under the Principal Documents and

**(ii)** in contemplation of or otherwise in connection with, the enforcement of, or preservation of any rights under the Principal Documents

**5. PAYMENT OF CONTRACT PRICE**

Payments to be made to the Manufacturer/Supplier under this Agreement shall be made after adjustment of such withholding that the Institution is required to deduct under various laws in force. The Institution shall promptly deliver to the Manufacturer/Supplier any receipts, certificates or other proof evidencing the amounts (if any) paid or payable in respect of any deduction or withholding as aforesaid;

**6. REPRESENTATIONS AND WARRANTIES**

**a)** The financial statements together with the notes to the accounts and all contingent liabilities and assets that are disclosed therein represent a true and fair financial position of the business and to the best of the knowledge of the Manufacturer/Supplier, its directors and principal officers and there are no material omissions and or mis-representations;

**b)** All requisite corporate and regulatory approvals required to be obtained by the Manufacturer/ Supplier in order to enter into the Principal Documents are in full force and effect

**c)** No material litigation, arbitration or administrative proceedings is pending or threatened against the Manufacturer/Supplier or any of its assets;

**d)** It shall inform the Institution within ---------- Business Days of an event or happening which may have an adverse effect on the financial position of the Manufacturer/Supplier, whether such an event

is recorded in the financial statements or not as per applicable International Accounting Standards[, as applicable in Pakistan].

**7. UNDERTAKING**

**7.01** The Manufacturer/Supplier covenants to and undertakes with the Institution that so long as it remains obliged under this Agreement:

**a.** It shall inform the Institution of any Event of Default or any event, which with the giving of notice or lapse of time or both would constitute an Event of Default forthwith upon becoming aware thereof;

**b.** The Manufacturer/Supplier shall do all such things and execute all such documents which in the judgment of the Institution may be necessary to; (i) enable the Institution to assign or otherwise transfer the liability of the Manufacturer/Supplier in respect of the Contract Price to any creditor of the Institution or to any third party as the Institution may deem fit at its entire discretion; (ii) create and perfect the Security; (iii) maintain the Security in full force and effect at all times including the priority thereof; (iv) maintain, insure and pay all Taxes assessed in respect of the Secured Assets and protect and enforce its rights and title, and the rights of the Institution in respect of the Secured Assets, and; (v) preserve and protect the Secured Assets. The Manufacturer/Supplier shall at its own expense cause to be delivered to the Institution such other documentation and legal opinion(s) as the Institution may reasonably require from time to time in respect of the foregoing;

**c.** It will satisfactorily insure all its insurable assets with reputable companies offering protection under the Islamic concept of Takaful. Until the Islamic insurance concept of Takaful is not available the Secured Assets shall be comprehensively insured (with a reputable insurance company to the satisfaction of the Institution) against all insurable risks, which may include fire, arson, theft, accidents, collision, body and engine damage, vandalism, riots and acts of terrorism, and to assign all policies of insurance in favour of the Institution to the extent of the amount from time to time due under this Agreement, and to cause the notice of the interest of the Institution to be noted on the policies of insurance, and to punctually pay the premium due for such insurance's and to contemporaneously therewith deliver the premium receipts to the Institution. Should the Manufacturer/Supplier fail to insure or keep insured the Secured Assets and/or to deliver such policies and premium receipts to the Institution, then it shall be lawful for the Institution but not obligatory to pay such premia and to keep the Secured Assets so insured and all cost charges and expenses incurred by it for the purpose shall be charged to the Manufacturer/Supplier and shall be paid by the Manufacturer/Supplier to the Institutions within five (5) days of a demand being made by the Institution. The Manufacturer/Supplier expressly agrees that the Institution shall be entitled to adjust, settle or compromise any dispute with the insurance company(ies) and the insurance arising under or in connection with the policies of insurance and such adjustments/compromises or settlements shall be binding on the Manufacturer/Supplier and the Institution shall be entitled to appropriate and adjust the amount, if any received, under the aforesaid policy or policies towards part or full satisfaction of the Manufacturer/Supplier's indebtedness arising out of the above arrangements and the Manufacturer/Supplier shall not raise any question or objection that larger

sums might or should have been received under the aforesaid policy nor the Manufacturer/Supplier shall dispute its liability(ies) for the balance remaining due after such payment/adjustment;

**d.** Except as required in the normal operation of its business, the Manufacturer/Supplier shall not, without the written consent of the Institution, sell, transfer, lease or otherwise dispose of all or a sizeable part of its assets, or undertake or permit any merger, consolidation, dismantling or re organization which would materially affect the Manufacturer/Supplier's ability to perform its obligations under any of the Principal Documents;

**e.** The Manufacturer/Supplier shall not (and shall not agree to), except with the written consent of the Institution, create, incur, assume or suffer to exist any Lien whatsoever upon or with respect to the Secured Assets and any other assets and properties owned by the Manufacturer/Supplier which may rank superior, pari passu or inferior to the security created or to be created in favour of the Institution pursuant to the Principal Documents;

**f.** It shall forthwith inform the Institution of:

**i)** Any event or factor, any litigation or proceedings pending or threatened against the Manufacturer/Supplier which could materially and adversely affect or be likely to materially and adversely affect: (A) the financial condition of the Manufacturer/Supplier; (B) business or operations of the Manufacturer/Supplier; and (C) the Manufacturer/Supplier's ability to meet its obligations when due under any of the Principal Documents, (D) expiry or cancellation of a material patent, copy right or license, (E) cancellation or termination of a material trade agreement;

**ii)** Any change in the directors or management of the Manufacturer/Supplier;

**iii)** Any actual or proposed termination, rescission, discharge (otherwise than by performance), amendment or waiver or indulgence under any material provision of any of the Principal Documents;

**iv)** Any material notice or correspondence received or initiated by the Manufacturer/Supplier relating to the License, consent or authorization necessary for the performance by the Manufacturer/Supplier of its obligations under any of the Principal Documents

**8. CONDITIONS PRECEDENT**

**8.01** The obligation of the Institution to purchase the Goods under this Istisna Contract shall be subject to the receipt by the Institution (in form and substance acceptable to the Institution), at least ___ Business Days prior to the first date on which the payment is to be made in accordance with clause 2.02 above, of:

**(a)** Documentary evidence that::

**(i)** This Agreement has been executed and delivered by the Manufacturer/Supplier;

**(ii)** The Manufacturer/Supplier's representatives are duly empowered to sign the Principal

Documents for and on behalf of the Manufacturer/Supplier and to enter into the covenants and undertakings set out herein or which arise as a consequence of the Manufacturer/Supplier entering into the Principal Documents;

**(iii)** The Manufacturer/Supplier has taken all necessary steps and executed all documents required under or pursuant to the Principal Documents or any documents creating or evidencing the Security in favor of the Institution and has perfected the Security as required by the Institution

**(b)** Certified copy(ies)of the Memorandum and Articles of Association of the Manufacturer/Supplier.

**(c)** Certified copies of the Manufacturer/Supplier's audited financial statements for the last ____ years

**(d)** The Written Offer and Cost Estimate;

**8.02** The obligation of the Institution to purchase the Goods shall be further subject to the fulfillment of the following conditions:

**(a)** The purchase of the Goods under this Istisna Agreement shall not result in any breach of any law or existing Agreement;

**(b)** The Security has been validly created, perfected and is subsisting in terms of this Agreement;

**(c)** The Institution has received such other documents as it may reasonably request in respect of sale of Goods and their necessity for the conduct of the Manufacturer/Suppliers' business;

**(d)** No event or circumstance which constitutes or which with the giving of notice or lapse of time or both would constitute an Event of Default shall have occurred and be continuing or is likely to occur and that the payment of the Contract Price shall not result in the occurrence of any Event of Default;;

**(e)** Delivery by the Manufacturer/Supplier to the Institution of a true and complete extract of all relevant parts of the minutes of a duly convened meeting of its Board of Directors approving the Principal Documents and granting the necessary authorizations for entering into, execution and delivery of the Principal Documents which shall be duly signed and certified by the person authorized by the Board of Directors'; and

**(f)** All fees, commission, expenses required to be paid by the Manufacturer/Supplier have been received by the Institution.

**8.03** Any condition precedent set forth in this Clause 8 may be waived and or modified by the mutual written consent of the parties hereto.

**9. EVENTS OF DEFAULT AND TERMINATION**

**9.01** There shall be an Event of Default if in the opinion of the Institution:

**a)** The Manufacturer/Supplier fails to deliver the Goods as per delivery schedule agreed under this Agreement;

**b)** Any representation or warranty made or deemed to be made or repeated by the Manufacturer/ Supplier in or pursuant to the Principal Documents or in any document delivered under this Agreement is found to be incorrect;

**c)** Any Indebtedness of the Manufacturer/Supplier in excess of Rs._____ (Rupees _____only) is not paid when due or becomes due or capable of being declared due;

**d)** Any authority of or registration with governmental or public bodies or courts required by the Manufacturer/Supplier in connection with the execution, delivery, performance, validity, enforceability or admissibility in evidence of the Principal Documents are modified in a manner unacceptable to the Institution or is not granted or is revoked or otherwise ceases to be in full force and effect;

**e)** The total interruption or cessation of the business activities of the Manufacturer/Supplier;

**f)** Any costs, charges and expenses under the Principal Documents shall remain unpaid for a period of _____ days after notice of demand in that behalf has been received by the Manufacturer/ Supplier from the Institution;

**9.02** Notwithstanding anything contained herein, the Institution may without prejudice to any of its other rights, at any time after the happening of an Event of Default by notice to the Manufacturer/ Supplier declare that:

**a)** The obligation of the Institution to take delivery of the Goods from the Manufacturer/Supplier and pay the Contract Price to the Manufacturer/Supplier shall be terminated, forthwith; and/or

**b)** The entire amount of the Contract Price or such part thereof against which the Goods have not been delivered to the Institution by the Manufacturer/Supplier along with all other costs, charges, expenses and damages etc. and any other amounts paid to the Manufacturer/Supplier under this Agreement shall forthwith become due and refundable.

**10. PENALTY**

**10.01** Where the Manufacturer/Supplier fails to deliver the Goods required to be delivered to the Institution under the Principal Documents and are not delivered by the Delivery Date, the Contract Price will be reduced by Rs._____ per day unless an extension is mutually agreed.

**10.02** When any amount is required to be paid by the Manufacturer/Supplier and is not paid by the specified date, the Manufacturer/Supplier hereby undertakes to pay directly to the Charity Fund, constituted by the Institution, a sum calculated @ ------% per annum of the total amount payable for

the entire period of default. Payment by the Manufacturer/Supplier to the Charity Fund shall be used at the absolute discretion of the Institution, exclusively for the purposes of approved charity.

**10.03** In case

**(i)** any amount(s) due under clause 10.02 above, including the amount undertaken to be paid directly to the Charity Fund, by the Manufacturer/Supplier is/ are not paid by him within the specified period, or

**(ii)** the Manufacturer/Supplier delays the payment of any amount due under the Principal Documents and/or the payment of amount to the Charity Fund as envisaged under Clause 10.02 above, as a result of which any direct or indirect costs are incurred by the Institution, the Institution shall have the right to approach a competent Court

**(i)** for recovery of any amounts remaining unpaid as well as

**(ii)** imposing of a penalty on the Manufacturer/Supplier and awarding of solatium to the Institution. In this regard the Manufacturer/Supplier is aware and acknowledges that notwithstanding the amount paid by the Manufacturer/Supplier to the Charity Fund of the Institution, the Court has the power to impose penalty, at its discretion, and from the amount of such penalty, a smaller or bigger part, depending upon the circumstances, can be awarded as solatium to the Institution, determined on the basis of direct and indirect costs incurred by the Institution, other than the opportunity cost.

**11. INDEMNITIES**

The Manufacturer/Supplier acknowledges that in case of any breach of this Agreement the Institution may suffer losses. The Manufacturer/Supplier shall, therefore, indemnify the Institution against any expense which the Institution shall prove as rightly sustained or incurred by it as a consequence of

**(i)** any default in payment by the Manufacturer/Supplier of any sum under the Principal Documents when due,

**(ii) the occurrence of any Event of Default, and**

**(iii) arising out of an misrepresentation**

**12. INCREASED COSTS**

If any law or regulation or any order of any court, tribunal or authority has the effect of subjecting the Institution to Taxes or changes the basis or rate of Taxation with respect to any payment under this Agreement (other than Taxes or Taxation on the overall income of the Institution), the same shall be borne by the Manufacturer/Supplier. No additional amount will be demanded or become payable by Institution;

**13. SET-OFF**

The Manufacturer/Supplier authorizes the Institution to apply any credit balance to which the Manufacturer/Supplier is entitled or any amount which is payable by the Institution to the Manufacturer/Supplier at any time in or towards partial or total satisfaction of any sum which may be due from or payable by the Manufacturer/Supplier to the Institution under this Agreement including the Contract Price in the event of the Manufacturer/Supplier failing to meet the delivery schedule as given in clause 2.04 above or the Contract Price has become due and/or payable to the Institution under this Agreement.

**14. ASSIGNMENT**

**14.01** This Agreement shall be binding upon and inure to the benefit of and be enforceable by the Institution, the Manufacturer/Supplier and respective successors permitted assigns and transferees of the parties hereto, provided that the Manufacturer/Supplier shall not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Institution. The Institution may assign all or any part of its rights or transfer all or any part of its obligations and/or commitments under this Agreement to any Institution, financial institution or other person. The Manufacturer/Supplier shall not be liable for the costs of the assignment and/or transfer of commitments hereunder by the Institution. If the Institution assigns all or any part of its rights or transfers all or any part of its obligations and commitments as provided in this Clause, all relevant references in this Agreement to the Institution shall thereafter be construed as a reference to the Institution and/or its assignee(s) or transferee(s) (as the case may be) to the extent of their respective interests.

**14.02** The Institution may disclose to a potential assignee or transferee or to any other person who may propose entering into contractual relations with the Institution in relation to this Agreement such information about the Manufacturer/Supplier as the Institution shall consider appropriate.

**15. FORCE MAJEURE**

Any delays in or failure by a Party hereto in the performance hereunder if and to the extent it is caused by the occurrences or circumstances beyond such Party's reasonable control, including but not limited to, acts of God, fire, strikes or other labor disturbances, riots, civil commotion, war (declared or not) sabotage, any other causes, similar to those herein specified which cannot be controlled by such Party. The Party affected by such events shall promptly inform the other Party of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall consult each other to decide whether to terminate this Agreement or to discharge part of the obligations of the affected Party or extend its obligations on a best effort and on an arm's length basis.

**16. GENERAL**

**16.01** No failure or delay on the part of the Institution to exercise any power, right or remedy under this Agreement shall operate as a waiver thereof nor shall a partial exercise by the Institution of any power right or remedy preclude any other or further exercise thereof or the exercise of any other power right or remedy. The remedies provided in this Agreement are cumulative and are not exclusive of any remedies provided by law;

**16.02** This Agreement represents the entire Agreement and understanding between the Parties in relation to the subject matter and no amendment or modification to this Agreement will be effective or binding unless it is in writing, signed by both Parties and refers to this Agreement;

**16.03** This Agreement is governed by and shall be construed in accordance with the Pakistani law. All competent courts at _____ shall have the non-exclusive jurisdiction to hear and determine any action, claim or proceedings arising out of or in connection with this Agreement.

**16.04** Nothing contained herein shall prejudice or otherwise affect the rights and remedies that may otherwise be available under law to the parties.

**16.05** Any reconstruction, division, reorganization or change in the constitution of the Institution or its absorption in or amalgamation with any other person or the acquisition of all or part of its undertaking by any other person shall not in any way prejudice or affect its rights hereunder.

**16.06** The two parties agree that any notice or communication required or permitted by this Agreement shall be deemed to have been given to the other party seven days after the same has been posted by registered mail or the next Business Day if given by a facsimile message to telex or by any other electronic means, or the next Business Day as counted from the date of delivery if delivered by courier mail;

**IN WITNESS WHEREOF,** the Parties to this Agreement have caused this Agreement to be duly executed on the date and year first aforementioned.

| | **WITNESSES:** | For and on behalf of [insert name of the Institution] |
|---|---|---|
| 1 | _____ | _____ |
| 2 | _____ | _____ |
| | | For and on behalf of |
| 1 | _____ | _____ |
| 2 | _____ | _____ |

**APPENDIX- A**

**WRITTEN OFFER**

Date: _____

To

_____
[Insert name and address of the Institution]

Dear Sirs,

**Written offer for manufacture of Goods [insert description]**

Reference our recent meeting, we are pleased to confirm our willingness to manufacture the Goods subject to the following terms and conditions:

**(a)** Description of the Goods:
---
---
---
----------* (attach details if required)

**(b)** Terms of delivery:
**(c)** Terms of Payment:
**(d)** Validity of the Offer:
**(e)** Place of delivery:

**2.** We certify that:

**a)** There have not been any circumstances (i) that would materially and adversely affect the carrying on of the Manufacturer/Supplier's business and operations or the Manufacturer/Supplier's prospects or financial position, or (ii) which has made the fulfillment of the Manufacturer/Supplier's obligations;

**(b)** The delivery of the Goods by us to you shall not result in a breach of its organizational documents, any provision of any document to which the Manufacturer/Supplier is a party or by which the Manufacturer/Supplier is bound, or any applicable law, rule or regulation whether directly or indirectly.

Yours faithfully,

For and on Behalf of the Manufacturer/Supplier

_____

**APPENDIX- B**

**GOODS RECEIVING NOTE**

Date_____

**To**

_____

**[Insert name and address of the Manufacturer/Supplier]**

**Dear Sirs,**

**Istisna Agreement dated [ ] - Goods Receiving Note**

Reference to the above, we are pleased to inform you that we have received the Goods contracted to be delivered by you as per the following details:

**a)** Date of Receipt:
**b)** Time:
**c)** Address:
**d)** Description of Goods received:
**e)** Additional remarks:

i. Subject to 1(e), we hereby confirm that there are no claims or liabilities against you.

Yours faithfully,

For and on Behalf of (Institution)

_____

**AGREEMENT TO SELL**

**THIS AGREEMENT TO SELL**
(the "Agreement") is made at_____ on _____ day of _____ by and

**BETWEEN**
_____, (hereinafter referred to as the "**Institution**" which expression shall where the context so permits mean and include its successors in interest and assigns) of the one part.
AND
_____ (hereinafter referred to as the "**Customer**") which expression shall where the context so permits mean and include its successors in interest and assigns) of the other part.
Whereas:

**1.** The Institution is acquiring the goods described in the Appendix 1 ("**Goods**") from the Manufacturer/ Supplier namely _____ ("**Manufacturer/ Supplier**"); and

**2.** The Customer has requested vide written request dated ..... to purchase the Goods from the Institution on the terms and condition contained hereinafter..

**NOW THEREFORE THIS AGREEMENT WITNESSETH:**

**1.** That the Institution agrees to sell and the Customer agrees to purchase the Goods from the Institution at the price of Rs. _____.

**2.** That the Customer shall pay the price of the Goods in advance to the Institution upon receipt of a notice from the Institution confirming that the Goods are ready for delivery to the Customer.

**3.** The Customer shall satisfy itself as to the quality and quantity of the Goods at the time of delivery and shall issue a Delivery Receipt in the form of Appendix 2 hereto.

**4.** Upon payment of the price, all rights and claims of the Institution against the Manufacturer/ Supplier on account of warranties pertaining to the Goods shall stand assigned to the Customer. In case of any defect in the Goods, the Customer shall only have a claim against the Manufacturer/ Supplier to the complete exclusion of the Institution.

**IN WITNESS WHEREOF**, the Parties to this Agreement have caused this Agreement to be duly executed on the date and year first aforementioned.

| | **WITNESSES:** | For and on behalf of [insert name of the Institution] |
|---|---|---|
| 1 | _____ | _____ |
| 2 | _____ | _____ |
| | | For and on behalf of |
| 1 | _____ | _____ |
| 2 | _____ | _____ |

# MODEL MURABAHA FACILITY AGREEMENT

For Corporate Clients-local purchases

**THIS MURABAHA FACILITY AGREEMENT**
(this "Agreement") is made at_____on ___ day of _____ by and

**BETWEEN**

_____, (hereinafter referred to as the "Client" which expression shall where the context so permits mean and include its successors in interest and permitted assigns) of the one part

**AND**

_____, (hereinafter referred to as the "Institution" which expression shall where the context so permits mean and include its successors in interest and assigns) of the other part.

**IT IS AGREED BY THE PARTIES** as follows:

**1. PURPOSE AND DEFINITIONS**

**1.01** This Agreement sets out the terms and conditions upon and subject to which the Institution has agreed to purchase the Goods from time to time from the Suppliers and upon which the Institution has agreed to sell the same to the Client from time to time by way of Murabaha facility.

**1.02** In this Agreement, unless the context otherwise requires:

**"Act"** means the Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997 or any statutory modification or re-promulgation thereof;

**"Agent"** means the person appointed under the terms of the Agency Agreement;

**"Agency Agreement"** means the Agency Agreement between the Institution and the Client as provided in the Murabaha Document # 2;

**"Business Day"** means a day on which banks are open for normal business in Pakistan;

**"Cost Price"** means the amount which may be incurred by and/or on behalf of the Institution for the acquisition of Goods plus all costs, duties, taxes and charges incidental to and connected with acquisition of Goods;

**"Contract Price"** means aggregate of Cost Price and a Profit of ___ per cent calculated thereon payable by the Client to the Institution for Goods as stipulated in Part-III of the Declaration (Murabaha Document # 5) to be issued by the Institution from time to time;

**"Declaration"** means Declaration as set out in Murabaha Document # 5;

**"Event of Default"** means any of the events or circumstances described in Clause 9 hereto;

**"Goods"** means the Goods as may be specified in the Purchase Requisition(s) to be issued by the Client from time to time;

**"Indebtedness"** means any obligation of the Client for the payment or any sum of money due or, payable under this Agreement;

**"License"** means any license, permission, authorization, registration, consent or approval granted to the Client for the purpose of or relating to the conduct of its business;

**"Lien"** shall mean any mortgage, charge, pledge, hypothecation, security interest, lien, right of set-off, contractual restriction (such as negative covenants) and any other encumbrance;

**"Payment Date"** or **"Payment Dates"** means the respective dates for the payment of the installments of the Contract Price or part thereof by the Client to the Institution as specified in Murabaha Document # 6 hereto, or, if such respective due date is not a Business Day, the next Business Day;

**"Profit"** means any part of the Contract Price which is not a part of the Cost Price;

**"Parties"** mean the parties to this Agreement;

**"Principal Documents"** means this Agreement, the Agency Agreement; and the Security Documents;

**"Promissory Note"** is defined in Clause 3.02 and is negotiable only at the face value, if required;

**"Prudential Regulations"** means Prudential Regulations or other regulations as are notified from time to time by State Bank of Pakistan;

**"Purchase Requisition"** means a request from time to time by the Client to the Institution as per Murabaha Document # 3/1;

**"Receipt"** means a confirmation by the Client (as Agent of the Institution) of receipt of funds by the Supplier for the supply of Goods Murabaha Document # 4.
**"Security Documents"** and "**Security**" is defined in Clause 3;

**"Supplier"** means the supplier from whom the Institution acquires Title to the Goods;

**"Secured Assets"** means (insert description of assets in respect of which charge/mortgage may be created) offered as security by the Client;

**"Rupees"** or "Rs." means the lawful currency of Pakistan;

**"State Bank of Pakistan"** means the State Bank of Pakistan;

**"Title"** means such title or other interest in the Goods as the Institution receives from the Supplier;

**"Taxes"** iincludes all present and future taxes (including central excise duty and sales tax), levies, imposts, duties, stamp duties, penalties, fees or charges of whatever nature together with delayed payment charges thereon and penalties in respect thereof and "**Taxation**" shall be construed accordingly;

**"Value Date"** means the date on which the Cost Price will be disbursed by the Institution as stated in the Purchase Requisition.

**1.01** Clause headings and the table of contents are inserted for convenience of reference only and shall be ignored in the interpretation of this Agreement. In this Agreement, unless the context otherwise requires, references to Clauses and Murabaha Documents are to be construed as references to the clauses of, and Murabaha Documents to, this Agreement and references to this Agreement include its Murabaha Documents; words importing the plural shall include the singular and vice versa and reference to a person shall be construed as including references to an individual, firm, Institution, corporation, unincorporated body of persons or any state or any Agency thereof.

**1.02** The recitals herein above and Murabaha Documents to this Agreement shall form an integral part of this Agreement.

**2. SALE AND PURCHASE OF THE GOODS**

**2.01** The Institution agrees to sell the Goods to the Client to a maximum amount of Rs_____ and the Client agrees to purchase the Goods from the Institution from time to time at the Contract Price.

Upon receipt by the Institution of the Client's Purchase Requisition advising the Institution to purchase the Goods and making payment therefore, the Institution shall acquire the Goods either directly or through the Agent. The payment for such goods shall be made by the institution directly to the Supplier on submission of Purchase Advice by the client/agent. The said Receipt shall be substantially in a form given in Murabaha Document # 4. (For making payment to the Supplier the bank should prepare a Pay Order/Cross cheque, etc in the name of Supplier that should be handed over to him through client/agent. The supplier should issue invoice in the name of Bank Account Client e.g. '1st Islamic Bank - ABC Company'. This way, the problem of claiming Sales or other Taxes Refund could be solved easily).

**2.02** Upon receipt of purchase of Goods by the Institution, directly or through an Agent, from the Supplier, the Goods shall be at the risk and cost of the Institution until such time that these Goods are sold to the Client, to be evidenced by the acceptance, duly signed and endorsed by the Institution in Part-III of the Declaration.

**2.03** After the purchase of Goods by the Institution, the Client shall offer to purchase the Goods from the Institution at the Contract Price in the manner provided in the Part-II of the Declaration.

**2.04** The Client's purchase of Goods from the Institution shall be effected by the exchange of an offer and acceptance between the Client and the Institution as stipulated in the Declaration.

**3. SECURITY**

**3.01** As security for the indebtedness of the Client under this Agreement, the Client shall:-

**(a)** Furnish to the Institution collateral(s)/security(ies), substantially in the form and substance attached hereto as Murabaha Document # 7;

**(b)** Execute such further deeds and documents as may from time to time be required by the Institution for the purpose of more fully securing and or perfecting the security created in favour of the Institution; and

**(c)** Create such other securities to secure the Client's obligations under the Principal Documents as the parties hereto, may by mutual consent agree from time to time.

(The above are hereinafter collectively referred to as the "**Security**").

**3.02** In addition to above, the Client shall execute a demand promissory note in favour of the Institution for the amount of the Contract Price (the "Promissory Note");
(The **Security** and the Promissory Note are hereinafter collectively referred to as the "**Security Documents**").

**4. FEES AND EXPENSES**

The Client shall pay to the Institution on demand within 15 days of such demand being made, all expenses (including legal and other ancillary expenses) incurred by the Institution in connection with the negotiation, preparation and execution of the Principal Documents and of amendment or extension of or the granting of any waiver or consent under the Principal Documents.

**5. PAYMENT OF CONTRACT PRICE**

**5.01** All payments to be made by the Client under this Agreement shall be made in full, without any set-off, roll over or counterclaim whatsoever, on the due date and when the due date is not a Business Day, the following Business Day and save as provided in Clause 5.02, free and clear of any deductions or withholdings, to a current account of the Institution as may be notified from time to time, and the Client will only be released from its payment obligations hereunder by paying sums due into the aforementioned account.

**5.02** If at any time the Client is required to make any non refundable and non-adjustable deduction or withholding in respect of Taxes from any payment due to the Institution under this Agreement, the sum due from the Client in respect of such payment shall be increased to the extent necessary to ensure that, after the making of such deduction or withholding, the Institution receives on the Payment Date, a net sum equal to the sum which it would have received had no such deduction or withholding been required to be made and the Client shall indemnify the Institution against any losses or costs incurred by the Institution by reason of any failure of the Client to make any such deduction or withholding. The Client shall promptly deliver to the Institution any receipts, certificates or other proof evidencing the amounts (if any) paid or payable in respect of any deduction or withholding as aforesaid.

**6. REPRESENTATIONS AND WARRANTIES**

**a.** The Client warrants and represents to the Institution that:

**b.** The execution, delivery and performance of the Principal Documents by the Client will not

**(i)** contravene any existing law, regulations or authorization to which the Client is subject

**(ii)** result in any breach of or default under any agreement or other instrument to which the Client is a party or is subject to, or

**(iii)** contravene any provision of the constitutive documents of the Client or any resolutions adopted by the board of directors or members of the Client;

**c.** The financial statements submitted together with the notes to the accounts and all contingent liabilities and assets that are disclosed therein represent a true and fair financial position of the

business and to the best of the knowledge of the client, its directors and principal officers, there are no material omissions and/or mis-repsentations;

**d.** All requisite corporate and regulatory approvals required to be obtained by the Client in order to enter into the Principal Documents are in full force and effect and such approvals permit the Client, inter alia, to obtain financial facilities under this Agreement and perform its obligations hereunder and that the execution of the Principal Documents by the Client and the exercise of its rights and performance of its obligations hereunder, constitute private and commercial acts done for private and commercial purposes;

**e.** No material litigation, arbitration or administrative proceedings is pending or threatened against the Client or any of its assets;

**f.** It shall inform the Institution within ____ business days of an event or happening which may have an adverse effect on the financial position of the company, whether such an event is recorded in the financial statements or not as per applicable International Accounting Standards.

**7. UNDERTAKING**

The Client covenants to and undertakes with the Institution that so long as the Client is indebted to the Institution in terms of this Agreement:

**(a)** It shall inform the Institution of any Event of Default or any event, which with the giving of notice or lapse of time or both would constitute an Event of Default forthwith upon becoming aware thereof;

**(b)** It shall provide to the Institution, upon written request, copies of all contracts, agreements and documentation relating to the purchase of the Goods;

**(c)** The Client shall do all such things and execute all such documents which in the judgment of the Institution may be necessary to; (i) enable the Institution to assign or otherwise transfer the liability of the Client in respect of the Contract Price to any creditor of the Institution or to any third party as the Institution may deem fit at its absolute discretion; (ii) create and perfect the Security; (iii) maintain the Security in full force and effect at all times including the priority thereof; (iv) maintain, insure and pay all Taxes assessed in respect of the Secured Assets and protect and enforce its rights and title, and the rights of the Institution in respect of the Secured Assets, and; (v) preserve and protect the Secured Assets. The Client shall at its own expense cause to be delivered to the Institution such other documentation and legal opinion(s) as the Institution may reasonably require from time to time in respect of the foregoing;

**(d)** It will satisfactorily insure all its insurable assets with reputable companies offering protection under the Islamic concept of Takaful. The Secured Assets shall be comprehensively insured (with a reputable insurance company to the satisfaction of the Institution) against all insurable risks, which

may include fire, arson, theft, accidents, collision, body and engine damage, vandalism, riots and acts of terrorism, and to assign all policies of insurance in favour of the Institution to the extent of the amount from time to time due under this Agreement, and to cause the notice of the interest of the Institution to be noted on the policies of insurance, and to punctually pay the premium due for such insurances and to contemporaneously therewith deliver the premium receipts to the Institution. Should the Client fail to insure or keep insured the Secured Assets and/or to deliver such policies and premium receipts to the Institution, then it shall be lawful for the Institution, but not obligatory, to pay such premia and to keep the Secured Assets so insured and all cost charges and expenses incurred by it for the purpose shall be charged to and paid by the Client as if the same were part of the Indebtedness. The Client expressly agrees that the Institution shall be entitled to adjust, settle or compromise any dispute with the insurance company(ies) and the insurance arising under or in connection with the policies of insurance and such adjustments/compromises or settlements shall be binding on the Client and the Institution shall be entitled to appropriate and adjust the amount, if any received, under the aforesaid policy or policies towards part or full satisfaction of the Client's indebtedness arising out of the above arrangements and the Client shall not raise any question or objection that larger sums might or should have been received under the aforesaid policy nor the Client shall dispute its liability(ies) for the balance remaining due after such payment/adjustment;

**(e)** Except as required in the normal operation of its business, the Client shall not, without the written consent of the Institution, sell, transfer, lease or otherwise dispose of all or a sizeable part of its assets, or undertake or permit any merger, consolidation, dismantling or re organization which would materially affect the Client's ability to perform its obligations under any of the Principal Documents;

**(f)** The Client shall not (and shall not agree to), except with the written consent of the Institution, create, incur, assume or suffer to exist any Lien whatsoever upon or with respect to the Secured Assets and any other assets and properties owned by the Client which may rank superior, pari passu or inferior to the security created or to be created in favour of the Institution pursuant to the Principal Documents;

**(g)** It shall forthwith inform the Institution of:

**(i)** Any event or factor, any litigation or proceedings pending or threatened against the Client which could materially and adversely affect or be likely to materially and adversely affect:

**(a)** the financial condition of the Client;

**(b)** business or operations of the Client; and

**(c)** the Client's ability to meet its obligations when due under any of the Principal Documents;

**(ii)** Any change in the directors of the Client;

**(iii)** Any actual or proposed termination, rescission, discharge (otherwise than by performance), amendment or waiver or indulgence under any material provision of any of the Principal Documents;

**(iv)** Any material notice or correspondence received or initiated by the Client relating to the License, consent or authorization necessary for the performance by the Client of its obligations under any of the Principal Documents

**8. CONDITIONS PRECEDENT**

**8.01** The obligation of the Institution to pay the Cost Price shall be subject to the receipt by the Institution (in form and substance acceptable to the Institution) at least ___ Business Days prior to the Value Date of:

**(i)** Documentary evidence that:

**(a)** This Agreement and the Agency Agreement (should the Institution appoint the Client as its Agent) have been executed and delivered by the Client;

**(b)** The Client's representatives are duly empowered to sign the Principal Documents for and on behalf of the Client and to enter into the covenants and undertakings set out herein or which arise as a consequence of the Client entering into the Principal Documents;

**(c)** The Client has taken all necessary steps and executed all documents required under or pursuant to the Principal Documents or any documents creating or evidencing the Security in favour of the Institution and has perfected the Security as required by the Institution.

**(ii)** Certified copy of the Memorandum and Articles of Association of the Client.

**(iii)** Certified copies of the Client's audited financial statements for the last ____ years

**(iv)** The Purchase Requisition.

**8.02** The obligation of the Institution to pay the Cost Price on the Value Date shall be further subject to the fulfillment of the following conditions (as shall be determined by the Institution in its sole discretion):

**(a)** The payment of Cost Price by the Institution to the Supplier on the Value Date shall not result in any breach of any law or existing agreement;

**(b)** The Security has been validly created, perfected and is subsisting in terms of this Agreement;

**(c)** The Institution has received such other documents as it may reasonably require in respect of the

payment of the Cost Price;

**(d)** No event or circumstance which constitutes or which with the giving of notice or lapse of time or both, would constitute an Event of Default shall have occurred and be continuing or is likely to occur and that the payment of the Cost Price shall not result in the occurrence of any Event of Default;

**(e)** Delivery by the Client to the Institution of a true and complete extract of all relevant parts of the minutes of a duly convened meeting of its Board of Directors approving the Principal Documents and granting the necessary authorizations for entering into, execution and delivery of the Principal Documents which shall be duly signed and certified by the person authorized by the Board for this purpose;

**(f)** All fees, commission, expenses required to be paid by the Client to the Institution have been received by the Institution.

**8.03** Any condition precedent set forth in this Clause 8 may be waived and or modified by the mutual written consent of the parties hereto.

**9. EVENTS OF DEFAULT**

**9.01** There shall be an Event of Default if in the opinion of the Institution

**(a)** Any representation or warranty made or deemed to be made or repeated by the Client in or pursuant to the Principal Documents or in any document delivered under this Agreement is found to be incorrect;

**(b)** Any Indebtedness of the Client to the Institution in excess of Rs._____ (Rupees _____ only) is not paid when due or becomes due or capable of being declared due prior to its stated maturity;

**9.02** Notwithstanding anything contained herein, the Institution may without prejudice to any of its other rights, at any time after the happening of an Event of Default by notice to the Client declare that entire amount by which the Client is indebted to the Institution shall forthwith become due and payable.

**10. PENALTY**

**10.1.** Where any amount is required to be paid by the Client under the Principal Documents on a specified date and is not paid by that date, or an extension thereof, permitted by the Institution without any increase in the Contract Price, the Client hereby undertakes to pay directly to the

Charity Fund, constituted by the Institution, a sum calculated @ ------% per annum for the entire period of default, calculated on the total amount of the obligations remaining un-discharged. The Charity Fund shall be used at the absolute discretion of the Institution, exclusively for the purposes of approved charity.

**10.2.** In case (i) any amount(s) referred to in clause 10.01 above, including the amount undertaken to be paid directly to the Charity Fund, by the Client, is not paid by him, or (ii) the Client delays the payment of any amount due under the Principal Documents and/ or the payment of amount to the Charity Fund as envisaged under Clause 10.01 above, as a result of which any direct or indirect costs are incurred by the Institution, the Institution shall have the right to approach a competent Court (i) for recovery of any amounts remaining unpaid as well as (ii) for imposing of a penalty on the Client. In this regard the Client is aware and acknowledges that notwithstanding the amount paid by the Client to the Charity Fund of the Institution, the Court has the power to impose penalty, at its discretion, and from the amount of such penalty, a smaller or bigger part, depending upon the circumstances, can be awarded as solatium to the Institution, determined on the basis of direct and indirect costs incurred, other than the opportunity cost.

**11. INDEMNITIES**

The Client shall indemnify the Institution against any expense which the Institution shall prove as rightly incurred by it as a consequence of

**(a)** the occurrence of any Event of Default,

**(b)** the purchase and sale of Goods or any part thereof by the Client or the ownership thereof, and

**(c)** any mis-representation.

**12. SET-OFF**

The Client authorizes the Institution to apply any credit balance to which the Client is entitled or any amount which is payable by the Institution to the Client at any time in or towards partial or total satisfaction of any sum which may be due or payable from the Client to the Institution under this Agreement.

**13. ASSIGNMENT**

**13.01** This Agreement shall be binding upon and inure to the benefit of and be enforceable by the Institution, the Client, and respective successors permitted assigns and transferees of the parties hereto, provided that the Client shall not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Institution. The Institution may assign all or any part of its rights or transfer all or any part of its obligations and/or commitments under this Agreement to

any Institution, or other person. The Client shall not be liable for the costs of the assignment and/or transfer of commitments hereunder by the Institution. If the Institution assigns all or any part of its rights or transfers all or any part of its obligations and commitments as provided in this Clause, all relevant references in this Agreement to the Institution shall thereafter be construed as a reference to the Institution and/or its assignee(s) or transferee(s) (as the case may be) to the extent of their respective interests.

**13.02** The Institution may disclose to a potential assignee or transferee or to any other person who may propose entering into contractual relations with the Institution in relation to this Agreement such information about the Client as the Institution shall consider appropriate.

**14. FORCE MAJEURE**

Any delays in or failure by a Party hereto in the performance hereunder if and to the extent it is caused by the occurrences or circumstances beyond such Party's reasonable control, including but not limited to, acts of God, fire, strikes or other labor disturbances, riots, civil commotion, war (declared or not) sabotage, any other causes, similar to those herein specified which cannot be controlled by such Party. The Party affected by such events shall promptly inform the other Party of the occurrence of such events and shall furnish proof of details of the occurrence and reasons for its non-performance of whole or part of this Agreement. The parties shall consult each other to decide whether to terminate this Agreement or to discharge part of the obligations of the affected Party or extend its obligations on a best effort and on an arm's length basis.

**15. GENERAL**

**15.01** No failure or delay on the part of the Institution to exercise any power, right or remedy under this Agreement shall operate as a waiver thereof nor a partial exercise by the Institution of any power, right or remedy preclude any other or further exercise thereof or the exercise of any other power right or remedy. The remedies provided in this Agreement are cumulative and are not exclusive of any remedies provided by law;

**15.02** This Agreement represents the entire agreement and understanding between the Parties in relation to the subject matter and no amendment or modification to this Agreement will be effective or binding unless it is in writing, signed by both Parties and refers to this Agreement;

**15.03** This Agreement is governed by and shall be construed in accordance with Pakistan law. All competent courts at _____ shall have the non-exclusive jurisdiction to hear and determine any action, claim or proceedings arising out of or in connection with this Agreement.

**15.04** Nothing contained herein shall prejudice or otherwise affect the rights and remedies that may otherwise be available under law to the parties.

**15.05** Any reconstruction, division, re-organization or change in the constitution of the Institution or its absorption in or amalgamation with any other person or the acquisition of all or part of its undertaking by any other person shall not in any way prejudice or affect its rights hereunder.

**15.06** The two parties agree that any notice or communication required or permitted by this agreement shall be deemed to have been given to the other party seven days after the same has been posted by registered mail or the next Business Day if given by a facsimile message or telex or by any other electronic means, or the next Business Day as counted from the date of delivery if delivered by courier mail;

**IN WITNESS WHEREOF**, the Parties to this Agreement have caused this Agreement to be duly executed on the date and year first aforementioned.

| | **WITNESSES:** | For and on behalf of [insert name of the Institution] |
|---|---|---|
| 1 | _____ | _____ |
| 2 | _____ | _____ |
| | | For and on behalf of |
| 1 | _____ | _____ |
| 2 | _____ | _____ |

**To:** _____

_____

**AGENCY AGREEMENT**

With reference to the Murabaha Facility Agreement dated _____ , we hereby confirm our agreement to appoint you as our Agent to acquire for our account and benefit goods of the description to be specified in the purchase requisition which shall be issued from time to time, under the following terms and conditions;

**1.** As an Agent of the Institution, you will be responsible to receive the Goods directly from the Supplier (s) from time to time in terms of Purchase Requisition(s) to be duly endorsed by the Institution and provide us a declaration confirming acquisition thereof, alongwith a statement containing relevant details including place of storage.

**2.** The bank shall prepare a Pay Order/Cross cheque, etc in the name of Supplier that will be handed over to the Agent. The supplier will issue an invoice in the name of Bank - Account Client (e.g. '1st Islamic Bank - ABC Company').

**3.** In case of failure on your part to:-

**a)** Acquire goods in terms of this agreement and to refund, in consequence, the amount paid by us (the Institution) therefore, and/or

**b)** Repay the amount, if any, due from you upon a notice of revocation, if any, served by you in the manner provided hereunder; you shall become liable to pay a penalty to the institution by credit to a special Account, separately maintained by the institution, an amount which shall be 5% over the rate announced by State Bank of Pakistan for providing short term accommodation to commercial banks, as on the date of such default by you. This amount will be calculated on the entire amount due from you, under this Agency Agreement and for the entire period for which the default subsists. The amount of such penalty shall be utilized by the institution only for the purposes of charity, in its absolute discretion.

**4.** The Institution shall have the authority, in its absolute discretion to refuse the disbursement of funds or to revoke this Agency Agreement at any time., subject to a notice in writing served given at least 07 days prior to revocation.

**5.** You may revoke this Agency Agreement by giving a notice in writing of at least 07 days prior to the date of intended revocation, provided that any amount due by you to the Institution shall become payable immediately and until such time that any such amount due from you has been discharged in full, this agreement shall not be deemed to have been revoked.

**6.** This Agency Agreement shall remain in force until revoked and shall be governed by the prevailing laws of Pakistan and the Murabaha Facility Agreement dated _____. Any dispute between the parties shall be submitted to a Court/Tribunal of competent jurisdiction in _____.

Kindly signify your acceptance of the foregoing terms and conditions by signing the duplicate.

For and on behalf of (insert name of the Institution)

_____

**AUTHORISED SIGNATORY OF THE INSTITUTION**

**AGREED AND ACCEPTED**

For and on behalf of [insert name]

_____

**AUTHORISED SIGNATORY OF THE AGENT**

| | **WITNESSES:** |
|---|---|
| | |
| 1 | _____ |
| 2 | _____ |
| | |

**PURCHASE REQUISITION**

S. No._____
Date: _____

To:
_____ [Insert name and address of the Institution]
_____
_____

Dear Sirs,

**PURCHASE REQUISITION FOR PURCHASE OF THE GOODS**
**MURABAHA FACILITY AGREEMENT DATED**

**(1)** Please refer to the Murabaha Facility Agreement dated [_____] (the **"Agreement"**) between [insert name of the Client] (the **"Client"**) (of the first part) and [insert name of the Institution] (the "Institution") (of the second part).

**(2)** All terms defined in the Agreement bear the same meanings herein.

**(3)** The Client hereby requests you to purchase the Goods from the Suppliers as per the provisions of the Agreement as follows:

**(a)** Goods as detailed in Murabaha Document # 3/2:
**(b)** Cost Price: _____
**(c)** Value Date: _____

**(4)** Please make arrangements to pay the Cost Price to the account of _____on the Value Date in immediately available funds.

**(5)** All the terms and conditions of the Agreement shall form an integral part of this Requisition.

Yours faithfully,

For and on Behalf of the Client
_____
_____

## INSTITUTION'S INSTRUCTIONS

No. _____
Date: _____

_____
_____
_____

Dear Sir,

You are hereby instructed to execute the aforesaid Purchase Requisition for and on our behalf in the manner, to the extent and for the Goods stipulated therein.

For and on Behalf of

_____
(Insert Institution's name)

## DETAILS OF GOODS TO BE PURCHASED
**(To be attached to Purchase Requisition)**

| | |
|---|---|
| Name of Supplier : _____ | Date:_____ |

Address: _____

## R E C E I P T

Received with thanks **Pay Order/Cross cheque, in the name of Supplier** from _____ branch,amounting to Rs._____ (Rupees _____ only) for the purchase of goods in respect of which a Quotation date _____ has been issued by M/S _____.

In the event of failure on the part of the Supplier to supply the said goods within the period specified in the Purchase Requisition, I/We undertake and agree to refund/reimburse the full amount of Rs._____ and all cost and consequences under and in terms of the Agency Agreement.

For and on behalf of
[Insert name of the Agent)

_____
Authorized Signatory

Date: _____

**DECLARATION**

**(Part-I)**
**CONFIRMATION OF GOODS PURCHASED**

Date: _____

Messrs. _____

With reference to the Agency Agreement dated _____ and the Institution's instructions contained in Murabaha Document # 3/1, we hereby declare and certify that acting as your Agent, we have delivered the payment order/ Cross Cheque given by your good selves to M/s _____ and purchased on your behalf the Goods as detailed in Murabaha Document # 3/2).

Further the Goods are in my/our possession at the following address:

Copies of bill/cash memo/invoice issued in the name of "Ist Islamic Bank - ABC Company" by M/s _____are attached.

For and on behalf of [insert Agent's name]

_____
**AUTHORISED SIGNATORY**

**(Part-II)**

**OFFER TO PURCHASE**

I/We offer to purchase the above Goods from you for a Contract Price of Rs. _____ (Rupees _____ only).

I/We undertake to pay the Contract Price referred to above in lump sum on _____, or in _____installments, if agreed by the Institution, as per the attached schedule (Murabaha Document # 6).

For and on behalf of [Insert Agent's name]

**AUTHORISED SIGNATORY**
Date:

**(Part-III)**

**INSTITUTION'S ACCEPTANCE**

We have accepted your offer and have sold the above-mentioned Goods to you on the following terms and conditions.

**1)** The Contract Price is Pak Rs._____ (Rupees only) comprising cost incurred Rs._____ , plus Profit Rs. _____ (Rupees_____).

**2)** The Contract Price stated above shall be payable in lump sum on _____ or in _____installments, as per the attached schedule (Murabaha Document # 6).

For and on behalf of [Insert name of the Institution]

_____ _____

**AUTHORISED SIGNATORY** **AUTHORISED SIGNATORY**

Date: Date:

**SCHEDULE OF PAYMENTS OF CONTRACT PRICE**

| Payment Date | Installment Amount |
|---|---|
| | |

**SCHEDULE OF SECURITY**

| Description of Security | Nature of Charge |
|---|---|

# MODEL SYNDICATION MUDARABAH AGREEMENT

**THIS AGREEMENT**
is entered into this _____ day of _____ 200 _____.

**BETWEEN**

[Name of Institution] a company duly organised under the laws of Pakistan having its registered office at [address] (hereinafter referred to as the **Mudarib**).

**AND**

[name of the investing person/company/body], _____, having its place of business at / resident of _____ (hereinafter referred to as **Rab Al-Maal).**

**WHEREAS,** the Mudarib is a financing institution offering financial services, including but not limited to the investment of funds in short and medium-term transactions in accordance with the Islamic Shariah;

**WHEREAS**, the Mudarib is currently entering into a Murabaha Financing Agreement with [name and address of Client] (hereinafter referred to as the Client) to finance the acquisition of materials (hereinafter referred to as the Goods)

**WHEREAS**, the Rab Al-Maal desires to invest, among other investors, an amount of [currency and amount] for the financing of the said Goods in accordance with the terms and conditions of the Murabaha Financing Agreement dated _____ between Mudarib and Client.

**THEREFORE**, the parties hereto agreed upon the following:

**1.** The Rab Al-Maal hereby agrees to entrust to the Mudarib an amount of (currency and amount) to be invested together with the other investors' funds for the purpose of acquisition of the Goods specified in the Murabaha Financing Agreement. Such amount shall be remitted to the Mudarib upon written request sent by the Mudarib to the Rab-al-Maal. The said remittance shall be made at least four (4) working days before the effective date of Murabaha financing.

**2.** The Mudarib undertakes to invest the amount entrusted to it by the Rab Al-Mall together with the funds of the other investors in the acquisition of the Goods in accordance with the terms and conditions of the Murabaha Financing Agreement. All the Murabaha Financing documents will be made out in the name of the Mudarib, and will be held by him on behalf of the Rab Al-Mall and the other investors.

**3.** The Rab Al- Maal has independently studied and is satisfied with the Murabaha financing. The liability of the Rab Al-Mall is, however, limited to the funds entrusted to the Mudarib in accordance with this Agreement.

**4.** The Mudarib undertakes to maintain the funds entrusted to it separate from its own assets and away from the claims of its creditors.

**5.** The profit generated from Murabaha Financing Agreement shall be distributed on a pro-rata basis to the investors including the Rab Al-Maal as follows:

**(i)** [ ] % of the profit on a pro-rata basis to the Rab Al-Maal;

**(ii)** [ ] % of the profit to the Mudarib.

The profit distribution formula given above may be amended by the mutual written agreement of both parties.

**6.** The Mudarib shall pay to the Rab Al-Maal its part in the profit received with respect to the investments made in accordance with the Murabaha Financing Agreement not later than the following business day as of the date of any payment received whether on principal, profit or any other account whatsoever.

**7.** The Mudarib's obligations to make payments to the Rab Al-Maal under this Agreement in respect of the Rab Al-Maal's investment is conditional upon the Mudarib receiving the corresponding payments from the Client in accordance with the Murabaha Financing Agreement dated ……

**8.** It is understood and acknowledged by the Mudarib that any collateral or security held in the Mudarib's name is for the benefit of the Mudarib, the Rab Al-Maal and the other investors on a pro-rata basis.

**9.** As provided by the Islamic Sharia, the Mudarib is liable for any loss of the capital invested under this Agreement only if it is proven that the Mudarib has breached the conditions of this Agreement or proven to be negligent in keeping or managing the said capital.

**10.** In case of default of the client, the Mudarib shall inform the Rab Al -Maal and the other investors and take necessary action on their behalf as it deems fit to protect their interest.

**11.** This Agreement shall be governed by the law of Islamic Republic of Pakistan. Any court of competent jurisdiction located at [ ] shall have the jurisdiction to adjudicate upon all disputes and differences in connection with this Agreement.

**12.** This Agreement shall become effective on [ ] and shall continue to be valid up to [ ].

| _____ | _____ |
|---|---|
| **Mudarib** | **Rab-Al-Maal** |
| (Duly authorized signatory) | (Duly authorized signatory) |

| **Witnessed** |
|---|
| **1. Name:** _____ |
| **Signature:** _____ |

| |
|---|
| **1. Name:** _____ |
| **Signature:** _____ |

| | |
|---|---|
| **EXHIBIT A** | PROJECT INFORMATION FORM |
| | |
| **EXHIBIT B** | CASH FLOW AND REVENUE PROJECTION FOR PROJECT AND MANAGEMENT SERVICES |
| | |
| **EXHIBIT C** | SCHEDULE OF EXPENSES |
| | |
| **EXHIBIT D** | CLIENT INFORMATION FORM |
| | |
| **EXHIBIT E** | DRAW DOWN DATES |
| | |
| **EXHIBIT F** | AUTHORISED SIGNATORIES |
| | |

# INTEREST-FREE LOAN AGREEMENT

**This AGREEMENT**
is made at _____ this _____ day of _____ 2001.

**BETWEEN**

_____ Limited, having its place of business at / resident of _____ hereinafter referred to as "the Client" (which term shall wherever the context so requires or permits mean and include its successors-in-interest and assigns) of the ONE PART.

**AND**

_____ Bank Limited (or financial institution), a duly incorporated banking company (or financial institution) having its registered office at _____ hereinafter referred as "the Institution" (which expression shall wherever the context so requires or permits mean and include the heirs, legal representatives and successors-in-interest and assigns) of the OTHER PART.

**WHEREAS** the Institution has agreed to give an Interest Free Loan to the Client on terms and conditions hereinafter appearing.

**NOW, THEREFORE, THIS AGREEMENT WINTESSETH AS UNDER:-**

**1.** The Institution hereby agrees to provide to the Client an Interest Free Loan (hereinafter referred to as "the Loan") upto a maximum of Rs. _____ on the terms and conditions hereinafter contained.

**2.** The parties hereto hereby mutually agree and covenant as under:-

**i.** The Client undertake to repay the loan without any interest on or before _____ .

**ii.** In case the Client fails to perform as per provisions of this Agreement or any amount is required to be paid by the Client on a specified date and is not paid on that date, or any amount is payable by the Client under this Agreement within a specified period after the receipt of a demand from the

Institution and is not paid by it within the specified period after the receipt of the demand and such amounts have to be recovered through litigation, a court may award solatium to the Institution to cover the expenses incurred in the recovery of its dues.

**3.** As security for repayment of the Institution's loan and/or all other sums payable as aforesaid the Client hereby agrees and undertake to give such security as may be acceptable to the Institution and the terms and conditions of which shall be such as the Institution may determine.

**IN WITNESS WHEREOF** the Client and the Institution have executed this agreement on the day, month and year hereinabove mentioned.

| **Witness** | **CLIENT** |
|---|---|
| **1.** _____ | _____ |
| **2.** _____ | |

| **Witness** | **INSTITUTION** |
|---|---|
| **1.** _____ | _____ |
| **2.** _____ | |

**Appendix A**
Description of the Project

**Appendix B**
Schedule for Purchase of Project Shares

**Appendix C**
Cost/Value of the Project

# CIFE™ STUDY NOTES

# CIFE™ STUDY NOTES

## *A User's Guide to Ethica's Certified Islamic Finance Executive™ Program*

**Important Note:**

The following CIFE Study Notes are an accompaniment to the online training modules available at Ethica and are not meant to replace the blended learning experience of the complete Certified Islamic Finance Executive™ program.

# CIFE01:
# WHY ISLAMIC FINANCE?

**What makes Islamic finance different from conventional finance? And what makes it better? We look at 3 real-world examples and find out. We also introduce you to the 4 principles that guide Islamic finance transactions.**

The difference between Islamic finance and conventional finance is the difference between buying and selling something real and borrowing and lending something fleeting.

Conventional banking transactions are interest based.

Islamic bank transactions are asset or service backed.

An asset or service cannot be compounded like an interest based loan. An asset or service can only have one buyer or seller at any given time, whereas interest allows cash to circulate and grow into enormous sums.

Interest creates an artificial money supply that isn't backed by real assets resulting in increased inflation, heightened volatility, rich getting richer, and poor getting poorer.

### Nigerian President Obasanjo - Example

Nigeria took a $5 billion loan in 1985 and paid it off as $44 billion in 2000 as a result of compound interest.

How would the Islamic bank manage such a developing country's need?

- An Islamic bank could have arranged for the $4 billion construction of a natural gas pipeline and delivered it to Nigeria for $5 billion using an Istisna.
- Or taken an equity stake in a highway project and shared in profits and losses using Musharakah or Mudarabah.
- Or purchased commodities and sold them at a premium using a Murabaha.
- Or structured a project financing using an Ijarah Sukuk.

**Nick the Homebuyer - Example**

In 2009 Nick lost his job, his house, and all the money he had spent paying off his mortgage.

The property bubble that triggered the global financial meltdown could not have happened if the properties had been financed Islamically because a conventional bank merely lends out cash. Legally, it can keep lending this cash over and over, well above its actual cash reserves.

An Islamic bank, on the other hand, has to take direct ownership of an actual asset. Whether for a longer period in a lease or partnership, or a shorter period in a sale or trade, Islamic finance always limits the institution to an actual asset.

How could Islamic finance have fulfilled Nick's need for a home?

Based on a *Diminishing Musharakah*.

Musharakah refers to partnership. In a Diminishing Musharakah, the bank's equity keeps decreasing throughout the tenure of the financing, while the client's ownership keeps increasing through a series of equity purchases. Eventually, the client becomes the sole owner.

At no time does the homebuyer pay any interest and at no time does any payment compound. The homebuyer just pays for two things: the house, in small payments, little by little. And the rent, for the portion of the house he doesn't yet own.

**Faisal the Student - Example**

Faisal took a student loan. His university cost him $120,000 for four years. He began borrowing $30,000 at the beginning of each year. Three years after graduation he began paying off his student loans at the rate of $20,000 a year.

It took him 25 years to pay off his loan and he ended up paying over $400,000.

How would an Islamic bank fulfill Faisal's need?

An Islamic bank could structure a service-based Ijarah to lease out the university's credit hours. Faisal ends up paying about 20% or 30% more; but with the interest-based loan, he pays about 400% more.

Islamic finance never can, and never will be able to grow Faisal's debt once it's fixed.

**Islamic Finance Essentials**

All banking products can largely be divided into the following 4 categories:

1. Equity
2. Trading
3. Leasing
4. Debt

**Some important Islamic finance transactions:**

- Equity based - Mudarabah, Musharakah, and Sukuk
- Trade based - Murabaha, Salam, and Istisna
- Lease based - Ijarahs

**Islamic banking transactions must:**

1. Be interest free.
2. Have risk sharing and asset and service backing: Based on the Islamic concept of "no return without risk." An Islamic bank takes a direct equity position, or buys a particular asset and charges a premium through a trade or a lease. It uses risk mitigants, but not without first taking ownership risk.
3. Have contractual certainty: Contracts play a central role in Islam and the uncertainty of whether a contractual condition will be fulfilled or not is unacceptable in the Shariah.
4. Be ethical: There is no buying, selling, or trading in anything that is, in and of itself, impermissible according to the Shariah for instance dealing in conventional banking and insurance, alcohol, and tobacco.

# CIFE02, 03, 04: UNDERSTANDING MUSHARAKAH - ISLAMIC BUSINESS PARTNERSHIPS

**You have heard of joint-stock companies. Now learn about the Islamic variation.**

**We look at Musharakah, the Islamic business partnership where partners pool together capital, expertise or goodwill to conduct business or trade. We look at the basic features of a Musharakah and its types, their mode of operation, duration and the various forms of capital contribution.**

**We discuss the management of the Musharakah business and take you through some practical applications of how Islamic banks use Musharakah. We also look at profit and loss sharing ahead of the subsequent module's profit calculation exercises. We complete our discussion on general aspects of Musharakah, including how banks handle negligence, termination, and constructive liquidation. We round our discussion with some practical examples of Musharakah calculation, a quick review of financial statements and how exactly profit gets calculated.**

A Musharakah is a partnership that is set up between two or more parties usually to conduct business or trade. It is created by investing capital or pooling together expertise or goodwill.

Partners share profit based on ownership ratios and to the extent of their participation in the business and share loss in proportion to the capital they invest.

Profit cannot not be fixed in absolute terms such as a number or percentage of invested capital or revenue.

**Types of Musharakah:**

- Shirkah tul Aqd
- Shirkah tul Milk

Shirkah tul Aqd is a partnership to enter into a joint business venture and trade. Partners enter into a contract to engage in a defined profit seeking business activity.

Shirkah tul Milk is a partnership in the ownership of property or assets for personal use.

Every Shirkah tul Aqd has a Shirkah tul Milk imbedded in it, namely joint ownership of assets and property.

**Differences between Shirkah tul Aqd and Shirkah tul Milk**

1. Shirkah tul Aqd is a direct contract of partnership in a business or income generating activity whereas Shirkah tul Milk comes indirectly through contracts or arrangements unrelated to production or income generation.
2. Shirkah tul Milk is a partnership of joint ownership as opposed to a commercial venture (Shirkah tul Aqd). It may serve as source of income for one party but not for both.

**Types of Shirkah tul Aqd:**

- **Shirkah tul Wujooh:** Partnership where subject matter is bought on credit from the market based on a relationship of goodwill with the supplier.
- **Shirkah tul Aa'mal:** Partnership in the business of providing services. There is no capital investment, instead partners enter into a joint venture to render services for a fee.
- **Shirkah tul 'Amwaal/Shirkah tul 'Inaan:** Partnership between two or more parties to earn profit by investing in a joint business venture.

**Musharakah Duration**

*Ongoing Musharakah:* Most common form also referred to as open-ended or permanent. Partnership where there is no intention of terminating or concluding the business venture at any point for instance equity participation.

Partners may exit the business at any point they want. This is usually done by the remaining partner(s) purchasing the share of the individual exiting the Musharakah.

*Temporary Musharakah:* Partnership created with the intention of terminating it at a given time in the future at which point Musharakah assets are sold and distributed along with any remaining profit on a pro-rata basis.

It is used to meet working capital needs of businesses, other examples being private equity followed by planned exit.

**Musharakah Capital**

All Shariah-compliant items of material value may be used as capital in a Musharakah.

It may be in the form of cash or it may be in kind, for instance contributing assets to the business in which case it is necessary to ensure the assets are valued at the time of Musharakah execution.

Partners' capital investment ratio must be determined at Musharakah inception or before the business generates profit.

In case of a Musharakah investment in different currencies, partners must agree upon the numeraire, i.e. one particular currency to serve as the standard of value in the business which is usually the currency of the country where the business is located.

Debt may not constitute Musharakah capital.

**Musharakah Management**

All partners possess the right to be involved in the administration of the business.

Partners who opt for limited partnership are silent partners. Since they do not participate in the business unlike the working partners, according to Shariah, they cannot be allocated a profit share greater than their capital contribution ratio.

The working partner is responsible for running the Musharakah but cannot receive separate remuneration for his services although he may receive an increased profit share as a reward for his management role.

Unlike for the silent partner, the working partner's profit share may exceed his capital contribution ratio.

In case an individual who is not a business partner serves as business manager, he is paid a fixed wage for his services but does not share business profit or loss.

The business manager is liable for loss in case of his proven negligence.

If the business manager invests in the Musharakah business by means of a separate contract, his capacities of manager and partner are independent of one another. He earns remuneration for his managerial role and shares profit and loss based on his business partnership.

### Musharakah Profit and Loss

It is important to remember that profits are not fixed in absolute terms, such as a number, or as a percentage of the invested capital or the revenue.

For instance, $1,000 of profit cannot be stipulated as a fixed number at the time of the contract's execution because the profit itself is not yet known.

Or, for instance, if a person invests $100,000 and their profit is guaranteed to be 10% of their investment amount. This would result in an absolute positive number, or $10,000, regardless of whether the business gains or loses money.

Similarly, profit rates cannot be set as a percentage of the revenue either as if there's no revenue; how can there be any profit? And what if the revenue is unexpectedly high; why should investors be denied higher profits?

In a Musharakah:

- Profit may not be guaranteed or fixed in absolute terms for any of the Musharakah partners.
- Profit may not be set as a percentage of capital.
- Each partner whether minority or majority shareholder must be allocated a profit share.
- One partner cannot guarantee any part of the profit or capital of another partner.
- Silent partner's profit ratio may not exceed his investment ratio.
- During the Musharakah, a partner may surrender all or part of his profit share to another provided doing so is not agreed at the time of Musharakah execution.
- Profit sharing mechanism and profit ratios must be clearly determined at Musharakah inception.
- Musharakah may only announce an expected return for the business; actual returns are declared only after they are known.

### Profit Calculation

Profit is calculated by subtracting costs and expenses from revenue.

Loss can only be shared by capital contribution ratios.

### In Practice

Many Islamic banks base profit and loss sharing investment or savings accounts on Musharakah. The bank is the working partner and the account holders are silent partners.

Modern ijtihad has enabled a profit calculation system based on a combination of tiers of investment amounts, investment duration, minimum and average balance.

Many businesses need running finance, but are unwilling to opt for finance on interest. In a conventional running finance facility the bank offers credit to a client over a certain period and charges interest. To address this, the bank and its client enter into a temporary Musharakah.

In a Shariah-compliant running Musharakah facility:

1. The bank and the client agree to a financing limit.
2. The bank opens a current account to hold the client's sale proceeds and also to allow him to utilize the finance facility.
3. The client's contribution to the Musharakah is the business he owns, while the bank's contribution to the Musharakah are the running facility funds.
4. After a certain period, the client and the bank share the business's operating profit based on a predetermined ratio.
5. Eventually, one partner, the bank, sells shares to the remaining partner, the client, and exits the Musharakah.

Unlike interest-based financing, where the bank is only interested in the repayment of a debt, in a running Musharakah, the bank has actual equity ownership in the client's business.

**Negligence in Musharakah**

Negligence refers to loss resulting from the violation of contract conditions or willful or intentional damage to the Musharakah.

**Musharakah Termination**

If partners have not agreed on a Musharakah term, one of them may terminate his partnership unilaterally at any time.

Alternatively, a condition may be stipulated at contract execution that no partner can terminate the contract without the consent of the other partners.

In case of Musharakah termination, if assets are realized as cash, they are distributed based on partnership ratios. In case a profit has been earned, it is distributed based on predetermined profit ratios.

Tangible assets may be liquidated by granting them to existing partners in exchange for the profit they have earned or they may be sold in the market and the income from them distributed.

# CIFE05, 06, 07: UNDERSTANDING MUDARABAH - ISLAMIC INVESTMENT PARTNERSHIPS

**Where Islamic banks meet conventional private equity type investing. Here you learn Mudarabahs, the Islamic business partnership where one partner supplies capital for the business and the other provides management expertise.**

**We explain the Mudarabah structure and contrast it with Musharakah and Wakalah, explaining how they differ in banking practice.**

**How is an investment partnership different from an agency contract? We discuss the relative merits of the Mudarabah and the Wakalah structure in different situations. We also describe the Mudarib's role, the duration of Mudarabahs and the forms of capital contribution by the investor and in some cases even the Mudarib. We discuss the Mudarabah's management and the rules for sharing profit and loss. We also look at some practical examples showing how Islamic banks use Mudarabahs.**

A Mudarabah is a partnership between two or more parties usually to conduct business or trade. Typically, one of the parties supplies the capital for the business and the other provides the investment management expertise.

The financier or the Rabb al Maal provides all the investment capital for the business.

The investment manager or the Mudarib is entrusted with the Rabb al Maal's capital, invests it in a Shariah-compliant project and takes full management responsibility.

The Rabb al Maal and Mudarib share profit based on pre-agreed ratios.

**Types of Mudarabah**

With respect to the scope of business activity, Mudarabahs may be unrestricted or restricted.

*Unrestricted Mudarabah*

The Mudarib is free to invest capital in any Shariah-compliant project of his choice.

*Restricted Mudarabah*

The Mudarib's investment of capital is restricted to specific sectors and activities and/or geographical regions only. Here too, all investments must be Shariah-compliant.

**Investment of Mudarabah Capital**

1. More than one Rabb al Maal
2. Mudarib also contributes capital
3. Mudarib invests business capital in a different project

*More than one Rabb al Maal*

Multiple capital providers pool in their contributions to the same project and hire an investment manager as Mudarib.

*Mudarib also contributes capital*

The Mudarib is permitted to contribute capital to the Mudarabah provided that the Rabb al Maal/ Arbaab al Maal approve.

*Mudarib invests business capital in a different project*

The Mudarib as business manager is responsible for investing and managing the Rabb al Maal's funds, however, the Shariah permits him to use the capital for parallel investments (i.e. receive capital for Mudarabah and invest in a different venture).

**Differences Between Mudarabah and Musharakah**

1. In a Mudarabah, the Mudarib is solely responsible for managing the business, whereas in a Musharakah all partners have the right to participate in the business.
2. The Rabb al Maal provides the business capital and only on condition that the Rabb al Maal agrees can the Mudarib contribute capital to the Mudarabah whereas in a Musharakah all partners must contribute capital.
3. Rabb al Maal bears any loss to the business provided it is not due to the Mudarib's negligence, however, in a Musharakah all partners bear loss pro-rata to their capital contributions.

4. Mudarabah costs that relate to tasks that pertain to the Mudarib's domain are not billed to the Mudarabah business; only running costs are whereas in a Musharakah, partners bear all costs as they are subtracted from revenue prior to profit distribution.

5. The Mudarib may only receive the amount of capital that he requires to invest in the business whereas in a Musharakah, when the business project concludes, the partners retain the right to receive Musharakah capital according to capital contribution ratios.

**Similarity between Mudarabah and Musharakah**

1. The Mudarib is permitted to surrender all or part of his profit to the Rabb al Maal provided it is not pre-agreed. Similarly in a Musharakah, a partner may give up his profit in favour of another on the strict condition that it is not predetermined.

**Differences between Mudarabah and Wakalah**

1. The Mudarib in a Mudarabah receives a share in profit whereas the Wakeel or agent in a Wakalah receives a fixed fee for services.

2. The Mudarib gets paid his profit share only if there is profit whereas the Wakeel receives a fee in any case.

**Similarity between Mudarabah and Wakalah**

1. Both Mudarabah and Wakalah are principal-agent contracts and profit is not guaranteed in either case.

**Mudarabah Duration**

*Ongoing:* Partnerships where there is no intention of concluding the business venture at any known point, however, partners have the option of exit provided they give prior notice to the other partners.

*Temporary:* Partnerships created with the specific intention of terminating them at a given future point in time. When the time is over, the Mudarabah assets are sold and distributed with any remaining profit on a pro-rata basis.

**Mudarabah Capital**

All Shariah-compliant items of material value may serve as Mudarabah capital. The capital may be cash or in kind. In case it is in kind it is important to ensure that the assets are valued at the time of Mudarabah's execution.

Partners' capital investment must be established at Mudarabah execution or at the latest before the business generates any profit. If partners are investing in different currencies it is important to agree upon one particular currency or numeraire to serve as a standard value for the business.

Debt cannot serve as Mudarabah capital.

Partners may agree on individual profit shares.

For the Arbaab al Maal, the ratios of capital contribution may help them in developing their profit sharing ratios but in practice these profit sharing ratios differ from capital contributions ratios.

**Example:**

A furniture business is set up between one Mudarib and one Rabb al Maal.

The Rabb al Maal contributes $5,000 cash. There are no other assets at this point.

The annual profit sharing ratios are agreed at 60% for the Rabb al Maal and 40% for the Mudarib.

The profit in the first year is $10,000 which is distributed as $6,000 for the Rabb al Maal and $4,000 for the Mudarib.

**Mudarabah Management**

Only the Mudarib possesses the right to manage the business.

The Rabb al Maal/Arbaab al Maal serve in the capacity of silent partners.

While restricted Mudarabahs are permitted, no conditions that may restrict or impede the Mudarib's management of business are allowed.

As business manager, the Mudarib receives a profit share for his effort however he is not entitled to a fixed remuneration for his services.

If the manager wants to receive a fixed wage he must be employed under a Wakalah contract as Wakeel, in which case he does not receive a profit share.

If the Mudarib is permitted by the Rabb al Maal/Arbaab al Maal to invest in the business, then by means of a separate contract he may make an investment contribution and become a Rabb al Maal. It is important to remember that his roles as Mudarib and Rabb al Maal are independent of one another.

**Mudarabah Profit Sharing**

The profit sharing mechanism and mutually agreed profit ratios must be clearly defined for all the partners at the Mudarabah's inception or before profit or loss is generated.

Profit amount cannot be guaranteed or fixed in absolute terms for any of the Mudarabah partners and neither can it be a percentage of capital.

A partner may voluntarily surrender all or part of his profit share to another partner provided it is not pre-agreed at contract execution.

**Loss in a Mudarabah**

The Rabb al Maal/Arbaab al Maal bear(s) the entire loss based on capital contribution ratios.

The Mudarib does not bear any loss except that caused by his proven negligence.

**Mudarabah Termination**

A Mudarabah may be terminated by any party at any time provided the terminating party gives prior notice however a 'lock-in' clause may be established for a certain period that the Mudarabah must remain in operation unless unexpected circumstances such as death or injury materialize.

At termination, business assets in the form of cash are distributed based on capital contribution for cash and profit sharing ratio for profit. If the business capital is in illiquid form, it is realized in cash. Next after calculating accrued profit, the cash and profit are distributed as per capital contribution and profit sharing ratios.

**Mudarabah - Practical Applications at the Islamic Bank**

Islamic banks collect money from their depositors on a Mudarabah (or Musharakah) basis and then form a Mudarabah (or Musharakah) pool.

The bank serves as Mudarib to manage the pool.

Based on its contractual agreement with its account holding customers, the bank retains the right to invest in the Mudarabah (or Musharakah) pool if it wants to.

The bank uses the capital to make a range of Shariah-compliant investments.

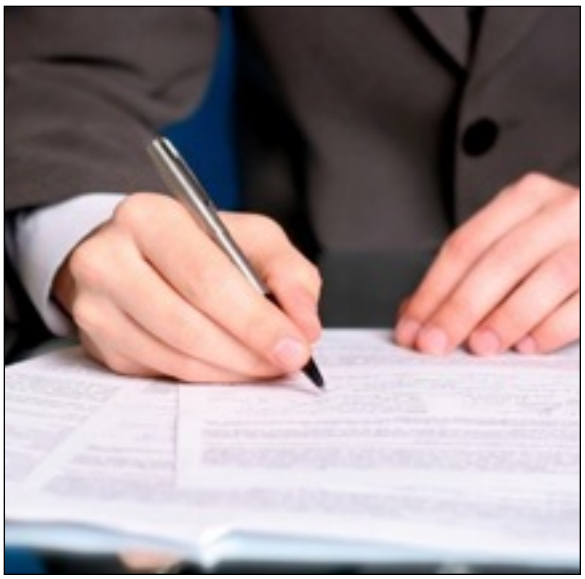
Operationally there is one difference, where normally profit in partnership based ventures like Mudarabah are shared after costs have been deducted from the revenue, since it is difficult for Islamic banks to identify and allocate costs to different pools and projects, they absorb the costs and instead share gross profit.

Mudarabah accounts are usually offered through savings or term deposit accounts where normally a longer duration of deposit corresponds to a higher expected profit rate.

Such accounts have 'expected' profit rates attached with them. These are the rates the account holders can expect to receive.

It is important to remember that the bank cannot guarantee its rates of return.

# CIFE08, 09: UNDERSTANDING IJARAH - ISLAMIC LEASING



**What is an Islamic lease? This module helps you find out. We introduce Ijarah, the Islamic lease, and look at the prerequisites for their execution, legal title, possession, maintenance, earnest money, default, and insurance.**

**We begin answering the question "How does an Ijarah work?" with step-by-step practical explanations.**

**You learn the rights and obligations of the lessor and the lessee and focus on defective assets, sub-leases, extensions and renewals, transfer of ownership, and termination.**

Ijarah is the lease of a specific asset or service to a client for an agreed period of time in exchange for rent which at the end of the lease period may result in transferring the subject matter's ownership to the lessee.

**Types of Ijarah**

- Ijarah tul Aamaal
- Ijarah tul Manafaay

*Ijarah tul Aamaal:*

A lease contract providing services in exchange for agreed rent. For instance, the services of a lawyer purchased by a client in return for a fee.

*Ijarah tul Manafaay:*

A lease contract executed to transfer the benefits of an asset in exchange for an agreed price. For instance, an apartment leased for a year in exchange for a monthly rent. A part of the year's rent may be paid in advance and the remainder be paid as monthly installments, mutually agreed upon between the lessor and lessee.

**Usufruct lease categorized as:**

- *Specific Asset Lease:* A particular asset. For instance, a specific car identified by the lessee with license plate "BZM912" or apartment with address "Suite 1201, Tower Plaza B, Downtown Dubai"
- *Lease of asset based on specifications:* An asset not specifically identified by the lessee but one required to meet certain conditions. For instance any, a 2016 fully loaded, automatic sedan with less than 100,000 mileage, or an unfurnished modern apartment in Downtown Dubai, with at least three bedrooms, two bathrooms, one large living room, a small kitchen and a balcony, facing east within 2 km of the main shopping mall.

**Ijarah classification based on transfer of ownership to lessee**

*Standard Ijarah*

A lease contract where the lessee benefits from the asset for a specific time period but it does not result in the eventual transfer of ownership of the asset to the lessee.

*Ijarah wa Iqtina*

A lease contract conducted solely to transfer ownership of the leased asset to the lessee at the end of the lease period.

**Ijarah prerequisites**

The client and lessor enter into a promise to execute an Ijarah for the usufruct of a particular asset or service. The institution undertakes to provide the asset or service and the client undertakes to enter into a lease contract for it. The asset or service must be owned by the lessor and made available to the lessee before the Ijarah commences. The lease period commences once the subject matter of the lease is made available to the lessee.

**Ijarah - Key Elements**

**Subject Matter**

All Shariah-compliant assets or services may be used as Ijarah subject matter.

*Legal Title*

Generally the lessor owns the leased asset and it should be in his name however for regulatory reasons the asset may be registered in the lessee's name.

*Possession*

Ijarah may only be executed for subject matter the lessor owns and possesses.

*Maintenance*

Periodic Maintenance: The lessee is responsible for regular maintenance of the leased asset.

Major Maintenance: The lessor is responsible to meet all requirements to ensure the leased asset continues to provide intended use.

*Earnest Money*

A sum of money the lessee deposits with the lessor. The lessor maintains it as compensation for actual loss in case the client goes back on his word about executing an Ijarah. If the client fulfills his undertaking to lease and enters into an Ijarah contract, the lessor returns him the earnest money.

*Insurance*

The Ijarah asset can be insured by means of Shariah-compliant Takaful insurance.

**Ijarah Rent and Remuneration**

*Rent*

1. Rent must be clearly defined, it may in the form of cash or kind or an asset's usufruct.
2. Different rentals may be established for different periods.
3. Rent for the initial Ijarah period must be established and rent for the remaining period may be linked to a well known benchmark.
4. Rent begins to accrue as soon as the subject matter of the lease is made available to the lessee.

*Remuneration*

Remuneration for a service is established in relation to time.

**Default in Ijarah**

Default in an Ijarah is a failure on the lessee's part to make a rental payment.

If the lessee defaults on lease payments, the lessor may reclaim the asset or grant him respite until his financial condition improves.

**Lessor's Rights and Obligations**

*Lessor's Obligations*

1. Lessor bears all the risks associated with the leased asset during the lease term.
2. Lessor takes care of major maintenance expenses and insurance costs. The lessor may include insurance costs at the time rentals are determined however once rentals are established, they may not be adjusted to accommodate a change in expenses. Lessor may appoint client as agent to deal with the insurance company.
3. The lessor is obliged to deliver the asset and all associated leased items necessary to transfer usufruct to the lessee. The lessor must rectify any problem that prevents the lessee from utilizing the usufruct.

*Lessor's Rights*

1. In case the lessee defaults on lease payments, the lessor is within his rights to reclaim the leased asset or grant respite for a time. He may also charge a late payment fee which includes administrative charges that belong to the lessor and a late payment penalty that is given to a designated charity.
2. In case of excessive damage to the leased asset, the lessor may rescind the Ijarah.
3. The lessor may contract an Ijarah with more than one lessee for the same asset for different time periods.
4. The lessor may rescind the contract if he becomes aware of the lessee's intent to use the Ijarah asset for unlawful purposes.

**Lessee's Rights and Obligations**

*Lessee's Obligations*

1. Lessee must utilize the Ijarah asset according to customary practice by which similar assets are used. He must take necessary measures to preserve it from damage or defect and benefit from the usufruct as provided in the contract and not in any way beyond its scope.
2. The lessee is obliged to pay rentals once the Ijarah's subject matter is made accessible to him. If the Ijarah asset is available to the lessee only for a part of the contract's duration, the lessee is not obliged to pay rentals for the period the usufruct is not at his disposal.

*Lessee's Rights*

1. The lessee is within his rights to rescind the Ijarah contract if the lessor refuses to repair the Ijarah asset's defects that occur after the contract date or exist on the contract date unbeknownst to the lessee.

**Sublease**

The lessee may sublease the Ijarah asset to a third party with the lessor's consent.

**Ijarah Renewal**

The Ijarah may be extended when it reaches maturity if the lessee still wants to continue benefiting from it. A new Ijarah is not required.

**Transfer of Ijarah Asset Ownership**

In order to transfer the Ijarah asset's ownership to the lessee at the end of the lease term, a separate document independent of the original Ijarah contract is prepared. In this document the lessee undertakes to purchase the Ijarah asset at the end of the Ijarah period for a mutually agreed amount at the time of Ijarah contract execution.

The price may be the actual cost of the leased asset or any other nominal value. Alternatively the lessor may gift the leased asset to the lessee at the end of the Ijarah period.

In some cases, with the lessor's consent, the lessee may even purchase the asset during the lease period by making complete payment of rentals due or paying for the market value of the asset at the time. The asset is sold to the client at the end of the lease period based on a separate sale contract that represents the transfer of ownership.

**Negligence in Ijarah**

Negligence is the loss that results from the violation of contract conditions.

If the Ijarah asset is damaged as a result of the lessee's negligence, he must bear repair expenses. However the lessee is not liable for rent for the period the asset remains out of use.

**Ijarah Termination**

The Ijarah is terminated:

- Based on contractual terms
- One of the party's rescission
- Due to the theft or destruction of the Ijarah asset's usufruct.

As a general rule, contracts cannot be terminated unilaterally but only by mutual consent, however there are some conditions as a result of which contracts are automatically terminated:

1. If the lessee fails to meet lease terms
2. If the lessee loses his sanity during the lease period
3. In case of the lessee's death

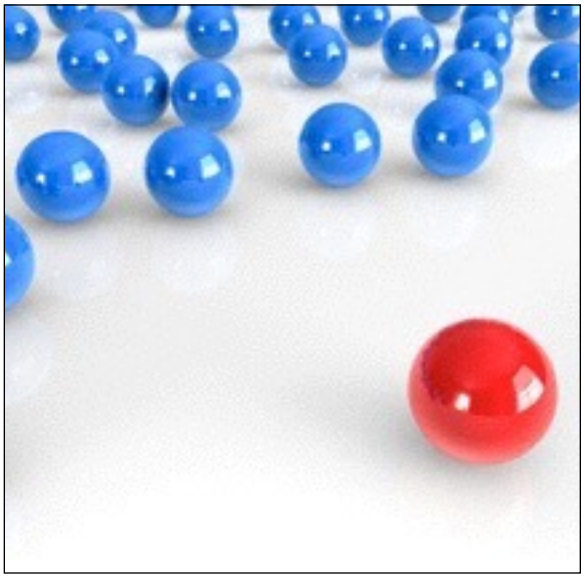
*Lessee can terminate the Ijarah:*

If the Ijarah asset contains or develops defects. He may return the asset to the lessor and demand compensation for the period of defect. The lessee may not rescind the contract if the defect does not hinder usufruct utilization or the lessor ensures its immediate replacement.

Remember that the lessee can exercise rights of rescission in an Ijarah of a specific asset only.

# CIFE10, 11, 12: UNDERSTANDING MURABAHA - COST PLUS FINANCING

**Learn about the most widely used Islamic finance product: buy an asset for the customer; sell the asset at a premium in installments to the customer. That's a Murabaha. In these modules we introduce Murabahas and walk you through the steps necessary for a Murabaha's valid execution. We go on to discuss common mistakes bankers make when executing Murabahas and how to avoid them.**



**We also look at risk management, default, early repayment, and profit calculation in Murabahas. And how does it work in the real world? We look at 6 practical examples of Murabahas based on installment repayments, bullet repayments, advance payments, and credit and import Murabaha.**

A Murabaha is a sale in which the seller's cost of acquiring the asset and the profit earned from it are disclosed to the client or buyer.

Islamic banks offer the Murabaha to fulfill asset purchase requirements and not as a liquidity financing facility.

### Murabaha Prerequisites

#### *Subject Matter*

1. Murabaha subject matter or the Murabaha asset must exist at the time of contract execution. For instance a Murabaha can be executed for a car that exists not for one that is to be manufactured.
2. The bank must own the asset and have either physical or constructive possession.

3. The subject matter must be an item of value and Shariah-compliant.
4. The subject matter must be a tangible good, clearly identified and quantified.

For instance, if the buyer wants to purchase rice, its exact quality and quantity in terms of weight must be clearly specified in the Murabaha contract to avoid gharar or uncertainty that leads to dispute between contracting parties.

***Price***

1. The Murabaha asset cost must be declared to the client.
2. The cost refers to all expenses involved in the asset's acquisition.
3. The asset's price includes all direct expenses where the bank pays for all indirect expenses.
4. Parties to the contract establish a profit rate by mutual consent or in relation to a specific and known benchmark.
5. The Murabaha price may be charged at spot or be deferred and paid as a lump sum at the end of the contract or in installments on fixed dates during the term.
6. The Murabaha profit must be disclosed as a specific amount.

It is important to remember that the Murabaha's execution must adhere to a certain sequence of procedures in order to ensure Shariah-compliance.

**Steps of Murabaha Execution**

1. The client's submission of a purchase requisition for Murabaha goods:
   Based on the requisition the bank approves the credit facility before entering into an actual agreement.
2. The Master Murabaha Facility Agreement between the financial institution and the client. It includes:

   i. An approval of the client's credit facility

   ii. The terms and conditions of the Murabaha contract

   iii. Murabaha asset specification

   iv. Client's undertaking to purchase the Murabaha asset once the bank acquires it (if not included in the MMFA, it constitutes step 3)
3. The client's unilateral promise to purchase the Murabaha goods and the financial institution's acceptance of collateral. At this stage the bank in order to safeguard its rights in case the client backs out from entering into a Murabaha, requests the client to furnish a security or earnest

money called Haamish Jiddiah. In case the client backs out from entering into a Murabaha, the bank makes up for the actual loss from it and returns the remainder to the client.

4. The agency agreement between the financial institution and the client or a third party

   Since banks do not possess the expertise or manpower to purchase the asset, they appoint the client as the agent to procure the asset from the supplier on their behalf.

Agency agreements are of two types:

**Specific Agency Agreement:** Agent is restricted to purchase a specific asset from a specific supplier

**Global Agency Agreement:** Agent may purchase the asset from any source of his choice. Such an agreement also lists a number of assets which the agent may procure on the bank's behalf without executing a new agency agreement each time.

***Key points to remember about the agency***

- During the agency stage, the bank's exposure to asset risk is highest and it is in the bank's interest to shorten this period as much as possible.
- Bank may also minimize risk by ensuring the supplier receives payment for the Murabaha asset.
- Bank must also ensure that the Murabaha asset to be purchased is not already in the client's possession. To maintain correct sequence, the bank must disburse the money to the agent before the agent purchases the goods.
- The agency agreement is not a prerequisite but motivated by logistical ease.
- Banks can procure Murabaha goods directly or establish a third party agency.

5. The possession of the Murabaha goods by the agent on behalf of the financial institution. After the agency agreement the client completes the purchase order form. The bank disburses the money to the client, who as agent pays it to the supplier and receives possession of the Murabaha goods.
6. The exchange of an offer and acceptance between the client and the financial institution to implement the Murabaha sale. Either party can make the offer; the client may offer to buy the Murabaha goods or the bank may offer to sell them. The Murabaha sale is completed at the time of offer and acceptance.
7. The transfer of possession of Murabaha goods from the financial institution to the client. The client is the owner of goods and all the associated risk and rewards however his obligation does not conclude until he makes complete payment of the Murabaha price.

### Mitigating Murabaha Risks

- The Shariah validity of a Murabaha is strongly sensitive to following the designated steps in the correct sequence.
- A deferred Murabaha may not be executed for mediums of exchange (i.e. commodities such as gold, silver and currencies). Only a spot Murabaha may be executed for them.
- The bank must seek Shariah-compliant Takaful insurance for Murabaha goods to cover transit period risk (i.e. the risk posed to the bank once it purchases the goods from the supplier and has their possession and before it sells them to the client).

### Default in a Murabaha

There is no concept of a late payment penalty in a Murabaha contract, however, a charity clause is established at contract execution to serve as a deterrent to default.

In case of a default in payment, based on the charity clause, the client is obliged to pay a predetermined amount to a designated charity.

### Murabaha Prohibitions

A roll-over is the provision of an extension in return for an increase in the original payable amount and is impermissible in a Murabaha.

It constitutes *repricing* and *rescheduling*:

**Repricing** is prohibited because the Shariah does not permit an increase in debt once it is fixed.

**Rescheduling** is only permissible when the creditor provides an extension to ease the burden of a debtor, so a roll-over where the bank increases the debt in return for an extension is impermissible as the resulting amount of debt is analogous to riba or interest which is prohibited in Islam.

### Calculating Murabaha Profit

From an accounting perspective, there are two stages in a Murabaha:

**1st stage:** The investment stage - Begins after the bank and client sign the agency agreement. It is the time period where the bank has disbursed money for the purchase of the asset from the supplier but has not yet acquired possession in order to sell it.

**2nd stage:** The financing stage - This stage begins when the bank receives the asset and goes ahead with the exchange of offer and acceptance with the client. It ends once the bank receives the Murabaha payment from the client. It is during this time that the bank has the right to accrue profit.

**Example**

A bank extends an advance for Murabaha to the client on the 1st of March, knowing that he will not purchase the asset until the 1st of June.

The client purchases the asset on the 1st of June and the Murabaha sale takes place between him and the bank on the same day.

If the tenure of the Murabaha is 4 months, it will commence on the 1st of June and last until the 1st of October.

The bank will begin calculating profit on the 1st of June and not the 1st of March so that no income accrues to the bank between 1st of March and 1st of June.

In case the client as agent is unable to purchase the asset on the 1st of June due to some unavoidable circumstances such as a supply shortage and the Murabaha is terminated, the bank is entitled to receive only the capital back and nothing more.

This is the key difference between a loan on interest and a Murabaha.

# CIFE13, 14, 15: UNDERSTANDING SALAM AND ISTISNA - FORWARD SALE AND MANUFACTURING CONTRACTS

**What makes a forward contract Islamic? Learn here. In this module on Salam, the Islamic forward sale, and Istisna, the Islamic manufacturing contract, we begin with Salam.**

**We look at the goods for which a Salam may be executed, the prerequisites, and the use of a Parallel Salam.**

**We discuss security, replacement, and default before explaining how its pricing is calculated. We then look at Istisna and discuss the major differences between it and the Salam. We also discuss delivery, default, and termination in an Istisna. We conclude the 3 module series with a practical product structuring exercise where you get to choose the appropriate financing tools in a given scenario.**

Salam is a sale where the price of the subject matter is paid in full at the time of the contract's execution while the delivery of the subject matter is deferred to a future date. It is not necessary that the subject matter exist, and be owned and possessed by the seller at the time of the Salam's execution as is the customary requirement of a standard sale, provided it meets the other criteria specific to it. Salam is a mode of finance that helps the seller generate and utilize liquidity and at the same time allows the buyer to purchase commodities for a price lower than the spot market price.

A Salam may be executed for homogeneous commodities but not for specific commodities and mediums of exchange.

Homogeneous commodities, also termed fungible, are similar to one another and are sold as units.

The difference between them is negligible. Since they are homogeneous, in case of loss, one unit may be replaced by another.

**Salam Prerequisites**

1. The quantity and quality of Salam goods must be specified in order to avoid any ambiguity that may lead to dispute between contracting parties. Salam goods must be readily available in the market so that at the time of delivery if they do not meet specifications the seller can procure them easily and supply them to the buyer.

2. Salam price must be paid at spot. The price is fixed and cannot be increased due to an increase in the price of Salam goods in the market during the contract's term. The seller must deliver the goods without demanding any excess money as the Salam goods become the property of the purchaser once the contract is signed.

3. The place of delivery of Salam goods must be specified and they must be delivered in their entirety on a fixed future date or in installments on predetermined dates.

4. Salam goods cannot be sold to a third party before receiving possession however a parallel Salam may be executed for them.

**Parallel Salam**

A Parallel Salam is a transaction executed simultaneously with the original Salam. The buyer of goods in the first Salam is the seller of goods in the second or Parallel Salam.

For instance, a buyer makes a payment for the subject matter to be delivered at a date, three months in the future.

At the same time, as a seller, he executes another Salam for a higher price with a third party for the same goods to be received by him in the future. This way the money disbursed to purchase goods in the first Salam is retrieved as price payment and profit from the parallel Salam. Once the goods of the original transaction are delivered they are transferred to the buyer in the Parallel Salam.

A Parallel Salam is permitted with a third party only.

**Salam Essentials**

***Price***

Most things established as the price for an ordinary sale may also be established as Salam price (i.e. cash, goods and usufruct).

It is important to remember that goods may serve as the Salam price provided they do not fall into the Amwaal e Ribawiya category.

Usufruct refers to the benefits received from a particular asset. The buyer in a Salam may offer the seller an asset's usufruct for a specific time period as the Salam price.

The Salam price is determined based on the number of days the bank's funds remain invested in the Salam transaction.

***Subject Matter***

1. The subject matter must fall into the category of homogeneous goods and be easily available in the market throughout the contract's term or at the time of delivery.
2. The subject matter must be clearly specified in terms of quantity and quality.
3. The subject matter must not be a commodity for which value cannot be established. For instance precious stones.
4. The Khayar al Aib (option of defect) may be exercised for Salam subject matter, however, not the Khayar al Rooyat (option of refusal).

The *Khayaar al Aib* is an option that a buyer may exercise to return goods to the seller if they are found to be defective according to the specifications at the time of delivery.

The *Khayaar al Rooyat* is an option of refusal based on which the buyer may decline from accepting the goods as a result of non-conformity to specifications.

***Delivery of Salam goods***

1. The date of delivery of the subject matter must be clearly established at the time of the contract's execution.
2. The place of delivery of the Salam goods must also be clearly specified.
3. The delivery of the subject matter implies the complete transfer of its ownership.

**Salam Termination**

Once executed, a Salam may not be revoked unilaterally by either party. It is a sale contract binding on both parties and may be terminated completely or partially by mutual consent by returning the actual or proportionate amount of the price paid.

**Salam Term**

A Salam may be executed for any length of time mutually agreed upon between the buyer and the seller.

**Security in a Salam**

Since Salam is based on advance payment, the buyer is within his rights to obtain a form of security from the seller. In case of default, the buyer liquidates the security and makes up for the actual price paid for the subject matter.

Alternatively at the time of contract execution, the buyer may establish that in case of default, he will sell the security in the market and purchase the goods that the seller was supposed to provide at their going rate. The seller will then make up for the price difference if any.

**Replacement of Salam Subject Matter**

Salam subject matter cannot be replaced before the delivery date however it may substituted for another commodity based on mutual consent and the observance of some conditions.

**Delay in Delivery of Salam Subject Matter**

In case the seller is unable to deliver the subject matter on time, the buyer may not charge a penalty, however, a charity clause established at the time of contract execution serves as a deterrent against a delay in delivery.

**Default in Salam**

Default in a Salam may be intentional or unintentional.

*Unintentional*

If the seller is unable to meet delivery due to unavailability of goods or a price rise:

- The buyer may wait for the commodity to return to the market or
- Both parties can mutually agree to terminate the contract and the buyer may be reimbursed the entire payment or
- Both parties may mutually agree to replace the original subject matter with another commodity

*Intentional Default*

In the case where the seller deliberately does not purchase the commodity from the market to avoid a personal loss, he must be compelled to follow through with the original commitment or else the buyer may liquidate the security to make up for loss.

**Salam: Practical Application**

The price of goods in a Salam may be fixed at a lower rate than the price of goods delivered at spot. The difference between the two prices earns the financial institution a legitimate profit.

The Islamic bank after purchasing the commodity may sell it through a parallel Salam contract for the same delivery date.

If a parallel Salam is not feasible, the Islamic bank may obtain a promise to purchase from a third party.

**Istisna**

An Istisna is a transaction used to acquire an asset manufactured on order. It may be executed directly with the supplier or any other party that undertakes to have the asset manufactured.

There are usually two parties involved in an Istisna contract; the Istisna requestor, or orderer, and the manufacturer.
An Istisna takes place when one party agrees to manufacture a product for another party at a specific price. This agreement involves an exchange of an offer and an acceptance which completes the contract.

**Subject Matter in an Istisna**

1. The subject matter of an Istisna need not exist, be owned or possessed by the manufacturer at the time of contract execution.
2. It must be an item that is manufactured as customary market practice and undergoes processing to convert from one form to another.
3. The manufacturer cannot execute a pre-agreed Istisna for goods that he already possesses.
4. The Istisna subject matter must be clearly specified.
5. The manufacturer and not the Istisna requestor must procure the subject matter.
6. Unless the requestor stipulates otherwise, the manufacturer may also have the goods produced from another source.
7. The quantity or quality of Istisna subject matter can be changed by mutual consent of the contracting parties.
8. The Istisna requestor reserves the right to exercise the Khayar al Aib after receiving the delivery of Istisna goods within a certain time limit the manufacturer specifies.

**Istisna Essentials**

1. Cash, goods and usufruct may serve as the Istisna price.

   Goods may be established as the Istisna price provided they do not fall into the category of Amwaal al Ribawiya.
2. Istisna price may be paid at the time of contract execution, in fixed installments over the contract's term or as a lump sum at the end of the contract's term.
3. The Istisna price is mutually agreed upon between the Istisna requestor and manufacturer at the time of contract execution.
4. The Istisna price may not be established on a cost plus profit basis like a Murabaha but as a lump sum.

The manufacturer need not pass on the benefit of a lower manufacturing cost to the requestor and conversely if the manufacturing cost turns out to be greater than the estimate, he must bear it.

**Istisna Term**

An Istisna may be executed for a time period mutually agreed between the Istisna requestor and Istisna manufacturer. In case a time period is not agreed upon, the goods may be manufactured and delivered within a reasonable period of time as is the market norm for those goods.

**Parallel Istisna**

A parallel Istisna is a second Istisna contract executed alongside the first Istisna. The manufacturer in the original contract serves as the Istisna requestor in the parallel contract and profits from a difference in price. The parallel Istisna is completely separate and independent of the original Istisna contract.

For instance a client places an order for the manufacture of goods with an Islamic bank, the bank enters into an Istisna with the manufacturer.

Once the bank receives the goods, it transfers them to the client.

As the client is the ultimate buyer, the bank may appoint him as an agent to supervise the production of the Istisna goods.

It is important to remember that the bank may not enter into an existing Istisna contract between two parties.

**Default in Istisna**

The Islamic bank may demand security in its capacity as requestor or manufacturer. Such a security is called Arbun. Arbun is a non-refundable down payment that the seller/manufacturer receives from the buyer/requestor, in order to secure the purchase of goods.

**Delivery of Istisna Goods**

1. The buyer may not consume Istisna goods before they are delivered. The buyer must first assume physical or constructive possession of the goods.
2. If Istisna goods do not meet specifications and are of an inferior quality, the buyer can reject them however if they are of superior quality he must accept them unless he requires them as raw material.
3. The buyer may accept Istisna goods of an inferior quality if the manufacturer agrees to reduce their price.
4. In case of early delivery, the buyer may accept it provided it does not adversely affect his prior arrangements.

5. If the buyer delays accepting goods delivered on time, the manufacturer may charge him for the expense for holding them on his behalf.

6. If the buyer refuses to accept goods, the manufacturer may sell the goods as agent on the buyer's behalf. Any amount above the original price is returned to the buyer and if goods sell for a lower price, the buyer is expected to pay the difference.

**Shart al Jazai**

A penalty established at the time of contract execution that allows for a reduction in the price of manufactured goods in case of a delay in their delivery. Such a penalty is only permitted in manufacturing contracts as the buyer requires the goods at a fixed time and in the absence of a deterrent, a delay in delivery could have serious consequences with respect to follow-on commitments.

**Rebate in an Istisna**

The manufacturer is permitted to grant the Istisna requestor a rebate in the price at his own discretion. A rebate may not be stipulated at contract execution.

**Prohibition of Buy-Back**

The Istisna must not involve a buy-back at any stage. Before the Istisna is executed it is important to ensure that the contracting parties are separate and independent legal entities.

**Istisna Termination**

Either of the two contracting parties may terminate the Istisna unilaterally provided the manufacturing process has not commenced. If manufacturing has begun then the contract is binding on both parties and can only be terminated by mutual consent.

**Istisna: Practical Applications**

An Istisna can be used to finance construction, export and infrastructure development.

# CIFE16: UNDERSTANDING TAKAFUL - ISLAMIC INSURANCE

**You learn the difference between Islamic and conventional insurance and the essentials that make Islamic insurance unique.**

Islamic Insurance is based on mutual assistance and co-operation through voluntary contributions to a common fund that provides its members mutual indemnity in the event of loss.

**Prohibition of Conventional Insurance**

Conventional insurance is prohibited as it possesses the following elements:

- **Gharar:** Contractual uncertainty that leads to dispute.

  Gharar exists in conventional insurance as one party in the contract, the insurer, has a right to profit from the investment of insurance premiums and the other party, the insured, does not have access to its funds.

- **Maisir:** The element of speculation in a contract.

  In conventional insurance, the insured pays a premium expecting a much greater amount in case of loss, but loses the entire premium when an uncertain event does not occur.

- **Riba:** Any amount that is charged in excess which is not in exchange for a due consideration.

Conventional insurance possesses the element of riba in two ways:

- It involves direct riba in terms of the excess that is involved in an exchange between the insured's premium and the insurer's payment against a claim.

- It involves indirect riba based on the interest earned on interest based investments made by the insurance company with the insured's premium.

**Differences between conventional insurance and Islamic cooperative insurance**

| Conventional Insurance | Islamic Insurance |
|---|---|
| The conventional insurance contract is a purely financial contract involving uncertainty. | The Islamic insurance contract is based on co-operation and seeks mutual benefit through contributions to a common fund. |
| The insurance company executes the contract in its own name. | The insurer serves as the insured's agent to manage operations and invest premiums based on Mudarabah. The insured has equity in the pooled funds. |
| The insurer owns the premiums in return for being obliged to pay insurance claims | The cooperative insurance account is the owner of funds. |
| All the premiums after deduction of insurance expenses are considered the insurer's revenue. | Any surplus after deduction of expenses from the premiums is distributed among the members of the insurance fund based on their contribution ratios or any other method agreed upon in the insurance policy. |
| All returns from investment transfer to the insurer. | The Mudarabah based return from investment of premiums, after deduction of the Mudarib's share, belong to the fund members. |
| The insured and the insurer are two separate entities; the seeker of insurance and its provider. | The insurer and the insured are the same; members of a mutual fund seeking to indemnify each other against loss. The participants pool together their risk and their premiums to share them. |
| Provides protection against speculative risk in addition to pure risk. | Only provides protection against pure loss exposures. |
| The amount left over in the insurance account at the time of liquidation is kept by the insurance company. | The amount left over in the insurance account is disbursed to charity at the time of liquidation. |

**Speculative Risk**

Speculative risk is the risk that involves the possibility of loss, no loss or gain. For instance, the risk involved in a new business venture.

It is prohibited to insure speculative risk as it entails gharar with respect to the probability of gain as well as that of loss.

**Pure Risk**

Pure risk involves the possibility of loss. For instance damage to property due to a fire. Such risk can be insured Islamically as it does not involve uncertainty with regard to the probability of gain as well as loss.

**Islamic Insurance - Essentials**

1. Islamic insurance offers risk protection based on Shariah principles of mutual co-operation.
2. It is offered on the principles of good faith where both contracting parties make full disclosure of all relevant material facts without intending to manipulate, cheat or disadvantage each other.
3. Based on three main relationships, the Musharakah between participants of the joint fund, the Wakalah between the Islamic insurance company and the insurance policy holders and a Mudarabah between the insurance policy holders and the fund itself.
4. The insurer in his capacity as the agent cannot guarantee premiums and can only be liable in case of his proven negligence.
5. The insurer and the insured must fulfill their responsibilities in the contract. This may include conditions that do not affect the co-operative nature of the agreement.
6. The insurance company may charge a fee for its services as agent of insurance operations. However, the returns from the investment of premiums in Shariah-compliant endeavours based on the Mudarabah must be distributed between the insurer and the insured according to their investment ratios.
7. In case of loss to members, the Islamic Insurance company may demand indemnity from the party responsible for damage. Additionally, it may take all necessary action to receive the insurance amount on behalf of its participants. Alternatively, the participants of the Islamic Insurance company and the party causing the damage may even reconcile with one another according to Shariah principles.
8. A Shariah advisory board must be established to supervise insurance operations and ensure Shariah-compliance

**Types of Islamic Insurance**

There are two types of Islamic insurance:

- Property insurance; or insurance against injuries or mishaps such as fires, earthquakes, car accidents and so on.
- Personal insurance; which refers to indemnity against the risk of disability or death, also known as Takaful.

**Islamic Insurance - Duration**

Islamic Insurance requires both the insurer and the insured to adhere to certain time limits.

- The insured must make timely payment of premiums, if he doesn't, the insurer is within his rights to withhold indemnity, cancel the contract or alternatively take legal action and pursue due payment from him.
- The insured must provide evidence for a claim within a stipulated period of time. On the other hand, the insurer must follow through with providing timely and agreed upon indemnity for loss to him.
- The insurance contract runs its course for a specified term before it expires. It is also terminated upon damage to insured property or death of the insured, as in such cases the object of commitment ceases to exist.

**Islamic Insurance - Overview**

Islamic Insurance funds are invested in a joint pool created to share risk and provide its members mutual guarantee and protection against it.

The fund is managed by one of its members in exchange for a payment of a fixed fee or alternatively a manager is hired for the job.

The operator manages the funds in the pool, maintains a part of the funds to pay for claims and invests the rest in Shariah-compliant business ventures.

In case a loss is experienced by any member of the pool it is distributed equally amongst all its participants and is made up for from the funds within the pool.

In the event of a profit from business investments, it is distributed among the investors according to their investment ratios.

After the fulfillment of claims, if any, the operator is remunerated for his services from the amount in the pool and the remaining balance is distributed among its members.

**Re-insurance**

A new insurance arrangement consistent with Islamic insurance principles and guidelines provided by the Shariah board. It is enacted in the event that the amount in the original fund is insufficient to meet the needs of its members.

# CIFE17, 18: UNDERSTANDING SUKUK - ISLAMIC SECURITIZATION

**Sukuks are Islamic shares and we show you the main features walking you through the 8 step structuring process concluding with a study of Ijarah Sukuk. We continue our discussion on Sukuk with a look at Musharakah and Mudarabah Sukuk and the limitations of issuing using Murabaha, Salam and Istisna. We close with a case study of the IDB Sukuk.**

Sukuk is the Arabic plural of the word Sakk which means certificate. Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services.

For instance, six partners invest in a business venture worth $60,000 by making an investment of $10,000 each.

In order to represent their shareholding they create certificates to divide the business into 60,000 units.

Each partner is allotted 10,000 shares.

Securitization is the process of issuing certificates of ownership against an asset or business. Securitization turns an ordinary asset into a tradable security.

If the securities represent a proportionate share of ownership in tradable assets, the trade of such securities is permissible.

**Important to remember:**

The asset portfolio must consist of 25% tangible assets because if the majority of assets are liquid and sold for any amount other than their face value, the transaction is analogous to riba.

The core contract used in the process of securitization to create Sukuk is the Mudarabah, based on a predetermined profit sharing ratio, where one party serves as an agent on behalf of the principal who is the capital owner.

The Mudarabah contract creates the Sukuk with the establishment of an independent legal entity known as a Special Purpose Vehicle or SPV.

In the case of Sukuk, the SPV acquires Shariah-compliant assets and issues ownership certificates against them.

**8 Steps of Sukuk Issuance**

1. The identification of assets to be securitized;
2. The creation of the SPV;
3. The transfer of the assets to the SPV;
4. The issuance of participation certificates against the identified assets;
5. The lease of the assets back to the seller;
6. The provision of a guarantee by an investment bank for future payments or to replace assets if and when required;
7. Periodic payments to investors where there is income from the securitized assets;
8. The termination of the SPV at maturity by the sale of the assets to the original seller at a pre-determined price and after paying any dues owed to the certificate holders or investors

**Ijarah Sukuk**

A Sukuk al Ijarah may be issued for 3 purposes:

1. To securitize ownership of a leased asset.
2. To securitize ownership of the usufruct of an asset.
3. To securitize ownership of the right to receive benefits from services.

**Ijarah Sukuk issuance prerequisites**

1. Ijarah Sukuk must represent the holder's proportionate ownership of the leased asset.
2. The Sukuk holder must assume the rights and obligations proper to a lessor to the extent of his ownership.
3. As the owner, the Sukuk holder has the right to receive rent proportionate to his ownership in the asset.
4. It is essential that the Ijarah Sukuk is designed to represent real ownership of leased assets, and not only a right to receive rent.

**Ijarah Sukuk Advantages**

*Pricing*

Rentals amounts that are eventually transferred to Sukuk-holders may be fixed or benchmarked against a known standard.

*Reassignment*

Ijarah Sukuk may be reassigned or sold to those seeking ownership in the secondary market provided the underlying assets represent a considerable portion of tangible assets.

*Maturity*

The Ijarah may be executed for any length of time mutually decided between the lessor and the lessee provided the subject matter of the Ijarah continues to exist.

*Timing*

The asset represented by the Ijarah Sukuk need not exist at the time of contract execution.

**Equity Based Sukuk**

*Musharakah Sukuk*

- Used to create new projects, develop existing projects and finance business activity on the basis of a partnership contract.

*Mudarabah Sukuk*

- Based on the Mudarabah contract for which capital is received from investors to finance a project.
- Sukuk are issued to investors to represent their proportion of ownership in the investment activity.
- The investors earn profit from the business venture and may even sell their ownership share in the secondary market.

Both Musharakah and Mudarabah Sukuk are bought and sold in the market where Sukuk-holders share profits by an agreed ratio and losses in proportion to investment ratios. In a Mudarabah the principal bears all loss.

To allow tradability, the asset portfolio of Musharakah and Mudarabah Sukuk should include 25% tangible assets. Sukuk issuer cannot guarantee profits.

**Sale Based Sukuk**

*Murabaha Sukuk*

- Sukuk investors provide issuer with funding to purchase assets
- Asset is purchased from supplier
- Asset is sold to the issuer for a deferred price
- Profit earned is distributed proportionately among the investors

**Important to remember:**

These Sukuk represent the investors' shares in receivables from the purchaser. And since these receivables are a debt, they cannot be traded in the secondary market.

*Salam Sukuk and Istisna Sukuk*

Salam and Istisna Sukuk are a useful investment tool for a variety of short, medium and long-term financings

For the issuance of Salam or Istisna Sukuk:

- An SPV is created, which buys a commodity such as crude oil in a Salam, or constructs infrastructure such as a highway in an Istisna.
- The SPV pays the price of the crude oil, or cost of construction of the highway at the time of the contract's execution with the income generated from the sale of certificates to investors.
- After executing the Salam or Istisna, a promise is obtained from the ultimate beneficiary of the deliverable to buy it from the SPV on the date that it is due.
- Since Salam Sukuk represent a debt in the form of Salam goods to be delivered at a specified date in the future, they may not be sold in the secondary market. Istisnas, on the other hand, gradually transform from a pure debt to a manufactured item, so once the item is substantially created, where the timing depends on the asset and the opinion of the Shariah board, the certificates are tradable.

# CIFE19, 20: LIQUIDITY MANAGEMENT IN ISLAMIC FINANCE

**What do Islamic banks do with excess capital in the short term? How do they access capital for the long term? You learn the answers to these and other questions in this module.**

**We discuss how Islamic banks manage liquidity and begin by explaining an inter-bank Mudarabah, walking you through how a weightage table works.**

**We close the module with a look at the application of Sukuk in liquidity management. You look at filters for stocks, shares, Musharakah investment pools, and the use of agency contracts to manage liquidity. We also look at local and foreign currency Commodity Murabahas.**

Liquidity management refers to the financial management of an excess or shortage of funds. In order to maximize returns and to ensure that funds are used efficiently, banks place their excess liquidity somewhere for the time they do not require the funds, (sometimes even for a night) and when they have a shortage of liquidity, they tap markets and other financial institutions for access to funds.

### Liquidity Management Tools

#### Mudarabah

A Mudarabah is a business partnership between two or more parties, where one party supplies capital and the other provides management expertise.

The objective of the Mudarabah deal is to provide a Shariah-compliant structure to conduct permissible transactions in order to meet business needs and reserve requirements.

The basic structure for inter-bank dealings for managing liquidity is the implementation of the master Mudarabah agreement conducted for a maximum period of 180 days, which discloses the profit and loss sharing ratios between the partners as well.

In this way the master Mudarabah agreement serves as the basis for money market transactions provided:

- The investor and working partner mutually agree on a profit sharing ratio at the time of contract execution
- The investor is held liable for loss to the business venture when not caused by the working partner's negligence

It is a Shariah requirement to establish profit and loss sharing ratios at the time of Mudarabah execution.

For the appropriate allocation of profit, weightages are assigned to each investment category, whereas loss is shared in proportion to investment amounts.

Weightages are profit ratios. The longer the term of the deposit, or the higher the balance, the greater the weightage allocated to it.

**Steps of an Interbank Mudarabah Transaction**

- Step 1: After the Mudarabah deal between the bank and investor the transaction is reported to the financial institution's treasury operations department.
- Step 2: The treasury department verifies the deal between both parties, confirms the weightages, their conversion to expected profit rate and contract maturity date.
- Step 3: Based on the Mudarabah contract, the Islamic bank as working partner pays regular profit to investors during the contract's term.

At maturity the Mudarabah closes out the balance of profits and losses.

***Sukuk***

Sukuk are certificates of equal value representing undivided shares in the ownership of tangible assets, usufruct and services. They are equity stakes in assets and companies, so unlike conventional bonds, which are debt instruments, they are directly affected by profits and losses.

The process of issuing tradable certificates of ownership against assets, investment goods and businesses is referred to as securitization.

The underlying instrument used in Sukuk ranges from commonly used Ijarah and Musharakah to Mudarabah and hybrids that include Murabaha, Salam, and Istisna.

These Sukuk are floated on the capital markets and are available to institutions seeking a relatively liquid means to park their capital while also receiving attractive returns.

Alternatively, in case of a shortage of funds, financial institutions sell Sukuk to generate the liquidity necessary to meet requirements.

### Shariah-Compliant Equities

Like investment in Sukuk, Islamic financial institutions also make investments in Shariah-compliant equities in general provided they meet the Shariah-compliance criteria for stocks.

### Musharakah Investment Pools

In order to handle a shortage of funds, Islamic banks create investment pools consisting of financing assets based on Murabahas, Ijarahs and Diminishing Musharakahs. When necessary, these assets are transferred from the general pool to the specific investment pool to fulfill short-term liquidity requirements.

### Musharakah Pool Creation Checklist

1. In order to ensure Shariah compliance, the pool must consist of at least 33% tangible assets.
2. The Islamic bank accepts funds in the capacity of working partner and investors serve as silent partners.
3. The tenure of the pool must be less than or equal to the tenure of the financing assets it comprises.
4. The pool must consist of those assets expected to earn a profit greater than the profit required by the financial institutions making the investment.
5. The profit and loss sharing ratio established between the financial institution and the Islamic bank must be the same that could be availed for an investment of an equivalent amount of capital in another financial concern.
6. At maturity, the pool must be dissolved and the assets transferred back to the general pool.

When disbursed from the general pool, the assets must be appropriately assigned to a specific investment pool.

The proper allocation of financing assets ensures that the profit earned from them is properly attributed to the specific pool.

### Agency or Wakalah

In a Wakalah, the bank possessing excess liquidity as principal, appoints another bank as its agent to invest its money in various profitable, Shariah-compliant ventures.

The invested funds become a part of the treasury pool of the bank receiving the investment.

Before investing the funds in a business venture, the agent presents the principal with an offer for a probable investment opportunity where it discloses the amount to be invested, and the tenure and profit to be expected from the investment.

If the principal accepts the agent's offer, the deal is executed.

An agency fee is fixed for each deal between the agent and the principal and when the realized profit is greater than the amount expected, the agent is entitled to retain the amount that is in excess in addition to the pre-agreed agency fee.

If the business venture suffers a loss as a result of the agent's negligence, the principal is entitled to the profit and any compensation for actual costs, expenses and the original investment.

**Foreign Currency Commodity Murabaha**

The foreign currency commodity Murabaha is commonly used for investing excess funds and is available for maturities ranging from overnight to a period of a year.

In a commodity Murabaha, the Islamic bank purchases a commodity on spot and sells it based on a deferred payment ensuring that the transaction is used only to manage liquidity.

- The Islamic bank with the surplus funds through a broker procures a metal listed on a metal exchange in order to sell it to the Islamic bank short of funds.
- After purchasing the metal from the broker the Islamic bank maintains the amount payable to him as foreign currency in a separate account.
- The metal is now sold to the bank in need of funds in exchange for a deferred payment through a Murabaha sale. Having purchased the commodity, the bank in need of funds pays the Murabaha price in foreign currency within 90 days.
- The selling Islamic bank discloses its cost for purchasing the foreign currency, the cost of the metal from the broker, and the profit earned over the 90 days. The profit is linked with a money market benchmark such as LIBOR.
- The bank short of funds sells the metal to a different broker than the one used earlier and receives payment in foreign currency.
- This broker then sells the metal to the first broker.
- The Islamic bank makes the payment of metal's price owed to the first broker in foreign currency and this broker pays the second broker.
- The bank short of funds receives the metal's price in foreign currency from the second broker and, after 90 days, the selling Islamic bank recovers the foreign currency principal amount in addition to a profit linked to LIBOR.

**Local Currency Commodity Murabaha**

The process involved here is different from a foreign currency commodity Murabaha because an organized asset exchange market is not used.

Commodities like sugar, cotton and fertilizer are physically identified before a sale takes place.

- The Islamic bank appoints an agent who takes possession of the commodities on the bank's behalf. Whenever instructed, the agent sells out or issues a delivery order for the commodities in favour of another person or party.
- The bank purchases a commodity from a broker at a spot cash price.
- Another commodity broker representing a financial institution requiring liquidity, issues a delivery order to the Islamic bank's agent. The agent checks the availability of the commodity required by the delivery order and informs the Islamic bank.
- After taking delivery of the commodity from the agent, the Islamic bank sells it to the financial institution on deferred payment. The price of the commodity is fixed based on a benchmark for a matching tenure.
- The commodity is received by the financial institution and the buyer, now having taken constructive possession of the commodity sells it.

# CIFE21, 22:
# RISK MANAGEMENT IN ISLAMIC FINANCE

**Some have said "Banking is risk management." If you don't know anything about risk management this is the module for you.**


**You learn the basics about risk management in Islamic finance and discuss the most common risks facing Islamic banks and the mitigation techniques used to address them.**

**Now you learn about how risk relates to each specific Islamic finance product. We go through each major Islamic banking product, namely Murabaha, Salam, Istisna, Ijarah, Musharakah and Mudarabah, and explain the specific risks associated with each.**

Risk is defined as exposure to the likelihood of loss, where this loss takes on many forms depending on the kind of risk involved. It is the possibility that the outcome of an action or event could bring an adverse impact to the bank. Some of the many threats to a financial institution are low profitability, bankruptcy, fraud, false financial reporting and mismanagement.

For a transaction to be Shariah-compliant, the main principle with regard to risk is that in order to benefit, liability must be assumed.

Risk management is the process of evaluating and responding to the exposure facing an organization or an individual. It is a structured and disciplined approach employing people, processes and technology for managing the many uncertainties faced by an organization.

**Forms of Risk**

- **Credit risk:** Refers to the possibility of a counter party failing to meets its financial obligations according to agreed terms. It represents 80% of the risk linked to a bank's asset portfolio.
- **Equity investment risk**: Arises from entering into a partnership to finance a specific business activity. Mudarabah, Musharakah and most Sukuk are susceptible to equity investment risk.

- **Market risk:** Represents the market's volatility and its effects on an investment's value
- **Liquidity risk:** Refers to the potential risk of loss to financial institutions arising from the inability to meet financial obligations.
- **Rate of return risk:** Financial institutions are exposed to rate return risk in the context of their overall balance sheet exposures. Increased benchmark rates may result in investment account holders having increased expectations of higher rates of return.
- **Operational risk:** Refers to the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems.
- **Legal or Shariah non-compliance risk:** Relates to operational risk given the Shariah sensitivity to mistakes in operations

**Risk Mitigating Tools**

**Personal guarantees**

Guarantees of different types, such as a guarantee for timely payment, a guarantee for supplying goods at a specific time etc.

**Pledges**

A form of security, an asset or cash, taken from the client and maintained by the financial institution.

**Earnest Money**

Security the client deposits with the bank as security to serve as compensation in case he backs out from entering into a contract.

**Promises**

The client undertakes to purchase goods from the financial institution in order execute a contract.

**Agency Agreements**

In order to ensure goods are procured according to specifications the financial institution may appoint the client or a third party as agent for the job.

- Specific agency agreement
- Global agency agreement

**Advance Payment**

An amount paid at the time of contract execution and considered a part of the asset's price if client makes all payments within the agreed time period.

**Options**

Several options can be granted or possessed in order to mitigate risk in contracts.

For instance:

- Khayar al Shart - Optional Condition
- Khayar al Rooyat - Option of Inspection
- Khayar al Aib - Option of Defect
- Khayar al Wasf - Option of Quality
- Khayar al Ghaban - Option of Price

**Takaful**

An Islamic alternative to conventional insurance. Based on the concept of mutual indemnity in case of loss.

**Shart al Jazai**

A penalty that allows for a reduction in price of manufactured goods in case of a delay in their delivery. Such a penalty is permitted in manufacturing contracts.

**Charity Clause**

The charity clause serves as a deterrent to default, based on it the client undertakes to give a certain amount to charity in case of default in payment.

**Risks in Murabaha**

- Credit risk
  - Client backs out from purchasing the goods
- Market risk
  - Exposure to the fluctuating market price of goods
- Supplier risk

  - Supplier is unknown to the bank which may cause a delay in delivery time of goods and non-conformity to specifications

- Operational/Ownership Risk
  - Client as agent gains possession of goods from the supplier without informing the bank
- Transit period Risk
  - The risk associated with goods after the bank purchases them from the supplier and before the client purchases them from the bank
- Documentation Risk
  - The risk that the counter party does not provide sufficient documentation.

**Risks in Salam**

- Holding risk
  - The risk of holding goods until the time of delivery
- Shariah non-compliance Risk
  - Arises if goods are sold before receiving their physical or constructive possession
- Settlement and Delivery Risk
  - Arises in the event goods are not delivered on time and do not conform to specifications
- Risk of Early Termination
  - Arises in the event the client terminates the contract before delivering the goods
- Rate of Return and Price Risk
  - The risk that a decrease in the commodity's price after contract maturity will result in a lower rate of return

**Risks in Istisna**

- Risk of hidden defects
  - Risk of defects inherent in the manufactured products
- Shariah non-compliance Risk
  - Arises as a result of not specifying the characteristics of goods, the time or place of delivery or lack of information about the supplier

- Settlement and Credit Risk
  - Arises when the customer in unable to honour deferred payments
- Price Risk
  - Bank's exposure to the risk of selling goods to a third party for a lesser price as a result of contract cancellation
- Delivery Risk
  - The risk of not being able to make a scheduled delivery of manufactured goods for a Parallel Istisna
- Legal Risk
  - Litigation costs for claims against Istisna requestor that terminates the contract

**Risks in Ijarah**

- Risk associated with security that sells for a lower price in the market as a result of which the bank cannot cover its loss
- Asset Risk
  - Asset is stolen, damaged
- Price Risk
  - Banks exposure to changes in costs during the Ijarah's term. The longer the term the greater the bank's exposure to price fluctuations
- Risk that the customer will back out from his promise to lease, the bank may have to sell the asset at a price lower than its market price
- Legal Risk
  - Litigation costs against the client who refuses to compensate the bank for losses resulting from unfulfilled promises

**Risks in Musharakah and Mudarabah**

- Shariah Non-Compliance Risk
  - Debt cannot be used as a substitute for equity
  - One partner cannot guarantee the other partner's principal or profit

- Risk of the funds being from a prohibited source

- **Credit Risk**
  - Managing partner manipulates reports to show lower returns
  - Silent partner opts out of partnership while still owing money
  - Working partner takes a percentage of the vendor's payment in return for awarding the vendor a mandate.
  - Prohibition of any collateral to secure the bank's investment poses additional risk.

# RECOMMENDED READING

# FOR ISLAMIC FINANCE PRACTITIONERS AND STUDENTS

**Islamic finance is more than just delivering products and services to customers. It is about having a certain kind of worldview that understands the competing realities of the poor and the rich, the environment and the economy, and the future and the present. These books go beyond the simple prohibition of interest to help us answer the question: what has gone so wrong?**

**Shariah Standards**

**Accounting and Auditing Organization for Islamic Financial Institutions (2010, English Edition)**

In 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, pronounced "a-yo-fee") formed as an independent, non-profit, standard-setting body with a remit to promulgate Islamic finance standards for the entire industry. Twenty years on, AAOIFI is now widely regarded by banks and governments as the de facto industry standard for Islamic finance practitioners. Numerous central banks and financial service authorities now recommend the standards as a source of guidance for local banks.

According to the Institute of Management Accountants, AAOIFI standards are now mandatory in Bahrain, the Dubai International Financial Centre, Jordan, Qatar, Qatar Financial Centre, Sudan, South Africa, Syria, and the Islamic Development Bank Group. AAOIFI standards also form the basis for national standards in Bangladesh, Brunei, France, Indonesia, Kuwait, Lebanon, Malaysia, Pakistan, Russian and Central States, Saudi Arabia, the United Arab Emirates, and the United Kingdom. AAOIFI's regularly updated texts have become the definitive reference work for those seeking a comprehensive rule book about Islamic financial products and practices. Its 85 standards (as of 2011) cover everything from accounting and auditing to governance and product-specific Shariah standards. The 16 to 20 scholars - the number depending on the year - who sit on AAOIFI's Shariah Board are leading Islamic finance scholars who come from the Gulf, South Asia, South East Asia, Africa, and North America; each of them legally qualified to issue a fatwa and adjudicate on matters Islamic finance.

**Introduction to Islamic Finance**

**Mufti Taqi Usmani (New Delhi, Idara Isha'at e Diniyat, 2008)**

An attempt to facilitate an understanding of the basic principles of Islamic finance and the main points of difference between conventional and Islamic banking among other issues. This lucid treatment of the major Islamic financial products is required reading for anyone seeking an introduction to Islamic finance by one of the industry's leading scholars.

**The Historic Judgment On Interest - Delivered In the Supreme Court of Pakistan**

**Mufti Taqi Usmani (Karachi, Maktaba Ma'ariful Quran, 2007)**

On 23rd December 1999 the Shariat Appellate Bench of the Supreme Court of Pakistan announced its historic judgment declaring interest unlawful according to Islamic Law. This book is the work of Justice Taqi Usmani that was influential in that decision and summarizes many of the arguments that were made in this historic case.

**Financial Transactions in Islamic Jurisprudence**

**Dr Wahbah Al-Zuhayli (Damascus, Syria, Dar al-Fikr, 1997)**

This two volume translation is from volume 5 of Dr Wahbah Al-Zuhayli's 8 volumes of the Al-Fiqh Al-Islami wa-Adillatuh (Islamic Jurisprudence and its Proofs, Damascus, Darl Al-Fikr, Fourth Edition 1997). The author covers issues in this volume that were not covered in previous ones, including recent Fatwas related to the stock market (options, short selling, etc). Includes a selection of papers on Islamic Law, Economics and Finance. Provides comprehensive Fiqh coverage including the views of all major schools of Thought (madhhab) in an easy to understand language. The thorough indexes make it easy to locate any topic within the set.

**Reliance of the Traveller: A Classic Manual of Islamic Sacred Law**
**Nuh Ha MIM Keller (Amana Pubns, Revised Edition, 1997)**
This is a 1,232 page reference guide is a classic manual of fiqh rulings based on Shafi"i School of jurisprudence and includes original Arabic texts and translations from classic works of prominent Muslim scholars such as al Ghazali, al Nawawi, al Qurtubi, al Dhahabi and others. It is an indispensable reference for every Muslim or student of Islam who needs to research on Islamic rulings on daily Muslim life.

**The Web of Debt - The Shocking Truth About Our Money System And How We Can Break Free**
**E.H. Brown (Baton Rouge, LA, Third Millennium Press, 2012)**
This is a book about power and about an extraordinarily wealthy elite that has wielded unprecedented power, not for the good, but rather for the enhancement of their own private position. The book tracks the evolution of the power amassed by a tiny group of men who have regarded themselves, quite literally, as gods-the Gods of Money. The book reveals how this powerful elite has systematically set out to literally control the entire world, backed by the most powerful military force the world has ever seen.

**Money, Bank Credit and Economic Cycles**
**Jesus Huerta de Soto (Auburn, Ludwig von Mises Institute, 2012)**
Can the market fully manage the money and banking sector? Jesús Huerta de Soto, professor of economics at the Universidad Rey Juan Carlos, Madrid, has made history with this mammoth and exciting treatise that it has and can again, without inflation, without business cycles, and without the economic instability that has characterized the age of government control.

**How to Break Free from Your Own Debt Prison**
**Trent Hamm (Upper Saddle River, NJ, FT Press, 2011)**
How three years of focused debt repayment transformed Trent Hamm's life - and how you can do it, too. Your greatest personal freedom comes when you get rid of your debts - all of them.

**Early Retirement Extreme - A Philosophical and Practical Guide to Financial Independence**
**Jacob Lund Fisker (CreateSpace, 2010)**
Early Retirement Extreme provides a robust strategy that makes it possible to stop working for money in just a short number of years. It provides a paradigm shift in economic perspective from consuming to producing. Your value to society is not how much you earn or how much you buy. It is what you create and produce for yourself and for others. It is what you leave, not what you take.

**Deep-Economy - The Wealth of Communities and the Durable Future**
**Bill McKibben (New York, Henry Holt and Company, 2008)**
In this powerful and provocative manifesto, Bill McKibben offers the biggest challenge in a generation to the prevailing view of our economy. Deep Economy makes the compelling case for moving beyond "growth" as the paramount economic ideal and pursuing prosperity in a more local direction, with regions producing more of their own food, generating more of their own energy, and even creating more of their own culture and entertainment.

**Beyond Growth - The Economics of Sustainable Development**
**Herman E. Daly (Boston, Beacon Press 2010)**
In a book that will generate controversy, Daly turns his attention to the major environmental debate surrounding "sustainable development." Daly argues that the idea of sustainable development - which has become a catchword of environmentalism and international finance - is being used in ways that are vacuous, certainly wrong, and probably dangerous.

**For the Common Good - Redirecting the Economy toward Community, the Environment, and a Sustainable Future**
**Herman Daly, John B. Cobb, Jr. & Clifford W. Cobb (Cambridge, International Society for Science and Religion, 2007)**
Winner of the Grawemeyer Award for Ideas Improving World Order 1992, Named New Options Best Political Book. Economist Herman Daly and theologian John Cobb, Jr., demonstrate how conventional economics and a growth-oriented industrial economy have led us to the brink of environmental disaster, and show the possibility of a different future. Named as one of the Top 50 Sustainability Books by University of Cambridges Programme for Sustainability Leadership and Greenleaf Publishing.

**Profit Over People - Neoliberalism and Global Order**
**Noam Chomsky (New York, Seven Stories, September 2011)**
Why did traders at prominent banks take high-risk gambles with the money entrusted to them by hundreds of thousands of clients around the world, expanding and leveraging their investments to the point that failure led to a global financial crisis that left millions of people jobless and hundreds of cities economically devastated? The culprit is neoliberal ideology—the belief in the supremacy of "free" markets to drive and govern human affairs. In the years since the initial publication of Profit Over People, the stakes have only risen. Now more than ever, Profit Over People is one of the key texts explaining how the crisis facing us operates—and how, through Chomsky's analysis of resistance, we may find an escape from the closing net.

**Good Work**
**Ernst Freidrich Schumacher (Canada, Harper Collins, 1985)**
Variations on the themes of Small Is Beautiful (1973) and A Guide for the Perplexed (1977). In these speeches and previously uncollected essays, Schumacher (who died in 1977) mounts the pulpit to denounce the evils of modern industrial society - and what he sees as its bane, large-scale technology - and exhorts us by individual, personal example to undertake its reform.

**Prosperity Without Growth - Economics for a Finite Planet**
**Tim Jackson (Boca Raton, Florida, CRC Press, 2012)**
Is more economic growth the solution? Will it deliver prosperity and well-being for a global population projected to reach nine billion? In this explosive book, Tim Jackson, a top sustainability adviser to the UK government, makes a compelling case against continued economic growth in developed nations. Unless we can radically lower the environmental impact of economic activity and there is no evidence to suggest that we can we will have to devise a path to prosperity that does not rely on continued growth. Tim Jackson provides a credible vision of how human society can flourish within the ecological limits of a finite planet. Fulfilling this vision is simply the most urgent task of our times.

**The Corporate Planet - Ecology and Politics in the Age of Globalization**
**Joshua Karliner (San Francisco, Sierra Club Books, 1997)**
The Corporate Planet brilliantly exposes the elaborate efforts of the giant corporations to "greenwash" themselves, and it demonstrates how they are using free trade agreements and World Bank loans to build a world order where they are accountable only to themselves. From Tokyo, where Mitsubishi processes rain forest logs from around the world, to a polluting Chevron oil refinery in California, to India, China, and Brazil, where global chemical companies are setting up shop, Joshua Karliner takes us on a stunning world tour.

**Banking - The Root Cause of the Injustices of Our Time**
**Abdalhalim Orr and Abdassamad Clarke (London, Diwan Press, 2009)**
The original 1987 Norwich seminar, Usury: The Root Cause of the injustices of our Time, whose proceedings form the core of this work, had an extraordinary effect. After the endless analyses and altercations of left and right to which we were accustomed, here was an argument that went to the core of the matter in one bound, and yet did so with a degree of scholarship and indeed erudition that was not cavalier. This book contains the text of the original lectures as well as some contemporary material that updates it. The 80's material was remarkably prescient, as the reader will discover. However, history has furnished us another opportunity-the catastrophic bank collapses of 2008 and the impending total systems shutdown of 2009 - to revisit this vital material and place it before the reader.

**Real Money - Money and Payment Systems from an Islamic Perspective**
**Ahmed Kameel Mydin Meera (Kuala Lumpur, IIUM Press, 2009)**
Real Money: Money and Payment Systems from an Islamic Perspective is a new anthology from the IIUM Press. It outlines the basic framework for a global credit clearing network that utilizes no national currencies as payment media and no political currency unit as a value measure. It discusses how the Shariah could provide inflation-free accounting, achieve full employment, reduce the need for foreign exchange reserves, eliminate exchange rate risks, and provide more equitable trading relations among all the peoples of the world.

**The Corporation - The Pathological Pursuit of Profit and Power**
**Joel Bakan (New York, Free Press, 2005)**
Over the last 150 years the corporation has risen from relative obscurity to become the world's dominant economic institution. Eminent Canadian law professor and legal theorist Joel Bakan contends that today's corporation is a pathological institution, a dangerous possessor of the great power it wields over people and societies. Featuring in-depth interviews with such wide-ranging figures as Nobel Prize winner Milton Friedman, business guru Peter Drucker, and cultural critic Noam Chomsky, The Corporation is an extraordinary work that will educate and enlighten students, CEOs, whistle-blowers, power brokers, pawns, pundits, and politicians alike.

**Small is Beautiful - A Study of Economics as if People Mattered**
**E. F. Schumacher (New York, Random House, 2011)**
Small is Beautiful is Schumacher's stimulating classic study of world economies. This remarkable book is as relevant today and its themes as pertinent and thought-provoking as when it was first published thirty years ago. Small is Beautiful looks at the economic structure of the Western world in a revolutionary way. Schumacher maintains that man's current pursuit of profit and progress, which promotes giant organizations and increased specialization, has in fact resulted in gross economic inefficiency, environmental pollution and inhumane working conditions. Schumacher challenges the doctrine of economic, technological and scientific specialization and proposes a system of Intermediate Technology, based on smaller working units, communal ownership and regional workplaces utilizing local labour and resources.

**The Ascent of Humanity - Civilization and the Human Sense of Self**
**Charles Eisenstein (Berkeley California, Evolver Editions, 2012)**
Charles Eisenstein explores the history and potential future of civilization, tracing the converging crises of our age to the illusion of the separate self. In this landmark book, Eisenstein argues that our disconnection from one another and the natural world has mislaid the foundations of science, religion, money, technology, economics, medicine, and education as we know them. It has fired our near-pathological pursuit of technological Utopias even as we push ourselves and our planet to the brink of collapse.

**The Problem with Interest**
**Tarek El Diwany (London, Kreatoc Ltd, 2010)**
In this third edition of The Problem With Interest, evidence arising from the recent financial crisis has been included to support the main themes of the 1997 and 2003 editions. The author's experience in both secular and Islamic finance help him to provide a practical and relevant commentary on the state of the modern financial system and the Islamic alternative. A description is given in detailed but accessible terms of the extent to which interest-based finance is now affecting humanity and a passionate case is made for reform of the fractional reserve banking system.

**Sacred Economics - Money, Gift & Society in the Age of Transition**
**Charles Eisenstein (Berkeley California, Evolver Editions, 2011)**
Sacred Economics traces the history of money from ancient gift economies to modern capitalism, revealing how the money system has contributed to alienation, competition, and scarcity, destroyed community, and necessitated endless growth. Today, these trends have reached their extreme—but in the wake of their collapse, we may find great opportunity to transition to a more connected, ecological, and sustainable way of being.

**The Future of Money - Creating New Wealth, Work and a Wiser World**
**Bernard Lietar (London, Random House, 2002)**
Based on the four mega-trends of monetary instability, global greying (an ageing global population), the information revolution, and climate change and species extinction, Bernard Lietaer looks at different scenarios of what the world might be like in 2020. A society of sustainable abundance is achievable - but only if we are willing to re-invent our money system and create new currencies.

**The Growth Illusion - How Economic Growth Has Enriched the Few, Impoverished the Many and Endangered the Planet**
**Richard Douthwaite (Gabriola Island B.C, New Society Publishers, 1999)**
The idea that economic growth is necessary is deeply rooted in Western culture and forms the basis of the economic strategies for developed and developing nations around the globe. A finalist in the GPA Book Award when first released in 1993, this fully updated and revised edition of Richard Douthwaite's critically acclaimed The Growth Illusion demonstrates why economic growth is a prescription for disaster and suggests how to redirect our capitalist system toward more positive ends.

**The Grip of Death - A Study of Modern Money, Debt Slavery and Destructive Economics**
**Michael Rowbotham (Charlbury, Jon Carpenter, 2007)**
A lucid and original account of where money comes from and why most people and businesses are so heavily in debt. It explodes more myths than any other book this century, yet it's all about subjects very close to home: mortgages, building societies and banks, agriculture, transport, global poverty, and what's on the supermarket shelf. The author proposes a new mechanism for the supply of money, creating a supportive financial environment and a decreasing reliance on debt.

**Masters of Illusion - The World Bank and the Poverty of Nations**
**Catherine Caufield (London, Pan Books, 1998)**
This is the story of good intentions gone wrong. It begins in 1945 with a pledge to end poverty through a newly created international banking institution. Staffed by the most talented economists from the best universities, the World Bank embarked on this task with the self-assurance only technicians isolated from reality can possess. Fifty years later, the gap between the rich and the underdeveloped nations is wider than ever, thanks in no small part to the measures taken by the World Bank.

**Short Circuit - A Practical New Approach to Building More Self-Reliant Communities**
**Richard Douthwaite (Devon, UK, Green Books, 1996)**
Short Circuit is an indispensable tool-kit for communities and individuals seeking to initiate their own renewal from within. Douthwaite feels that in this time of global uncertainty each community should build an independent local economy capable of supplying its own goods and services. Blending sophisticated analysis with practical guidance, Short Circuit opens up a wide range of possible futures and demonstrates sources of empowerment and cultural identity beyond conventional politics and economics. Douthwaite provides detailed information on hundreds of groups, magazines, and environmental and ecological associations worldwide.

**Debt and the Environment - Converging Crises**
**Morris Miller (New York: United Nations Publications, 1992)**
This book approaches the two topical issues of debt and environment as separate but closely related, mutually reinforcing crises. It presents the necessary conditions for resolving the crises and the obstacles to change. Proposals such as "Brazil's debt/Amazon tropical forest swap" are discussed, as well as the role of the World Bank, UNDP and other United Nations agencies.

**The Vanishing Face of Gaia - A Final Warning**
**James Lovelock (New York: Basic Books, 2010)**
The global temperature is rising, the ice caps are melting, and levels of pollution across the world have reached unprecedented heights. According to eminent scientist James Lovelock, in order to survive an assault from her dependents, the Earth is lurching ever closer to a permanent “hot state.” Within the next century, we will almost certainly be forced to give up many of the comforts of western living as supplies are threatened. Only the fittest—and the smartest—will survive.

**An Inconvenient Truth - The Planetary Emergency of Global Warming and What We Can Do About It**
**Al Gore (New York, Rodale Press 2006)**
With this book, Gore brings together leading-edge research from top scientists around the world; photographs, charts, and other illustrations; and personal anecdotes and observations to document the fast pace and wide scope of global warming. He presents, with alarming clarity and conclusiveness - and with humor, too - that the fact of global warming is not in question and that its consequences for the world we live in will be disastrous if left unchecked. This riveting new book - written in an accessible, entertaining style - will open the eyes of even the most skeptical.

**A Fate Worse Than Debt**
**Susan George (London, Penguin Books, 1994)**
George considers the Third World debt crisis as symptomatic of "an increasingly polarized world organized for the benefit of a minority that will stop at nothing to maintain and strengthen its control and privilege." She brings into focus the informal financial-political "club" of U.S. banks, creditor-country governments, the World Bank and the International Monetary Fund, and argues that they "work together…to keep the Third World in line."

**The Economics of Global Warming**
**William Cline (Washington D.C, Institute for International Economics, 1996)**
Economic progress has long been recognized to involve potential adverse environmental side effects at the local or the regional level. Correspondingly, it has generally been recognized that there may be a role for public policy intervention to correct such "external diseconomies," which arise because the associated damages are not included in the cost calculations of private firms and households. In recent years it has become increasingly clear that expanding economic activity can also impose environmental damage. This study examines public policy toward the other principal area of global pollution: the "greenhouse effect."

**Interest and Inflation Free Money - Creating an Exchange Medium that Works for Everybody and Protects the Earth**
**Margrit Kennedy (Okemos, Michigan, Seva International, 1995)**
This book takes a look at how money works. It exposes the reason for the constant change in one of our most important measures. The huge debt accumulated by developing world countries, unemployment, environmental degradation, the arms build-up and proliferation of nuclear power plants, are related to a mechanism which keeps money in circulation: interest and compound interest.

**Unholy Trinity: The IMF, World Bank and WTO**
**Richard Peet (Zed Books, 2009)**
Who really runs the global economy? The triad of ‘governance institutions’ - The IMF, the World Bank and the WTO. Globalization hugely increased these undemocratic institutions’ power, drastically affecting the livelihoods of peoples across the world with their particular kind of neoliberal capitalism. Their 'Washington Consensus' proposed that poverty was to be ended by increasing inequality. This new edition of Unholy Trinity is completely updated and revised. It argues neoliberal global capitalism has produced an unstable global economy, rife with speculation and structurally prone to crises. Indeed the crisis is now so severe that governance will become impossible. The IMF is in disgrace, the WTO can hardly meet and the World Bank survives as a global philanthropist. Is this the end for the Unholy Trinity?

**What Has Government Done to Our Money?**
**Murray N. Rothbard (CreateSpace Independent Publishing Platform, 2012)**
‘What Has Government Done to Our Money?’ details the history of money, from early barter systems, to the gold standard, to present-day systems of paper money. Rothbard explains how money was originally developed, and why gold was chosen as the preferred commodity to use as money. The author also explains how the gold standard makes money a commodity, and how market forces create a stable economy. Rothbard shows that many European governments went bankrupt due to World War I and left the gold standard in order to try to solve their financial issues, which was not the right solution. He also argues that this strategy was partially responsible for World War II and led to economic problems throughout the world.

**Theft of Nations: Returning to Gold**

**Ahamad Kameel (Coronet Books Inc., 2004)**

'Theft of Nations' is a critique of the interest-based fiat monetary system and gives reasons why the system is unsustainable. The major economies of the world are showing signs of distress as never before, from which emerge two major solutions to the global monetary problem: the establishment of a global central bank with a single world currency, or a return to real money systems like gold, commodity monies, complementary currencies, and the like. This book favors the latter: real money systems like the gold dinar as a way out of the fiat money debacle. It also provides models for using gold in international trade settlements and domestic payment systems.

**Islamic Gold Dinar**

**Ahamad Kameel (Pelanduk Pubns Sdn Bhd, 2002)**

This book looks at the problems inherent in contemporary financial systems. Taking the 1997 Malaysian economic and financial crisis as an example, it shows that the fundamental cause of business cycles, unemployment and inflation is rooted in some of the features of the present day financial system, namely fiat money, fractional reserve requirements and interest rates. It then shows how these features also indirectly bring about many social problems to such an extent that they threaten the culture and sovereignty of nations. After delving into the problems of the present monetary system, it then argues how a return to a gold payment system - like the Islamic dinar - could solve many of the woes of today's economic system. A return to such a system is not only desirable from the economic, political, social and religious perspectives, but also urgent in the present era of globalization and impending world recession, besides providing a conducive environment for Islamic economics, banking and finance to flourish.

**Gold: The Once and Future Money**

**Nathan Lewis (Wiley, 2007)**

For most of the last three millennia, the world's commercial centers have used one or another variant of a gold standard. It should be one of the best understood of human institutions, but it's not. It's one of the worst understood, by both its advocates and detractors. Though it has been spurned by governments many times, this has never been due to a fault of gold to serve its duty, but because governments had other plans for their currencies beyond maintaining their stability. And so, says Nathan Lewis, there is no reason to believe that the great monetary successes of the past four centuries, and indeed the past four millennia, could not be recreated in the next four centuries. In Gold, he makes a forceful, well-documented case for a worldwide return to the gold standard.

# FOR ISLAMIC FINANCE ENTREPRENEURS

**With the growth of Islamic finance we have the emergence of Islamic finance entrepreneurs. These are individuals and institutions starting up small and medium-sized enterprises to serve the growing needs of our burgeoning industry. This recommended reading list is for them.**

**The Long Tail - Why the Future of Business is Selling Less of More**
**Chris Anderson (New York, Hyperion, 11-Jul-2006)**
What happens when the bottlenecks that stand between supply and demand in our culture go away and everything becomes available to everyone? "The Long Tail" is a powerful new force in our economy: the rise of the niche. As the cost of reaching consumers drops dramatically, our markets are shifting from a one-size-fits-all model of mass appeal to one of unlimited variety for unique tastes. From supermarket shelves to advertising agencies, the ability to offer vast choice is changing everything, and causing us to rethink where our markets lie and how to get to them. Unlimited selection is revealing truths about what consumers want and how they want to get it, from DVDs at Netflix to songs on iTunes to advertising on Google.

**Getting Real - The smarter, faster, easier way to build a successful web application**
**37signals (Chicago, 37signals, 18-Nov-2009)**
37signals used the Getting Real process to launch five successful web-based applications (Basecamp, Campfire, Backpack, Writeboard, Ta-da List), and Ruby on Rails, an open-source web application framework, in just two years with no outside funding, no debt, and only 7 people (distributed across 7 time zones). Over 500,000 people around the world use these applications to get things done. Now you can find out how they did it and how you can do it too. It's not as hard as you think if you Get Real.

**The 4-Hour Workweek**
**Timothy Ferriss (Crown Archetype, December 15, 2009)**
This book is not about working 4 hours a week. This book is about removing pointless, time-wasting clutter from our lives. It also shows how to build scalable, low cost revenue streams that have maximum impact.

**Free - The Future of a Radical Price**
**Chris Anderson (New York, Hyperion, 7-Jul-2009)**
In his revolutionary bestseller, The Long Tail, Chris Anderson demonstrated how the online marketplace creates niche markets, allowing products and consumers to connect in a way that has never been possible before. Now, in Free, he makes the compelling case that in many instances businesses can profit more from giving things away than they can by charging for them. Far more than a promotional gimmick, Free is a business strategy that may well be essential to a company's survival.

**Purple Cow - Transform Your Business by Being Remarkable**
**Seth Godin (New York, Portfolio Hardcover, 12-Nov-2009)**
Godin showed that the traditional Ps that marketers had used for decades to get their products noticed-pricing, promotion, publicity, packaging, etc. - weren't working anymore. Marketers were ignoring the most important P of all: the Purple Cow. Cows, after you've seen one or two or ten, are boring. A Purple Cow, though...now that would be something. Godin defines a Purple Cow as anything phenomenal, counterintuitive, exciting...remarkable. Every day, consumers ignore a lot of brown cows, but you can bet they won't ignore a Purple Cow.

**Permission Marketing - Turning Strangers Into Friends And Friends Into Customers**
**Seth Godin (New York, Simon & Schuster, 6-May-1999)**
The man Business Week calls "the ultimate entrepreneur for the Information Age" explains "Permission Marketing" - the groundbreaking concept that enables marketers to shape their message so that consumers will willingly accept it. Whether it is the TV commercial that breaks into our favorite program, or the telemarketing phone call that disrupts a family dinner, traditional advertising is based on the hope of snatching our attention away from whatever we are doing. Seth Godin calls this Interruption Marketing, and, as companies are discovering, it no longer works.

**Tribes - We Need You to Lead Us**
**Seth Godin (New York, Portfolio Hardcover, 16-Oct-2008)**
A tribe is any group of people, large or small, who are connected to one another, a leader, and an idea. For millions of years, humans have been seeking out tribes, be they religious, ethnic, economic, political, or even musical (think of the Deadheads). It's our nature. Now the Internet has eliminated the barriers of geography, cost, and time. All those blogs and social networking sites are helping existing tribes get bigger. But more important, they're enabling countless new tribes to be born. Groups of ten or ten thousand or ten million who care about their iPhones, or a political campaign, or a new way to fight global warming.

**Blink - The Power of Thinking Without Thinking**
**Malcolm Gladwell (Boston, Back Bay Books, 3-Apr-2007)**
Blink is a book about how we think without thinking, about choices that seem to be made in an instant - in the blink of an eye - that actually aren't as simple as they seem. Why are some people brilliant decision makers, while others are consistently inept? Why do some people follow their instincts and win, while others end up stumbling into error? How do our brains really work - in the office, in the classroom, in the kitchen, and in the bedroom? And why are the best decisions often those that are impossible to explain to others?

**Outliers - The Story of Success**
**Malcolm Galdwell (Boston, Back Bay Books, 7-Jun-2011)**
In this stunning new book, Malcolm Gladwell takes us on an intellectual journey through the world of "outliers"--the best and the brightest, the most famous and the most successful. He asks the question: what makes high-achievers different?

**The Tipping Point - How Little Things Can Make a Big Difference**
**Malcolm Gladwell (Boston, Back Bay Books, 7-Jan-2002)**
The tipping point is that magic moment when an idea, trend, or social behavior crosses a threshold, tips, and spreads like wildfire. Just as a single sick person can start an epidemic of the flu, so too can a small but precisely targeted push cause a fashion trend, the popularity of a new product, or a drop in the crime rate. This widely acclaimed bestseller, in which Malcolm Gladwell explores and brilliantly illuminates the tipping point phenomenon, is already changing the way people throughout the world think about selling products and disseminating ideas

**The New Rules of Marketing & PR - How to Use Social Media, Online Video, Mobile Applications, Blogs, News Releases, and Viral Marketing to Reach Buyers Directly**
**David Meerman Scott (Manhattan, Wiley, 30-Aug-2011)**
This is the book every ambitious, forward-thinking, progressive marketer or publicist has at the front of their shelf. Business communication has changed over the recent years. Creative ad copy is no longer enough. The New Rules of Marketing and PR has brought thousands of marketers up to speed on the changing requirements of promoting products or services in the new digital age. This is a one-of-a-kind, pioneering guide, offering a step-by-step action plan for harnessing the power of the Internet to communicate with buyers directly, raise online visibility, and increase sales.

**The Google Story - Inside the Hottest Business Media and Technology success of our time**
**David. A. Vise (New York, Delacorte Press, 15-Nov-2005)**
"Here is the story behind one of the most remarkable Internet successes of our time. Based on scrupulous research and extraordinary access to Google, the book takes you inside the creation and growth of a company whose name is a favorite brand and a standard verb recognized around the world. Its stock is worth more than General Motors' and Ford's combined, its staff eats for free in a dining room that used to be run by the Grateful Dead's former chef, and its employees traverse the firm's colorful Silicon Valley campus on scooters and inline skates.

**Wikinomics - How Mass Collaboration Changes Everything**
**Don Tapscott, Antony D. Williams (New York, Portfolio Trade, 28-Sep-2010)**
This national bestseller reveals the nuances that drive Wikinomics, and share fascinating stories of how masses of people (both paid and volunteer) are now creating TV news stories, sequencing the human gnome, remixing their favorite music, designing software, finding cures for diseases, editing school texts, inventing new cosmetics, and even building motorcycles.

**The Big Switch - Rewiring the World, from Edison to Google**
**Nicholas Carr (Manhattan, W. W. Norton & Company 19-Jan-2009)**
Building on the success of his industry-shaking Does IT Matter? Nicholas Carr returns with The Big Switch, a sweeping look at how a new computer revolution is reshaping business, society, and culture. Just as companies stopped generating their own power and plugged into the newly built electric grid some hundred years ago, today it's computing that's turning into a utility.

**Groundswell - Marketing in the Groundswell**
**Charlene Li, Josh Bernoff (Boston, Harvard Business School Press, 8-Jun-2009)**
The book includes three core chapters from the original bestseller that focus on market research, marketing, and spreading word-of-mouth among your best customers. Sure, you already know that customers are writing about your products on blogs or talking about your brand on Twitter and Facebook. Now, turn that interest into opportunity and profit.

**Crowdsourcing - Why the Power of the Crowd Is Driving the Future of Business**
**Jeffe Howe (New York, Crown Business, 15-Sep-2009)**
Why does Procter & Gamble repeatedly call on enthusiastic amateurs to solve scientific and technical challenges? How can companies as diverse as iStockphoto and Threadless employ just a handful of people, yet generate millions of dollars in revenue every year? This book talks about how to leverage the experiences of the many using businesses run by the few.

**The Magic of Thinking Big**
**David J. Schwartz (Touchstone, 1987)**
Dr. David J. Schwartz, long regarded as one of the foremost experts on motivation, talks about how to succeed in business and personal life and presents a carefully designed program for getting the most out of your job, your marriage and family life, and your community. He proves that you don't need to be an intellectual or have innate talent to attain great success and satisfaction -- but you do need to learn and understand the habit of thinking and behaving in ways that will get you there.

**$100 Startup**
**Chris Guillebeau (Crown Business, 2012)**
In The $100 Startup, Chris Guillebeau shows you how to lead of life of adventure, meaning and purpose - and earn a good living. Still in his early thirties, Chris is on the verge of completing a tour of every country on earth - he's already visited more than 175 nations - and yet he's never held a "real job" or earned a regular paycheck. Rather, he has a special genius for turning ideas into income, and he uses what he earns both to support his life of adventure and to give back. There are many others like Chris - those who've found ways to opt out of traditional employment and create the time and income to pursue what they find meaningful. Sometimes, achieving that perfect blend of passion and income doesn't depend on shelving what you currently do. You can start small with your venture, committing little time or money, and wait to take the real plunge when you're sure it's successful.

**Steve Jobs: The Exclusive Biography**
**Walter Isaacson (Little, Brown 2013)**
Based on more than forty interviews with Jobs conducted over two years - as well as interviews with more than a hundred family members, friends, adversaries, competitors, and colleagues - this book chronicles the rollercoaster life and searingly intense personality of a creative entrepreneur whose passion for perfection and ferocious drive revolutionized six industries: personal computers, animated movies, music, phones, tablet computing, and digital publishing. At a time when societies around the world are trying to build digital-age economies, Jobs stands as the ultimate icon of inventiveness and applied imagination. He knew that the best way to create value in the twenty-first-century was to connect creativity with technology, so he built a company where leaps of the imagination were combined with remarkable feats of engineering.

# CHANGE THE RULES: WEBSITES WE LOVE

## Islamic finance finds itself in a constantly changing social, environmental, and economic world. use these website to understand how to navigate the changes.

**The Corporation: The Pathological Pursuit of Profit and Power**
**http://www.thecorporation.com/**
A Canadian documentary film written by University of British Columbia law professor Joel Bakan, and directed by Mark Achbar and Jennifer Abbott that examines the nature of the modern day corporation and its rise as the dominant institution of our time. Part film and part movement, The Corporation is transforming audiences and impressing critics with its insightful and compelling analysis. Taking its status as a legal "person" to the logical conclusion, the film puts the corporation on the psychiatrist's couch to ask what kind of a person it really is.

**We Have The Power To Change: The Rules**
**http://www.therules.org/**
Change the rules and you change the world – The richest 300 people have as much wealth as the poorest 3 billion. This is no accident – A global movement to bring power back to the people and change the rules that create poverty and inequality around the world. With a decentralized network and hubs around the globe, The Rules campaigns to empower the world's citizens to reclaim their rights by working together to create viable alternative rules and strategies to uplift the underdog majority.

**Qibla – Islamic Sciences Online**
**https://qibla.com/**
Traditional Islamic knowledge: The knowledge learned and passed on from teacher to teacher all the way back to the Messenger of Allah in an unbroken chain – An online institute offering a wide-range of courses imparting traditional Islamic knowledge to all Muslims seeking to practice their Deen. From programs in Arabic and Tajweed to Islamic jurisprudence, law and finance, Qibla endeavours to make the knowledge of authoritative Islamic scholarship accessible to all those eager for practical know-how in their path to the Divine.

**Enactus**
**http://enactus.org/**
A non-profit organization that brings together a community of student, academic and business leaders committed to using the power of entrepreneurial action to transform lives and shape a better more sustainable planet. Team Enactus aspires to create and implement community empowerment projects around the globe – its goal: changing lives for the better and developing just the kind of leadership essential to addressing the growing challenges of a complicated world.

**Inequality.org - Connecting the Dots on a Growing Divide**
**http://inequality.is/**
"Behind every great fortune is a crime." – The richest 1 percent of households owns over 35.6 percent of all private wealth, approximately $20 trillion – A portal for data, analysis and commentary on wealth and income disparity launched by the Institute for Policy Studies with the aim to determine and address the impact of extreme inequalities. Together with advocacy groups, think-tanks and active academic centers for social change, Inequality.org strives to identify and tackle the dangers and devastation the growing inequality poses.

**The Equality Trust**
**http://www.equalitytrust.org.uk/**
People in more equal societies live longer, have better mental health and better chances for a good education regardless of their background. Community life is stronger where the income gap is narrower. Supporting a dynamic network of campaign groups across the UK, The Equality Trust aims to build a social movement for change by analyzing and disseminating the latest research and promoting evidence-based arguments.

**Lead – Inspiring leaders for a sustainable world**
**http://www.lead.org/**
The world's largest non-profit organization dedicated to building leadership for sustainable development. Combining initiative, courage and a relentless will to improve lives and preserve the planet, the Lead network of fellows and partners are catalysts for change, turning imagination into reality, asking provocative questions and coming up with actionable and impactful solutions to the world's most pressing problems.

**Inequality For All – A Documentary by Robert B. Reich**
**http://inequalityforall.com/**
"We make the rules of the economy – and we have the power to change those rules." – Robert Reich, Chancellor's Professor of Public Policy at the University of California at Berkeley, former Secretary of Labor in the Clinton administration and author of the best sellers "Aftershock," "The Work of Nations" and "Beyond Outrage," aims to help people understand the challenges they face through a film that grabs the audience and moves them to action.

**Institute for New Economic Thinking At the Oxford Martin School**
**http://www.inet.ox.ac.uk/about**
A multidisciplinary research institute and philanthropic foundation dedicated to innovative economic research that addresses major economic and social challenges. To make the global financial system more robust, to invigorate economic growth and innovation, to tackle rising economic inequality and to create an economic growth model that is environmentally sustainable requires new economic thinking. INET Oxford researchers work closely with policy-makers and leaders in business and civil society to bring new economic ideas and thinking into debates and practice in the public, private and non-profit sectors.

**War On Want – Fighting Global Poverty**
**http://www.waronwant.org/**
At the frontlines of the struggle against global poverty and injustice – War on Want works in direct partnership with some of the bravest and most inspiring grassroots organizations in developing countries to address the issues faced in rural communities, factories, sweatshops and conflict zones. Campaigning for human rights in the fight against inequality, War on Want aspires to bring about real, lasting change in government policy and the way international institutions operate.

**Sacred Economics – Money, Gift And Society In the Age of Transition**
**http://sacred-economics.com/**
A book by Charles Eisenstein – a teacher, speaker, and writer focusing on themes of civilization, consciousness, money, and human cultural evolution – and now also a short film that traces the history of money from ancient gift economies to modern capitalism, revealing how the money system has contributed to alienation, competition, and scarcity, destroyed community, and necessitated endless growth. Today, these trends have reached their extreme – but in the wake of their collapse, there is great opportunity to transition to a more connected, ecological, and sustainable way of being.

**NEF – Economics As if People and the Planet Mattered**
**http://www.neweconomics.org/**
The UK and most of the world's economies are increasingly unsustainable, unfair and unstable. Many of the richest countries in the world do not have the highest well-being. From climate change to the financial crisis it is clear the current economic system isn't working. NEF is the UK's leading think tank promoting social, economic and environmental justice. Its mission: To kick-start a Great Transition to a new economics that delivers for people and the planet.

**P2P Foundation**
**http://p2pfoundation.net/**
An international organization focused on studying, researching, documenting and promoting peer-to-peer practices to bring about a shift in consciousness geared towards individual and networked participation. It aspires to promote a new public domain for common knowledge, use open source and open access movements to improve social and productive life, reconnect with older traditions to attempt to build a cooperative social order and offer youth a vision of renewal and hope to create a better world more in tune with their values. It aims to build awareness by combining new values, new relations and new forms of organizations that strengthen each other mutually.

**Share: The World's Resources**
**http://www.sharing.org/**
A non-profit, independent civil society organization campaigning for a fairer sharing of wealth, power and resources within and between nations. Works to implement economic sharing as a pragmatic solution to a broad range of interconnected crises that governments are currently failing to address – including hunger, poverty, climate change and environmental issues.

**Positive Money**
**http://www.positivemoney.org/**
The current financial system is responsible for the highest personal debt in the world's history, unaffordable housing, worsening inequality, high unemployment and banks that are subsidized and underwritten with taxpayers' money. All these problems have a common root: Money. Positive Money is a movement to democratize money and banking so that it works for society and not against it.

**Schumacher College – Transformative Learning for Sustainable Living**
**http://www.schumachercollege.org.uk/**
Having offered 20 years of transformative courses for sustainable living, deeply grounded in an ecological and holistic worldview, Schumacher College helps organizations and individuals understand and find solutions for the most pressing ecological and social concerns of modern life through an innovative approach to cutting-edge learning with experts from around the world.

**YES! – Powerful Ideas, Practical Action**
**http://www.yesmagazine.org/**
Today's world is not the one we want – climate change, financial collapse, poverty, and war leaves many overwhelmed and hopeless. YES! Magazine empowers people with the vision and tools to create healthy communities and a healthy planet. Online and in print, YES! outlines a path forward with in-depth analysis, methods for citizen engagement, and stories about real people working for a better world.

**Post Carbon Institute**
**http://www.postcarbon.org/**
A megaphone for some of the world's best thinking on the 21st century's global sustainability crisis. PCI works to build awareness and collaboration, create integrated knowledge and inspire relevant

action by providing individuals, communities, businesses, and governments with the resources needed to understand and respond to the current economic, energy, environmental, and equity crises. It envisions a world of resilient communities and re-localized economies thriving within ecological bounds.

**Community–Wealth.Org**
**http://community-wealth.org/**
Brings together information about the broad range of community wealth strategies, policies, models, and innovations. CWO aims to facilitate collaboration among those working within the field, encourage the support and participation of new constituencies, draw attention to how neighborhoods and communities can address economic challenges using an asset-based, community wealth approach. CWO works to lay the groundwork for changes in policies more supportive of community wealth-building programs.

**Geoff Lawton – You Can Solve the World's Problems in a Garden**
**http://www.geofflawton.com/sq/15449-geoff-lawton**
How can you create a self-sufficient farm with all the food and water you need? What do you need to know when choosing the right kind of land to survive? How can you ramp up an abundant 'urban food system' in your small backyard? Geoff Lawton in these free videos tells you all you need to know about creating paradise on earth with permaculture.

# QUESTIONS & ANSWERS

# AGENCY

### Agency Contract For Murabaha

*Why is an agency contract executed for a Murabaha?*

Since Islamic banks do not have the expertise or the manpower to actually purchase the asset, they appoint the client as an agent to procure the asset from the supplier on their behalf. The client as the bank's agent acts as a trustee and utilizes the money given by the bank for the intended purpose, which is to buy the specified Murabaha goods. Throughout the period of agency the customer acting as agent executes on behalf of the bank and, barring negligence, during this period the bank assumes the risk of asset ownership.

### Agency Agreements

*How many kinds of agency agreements are there?*

There are four types of agency agreements:

- The *disclosed agency agreement*, where the agent discloses to a third party that he represents a principal with whom he shares all the rights and obligations associated with the contract.
- The *undisclosed agency agreement* where the agent does not disclose the fact that he represents a principal. All the rights and obligations pertaining to the contract are possessed by the agent alone.
- The *specific agency agreement*, which is made for the procurement of specific goods and refers to a one time contract.
- The *global agency agreement*, which is conducted for the procurement of goods at different stages of a contract and at different times.

With this agreement, the financial institution appoints an agent to purchase goods for it from time to time without establishing a new agency each time.

### Using Agency Agreement For Portfolio Management

*Can we use agency agreements for portfolio managers?*

In a portfolio management contract, the investor requires the investment manager to invest funds in various Shariah-compliant ventures.In such a contract, profit and loss is not shared between the

investor and the agent but the agent is remunerated for his services. This fee may be paid as a fixed lump sum or as a percentage of investment, but not as a percentage of profit. The investment agent may also be given a performance-based bonus for achieving required returns and, in such a case, the contract becomes a hybrid of the agency agreement and the Mudarabah.

**Duties Of Agent Commissioned On Behalf Of Grantor**

*What acts may the commissioned agent perform on behalf of the grantor?*

Commissions are fiduciary relationships in which the agent acts on behalf of the grantor in:

a. contractual dealings: buying, selling, trading, leasing, transferring, canceling, deferring, renting, borrowing, lending, repaying a debt, guaranteeing, collateralizing, and the like;

b. Legal dealings: litigating, conducting a marriage or divorce, witnessing, establishing proof, punishing, and the like;

c. Religious dealings: performing hajj or umra, distributing zakat and charity, and the like;

d. Personal dealings: gifting, running errands, and the like.

**Agent's Contravention Of Specific Instructions**

*What does an agent's failure in conforming to his grantors specific instructions result in?*

Contraventions to the specific instructions of a commission render transactions related to the commission invalid, unless the instructions are not specific and the result is a favorable one (e.g. when something is sold for a higher price or when something is bought for a lower price, unless specified otherwise), in which case the sale is valid.

**Assigning Multiple Agents To Same Or Separate Commissions**

*Can one grantor assign two or more agents to the same or separate commissions?*

It is permissible for one grantor to assign two or more agents to the same or separate commissions. When two or more agents are assigned to the same commission, they must transact it together unless the grantor permits otherwise.

**Fees For Processing Documents**

*Is it lawful to take a service charge for processing documents as an agent for a payer or payee bank?*

It is lawful for the bank to accept a fee for the services it performs as an agent on behalf of the payer or payee bank.

**Fees For Agency**

*Can the bank in its capacity as an agent of another firm take a nominal percentage in return for its collecting sums of money for that firm?*

It is lawful for the bank to serve as an agent for another firm in which case it is permissible for it to accept a fee in return for its agency.

**Concurrent Agency**

*Can the bank appoint an agent for the purpose of both buying and taking delivery?*

Yes, the bank can appoint an agent for the purpose of both purchasing and taking delivery.

**Single Agency For Different Operations**

*Is it permissible to appoint one person as an agent for two different operations, i.e. to make a purchase on behalf of the bank or to sell to a client on credit?*

There is no legal impediment to granting agency to one person for purchasing and then selling.

**Identifying Oneself As Agent**

*Is it necessary that an agent specify at the time of purchase that he is the bank's agent?*

It is not a Shariah requirement that the agent specify at the time of purchase that he is serving as the bank's agent. However, for purposes of documentation it is better for the agent to do so.

**The Extent Of Agent's Liability**

*Is the agent responsible for merchandise for as long as it remains in his possession before selling it?*
An agent is not considered a guarantor except in cases of shortcoming or transgression. Merchandise in his possession is considered a trust.

**Agent And Surety**

*Is it lawful for an agent to be a surety as well?*

If the contract of agency is inclusive of both delivering goods and collecting the money paid for them, it will be lawful for the agent to be a surety as well. If the contract is limited to transacting, with no agency to collect payments on behalf of the principal, then it will be unlawful for the agent to act as both agent and surety.

**When Buyer's Agent Is Seller's Agent**

*Is it lawful to appoint an intermediary who will be the agent for the buyer and the seller at the same time?*

It is lawful to appoint an intermediary who will be the agent for the buyer and the seller at the same time. It is important that the agent restrict his dealings to the terms of the agency agreement.

**Permissibility Of Not Informing Buyer Or Seller About Supplier**

*Is it lawful for the intermediary agent to buy and sell without informing either the buyer or the seller about the party from which the merchandise is bought and the party to which it was sold?*

It is lawful for the agent to not disclose to the buyer or the seller the identity of the party from which the merchandise is bought and the party to which it is sold. It is essential however, that the agent does not transgress the limits of his agency either. If the agent sells at a price lower than the one specified by the principal, the transaction will be suspended and remain conditional upon the principal's approval. If the agent buys at a higher price than the one specified by the principal, the transaction will go through but will be binding on the agent and not the principal.

**Settlement Of Price For Agent In Sale Or A Purchase**

*Is it a condition that a price be agreed upon by at least one of the two principals and that these instructions be given in advance?*

The setting of the price for an agent in a sale or a purchase is not a condition to the validity of the agency however, if the principal does specify a price and the agent exceeds it, the rulings pertaining to the relevant agency agreement will apply, i.e. the transaction will go through but be binding on the agent and not the principal. If the agent sells the merchandise at a price lower than the one specified by the principal, the transaction will remain suspended and conditional upon the approval of the principal.

**Agency For Bank**

*Is it permissible for the bank to charge its clients an agency fee for the management and lease of their property, the cost of maintenance and repairs, administration of legal matters in addition to expenses such as postage, phone calls, faxes, telegraphs etc?*

It is permissible for the bank to charge its clients an agency fee for managing their property that would include all the mentioned costs and expenses.

**Agency Rates For Bank**

*Is it permissible for the bank to alter its agency rates represented in its schedule or to add new rates for new services?*

It is lawful for the bank to alter agency rates and make them effective from the date they are changed on the condition that the client is informed in advance. The client has the right to dispute any such changes within a fixed number of days based on which the bank exercises the right to either accept the client's objection or to invalidate its contract with him.

**General Terms Of Agency**

*Is it lawful for the bank to grant agency to someone to sell goods on its behalf to different parties, if the lowest price for the sales and the time within which all payments are to be collected is specified?*

An agency accepts conditions related to time, place, deeds, amounts and deadlines in addition to all other conditions agreed to between the principal and the agent. The agent must make every effort to realize the rights of the principal, however, he is not be responsible for any loss unless he is guilty of negligence or deliberately acting contrary to the conditions stipulated by the principal.

**When Agent Becomes Guarantor**

*Is it lawful for the principal to stipulate that the agent may not sell what he is authorized to sell except at spot for cash and if he sells for credit, he will become the buyer's guarantor?*

It is lawful for the principal to stipulate that the agent not sell except for cash and if he does sell for credit, that he become the buyer's guarantor for the sale price in the event that the buyer defaults on his payment.

**Stipulating The Means Of Delivery**

*If a company appoints an agent, is it lawful to stipulate that the agent only ship the goods in one of the company's own freighters?*

It is permissible for a principal to stipulate that an agent only use the principal's means of transport.

# AGRIBUSINESS

## Sharecropping

*What is sharecropping?*

Sharecropping is a permissible form of harvest sharing where a tenant farmer (sharecropper) enters into an agreement with a landowner for both to share an agreed upon percentage of the farmer's harvest in exchange for the right to use the landowner's land. It is a condition for the validity of a sharecropping agreement that the following be agreed upon beforehand: the duration of the sharecropping agreement; the landowner's contribution (i.e. land, seed, means of production); the sharecropper's contribution (i.e. labor, seed, means of production); the type of agricultural produce (though it is permissible for both parties to agree to leave this up to the sharecropper to independently decide later); and the division of the harvest yield (to which both are entitled to share).

## Qualifications For Landowner In Sharecropping

*What requirements must the landowner fulfill with regards to providing the land for the sharecropping agreement?*

The landowner must own the land and have full disposal over it, or at least be authorized by the owner to enter into a sharecropping agreement. The landowner is obligated to provide all the land related to the sharecropping agreement and ensure that it is arable and vacated.

## Providing Land Only In Sharecropping

*Which combinations of the three given agricultural variables (i.e. land, seed, means of production) is the landowner permitted to provide?*

It is permissible for the landowner to provide seed and the means of production with the land, or provide only seed with the land, or provide only the land; it is impermissible for the landowner to provide only the means of production with the land.

## Using Sharecropping Land Early

*May the sharecropper begin using the land before the beginning of the sharecropping period?*

The sharecropper is not permitted to use the land until the sharecropping period begins.

**Rent For Sharecropping**

*May the landowner charge the sharecropper rent in lieu of sharing the harvest?*

It is impermissible for the landowner to charge the sharecropper rent in lieu of sharing the harvest, because the sharecropper's labor serves as the consideration, though it is permissible to charge rent for land as long as the landowner makes no claims to ownership of any portion of the harvest yield.

**Two Separate Contracts For Rental And For Sharecropping**

*May the landowner enter into two separate agreements, of rental and sharecropping, with the sharecropper?*

It is permissible for a landowner to enter into two separate agreements with the same individual, one rental the other sharecropping, regardless of whether the two agreements are for land that is separate or adjoined.

**Division Of Harvest Yield**

*How is the harvest yield divided in sharecropping?*

It is obligatory that the harvest yield be divided between landowner and sharecropper in percentage terms, not absolute terms (e.g. it is unlawful to fix an amount, such as: "you will receive one ton of rice"; but lawful to fix a percentage; such as: "you will receive 25% of the rice").

**Harvest Shares Given From Entire Harvest Yield**

*May certain individuals be allotted yields from certain parts of the sharecropped land as opposed to being given harvest shares from the entire harvest yield?*

It is obligatory that the harvest shares be distributed from the entire harvest yield of the sharecropped land rather than by allotting yields from certain parts of the land for certain individuals.

**Sharecropper's Liability**

*Can the landowner, at the time of contracting, impose a general condition that may expose the sharecropper to all risk liability?*

It is improper for the landowner to impose a general condition at the time of contracting that all loss, damage or theft is the sharecropper's responsibility, even if compensation for the loss, damage or theft is taken in lieu of the harvest.

**Sharecropper Renting Services Of Landowner's Employees**

*May the sharecropper rent the services of the landowner's employees?*

It is permissible for the sharecropper to rent the services of the landowner's employees.

**Compensating Sharecropper Additional Days Worked**

*How is the sharecropper compensated for additional days worked if the harvest is not ready?*

If the harvest is not ready before the sharecropping agreement expires, the sharecropper is compensated at the current market salary for the additional days worked.

**Contract's Annulment In Case Of Death**

*In case of the death of either the sharecropper or the landowner, what happens to the sharecropping contract?*

The contract is annulled with the death of either the landowner or the sharecropper.

**Compensatory Damages In Annulled Sharecropping Agreement**

*What are the provisions for paying compensatory damages for an annulled sharecropping agreement?*

In an annulled sharecropping agreement, if the seed was provided by the sharecropper, the produce, if any, returns to the sharecropper and the landowner is retroactively compensated at comparable market rental rates (up to an amount equivalent to his agreed upon share); if the seed was provided by the landowner, the produce, if any, returns to the landowner and the sharecropper is retroactively compensated at a comparable market salary (up to an amount equivalent to his agreed upon share).

**Sharecropping Party Based On More Than One Individual**

*Can the sharecropping party be a group of individuals performing separate sharecropper functions?*

It is permissible for the sharecropping party to consist of more than one individual, even if these individuals perform separate sharecropper functions (e.g. one supplies the seed, one plants, one harvests).

**Misappropriation Of Sharecropped Land**

*May the sharecropper continue to occupy someone else's land just by virtue of having sharecropped the land for an extended period of time?*

It is impermissible to own, inherit, claim, rent or occupy in any way someone else's land just by virtue of having sharecropped the land for an extended period of time, unless permission is first received from the landowner.

# BEQUEST

**Bequest: Its definition**

*What is a "bequest"?*

A bequest is a testament given by one individual (the testator) to another individual (the executor) in order to perform a function or execute an activity for the benefit of another individual (the beneficiary) or group of individuals. Bequests include:

1. Contractual dealings: buying, selling, trading, leasing, transferring, canceling, deferring, renting, borrowing, lending, repaying a debt, guaranteeing, collateralizing, and the like;
2. Legal dealings: litigating, conducting a marriage or divorce for which the testator is guardian, witnessing, establishing proof, punishing, and the like;
3. Religious dealings: performing hajj or umra, distributing zakat and charity, paying burial expenses, and the like;
4. Personal dealings: maintaining the testator's property and dependents, gifting, running errands, and the like;
5. Future benefit: bequesting the right (without ownership) to a possible future benefit, including the right to its profit, whether the source of the benefit exists now or may exist in future;
6. Usufruct: bequesting the right to use (but not own) something, including the right to profit from its use.

**Bequesting Property Of Unascertained Value**

*Is it permissible to bequest the property whose quantitative and qualitative attributes are not known?*

It is permissible to bequest property when its quantitative and qualitative attributes are not known.

**Cancellation Of Bequest**

*When and how is the bequest cancelable?*

The bequest is cancelable at any time by the testator before the beneficiary takes constructive possession of the item; cancellation of the bequest is effected by:

1. the testator stating so, whether spoken or written;
2. the testator using (assuming this diminishes the usefulness of the item), losing, consuming, bequesting (where the new bequest supersedes the previous one), using as collateral, gifting,

selling, or any transactions that transfer the testator's ownership of the item and thereby nullifies the bequest;

3. the beneficiary's death, if this occurs before the beneficiary's acceptance or constructive possession of the item, though if the beneficiary dies before making an acceptance, the estate heirs are entitled to accepting the bequest.

**Invalid Bequests**

*When is a bequest invalid?*

All impermissible bequests are invalid; invalidity here entails that if the transaction has already been invalidly executed, the property should be returned to the valid owners, whereas if the transaction has not been executed, the bequest remains unexecutable until it is valid.

**The Bequestable Limit**

*How much of the total estate may the testator bequest?*

The testator may bequest up to one-third of his property, where the market value of this amount is measured at the time of the testator's death.

**Violation Of Eligible Heirs' Right To Inherit**

*Would a bequest still be valid if it denied the eligible heirs' right to receive their portion of the estate?*

A bequest is invalid if it violates the eligible heirs' right to receive their portion of the estate.

**Paying For Financial Obligation From Bequest**

*From where should the post-death outstanding obligations (e.g. unpaid debt) be paid for the testator: (i) from his bequested one-third; or (ii) from his remaining two-thirds?*

If the testator specifies a bequest to pay for something obligatory (e.g. unpaid debt), the money should come out of the bequested one-third; if the testator does not specify the bequest and the testator's obligation remains outstanding at the time of his death, the money should come out of the remaining two-thirds, and if obligations remain, the bequested one-third.

**Bequests Made To General Group Of Individuals**

*Is it permissible for the testator to make a bequest in favor of a general group of individuals?*

It is permissible for the testator to make a bequest to a general grouping of individuals (e.g. "to students of Sacred Law").

**Testator Forgiving Debts Near Death**

*Is a testator permitted to forgive debts when nearing death?*

It is impermissible for a testator on his deathbed (or a female testator in labor who eventually dies while giving birth) to forgive any portion of the debts owed unless all the sane, adult estate heirs unanimously agree to doing so, in which case debtors who are estate heirs may be forgiven the entire debt while debtors who are not estate heirs may only be forgiven up to one-third of the estate's value; if the testator recovers it is permissible to forgive debts.

**Bequests When There Are No Heirs**

*Is it permissible to bequest the entire estate to an individual or organization if there are no estate heirs?*

If there are no estate heirs, it is permissible to bequest the entire estate to an individual or organization.

**Assigning Multiple Executors To Same Bequest**

*Can two or more executors be assigned to the same bequest?*

It is permissible to assign two or more executors to the same or different tasks relating to the same bequest; if the testator does not specify that multiple executors are to perform separate tasks independently, then they must execute the bequest together, meaning that they must act out of consensus, not necessarily as physically together during the bequest's execution.

**Cancellation Of Executorship**

*When is the executorship cancelable?*

The executorship is cancelable at any time by either testator or executor, with the exception that if after the testator's death the executor is almost certain that the bequest will be misappropriated, the executor is forbidden from canceling the bequest unless a qualified executor is found to replace him.

**Ownership Transfer To Beneficiary**

*When does the ownership of the bequested item transfer to the beneficiary?*

In cases where the beneficiary is specified, once the beneficiary accepts the bequest, ownership of the bequested item transfers to the beneficiary upon the testator's death, even if actual possession takes place much later.

**Transfer Of Ownership On Beneficiary's Refusal**

*Who is entitled to the ownership of a bequest in case the intended beneficiary refuses the bequest?*

In cases where the beneficiary is specified, if the beneficiary refuses the bequest, ownership of the bequested item transfers to the estate heirs upon the testator's death, even if actual possession takes place much later.

**Beneficiary's Cancellation Of Bequested Item**

*Under what conditions may a beneficiary validly cancel the ownership of the bequested item?*

The beneficiary's ownership of the bequested item is only cancelable by the beneficiary before taking constructive possession of the item; thereafter, cancellation by the beneficiary is invalid and only a separate disposition removes the item from the beneficiary's property.

**Estate Heir As Beneficiary Of Bequest**

*Can an estate heir also be the beneficiary of a bequest?*

It is impermissible for the beneficiary of a bequest to be an estate heir, unless the sane, adult estate heirs unanimously agree to the bequest; meaning, an heir to the two-thirds (of the testator's property normally reserved for estate division) may receive a bequest from the one-third (of the testator's property normally reserved for estate division) if the sane, adult estate heirs unanimously agree.

# BONDS

**Impermissibility of Bonds**

*Is it permissible to deal in bonds?*

Bonds are interest-bearing securities that obligate the issuer to pay the holder an interest charge in addition to the principal amount at some given maturity date; it is unlawful to buy, sell, trade, recommend or assist in the purchase of bonds.

# BILLS OF EXCHANGE

**Impermissibility of Bills of Exchange**

*Is it permissible to deal in bills of exchange?*

Bills of exchange, or drafts, are written orders from one party to another instructing payment to a third party; it is impermissible to buy, sell or trade bills of exchange at anything but their par value.

# BRIBERY

## Shariah Opinion On Bribery

*What does the Shariah say about bribery?*

Amr bin Ala's reported that the Prophet (Allah bless him and give him peace) said: "There is no people among whom adultery becomes widespread but are overtaken with famine and there is no people among whom bribery becomes widespread but are overtaken with fear." (Ahmad)

Bribery is a kind of theft, because the key determinant for defining misappropriation is that property is taken against the will (or without the knowledge) of an owner. The one taking the bribe relies on influence and coercion so that the one paying the bribe often acquiesces to an ostensive agreement, but the fact remains that the one bribed would simply rather not pay the bribe.

## Bribe Given As Gift

*May I accept or give a bribe in the form of a gift?*

Bribes given or taken in the guise of a gift remain bribes and are impermissible.

## Bribe Given Willingly

*Are willingly-given bribes valid?*

Even when the bribe is given or taken willingly, they are impermissible and the sin remains.

## Compensation For Bribes Accepted

*Am I liable to compensate the other for any bribes taken?*

It is obligatory to return money taken in bribes or to monetarily compensate individuals or institutions to the extent that one benefits from the bribe.

# CHARITY

### Eligible Recipients Of Charity

*In what particular order of superiority should charity be distributed among people?*

In descending order of superiority, it is recommended to give to one's disaffected relatives, one's friendly relatives, and the pious; this is in addition to what is spent of one's wealth in supporting one's family and dependents, which is already regarded by God as a form of charity; generally, it is permissible to give charity to non-Muslims who are not enemies of Islam.

### Accepting Charity From One Eliminating Unlawful Earnings From Wealth

*Would it be permissible to accept charity from an individual who by giving charity is trying to eliminate unlawful earnings from his wealth?*

It is permissible to accept charity from an individual who is eliminating unlawful earnings from his wealth; the sin related to the earnings devolves to the one engaged in the original unlawful act, and accordingly the unlawfulness is attached to the original transaction, not to the money earned thereby.

### Ruling On Undistributed Charity

*When the one distributing charity is unable to distribute the entire amount, what happens to the remaining charity?*

When an individual or institution assigned with the task of distributing charity is unable to distribute the entire amount, the remaining charity should be returned to the donor or, with the permission of the donor, be given according to the payer's instructions; if contacting the original donor is not possible, the money should be given as charity to a similar cause.

### Giving Away Excess Wealth In Charity

*May I give all my excess wealth in charity?*

It is recommended to give away the excess of one's wealth, meaning wealth additional to what is necessary to earn one's livelihood, support one's dependents, and to reasonably support oneself, assuming that one is able to bear the hardship this austerity imposes, though if one's dependents or

oneself are unable to withstand it then it is offensive. It is also recommended to give the highest quality charity, whether monetarily (i.e. money from reliable sources rather than doubtful ones, which is offensive) or in-kind (i.e. goods from the superior of one's food, clothing, livestock, and so on, rather than from the inferior, which is offensive).

**Fulfillment Of Financial Obligations Versus Giving Charity**

*May I give charity with money that would have otherwise lifted a financial obligation?*

It is forbidden to give away money that would have otherwise fulfilled a financial obligation, such as a debt owed to a creditor or maintenance obligations owed to a dependent.

**Charity As Time And Effort**

*If a person would like to contribute to a charitable cause but he has an outstanding debt obligation, what should he do?*

If one is unable to donate money to a charitable cause because of an outstanding debt, one should instead donate one's time and effort.

# COLLATERAL

### Asking For Collateral

*Can banks request stocks or real estate owned by the client as collateral?*

It is lawful to take collateral from the client whether in the form of real estate or stocks once it is verified that the client has unobstructed, legal possession of the asset. The bank holds the debtor's title to the collateral until all the dues are paid. It is not lawful to give something as collateral that is not permissible to transact.

### Using Bank Accounts As Collateral

*Is it lawful to use money deposited in bank accounts as collateral?*

The use of deposits as collateral is lawful regardless of whether these are demand deposits or investment accounts. The amounts in such deposits may only be used as collateral if steps have been taken to prevent the depositor from accessing the amount for the entire period of collateralization. The profits accrued will be the right of the account holder.

### Using Interest Bearing Accounts As Collateral

*Is it lawful for the Islamic bank to accept a note from a conventional bank to the effect that the money possessed in its client's account will be held in the Islamic bank's favour as collateral?*

It is lawful for the Islamic bank to hold a deposit in a conventional bank as collateral.

### Placing Hold On Current Accounts As Collateral

*Is it lawful for the bank to place a hold on a current account for an amount equal to a debt that is either owed by the account holder himself or guaranteed through an agency for another?*

It is lawful to put a hold on a current account for debt owed by the client since in this way the client is considered to have honoured it by means of a deduction. It is also lawful to put a hold on the current account of a person serving as an agent on behalf of another for the purpose of honouring debt.

**Money In Investment Account As Collateral**

*Is it lawful to make a purchase on the basis of deferred payments for a client who is an investment account holder at the bank if the account is used as collateral for the purchase price?*

Such a purchase is lawful because the investment deposit represents a part of the goods purchased for sale and investment and it is lawful to hold material goods as collateral.

**Machinery As Collateral**

*If a merchant purchases machinery from a conventional bank and uses it as collateral for the Islamic bank until he finishes paying for it but is unable after a few payments to continue; will it be lawful for the Islamic bank to purchase the machinery from the conventional bank and then resell it to the merchant?*

It is lawful for the Islamic bank to purchase the machinery from the conventional bank and then resell it to the merchant. Ideally, however, it is better for the Islamic bank to refrain from dealing with interest-based banks altogether.

**Land As Collateral**

*Is it lawful for the bank to sign an Istisna contract with a land-owning client for the purpose of developing the land, building on it and then selling the building to the client based on a Murabaha while holding the land as collateral until the client finishes making his payments?*

It is permissible for the bank to enter into a contract of Istisna with its client for the purpose of developing land. Once the Istisna is concluded and the cost of the building becomes known, the cost will be the bank's right over the client or buyer. In case there is an agreement to defer payment, the bank will have the right to request the client to guarantee his payment of debt by offering the land as collateral.

**Bonus Shares As Collateral**

*Is it lawful for Islamic banks to offer bonus shares as collateral in favour of conventional banks?*

It is not lawful for Islamic banks to offer bonus shares as collateral in favour of conventional banks since it would be equivalent to facilitating an increase and guaranteeing a debt with interest.

**Accounts Receivable As Collateral**

*Is it lawful for the credit department to stipulate in a contract that a company's accounts receivable be held as a guarantee for debt deferred in return for credit?*

The credit department may reserve the rights to the accounts receivable of a company as a guarantee of its debt but only if this is made a condition at the time of contracting with the client.

**Taking Collateral Before Debt Is Incurred**

*Is it lawful for the bank to take collateral from its client before it purchases goods from the importer and sells them to him?*

The creditor has no right to take collateral from his client before the debt is established. It is only lawful to take collateral as confirmation of the execution of a contract of sale.

**Collateral For Credit Facilities**

*Is it permissible to grant credit facilities to clients in return for goods held as collateral at the bank's own warehouses or in those of the client but under the bank's supervision?*

It is permissible for the bank to accept pledges from its clients with regard to goods they may desire to purchase from it on a deferred basis, with the condition that they use the deferred price as collateral for a period of time. The goods may then be released in parts according to the percentages paid for the period of deferment.

# CONTRACTS

### Joining Two Contracts

*Is it permissible to join two separate contracts into one?*

It is permissible to join two separate contracts (even if they are related) into one (e.g. a home sale contract combined with a vehicle lease agreement), provided neither one conditions the other.

### Permissible Conditions In Contract

*What conditions are acceptable in a contract?*

Besides the permissible pre-agreed conditions that exist in a typical contract, the following conditions are also permissible:

- Condition of Payment: Where a good or service will be delivered according to payment;
- Condition of Receipt: Where a payment will be made according to delivery of some good or service;
- Condition of Collateral: Where a specified good secures the underlying price of a contract;
- Condition of Guarantor: Where a specified individual becomes legally obligated to ensure payment;
- Condition of Caveat Emptor: Where the seller declares himself free of responsibility for any defects, assuming the seller could not have been aware of any defects at the time of the sale;
- Condition of Payment Deferral: Where the date of deferred payment is clearly specified and agreed upon in the contract;
- Condition of Industry Practice: Where the contract includes a permissible condition that is accepted as the industry standard in the locality in which the transaction is conducted.

### Execution Of Contract

*When does a contract become executable?*

Unless otherwise noted because of the nature of the transaction itself, such as an ijarah property whose delivery is fixed for a future date, contracts are effective immediately.

**Termination Of Contract**

*How is a contract terminated?*

Contract termination may be deliberate or automatic. A contract may be terminated deliberately and unilaterally if it is non-binding. Examples are an agency contract or a contract of gift or loan. It may also be terminated by exercising an option provisioned in the contract at the time of its execution. A binding contract such as an Ijarah may be cancelled by mutual consent. A contract expires automatically once it reaches the end of its term. It also expires due to damage or loss to its subject matter. For instance, an Ijarah is annulled if the leased asset is stolen or destroyed before delivery to the lessee, due to invalid conditions or circumstances affecting it, or as a result of the death of one of the contracting parties.

**Ikala**

*What is an Ikala?*

An Ikala is the termination of a contract based on mutual consent. A contract may be terminated only if the subject matter possesses the same attributes with respect to quality and quantity as it did at the time of the sale. The money reimbursed to the buyer must be equal to the price paid at the time of the execution of the contract. If the subject matter of the sale has been consumed, the contract cannot be terminated.

**Cancellation Of Contract On Basis Of Time**

*Is it valid for both parties to agree on the unilateral cancellation of a contract within a specified time period?*

Both parties may agree in the contract that either party may cancel the transaction unilaterally, without having to supply a reason, within a specified number of days.

**Cancellation Of Contract Of Employment**

*May a contract of employment be cancelled at any time by either party?*

Where one party (employer) hires another party (employee) to perform a service, either party is entitled to cancel the contract at any time, though if the employer cancels the contract after the employee begins work, the employer is obligated to pay for work done at the agreed upon rate; but if the employee cancels, whether work had begun or not, the employee is entitled to nothing.

**Cancellation Of Contract Upon Inspection Of Transacted Item**

*Is a buyer entitled to cancel a contract upon inspection of the item?*

If a buyer purchases an item without having first seen it, he is entitled to return it upon physical inspection without delay, whether provided for in the contract or not, even if the item is not of low or defective quality; particularly relevant in cases where delivery occurs considerably later than the finalization of the contract (e.g. mail-ordered purchases);

if a seller sells an item without having first seen it, he is not entitled to demand it back, though the buyer is still entitled to return it upon inspection;

if physical inspection proves satisfactory at first (having inspected a part of the item to ascertain the quality of the whole, when it is customary to do so, as is commonly done with larger quantities of fungible goods), but because the item's quality varies markedly within itself (e.g. in a grain silo the visible grain is of satisfactory quality while the rest is not) the buyer discovers only later that the uninspected portion of the item is of low or defective quality, it is permissible to return the unsatisfactory portion of the item (if practicable, otherwise the whole item) once inspected.

**Cancellation Of Contract Based On Quality Of Product**

*Is it valid to cancel a contract due to the low or defective quality of the product?*

Products found to be of low or defective quality (such that their quality is below what is purported to be the case or what is customarily considered acceptable, and its usefulness is negatively affected thereby) are returnable (immediately upon discovery of the unsatisfactory quality) within a specified amount of time after delivery, assuming the low or defective quality existed at the time of the transaction but was not disclosed.

"Discovery of unsatisfactory quality" means that the item is seen (e.g. land), and if necessary, used (e.g. car) or consumed (e.g. food), in a manner customary to it before determining its quality. If the defect is not immediately discernible without use (e.g. operation of a new vehicle over long distances in hot weather), the seller is still obligated to compensate the buyer for the defect.

Qualitative or quantitative misrepresentation of any aspect of a good or service is impermissible and constitutes fraud, grounds for the aggrieved party to rescind the agreement at any time. The buyer, nevertheless, still has the choice of whether or not to accept the defective item. If the buyer decides to keep the item as it is, the buyer is not thereby entitled to a compensatory discount, though it is still permissible for the seller to offer a discount.

**Canceling Contract Due To Over-Pricing**

*Is it permissible to cancel a contract if there is a substantial difference between the transaction price and market price?*

If the difference between the market price and the transaction price is substantial enough at the time of payment, the transaction may be cancelled by the buyer. Though jurists do not seem to specify the degree of difference between the market and transaction prices constituting "substantial," a percentage may be incorporated into the contract itself.

**Canceling Contract By Mutual Agreement**

*Is it permissible to cancel a contract by mutual agreement of parties?*

Under all circumstances, transactions may be cancelled by mutual agreement at the original rates.

**Canceling Contract Unilaterally**

*Is it permissible for a party to cancel a contract unilaterally?*

Unilateral cancellations are only permissible if both parties mutually agree beforehand that either party may unilaterally cancel; it is recommended to agree to a cancellation that the other party proposes.

**Waiving Payment For Transaction**

*Is it permissible for one of the parties to a contract to waive payment for the transaction?*

The party that undertakes the monetary risk associated with a transaction, not his representative, is entitled to waive payment for the transaction.

**Artificial Contracts**

*What is meant by an artificial contract?*

Artificial contracts include the following:

*Hazal/Unserious Transacting*

When it is clear that two parties are not serious about actually entering into a contract, such a contract, if executed, comes under the classification of Hazal.

For instance, a sales transaction mentioned as a joke.

*Taljeeah/Secret Understanding*

A Taljeeah is when parties agree to conduct a contract ostensibly in a permissible manner but actually derive impermissible benefits.

There are 3 kinds of secret understanding:

a) The parties do not wish to conduct a contract right from the start execute it anyway.

b) The parties agree a secret price.

c) The parties agree that one or both parties are involved in the contract for ostensive purposes but are not the real parties.

*Sukar/Transacting When Intoxicated*

A contract executed in a state of intoxication is considered an artificial contract.

*Khataa/Transacting In Error*

A contract executed as a mistake or on the basis of an error is also referred to as an artificial contract.

For instance, if a party mistakenly quotes an inappropriately small price for an asset.

**Effect Of Invalid Conditions On Commutative And Voluntary Contracts**

*What makes a contract void or invalid?*

There are some conditions which render contracts void or invalid. A commutative contract is rendered void based on the stipulation of an invalid condition. For instance, if a person selling a car stipulates that he will use the car for three days every month for the first six months after it has been sold to the customer, such a condition annuls the contract. However, the stipulation of an invalid condition in a voluntary contract does not invalidate it. The condition remains invalid and may be removed without rendering the contract ineffective. For instance, a contract of gift is not annulled by the inclusion of a void condition.

# CONTRACTUAL UNCERTAINTY

## The Definition Of Gharar

*What is gharar?*

Gharar refers to uncertainty or ambiguity that may lead to dispute between contracting parties. For instance, executing a contract before the price, subject matter, or transacting parties are definitively known.

## Gharar In Sale Transaction

*What are the causes of gharar in a sale transaction?*

Gharar, or contractual uncertainty, in the subject matter, the price, or the credit period itself, renders a sale invalid.

A sale where the delivery of the subject matter is deferred until an uncertain event involves gharar. For instance, a sale of subject matter based on it raining on a certain day. A sale where the payment of price is deferred up to an event that is certain to take place but its exact time of occurrence is unknown has a small amount of gharar but is permissible in the Shariah.

For instance, a person purchasing a commodity against a future payment of price which is established as the time of harvest of a certain crop is permissible. In this case it is definite that the crop will be harvested though the exact time is unknown.

# CURRENCY AND PRECIOUS METALS

### Currency Exchange

*May I exchange different currencies?*

It is permissible to exchange different currencies at spot according to an agreed upon rate of exchange.

### Gold And Silver

*What constitutes gold and silver?*

Gold and silver includes pure gold and silver and items containing them, such as jewellery.

### Exchanging Gold Or Silver

*May I exchange gold for gold or silver for silver?*

It is obligatory that when gold is exchanged for gold or silver exchanged for silver (e.g. a gold bar for a gold coin) they be of equal weight and that the transaction is conducted on spot (i.e. transactions in which execution, payment, and delivery occur at the same time and the transacting parties are present throughout).

### Exchanging Between Gold And Silver

*May I exchange gold with silver, and vice versa?*

It is permissible that when gold is exchanged for silver or silver for gold (e.g. a silver coin for a gold coin) they be of different weight (or equal weight), though it is still obligatory that the transaction be conducted on spot.

### Exchanging Gold And Silver - Different Face And Market Values

*May I exchange gold and silver for each other if the market value is not consistent with the face value?*

When the market value of a gold or silver commodity is different from its face value (e.g. a $1000 gold coin is selling for $1100), or when the value addition to a gold or silver item increases its price in relation to its value in weight (e.g. gold jewellery worth $1000 in weight sells for $1100), its purchase in the same commodity (e.g. gold purchased for gold) for an amount other than its face value is forbidden. In order to make the purchase, it is necessary that one pay in a different currency (e.g. in cash or a similar exchangeable monetary instrument, in silver if buying gold, or in gold if buying silver). It is permissible to pay a part of the amount in the same commodity and the balance in a different currency (e.g. a gold coin whose face value is $100 and market value is $110 may be purchased with $90 of gold and $20 of cash). As a general rule to avoid riba, gold and silver and their products should be paid for in cash or a combination of the commodity and cash, and always on spot.

**Gold And Silver Combined With Other Metals**

*May I trade in gold/silver alloys or gold/silver jewellery mixed with other material by paying an amount greater than the value of the gold/silver in it?*

When buying anything containing a combination of gold and non-gold material, or silver and non-silver material, or silver and gold, it is forbidden to pay in gold (for items containing gold) or silver (for items containing silver) an amount that exceeds the gold or silver contained in the item. It is permissible to defer payment for the amount equivalent to the non-gold or non-silver material contained in the item, while it remains obligatory to pay on spot the amount equivalent to at least the gold or silver material contained in the item. Generally, when there is doubt, it is preferable to pay in cash or a combination of the commodity and cash.

**Spot Purchasing Of Gold And Silver**

*What should I do if spot purchasing gold or silver is not possible?*

If spot purchasing is not possible, it is permissible for the seller to first lend the buyer money as a separate transaction, and then make the exchange, placing no conditions between the loan transaction and the commodity transaction.

**Buying Cash With Gold Or Silver**

*May I defer payment when buying cash with gold or silver?*

It is permissible to defer payment when buying cash with gold or silver.

**Transfers To And From Abroad**

*Is it permissible for banks to issue cheques to their clients drawn against correspondent banks abroad and arrange for transfers by wire and by mail to all parts of the world in the same way that it accepts such transfers in the interest of those with whom it deals locally? Also is it permissible for the bank to accept brokerage fees as well as charge its client for its actual expenses?*

It is permissible for the bank to continue its dealings as mentioned in regard to the issuing of cheques and arranging for transfers to and from abroad.

**Forward Trading For Clients**

*Is it lawful for banks to arrange deals involving the forward trading of currencies for its clients?*

It is not lawful for banks to be involved directly or indirectly in arranging deals involving the forward trading of currencies.

**Selling Currency At Two Different Rates**

*Is it permissible for banks to sell foreign currency at two different rates; one rate for transfers and another for cash?*

It is permissible for banks to sell currency at a different rate for transfers than for cash as long as there is no international law to prevent it and on the condition that the transfer takes place at spot.

**Delays In Exchange**

*What is the ruling in regard to the purchase of currency when the receipt of possession and receipt of the counter value take place on two separate days?*

Granting a cheque payable on demand and without post dating it, or even ordering a payment without deferment over the telephone may be considered fulfilling the condition of possession.

**Setting Exchange Rates For Currency Deposited Without The Client's Or Bank's Information**

*What is the ruling in regard to an amount of currency deposited with a correspondent bank for a client without information to either him or the bank and on what basis should the exchange rate be set?*

In the event that an exchange is completed in a foreign currency and there are no instructions regarding the exchange to a local currency of the amount received in the client's name, the rate of exchange to be applied will be the price on the day the bank receives the transfer.

**Setting Rates For Currency Exchange Made By Client Through Correspondent Bank**

*What exchange rate is used when a client expects an exchange through a correspondent bank?*

When a client expects an exchange to be made in his favor through a correspondent bank, the exchange takes place at the rate on the day the transfer arrives.

**International Rates Of Exchange**

*Banks deal in currencies on the basis of two rates; one rate in the form of cash currency and one in the form of transfers. If a client wishes to deposit foreign currency in his account, is it permissible for the bank to purchase cash in that foreign currency and sell it in the form of a transfer deposited in the client's account?*

If the client wishes to deposit foreign currency in his account, it is permissible for the bank to purchase the cash in that foreign currency and sell it in the form of a transfer deposited into the client's account. It should be stipulated by the bank that the account is to be operated as a transfer account as in principle, when an account is opened with foreign currency, all withdrawals and maintenance take place in that currency.

**Advance Agreement On Rate**

*What is the Shariah ruling in regard to an agreement on the sale and purchase of foreign currency at a rate that is agreed upon in advance, such that the transacting takes place at a later date and the delivery and receipt of cash take place at the same time?*

It is permissible to make a promise to sell by agreeing upon a rate in advance for a transaction to take place at a later date and the delivery and receipt of cash to take place at the same time. In the event that the promise is linked to anything that is suggestive of a contract of sale, like a down payment, the deal will become like the sale of debt for debt which is prohibited and must be avoided at all costs.

**Exchanging Notes For Currency Other Than Original Issue**

*Is it lawful to exchange notes having payments deferred for several years for foreign currency other than the one in which the original note was issued?*

It is not lawful to exchange notes with deferred payments for the currency in which they were originally issued or for any other currency, as an exchange in the same currency will be like the sale of debt for debt that is deferred, when it is essential that the mutual exchange of equal counter values take place in the sale of currency for a similar currency.

**Buying Back Notes Based On Payment In Currency Other Than The One Note Was Originally Issued In**

*Is it lawful for the issuer of a note to buy it back with payment in a currency other than the currency in which the note was originally issued while disregarding its maturity date at the same time?*

The issuer's buying back the note and disregarding the maturity date is the same as his agreeing to exchange the currency of the note for another currency in which it is permissible for one of the counter values to be in excess of the other. For a lawful mutual exchange there must not be a maturity date, the currency of the original note will be considered to have been paid in an account termed as an exchange on account where the possession of the counter value brought about by the debt, is dropped. It must be ensured however that the bank does not use this allowance as a device to earn profit in return for dropping the maturity date.

**Mutual Promises To Buy Or Sell**

*What is the Shariah ruling in regard to a mutual promise for the sale of various currencies at the rate of exchange on the day of the agreement on the condition that delivery of both counter values will be delayed so that the exchange may take place hand to hand in the future?*
*Will it make a difference if the promise is binding or non-binding?*

A mutual promise such as this if binding on both parties is subject to the general prohibition against the sale of debt for debt and is therefore unlawful. In the event that the mutual promise is not binding on both parties, it is considered lawful.

**Replenishing Overdrawn Accounts**

*In the event that a client holds several accounts for different currencies in the bank and one of these currencies becomes overdrawn, while positive balances in the other accounts are retained, is it permissible for him to comply with the bank's request to make a payment to the account?*

If accounts in a certain currency become overdrawn while there are positive balances in other currency accounts, the client may request the bank to replenish the overdrawn account with funds from other accounts by way of exchange for the price on that day. The client may even replenish his account in the same currency if he so wishes.

**Promises And Commitments In International Exchange Market**

*What is the Shariah ruling with regard to the promises and commitments to enter into exchange operations for a specified price when delivery is delayed and no price or advance is paid out?*

If a promise is made to enter into exchange operations at a specified price, a delayed delivery and no advance payment, the exchange must be completed for each of the two currencies, hand to hand, such that each party takes possession of the currency it is owed at the time specified for delivery. Such a delayed exchange does not involve an element of riba since the international market regularly announces definitive prices for currencies around the world and markets operate on the basis of rules that are honored by all the parties who trade there.

**A Promise To Purchase Different Currencies**

*What is the ruling on a binding mutual promise to purchase different currencies at the rates current on the day of the promise when the delivery of the counter values will be delayed to allow for a hand to hand exchange in the future?*

In the event that the promise is considered binding on both parties it will fall under the general prohibition against the sale of debt for debt and will therefore be unlawful. If the promise is not binding on both parties then such an exchange involving different currencies at the rates current on the day of the promise for a hand to hand exchange in the future is permissible.

**Mutual Promises In Exchange**

*What is the ruling in regard to mutual promises, in the exchange of currencies?*

It is not permissible for a mutual promise in the exchange of currencies to be binding. If the promise is not binding on both parties, the exchange based on it will be lawful.

**Agreeing To Sell Currency At Pre-Determined Rate**

*Is it permissible for the bank to sell currency at a pre-determined rate that remains in effect for a certain period of time and which may be higher or lower than the exchange rate for the currency on the day the exchange takes place?*

It is permissible to exchange currencies at a rate that is fixed at the time of the agreement or one that is higher or lower than the exchange rate for the currency on the day of the exchange.

**Bearing Costs Of Exchange**

*Who bears the cost of exchange when a client seeks to exchange the value of a cheque in cash?*

The one to whom the cheque is written bears the cost of the exchange since he is the one carrying out the exchange.

**Foreign Currency Investment Accounts**

*What is the Shariah ruling in regard to deposits of foreign currency in joint investment accounts such that when withdrawals are made by the clients, they are made from these accounts in the same currency and at the same rate as the one prevailing when they were deposited?*

It is permissible for clients to make deposits of foreign currency in joint investment accounts in order to share in the resulting profits and to be able to retrieve these deposits in the same currencies at the time of withdrawal. The bank possesses the right to invest these deposits in overseas projects or for the purpose of covering letters of credit etc. The bank must calculate the earnings accrued to the amounts deposited, at the purchase or the average price of the day the deposits were made.

**Purchasing Currency For Cash**

*Is it permissible to purchase currencies for cash and at prices below the current market rates if the purchase is made from one of the banks with which a client has extensive dealings?*

In the event that a definite price for the currencies has not been set by a responsible authority, legal consideration may be given to what the two parties agree upon. The cash however must actually exchange hands or otherwise immediate ledger entries by both parties in the exchange of currencies may be considered lawful as well.

**Buying Foreign Currency From Local Client**

*When a client approaches the bank for a Murabaha deal, the bank purchases the goods from a dealer abroad and after taking possession, sells them to the client. In the event that the client offers to sell the bank foreign currency at an appropriate rate to make payment to the supplier of goods, will it be permissible for the bank to engage in such a transaction?*

As long as the contract for the sale of goods remains separate from and independent of the contract for the purchase of currency from the client, such a transaction is permissible.

**Promise To Purchase Currency**

*What is the Shariah perspective on the promise to purchase a designated currency, of a designated amount, for a certain price within a given period of time?*

It is not permissible to make a promise to purchase currency. The only sale of currency allowed is a straightforward sale that is accompanied by a direct receipt in money barter or the exchange of price for price at spot.

**Purchasing Currency On Credit**

*Is it lawful to purchase foreign currencies from mercantile banks by deducting the price of the currencies from the credit accounts held with them?*

It is lawful to purchase currencies in such a manner from mercantile banks since it is akin to paying something they owe as a debt, either in full or in part by means of the mutual cancellation of loans.

**Preferential Currency Exchange Rates With Mercantile Banks**

*To what extent is it lawful for the Islamic bank to deal in a preferential manner in regard to the rates of currencies with mercantile banks considering that exchange transactions are completed either by means of cash or through immediate receipt through entries in debit and credit ledgers?*

Preferential treatment between banks is a good practice however it should be ensured that the possession for the currency is taken in a setting in which the deal is transacted such that neither of the parties leaves until actual or abstract receipt is accomplished.

**Deferring Receipt Of Currency**

*In the event that the client imports goods on credit terms that require the payment to be made after 180 days from the date the goods are shipped, is it permissible for the importer to purchase the currency required for payment to the foreign exporter from the bank while the bank retains this amount until the date the payment falls due? Is it lawful for the bank to use the money and offer its client a price for that currency which is better than the going rate?*

In a transaction of currency it is unlawful to defer the receipt of the currency exchanged regardless of whether there is a condition to that effect. It will however be lawful after a spot exchange to deposit the currency with the bank until the time of payment to the exporter.

**Commissions On Transfers To Foreign Banks**

*Is it permissible for the bank to deduct a percentage from the value of the transfer which includes a 2.5% commission and other expenses involved in the wire transfer?*

It is permissible for the bank to deduct a certain percentage as commission for actual and direct services it performs for its client, in this case wiring funds.

**Transferring Deposits**

*Is the legal maxim that "all loans which bring on profit are riba" applicable to the exchange of deposits in the event that if the two parties fail to agree to the loan exchange, it will not take place at the initiative of only one party?*

The legal maxim mentioned does not apply to an exchange of deposits as no profit is realized from a loan per se; rather the same amount borrowed is returned without any increase in either cash or kind. In trade, benefits usually accrue in transactions where the parties agree to transact with one another.

**Trading In Currencies**

*What is the Shariah ruling in regard to the bank providing funds to trade in currencies?*

The Shariah permits the borrowing of amounts from the bank at no interest for the purpose of trading in currencies if the borrower is free to transact as he sees fit. However, if the deal is conducted as a currency exchange, without either party taking delivery, then it will not be lawful because it amounts to an exchange with a delay. The same will be true if the borrower is loaned an amount without him being able to take possession of it.

**Buying Gold From Bank And Selling It To Clients**

*Can one purchase gold from a bank, deposit the purchase price in that bank's account, and then sell the gold to clients on the basis of a mutual receipt?*

Since the sale of gold by the bank to clients takes place after its purchase and the deposit of its price in the seller's account, the sale is perfectly lawful. It is a sale of what is owned and possessed after mutual receipt of the two counter values in both the original purchase from the other bank and in the sale to the Islamic bank's clients.

**Stones Set In Gold Jewellery**

*What is the Shariah ruling in regard to the purchase of precious stones mounted in gold jewellery?*

It is lawful to purchase precious stones set in gold on the condition that there be compliance for the amount of gold present in the jewellery with the rule for selling gold. This rule is that the price of the gold be paid immediately to ensure actual possession. With regard to the jewels, however, their sale may be made on the basis of a deferred payment.

**Deferred Payments For Platinum**

*Is it lawful to purchase platinum on the basis of deferred payments?*

It is permissible to deal in platinum on the basis of deferred payments as it is not the same as gold or silver and the conditions applying to these two metals do not apply to it.

**Deferred Payments For Precious Metals And Stones**

*Is it lawful to sell precious metals and stones other than gold or silver on deferred payment?*

Yes, it is permissible to sell precious metals and stones other than gold or silver on deferred payment.

**Promise To Purchase Metals**

*Is it permissible to purchase precious metals from the international market? And may one take a down payment which may be forfeited and the seller freed of the agreement in the event that the buyer does not make a payment within the stipulated period of time?*

The sale of precious metals in the international market is termed a sale of a non-existent because the object of the sale is not present. If the object of sale is gold or silver, a deferral in no way may become a part of the deal in regard to the object of sale nor its price since mutual receipt is essential to the completion of such a contract. In the event that the object of the sale is a metal other than gold or silver, then all the conditions of a Salam contract must be complied with including the receipt of the price in its entirety and the specification for the time of delivery.

In the event that the metals are present physically with the seller and the contract is completed, it is not lawful to defer the exchange of the two counter values lest it become a sale of debt for debt. In case the seller offers to sell the metal at a certain price and promises to honor it for a certain period of time, then this may be considered a binding offer and it is lawful for the buyer to advance a sum on the understanding that when the deal is concluded the advance will be deducted from the selling price and if the deal is not concluded, the advance will be left to the seller.

**Delayed Delivery Of Gold Or Silver**

*Is it lawful to buy and sell gold, silver and currency for one another if the delivery is deferred until after the deal has been closed and the parties have left the place of closing?*

It is not lawful to buy and sell gold, silver or currency for one another unless possession is taken immediately.

**Paying Cash For Gold**

*Is it lawful to pay without delay the price of gold in ready cash and how can mutual possession be accomplished?*

It is lawful to pay for gold with ready cash in any currency at the market price on the day of payment. Possession of the counter values in such an exchange must take place on the spot.

**Methods Of Trading In Gold**

*What is the Shariah ruling in regard to the purchase, storage and possession of gold when prices are low and its sale and delivery when prices rise? Also what is the Shariah perspective with respect to the promise to purchase and sell gold at the same time, also referred to as a currency swap?*

Trade in gold is in and of itself lawful and it is imperative that execution be at spot. The purchase, receipt and storage of gold when prices are low followed by sale and delivery when prices rise is permissible provided the buyer receives the gold and the seller receives the price at the time the transaction takes place.

If a promise to buy and a promise to sell are both made at the same time and place, the goods are agreed upon with respect to their description in detail, their quantity and the date of their receipt in case of a purchase, or their delivery in case of a sale, the promise is considered completed.

If the promise is carried out by means of both parties initiating a new contract of sale such that the buyer receives the gold and the seller receives the selling price at the same time and place, then this transaction will be sound and lawful however if the receipt by one of the two parties to the transaction is delayed until after the other, the transaction will be unsound even if both parties agree.

**International Trade In Gold**

*How does the international trade department of the bank deal in gold and what is the Shariah ruling in regard to the promise to sell or purchase gold?*

Gold is purchased and the full price is paid and it is stored in the treasury of the correspondent bank in the Islamic bank's name. The bank then sells the gold to the one willing to pay the price acceptable to it, such that the transaction is hand to hand, the gold is delivered to the purchaser and the payment is received from him at the same time and place.

The bank may at times enact a promise to sell the gold it possesses at a later time for a higher price than its own purchase price based on the understanding that the exchange takes place hand to hand at the appointed time and without any advance. A promise is considered binding if a reason is given for soliciting it whether or not the one soliciting it becomes involved.

If no reason is given, then a promise is not binding and the one soliciting it is not bound to honor it. So there is no legal impediment to a promise to trade in gold as long as the sale or the exchange takes place after it and is Shariah compliant in terms of the transaction being hand to hand, at the same place and at the same time.

**Guaranteeing Gold**

*The operations of the bank include the sale of gold after its acquisition from international banks which require that the gold remains guaranteed in the hands of the Islamic bank for the entire period, i.e. from the Islamic bank's receipt of the gold to the time that a purchase is completed. What is the Shariah ruling regarding such a guarantee and the trade of gold in this manner?*

Such a deal is permissible because it includes the loan of gold and trading in it while it is the property of the seller-borrower and then a contract of exchange for the purchase of gold for a price agreed to by both parties on the condition that the price is paid immediately and without deferment.

**Standard Transactions On Gold Market**

*What is the Shariah ruling regarding the exchange of gold for paper currency?*

It is permissible to trade gold for paper currency in the international market as long as the transaction takes place in accordance with the rules governing the exchange of currencies.

**Promising to Buy Gold And Silver In Future**

*What is the ruling with regard to a promise to buy or sell either gold or silver at some time in the future?*

A promise to buy or sell gold or silver in the future opens the door to the sale of debt for debt which is prohibited. A contract for the sale of gold and silver may only be enacted on the basis of a direct mutual receipt of the gold on one side and the price for it on the other, at the same place and at the same time.

**Agency In The Sale Of Gold**

*What is the Shariah ruling in regard to certain foreign banks that deposit amounts of gold with local money changers engaged to arrange the sale of the gold on behalf of the banks?*

The Shariah views the money changer as an agent of the depositing bank and the gold in his safekeeping is considered a trust which cannot be guaranteed by the trustee except in cases of gross neglect or willful destruction. If the agent sells to other than himself, the price must be received from the buyer without delay. If the agent sells the gold to himself, the bank must be notified so that the deal may be completed between the two parties directly as stipulated by the Shariah. The bank may even deduct the sale price from the agent's account thereby fulfilling the requirement for direct and immediate exchange. If the agent does not possess an account with the bank, he must arrange to make immediate payment.

**Currency As Medium Of Exchange**

*What are the different types of mediums of exchange and what are the rules for their trade?*

There are two types of mediums of exchange: natural mediums of exchange (ie. gold and silver) and legal tender (ie. paper currency). In the exchange between two natural mediums (ie. gold for gold, silver for silver, or gold for silver), it is necessary that they be equal in value and delivered at spot. In an exchange involving legal tender or currency, both currencies must be of equal value and their payment may be either deferred or at spot.

**Permissibility Of Forward Currency Contracts**

*Is it permissible to enter into forward currency contracts?*

No, it is not permissible to enter into currency contracts for the future since they involve elements of riba and gharar.

**Ruling Regarding Exchange of Similar Currency**

*Can there be an exchange of similar currency between two contracting parties?*

Yes, in order to avoid the risk of loss due to fluctuating exchange rates, it is permissible for two contracting parties to deal in the same currency. If at the time of the contract's maturity the party that needs to make the payment is unable to do so in the established currency, the amount can be converted into the currency of the country at the going rate and paid as such. This ruling may be applied where the client is willing to leave himself open to the risk of fluctuating currency rates. The delivery of both amounts must be at spot.

**Actual And Constructive Delivery Of Payment**

*What do the terms "actual" and "constructive" delivery of currency mean?*

Actual delivery refers to a hand-to-hand exchange of currency between contracting parties. Constructive delivery refers to anything that is given to a party in the contract empowering it to use it completely to its benefit. For instance, constructive delivery may be made by means of a cheque, by purchasing a currency and financing it through an existing account or by means of the transfer of credit using a debit or credit card. According to the rules of currency exchange, both parties must receive possession of payment at "the place of the contract."

**Permissibility Of Trading Foreign Exchange At Spot**

*Is Forex trading where Islamic banks buy and sell foreign exchange at spot (where spot here means transaction settlement after 2 business days)Shariah-compliant?*

The scholars permit the settlement of spot transactions to take place 2 business days after the actual transaction provided that the buyer does not sell the item before taking legal constructive possession of it. If all other aspects of the foreign exchange trade are permissible, then this would be allowed.

# DEBT

## Transferring Debt

*What are the rules regarding the transfer of debt?*

Where one person (the lender) lends money to another person (the borrower) who is already owed money by a third person, the borrower may choose to transfer the debt (owed by the third person) so that the third person becomes obligated to pay the original lender.

However, the two debts (the one the borrower owes the lender and the one the third person owes the borrower) must be equal in type and amount to avoid riba; where two debts are of unequal amounts (e.g. if the borrower owes the lender $100 and a third person owes the borrower $200, then $100 of the amount the third person owes the borrower is transferable to the original lender, while $100 remains to be owed to the borrower). Transfer of debt requires the original lender's consent and his knowledge of the contents of the original debt transaction, though the transference does not require the third person's consent.

## Conditions Of Collateral And Guarantee In Transfer Of Debt

*Do conditions of collateral and guarantee transfer with the debt?*

Conditions of collateral and guarantee do not transfer, so that the one putting up the collateral or the one guaranteeing the transaction are absolved of responsibility once the loan transfers.

# DOCUMENTARY CREDIT

**Documentary Credit For Murabaha Sales**

*Is it permissible for the bank to issue documentary credit to a company for the purpose of selling it goods it has not yet received from the manufacturer? Would this be a Murabaha?*

It is not lawful for the bank to issue documentary credit to a company for the purpose of selling it goods before having purchased them from the manufacturer. This is because among the conditions of a sale is that the object of the sale be owned by the seller at the time of the sale. Such a transaction cannot be considered a Murabaha since the seller's ownership is a condition before it can be sold to the purchase pledger.

**The Client And Documentary Credit**

*How does documentary credit work from the client's perspective?*

Documentary credit may be issued based on the client's balance in his account with the bank provided the amount is sufficient to cover the entire value of cash credit. The bank can deduct the amount from the client's account without charging any interest for the interim period, i.e. between the date the negotiating bank pays the exporter and the date of importing on the client's account.

The fee should be reasonable and in keeping with customary practice. If the client's account does not have sufficient balance to cover the entire value of the goods to be imported, the bank may pay a part of the value and become a partner according to the rules of a Musharakah.

Both partners must receive their share of profits in accordance with the percentage of capital invested by them. If the client has no balance, the bank may issue him documentary credit on the basis of the client's specifications. The client agrees to buy the goods from the bank upon their arrival at the port or upon arrival of their title documents based on the conditions of a Shariah-compliant Murabaha sale.

**Repaying Documentary Credit**

*What is the Shariah perspective with regard to the bank extending financing for the import of goods in addition to issuing documentary credit?*

The procedure for issuing documentary credit does not usually include the bank's extension of financing to the client; all of the financing is usually undertaken by the client himself. The bank serves as the client's agent and receives a fee for the services it performs with respect to the issuance

of the documentary credit. If the client advances only a part of the documentary credit's value and the bank expends some of its own funds, then it is necessary for the bank to receive a percentage of the profits according to the rules of a Musharakah rather than a fee.

**When The Client Is Unable To Pay**

*What happens when the client is unable to pay all or part of the money due for the value of goods imported by means of documentary credit?*

If the client pays a portion of the money due for the goods the bank may enter into a contract of partnership with the client in which each partner's percentage of ownership will be based on the amount each paid for the goods so that this amount will represent the partnership's capital investment. If the client is unable to pay anything, it is lawful for the bank to buy the goods from the client at a mutually agreed upon price and sell it to a third party. In this case all the profits accrue to the bank alone. Alternatively, the bank may take the goods as collateral in return for the amount it paid out and then sell it to a third party to settle the client's account and use the proceeds to pay the seller.

**Approximation Of Value**

*When a client opens an account for documentary credit it is customary that the amount is considered approximate, varying upward or downward, for instance, 10%. When the client terminates this line of credit how does the bank calculate its fees?*

The bank should calculate its fees on the basis of the agreement between the two parties and in return for a banking service. It is of no consequence if the amount is greater or less than the initial estimate since when the bank determines the fee it must consider actual expenses only regardless of the credit amount.

# EMPLOYMENT

### On Jobs Directly Linked To The Unlawful

*What is said of doing a job directly linked to the unlawful, or working for an employer whose primary business is unlawful?*

It is unlawful to perform work that is directly unlawful (i.e. work that is itself unlawful or even assists in the unlawful) or to work for an employer (even if one does not participate directly in the transactions) whose primary business is unlawful (e.g. interest-based banking).

### Doing Lawful Jobs For Unlawful Businesses

*May one continue doing his job with an employer whose primary business is unlawful, given the job he does is not directly linked to the unlawful?*

If one is employed in lawful work (e.g. working as a security guard for an interest-based bank) or work that is not directly unlawful (e.g. working as a secretary for an interest-based bank) with an employer whose primary business is unlawful, it is permissible, though disliked, to continue with the work but superior to find work with an employer whose primary business is lawful.

### On Lawful Jobs Involving Occasional Unlawful Acts

*If one is required to perform occasional unlawful acts during the course of an otherwise lawful job, should one continue working with such an employer?*

If one is employed in lawful work that occasionally requires one to perform something unlawful, one must leave the employer unless one's obligation to perform the unlawful work is waived.

### Cancellation Of Employment Contract

*Who is entitled to initiate the cancellation of an employment contract?*

Both employer and employee are entitled to cancel the employment contract at any time given an agreed upon notice period, though if the employer cancels the contract after the employee begins work, the employer is obligated to pay for work done at the agreed upon rate; but if the employee cancels, whether work had begun or not, the employee is entitled to nothing.

**Recording Interest-Based Transactions**

*Is it permissible to record interest-based transactions?*

The unlawfulness of any form of employment depends on how direct one's involvement is to the unlawful: direct involvement entails that one participates in the actual execution of an unlawful transaction; using interest-based transactions as an example, the one who buys, sells, trades, witnesses, records, calculates or in any way directly assists in an interest-based transaction during its execution is culpable (e.g. car buyer who contracts an interest-based lease; homeowner who takes a mortgage; futures and options trader; insurance salesman; loan officer); if an accountant, for instance, merely records a transaction that has already taken place, the involvement is not considered direct, and therefore remains permissible, though it is always superior to avoid the doubtful.

**Worker's Compensation**

*To what permissible extent may I claim worker's compensation from my employer?*

Provided the employment contract entitles the employee to worker's compensation, it is permissible to take worker's compensation from one's employer for injuries sustained on the job and, if necessary, to contest disputes over financial settlements in court; worker's compensation permissibly includes, but is not limited to, payment for medical expenses, lost wages and emotional distress; if there is no provision in the contract, the employer is recommended, but not obligated, to provide worker's compensation unless injury is caused directly by the employer's negligence (and not merely by the employee having injured himself due to his own negligence).

**Secretly Monitoring Employees**

*What are the rulings regarding secretly monitoring employees?*

It is impermissible for an employer or his agent to secretly monitor the private dealings of his employees outside the workplace (e.g. hiring private detectives). The employer is entitled to monitor the employee's work-related activities at the workplace and, with the employee's consent, private activities at the workplace (e.g. personal emails and phone calls).

**Working For Company That Facilitates Interest-Based Investments**

*Is it permissible to provide investment consultancy services at a company that solicits interest-based loans for its clients from conventional banks and carries out feasibility studies for investments based*

*on these interest-based loans?*

There are two considerations with respect to the permissibility of working in such a company; timing and level of involvement.

Timing: If one assists in an impermissible transaction before the point of execution, one may fall into the impermissible. If one merely records an impermissible transaction that has already been executed (i.e. postmortem auditing and accounting), one does not fall into an area of clear prohibition, though the scholars state that this is better to avoid.

Level of involvement: If one is involved in initiating, proposing, assisting, or executing an impermissible transaction, one is culpable.

Since the company facilitates in obtaining of interest-based loans for its client and advises on them, providing investment consultancy services for such a company would be equivalent to assisting in prohibited transactions and, therefore, impermissible.

**On Accepting Wages For Work Not Done**

*An employee believes that a portion of his wages was taken for work not done altogether. What should he do?*

If an employee is certain that wages were taken for work not done altogether, those wages must be returned to the employer, unless the employer forgives the employee; if the wages were taken for work done partially or poorly, those wages may be kept by the employee.

**Employees And Temporary Workers Not Held Accountable For Loss**

*Are employees and temporary workers held accountable for loss, damage or theft resulting from their negligence?*

Employees and temporary workers do not count as individuals who rent out their services, and therefore may not be asked for compensation for loss, damage or theft, even due to their own negligence, unless the loss, damage or theft is intentional, in which case compensation may be demanded.

**Non-Compete Clauses**

*Are non-compete clauses that restrict an employee's ability to work in another company valid?*

Non-compete clauses that restrict an employee's ability to work in another company are impermissible and corrupt the entire contract, though the contract itself remains valid and the clause would only have the effect of a non-binding promise.

**Working For Employer Dealing In Futures And Options**

*May I work for an employer dealing in futures and options?*

It is unlawful to work for an employer whose primary business is futures and options (even if one does not participate directly in the transactions), unless one has absolutely no other means of supporting one's dependents (such as selling the excess of one's saleable wealth or accepting work at a low-paying job), in which case one may remain with the unlawful work as long as one is actively looking for another source of income and seeking God's forgiveness and help in the process.Insurance.

**Permissibility of 401K Plan**

*In order to have my 401K contribution matched by my employer, I must either invest 30% of my money in mutual funds that may or may not be Shariah-compliant or in government bonds that would give me a small interest rate. Would investing in the government bonds and donating the interest to charity be my best alternative?*

This is not investment advice but a general answer to the Shariah-compliance aspect of your question. If your company permitted you to choose your stocks, say a small basket of Shariah-compliant stocks prescreened by you, this would be permissible. It would not be permissible to invest in a bond with the intention of donating the charity. The following link has further information on 401Ks: http://spa.qibla.com/issue_view.asp?HD=1&ID=4348&CATE=5

# ENDOWMENT

**Islamic Endowment (Waqf)**

*What is an Islamic endowment (waqf)?*

The Prophet (God bless him and give him peace) said: "When a human being dies, his work comes to an end, except for three things: ongoing charity, knowledge benefited from, or a pious son who prays for him."(Muslim) The establishment of an endowment (waqf) is a recommended act entailing that the owner of a property give up ownership interest in the property (for the sake of God, "to" God) while specifying how it is to be used after its disposition, whereby any financial benefit accruing from the given property be directed to a specified purpose as supervised by some designated manager.

**Endowment Of Usufruct Must Accompany Ownership Transfer**

*Is it permissible to endow the usufruct of a property, without endowing its ownership?*

Usufruct alone is not endowable. While it is permissible to specify the manner in which the endowment is to be used (e.g. "the usufruct of this building goes to the poor and needy"), it is impermissible to endow only the use of a property while maintaining private ownership.

**Endowment Of Consumable Item**

*Is endowment of a consumable item permissible?*

Property whose consumption materially diminishes the property itself is not valid to endow (e.g. a fruit tree is endowable, while its fruit alone is not).

**Proceeds Of Endowment**

*Who is entitled to the proceeds of an endowment?*

After the endowment's establishment, the property itself is "owned" in a worldly sense by God, but the proceeds from the property are owned by the endowment manager who spends it according to the endowment's guidelines.

**Returning Endowment Found To Be Stolen**

*What is the ruling on returning an endowment later found to be stolen property?*

Third parties (i.e. non-thief and non-owner) who acquire stolen property through an endowment are obligated to return the item to the original owner (and compensate for damage and depreciation), even if they had no prior knowledge of the property's misappropriation.

**Assigning Portion Of Endowment Income To Non-Beneficiary**

*Is it permissible for the one endowing to allocate a share of the endowment's income for parties other than those already intended as beneficiaries?*

It is permissible for the one endowing to allocate a portion of the endowment's income to specified parties other than those already intended as beneficiaries; for example, the endower may allocate a percentage of a property's income to his heirs, and the remaining to the needy.

**Buying And Selling Items Within Endowment**

*May an endowment manager buy, sell or replace peripheral items contained within the endowment?*

It is permissible for the endowment manager to buy, sell or replace peripheral items contained within the property in a manner that benefits the endowment without diminishing its overall value. For example, for an endowed mosque the manager might buy new carpeting.

**On Using Endowments For Personal Gains**

*Can endowments be used for personal gain?*

Endowments may not be used for personal gain unrelated to the endowment's purpose or unspecified in the endowment's guidelines.

**Classification Of Endowments**

*How are endowments classified?*

Endowments are classified according to the circumstances in which they are given:

1. without a will, during the giver's lifetime, they are considered to be from the giver's personal property;
2. without a will, after the giver's lifetime, they are considered to be part of the bequest;
3. in a will, they are considered to be part of the bequest; and
4. with or without a will, if they are given under circumstances that ultimately lead to the individual's death (e.g. illness, war, travel, etc.), they are considered bequests.

**Ushr On Endowment**

*Is ushr, an Islamic tax on agricultural produce, levied on an endowment?*

Ushr is payable on an endowment.

# GAMBLING

**Games Of Chance**

*May I engage in games of chance?*

Games of chance (gambling, betting, lottery playing, etc.) are forbidden without exception, regardless of the probability of the outcome, because they are akin to trading in risk, where the possibility of reward rests on the likelihood of an event's occurrence without bearing an underlying relationship with an economic asset or service; additionally, games of chance incur riba because money (i.e. the amount gambled) is exchanged for money (i.e. the amount won), whether a small or large winning.

**Forecasting**

*Is it permissible for an English language training company to grant special service discounts to individuals that offer correct forecasts on the results of football games?*

Any benefit received, monetary or otherwise, such as in this case where a discount is offered, for correctly forecasting an outcome is considered gambling and impermissible.

# GENERAL

### Classification Of Gifts, Endowments And Charitable Contributions

*How are gifts, endowments and charitable contributions classified?*

Gifts, endowments and charitable contributions are classified according to the circumstances in which they are given:

1. without a will, during the giver's lifetime, they are considered to be from the giver's personal property;
2. without a will, after the giver's lifetime, they are considered to be part of the bequest;
3. in a will, they are considered to be part of the bequest; and
4. with or without a will, if they are given under circumstances that ultimately lead to the testator's death (e.g. illness, war, travel, etc.), they are considered bequests.

### Items Sold By Weight

*What constitutes items sold by weight?*

An item sold by weight includes anything that is customarily weighed before transacting, such as meat, grain and vegetables.

### Transacting "Like" Items Sold By Weight

*Is a transaction involving "like" items sold by weight deemed valid?*

A transaction involving "like" items sold by weight (e.g. one type of wheat for another) is valid. When transacting any like goods sold by weight, it is obligatory that they be of equal weight and, if not transacted on spot, be kept separately.

### Trading "Like" Items Sold By Weight But Different In Quality

*May I trade two "like" items sold by weight even if they differ greatly in quality?*

When two "like" goods sold by weight are traded and whose difference in quality is substantial, they should first be denominated in cash.

**Transacting Dissimilar Items Sold By Weight**

*Is a transaction involving dissimilar items sold by weight deemed valid?*

It is permissible to trade two different goods of different weights (e.g. 1 kg of rice for 5 kg of wheat) and, if not transacted on spot, the goods should be kept separately.

**Trading Inherently Similar But Customarily Dissimilar Items Sold By Weight**

*May I trade two items sold by weight that are inherently similar but are customarily regarded as dissimilar?*

In cases where two products sold by weight are inherently similar to one another but the value addition to one makes it something that is customarily regarded as a different product altogether, one item should be denominated in cash before transacting it with the other item. Such as with wheat and flour, where both are inherently similar to one another because the base product is still wheat, but because flour is a different end-product altogether having undergone extensive value additions, wheat and flour are regarded as substantively different.

**Items Sold By Measurement**

*What constitutes items sold by measurement?*

An item sold by measurement includes anything that is customarily measured or counted before transacting, such as cloth, eggs, and types of fruit.

**Trading Like Items Sold By Measurement**

*May I trade like items sold by measurement?*

It is permissible to transact any like goods sold by measurement or counting (e.g. one type of orange for another). It is not obligatory that they be equal weight, but they must be equal in measure or count, and the transaction must be conducted on spot.

**Transacting Dissimilar Items Sold By Measurement**

*Is a transaction involving dissimilar items sold by measurement deemed valid?*

It is permissible to trade two different goods of different weights (e.g. 1 dozen oranges for 2 dozen apples) and, if not transacted on spot, the goods should be kept separately.

**Trading Inherently Similar But Customarily Dissimilar Items Sold By Measurement**

*May I trade two items sold by measurement that are inherently similar but are customarily regarded as dissimilar?*

In cases where two products sold by measurement or counting are inherently similar to one another but the value addition to one makes it something that is customarily regarded as a different product altogether, one item should be denominated in cash before transacting it with the other item. Such as with fruit and fruit juice, where both are inherently similar to one another because the base product is still fruit, but because fruit juice is a different end-product altogether having undergone a degree of value addition, fruit and fruit juice are regarded as substantively different.

**Trading Items Of Different Categories**

*May I trade an item sold by weight with an item sold by measurement?*

It is valid to trade an item customarily sold by weight with an item customarily sold by measurement or counting (or vice versa). It is permissible to agree upon any rate of exchange; it is a condition for the validity of such a trade that the items be of different categories.

**Deferring Payment When Transacting Items Of Different Categories**

*May I defer payment when transacting an item sold by weight with an item sold by measurement?*

It is permissible to defer payment (or exchange) when transacting items sold by weight with items sold by measurement or counting (or vice versa); it is a condition for the validity of such a trade that the items be of different categories.

**Transacting An Item With Cash, Gold, Or Silver**

*May I defer payment or agree upon any rate when buying an item?*

It is permissible to agree upon any rate of exchange or to defer payment when buying any item sold by weight, measurement or counting with cash, gold, or silver.

**Theft - Benefit Derived From Wrongfully Acquired Property**

*May I keep any benefit derived from wrongfully taken property?*

It is impermissible to keep for oneself the benefit derived from wrongfully taken property (e.g. profits from the sale of real estate purchased with wrongfully taken money); while the property should be returned to the owner, the resulting benefit should be distributed in charity. It is also impermissible to keep for oneself the benefit derived from property (e.g. profit) one does not own without the owner's permission, even if there is no intention to wrongfully take the property itself but to merely benefit from its usufruct (e.g. borrowing a vehicle, milking a cow or investing money without the owner's permission).

**Cashing Time-Bound Cheque**

*Is it permissible for me to try and cash a cheque seven months after I received it when it said it would be void after 60 days?*

It would not be permissible since "void after 60 days" is a condition upon which this transaction is based. You will have to initiate a new transaction with the payer by requesting a new cheque.

**Shariah-Board Approval**

*(i) If a conventional bank borrows funds from an Islamic bank with excess funds for 30 days based on an FX Commodity Murabaha, will the conventional bank require a Shariah board? (ii) A bank short of funds in the FX Commodity Murabaha is involved in both conventional and Islamic banking. If its conventional banking arm borrows funds from a purely Islamic bank will the transaction require the borrowing bank's Shariah board approval?*

For both (i) and (ii): Only an institution claiming to be Islamic, have Islamic products, or conduct Islamic transactions, whether such an institution is Islamic or conventional, requires an opinion from a Shariah board.

**Compensation For Deriving Benefit From Wrongfully Taken Property**

*Am I liable to compensate another from any benefit I derived from wrongfully taking their property?*

It is obligatory to monetarily compensate individuals or institutions to the extent that one benefits from the wrongdoing; children or the insane who misappropriate are compensated for by their guardians; it is not a condition that individuals compensate with their own money, though if no one compensates, the wrongdoer remains liable.

**Dealing In Stolen Property**

*May I deal in stolen property?*

It is impermissible to deal in stolen property that one is certain is stolen; if there is doubt then it is permissible to deal in though it is always superior to avoid the doubtful.

**Transacting With Person Who Deals In Stolen Property**

*May I transact with a person who deals in stolen goods?*

The permissibility of transacting with a given source that might deal in stolen property depends on the extent to which the source's wealth is unlawful and the degree of certainty to which the one determines the extent of this unlawfulness. One should determine the unlawfulness of the source's earnings according to that which is reasonably apparent; it is neither recommended nor preferred to seek out information about the unlawfulness of a source's earnings.

**Misappropriating Non-Muslim's Wealth**

*Can a Muslim misappropriate the wealth of a non-Muslim?*

Islam does not differentiate between Muslims and non-Muslims in the matter of misappropriation. Some Muslims mistakenly regard the theft of non-Muslim property to be commendable. Rather, any kind of theft is forbidden.

**Copyright**

*What does Islam say about copyright?*

It is obligatory to abide by the laws of copyright and intellectual property unless doing so compels one to do something impermissible or refrain from something obligatory according to the standards of Islamic Sacred Law; it is permissible to store printed or electronic copyrighted material for oneself or to share it with others in a limited manner that does not financially or otherwise harm the copyright owner.

**Returning Wrongfully Acquired Property**

*Am I liable to return any wrongfully acquired property?*

It is obligatory to return wrongfully taken property to the rightful owner as soon as one is able, even if at one's own expense assuming no harm comes to one's own or another's life or property. The one who misappropriated is obligated to make every kind of reasonable effort to return the property (or its equivalent market value, if applicable) to the rightful owner. The one who misappropriated is obligated to return the very item that was taken, regardless of depreciation, unless the item was lost or destroyed ("destroyed" refers to extensive damage that seriously diminishes the usefulness of something), in which case he repays monetarily an amount equivalent to the market value of the item, even if he was not responsible for its loss or destruction.

**Compensation In Form Of Market Equivalent**

*May I compensate for misappropriation by returning the equivalent market value of the misappropriated item?*

If the owner and the one who misappropriated both agree that the owner will take the equivalent market value of the misappropriated item rather than the item itself, the item becomes permissible for the one who misappropriated to keep and use. Market value is measured as the highest market price between the times of theft and loss, destruction or unavailability.

**Misappropriation By Children Or Insane Persons**

*Who is responsible for misappropriations by children or insane persons?*

Guardians are responsible for returning items misappropriated by a child or insane person under their charge, and if applicable, compensating rightful owners or paying charity on behalf of the child or insane person; it is obligatory for one to return items misappropriated during childhood oneself.

**Misappropriation In Childhood**

*Am I liable for any misappropriations by me during my childhood?*

It is obligatory for one to return items misappropriated during childhood oneself.

**Repaying Misappropriated Usufruct**

*How do I repay misappropriated usufruct?*

Misappropriated usufruct (e.g. electricity, rental property) is repayed monetarily an amount equivalent to the rental cost of similar usufruct for the amount of time it was misappropriated.

**Beneficiary Of Misappropriation**

*Is one who benefits from misappropriation liable to repay, even if he was not involved in the act of misappropriation?*

Repayment is the responsibility of the one who misappropriates, not the responsibility of the one who merely benefits from the misappropriation (e.g. if the father steals food and the family benefits, only the father is liable to repay), unless the beneficiary is also involved.

**Altered Misappropriated Goods**

*What is my liability with regards to misappropriated goods that are altered in a way that affects their market value?*

If a good is neither damaged nor destroyed but merely altered in a manner that increases or decreases the value of the good, the owner is entitled to choose whether to demand compensation or accept the good back as it is.

**Change In Market Value Of Misappropriated Goods**

*Am I liable for fluctuations in the market price of misappropriated goods?*

The one who misappropriated is not responsible for changes in value caused by fluctuations in market prices.

**Third-Party Bona Fide Ownership Of Misappropriated Goods**

*What is the liability of a third party that acquired misappropriated goods bona fide?*

Third parties (i.e. non-thief and non-owner) who acquire the stolen property, whether by purchase, loan, endowment, gift, inheritance, bequest, or other means, are obligated to return the item to the

original owner (and compensate for damage and depreciation), even if they had no prior knowledge of the property's misappropriation.

**Misappropriated Items Lost And Repayed For, And Subsequently Found**

*What is my liability as regards misappropriated items lost and repayed for and subsequently found?*

If items wrongfully taken and subsequently lost had been compensated for and *then* found, there are two options: 1) if the compensation is equal to or greater than the market value (at the time of misappropriation) the item is not returned; 2) if the compensation is less than the market value (at the time of misappropriation) the original owner decides whether to take the item or accept the compensation as it is. For lost or unclaimed property, or property found on one's premises, the property should be returned to its rightful owner.

**Unable To Locate Owner In Case Of Misappropriated Money**

*What is my liability as regards misappropriated money if the owner is not traceable?*

If money was taken and every reasonable effort has been made to locate the original owner but he is untraceable or no longer exists, the one who misappropriated should give the money away in charity; it being superior to give charity to those eligible to receive zakat rather to an ordinary charity; while the debt would be cleared, it would be superior, but not obligatory, to continue searching for the original owner; it is impermissible to give the money away in charity when one is able to locate the rightful owner.

**Misappropriation By Group Of Individuals**

*What is the liability in case of misappropriation by a group of individuals?*

If a group of individuals misappropriate property, each individual is only responsible for his share of the involvement; in the absence of a quantifiable division of responsibility, the default assumption is that everyone share's the blame equally; the individual is not responsible for non-payment by other members of the group.

**Consideration Upon Return Of Misappropriated Property**

*Is it permissible to demand compensation upon repayment of misappropriation of property?*

It is impermissible to demand any form of consideration for returning misappropriated property, though the owner is entitled, at his own discretion, to make a reduction in the repayment or to make a gift of reward to the one returning, provided the gift is not a condition for the return.

**Informing Owner Of Misappropriated Property Upon Return**

*Am I liable to inform the owner of misappropriation of property upon its return?*

When returning misappropriated property, it is not a condition that the taker inform the owner that the property had been misappropriated; rather, the property may be returned by any means possible, whether as a gift, secretly or openly, provided the one returning does not accept any form of consideration in return.

**Unsure Of Misappropriated Amount**

*What must I do if I am unsure of the amount misappropriated?*

If the one who misappropriated is unsure of the amount taken, it is recommended to estimate a bit on the higher side.

**Begging**

*What does the Shariah say about begging?*

Begging is offensive for those not in need, where a person in "need" is defined as one unable to feed oneself and one's dependents for a period of a day, whether due to an inability to earn a livelihood or because of physical incapacity caused by illness or old age. Further, it is offensive for the individual not in need to accept voluntary charity. For the individual unable to fulfill the basic requirement of feeding one's family for the day, begging is permissible. Begging while pretending to be needy is absolutely forbidden.

**Giving To Professional Beggars**

*Is it permissible to give to professional beggars?*

It is offensive to give to professional beggars.

**Giving To Beggar When Certain Of Unlawful Usage**

*Is it permissible to give to a beggar when certain that he will use the money unlawfully?*

It is impermissible to give to any beggar that one is certain will not use the money lawfully; it is offensive to give to any beggar that one doubts will use the money lawfully.

**Engaging In Doubtful Transactions**

*Is it permissible to engage in doubtful transactions?*

As a general rule, it is offensive to engage in the doubtful. In relation to commercial dealings, any transaction in which one doubts its permissibility it is offensive to engage in.

**Transacting With Muslim When Doubtful Of His Source Of Income**

*May I transact with a Muslim when doubtful of his source of income?*

It is offensive to enter into a transaction with a Muslim when there is doubt about whether the worth that he derived directly from unlawful earnings exceeds 50%.

**Entering Into Contract That Entails The Unlawful**

*Is it permissible to enter into a contract that directly entails or assists in the unlawful?*

It is unlawful to enter into a contract that directly entails the unlawful (i.e. work that is itself unlawful or even assists in the unlawful) or to work for an employer (even if one does not participate directly in the transactions) whose primary business is unlawful (e.g. interest-based banking, insurance, futures trading).

**Deriving Benefit From Unlawfully Gained Property**

*Is it permissible to derive benefit in any way from unlawfully gained property?*

It is impermissible to buy, sell, trade, use, rent, borrow, finance, invest in, bequest, endow, gift, give in charity, put up as collateral, give a guarantee for or derive any form of benefit from unlawfully gained property that one is certain is unlawfully gained; if there is doubt then it is permissible though it is always superior to avoid the doubtful.

**Accepting Compensation From Unlawful Source**

*Is it permissible to accept compensation from a source whose earnings are unlawful?*

It is impermissible to accept any form of compensation from a source when the recipient is certain that the very earnings used in the transaction were unlawfully gained; though if the recipient is doubtful about the unlawfulness of the earnings then taking compensation is permissible because one assumes that one takes from the lawful portion of the earnings.

**Dealing With Someone Of Lawful As Well As Unlawful Earnings**

*Is it permissible to deal with someone who has both lawful and unlawful earnings?*

It is permissible to deal with an individual or institution whose lawful and unlawful earnings are mixed, provided the unlawful portion does not exceed the lawful portion, in which case it is impermissible if one is certain of it; if one is uncertain, it is permissible to assume that the lawful portion is greater, to the extent that it is reasonably possible, it is superior to avoid doubtful wealth altogether, though not obligatory.

If one is certain that a given source's unlawful wealth exceeds the lawful portion, one is forbidden from dealing with the source unless one is certain that the very earnings one receives are from the lawful portion.

In determining the lawfulness of a source's earnings, the recipient is only expected to rely on that which is reasonably apparent, such as publicly-available information, rather than attempt to uncover that which is hidden; it is neither recommended nor preferred to seek out information about the unlawfulness of a source's earnings, though if one happens to learn something that was otherwise not apparent, one is expected to act accordingly.

**Giving Money Or Property When Certain Of Unlawful Use**

*Is it permissible to give money or property to someone who may use it unlawfully?*

It is impermissible to give money or property to a party when one is certain it will not be used lawfully, and offensive when one doubts whether the money or property will be used lawfully.

**Conditional Acceptance**

*Is a conditional or partial acceptance to an offer to contract valid?*

Acceptance is valid only with respect to the whole offer; the sale would be invalid, for example, if a buyer transacted a part of the saleable item at the price of the whole item without the seller's consent (e.g. "100 kg of grain at the rate of 1 tonne").

**Conditional Transaction**

*Is a transaction that is conditional upon other agreements or future events valid?*

The transaction should be free of all conditions with other agreements, whether conditioning or being conditioned by a second agreement or a future event outside of the transaction.

**Dowry**

*What is the status of dowry in Shariah?*

Whereas a marriage payment is from the husband to the wife, the dowry, a common cultural practice in Muslim countries, is from the wife to the husband; dowry is neither forbidden nor recommended, but merely permissible provided that it is not stipulatory or excessive, but rather a moderate and voluntary gesture of goodwill; demanding dowry from the wife or her family is strictly impermissible.

**Supporting One's Parents**

*What are the rights of parents with regards to receiving support from their children?*

With money that is above basic needs, both men and women are equally obligated to support those of their Muslim or non-Muslim parents (grandparents, great grandparents, and their direct ascendants) stricken by poverty (obligatory only when there is poverty), even if the parents are capable of earning.

Money that is "above basic needs" is measured as the typical maintenance for oneself (and one's wife, if applicable) necessary for one day before spending it on one's parents; the one obligated to pay zakat al-fitr is obligated to support his or her parents. In order to satisfy this obligation, which includes sons paying for their father's marriage (including marriage payment and subsequent maintenance of the father's wife if the father is poor) and sons and daughters repaying any debts the parent incurs in order to cover living expenses, one is even compelled to sell property in excess of one's needs.

If more than one child is financially qualified to support the needy parent, the obligation of providing support is shared equally among the children, regardless of the child's gender or financial

status (provided the zakat al-fitr minimum is reached); women are only obligated to provide support if they earn or have sufficient money of their own.

### Obligation To Support Parents If One Is Needy Out Of Both

*Who is obliged to support a needy parent: their spouse or their children?*

If one parent is needy and the other is not, the obligation of providing support first returns to the parent who is not needy, then the obligation goes to the children.

### Hierarchy Of Supporting One's Dependents

*What is the hierarchy or order of precedence in supporting one's parents?*

The right of one's mother comes before the right of one's father (respectively for grandparents, great grandparents, and their direct ascendants); and the right of one's parent comes before the right of one's child; though this precedence is only relevant in the absence of sufficient funds to support everyone.

### Claiming Back Maintenance Provided To Parents

*Is it permissible to claim back any maintenance provided to parents?*

The one supporting the parent is not entitled to claim any portion of the obligatory or non-obligatory maintenance that has already been provided.

### Supporting Parents Who Are Not Needy

*Is it obligatory to support one's parents even when they are not needy?*

It is not obligatory to provide one's parent with financial support when they are not needy, though it is still recommended to give if they ask.

### Supporting Children

*What does the Shariah say regarding the obligation of supporting one's children?*
Both men and women are equally obligated to support their children until the child reaches adulthood, including those of their Muslim or non-Muslim children (grandchildren, great

grandchildren, and their direct descendants) stricken by poverty (obligatory only when there is poverty), even if these children grow to adulthood while they are still impoverished.

The obligation of support rests on parents who have the means to do so once they have paid the typical maintenance for themselves (and one's wife, if a husband) necessary for one day before spending it on one's children. In order to satisfy the obligation to support one's child, which includes repaying any debts the child incurs in order to cover the child's living expenses, one is even obligated to sell one's own property in excess of one's needs.

The right of the younger child comes before the right of the older one (respectively for grandchildren, great grandchildren, and their direct descendants); but the right of one's parent comes before the right of one's child; though this precedence is only relevant in the absence of sufficient funds to support everyone; male and female children have an equal right to maintenance.

**Supporting Relatives**

*What does the Shariah say regarding supporting male and female relatives?*

One is obligated to support one's needy male relatives (i.e. brother, uncle, cousin, nephew, etc.) who are unable to support themselves as a result of an illness or disability, though if they are needy for reasons other than illness or disability supporting them is merely recommended; the proportion of their financial support in relation to one's direct dependents is the same as the proportion of their inheritance in relation to one's direct dependents. One is also obligated to support one's needy unmarried female relatives (i.e. sister, aunt, cousin, niece, etc.) who are unable to support themselves regardless of the causes of their neediness; the obligation of supporting needy married females returns to the husband. The one supporting the relative is not entitled to claim any portion of the obligatory or non-obligatory maintenance that has already been provided.

**Accepting Welfare Payments From Government**

*Is it permissible to accept welfare payments from the government?*

It is permissible to take welfare payments, provided one fulfills the conditions necessary to be eligible; it is impermissible to lie about one's circumstances in order to receive welfare, even if the source of the payments is a non-Muslim government.

**Debtor Performing Pilgrimage**

*Is it obligatory to perform the pilgrimage if one is in debt?*

Debtors may perform the pilgrimage if the creditor grants permission to delay repayment until after the pilgrimage. Generally, when a debt (whose amount exceeds the cost of pilgrimage and its related obligations, such as providing for one's family during one's pilgrimage) is outstanding, the pilgrimage is no longer obligatory, though its performance is still valid if performed with the creditors consent.

**Pilgrimage With Borrowed Money**

*Is it permissible to perform the pilgrimage with borrowed money?*

A pilgrimage performed with borrowed money is valid provided the conditions for performing pilgrimage are met and the creditor obliges. The debtor is entitled to perform the pilgrimage without taking permission from the creditors if the debtor has no arrears and if his performing the pilgrimage does not hinder his ability to continue repaying the creditor on schedule. It goes without saying that one may not take an interest-based loan in order to perform pilgrimage.

**Pilgrimage Without Creditor's Consent**

*Is it valid to perform the pilgrimage without taking permission from the creditors?*

The debtor is entitled to perform the pilgrimage without taking permission from the creditors if the debtor has no arrears and if his performing the pilgrimage does not hinder his ability to continue repaying the creditor on schedule.

**Pilgrimage With Borrowed Money - Whether Obligation Is Lifted**

*Is the obligation to perform pilgrimage lifted if one borrows money to perform the pilgrimage?*

The obligation to perform the pilgrimage is lifted once one performs it - whether through borrowed money or otherwise.

**Delaying The Obligatory Pilgrimage**

*Is it permissible to delay performing the pilgrimage even if it is obligatory and one possesses the means?*

Once the physical, logistical and financial conditions exist for performing the pilgrimage, the individual is obligated to perform it that same year, and to delay doing so without a valid reason is impermissible, though no less obligatory; non-performance becomes a sin if the person dies while having had reasonable opportunity to perform the pilgrimage.

**Earning An Income - Whether It Is Obligatory**

*Is it obligatory to earn a halal income?*

It is obligatory to earn a lawful income if one is unable to support oneself and one's dependents without doing so, though it is merely permissible if one is able to support oneself and one's dependents without earning.

**Brokers Charging Fee**

*Is it permissible for brokers to charge a fee for their service?*

It is permissible for brokers and managers to charge a fee for their services, either as a pre-agreed fixed amount or as a pre-agreed percentage of the stock's price or the fund's net asset value.

**Investing In Unlawful Business**

*Is it permissible to invest in anything that could be used in unlawful ways?*

It is impermissible to invest in anything when one is certain the investment will not be used lawfully, and offensive when one doubts whether the investment will be used lawfully.

**Accepting Stolen Investment**

*Is it permissible to accept an investment that may have been stolen?*

It is impermissible to give or take investment when one is certain the investment itself is stolen; if there is doubt then it is permissible to give or take the investment, though it is always superior to avoid the doubtful.

**Interaction Between Shareholders Or Partners And Their Influence On Business**

*Is it a condition for the validity of an investment that the partners or shareholders interact or exert influence on the business?*

It is not a condition for the validity of an investment (e.g. stocks, mutual funds, business partnerships) that partners or shareholders of the business physically interact with one another or even meet with each other a single time, or that they exert any form of direct or indirect influence on the running of the business; it would be permissible for none of the shareholders to ever meet or even to know one another, provided the managing partners of the business maintained a level of interaction, though not necessarily physical, customary for the success of the business.

**Financing An Unlawful Business**

*Is it permissible to finance anything that could be used in unlawful ways?*

It is impermissible to provide financing when one is certain the money will not be used lawfully, and offensive when one doubts whether the money will be used lawfully.

**Earnest Money**

*Is it permissible to accept or pay earnest money?*

It is permissible to accept or pay earnest money (arbun) in the Shariah.

**Bank's Bidding For A Tender Offered By Itself**

*In the event of a bank offering a tender to the general public, is it permissible for a department of the bank to participate in bidding for that tender?*

It is permissible for a department of a bank to bid for a tender offered by the same bank. In case the bid is found to be suitable, it will be permissible for the bank to award the tender to its department.

**Brokerage Fees**

*Is it lawful for the bank to pay a brokerage fee to a party who brings in people interested in leasing unoccupied properties being offered by it?*

Yes, it is permissible to pay such a brokerage fee as such a payment is like a commission paid to one who brings a client or customer to the bank.

**Seeking Return Of Brokerage Fee**

*Is it lawful to seek the return of a brokerage fee paid to a broker if the deal is dissolved after the contract is signed?*

The amount paid as the brokerage fee is the right of the broker and may not be taken back after the contract is signed regardless of whether or not the contract is subsequently dissolved.

**Combining Guarantee With Agency**

*What is the Shariah position in regard to purchasing automobiles from a certain person with the understanding that he will serve as a paid agent for the sale of cars as well as act as guarantor for the buyers for any possible damages that may occur?*

It is not permissible to appoint the same person as an agent and as a guarantor during the same time period.

**Owner's Guarantee**

*Is it lawful for the bank to accept the guarantee of an owner for a contractor constructing a building for the guarantor himself?*

It is lawful for the bank to accept the guarantee of an owner for a contractor in the construction of something for the guarantor himself since the guarantor acts as a surety in relation to the work that is taking place between the contractor and the bank. The fact that the construction is undertaken in the guarantor's interest has no bearing on the matter.

**Payment Of Trade Bills**

*Is it permissible to make payment to the exporter on the arrival of the shipping documents for the goods and before delivery is taken?*

It is lawful to pay the exporter upon arrival of the bill of lading and before the goods are delivered.

**Lawful Payment Of Trade Bills**

*What are some lawful methods for paying trade bills?*

The importer pays local currency to the bank in return for the purchase price at the time of payment. The bank accepts this amount until it has sufficient foreign currency in its reserves to purchase the foreign currency at the current rate of exchange.

If anything remains of the local currency, the bank returns it to the importer. If the amount is insufficient, the bank requests the importer to make up the difference. Thereafter, the foreign currency is transferred to the exporter.

Another permissible way of clearing payment is for the importer to pay local currency to the bank on the understanding that the payment is in return for the amount of obligation in foreign currency at the current rate. The bank receives this amount as the exporter's agent and the importer is cleared of responsibility. The exporter receives the full price of the goods through the bank which he may collect in local currency or alternatively have the bank as its agent convert it into foreign currency before making the transfer.

**The Merchant's Request With Regard To Paying Bank Percentage Of Value Of Goods**

*Is it permissible for the merchant or the importer to pay the bank a 20% profit margin on the deal in order to guarantee the transfer of the value of the goods to the exporter within a month? If not, what is the Shariah compliant way of executing such a transaction?*

It is not lawful for the importer to pay the bank 20% as profit margin on the deal in order to guarantee the transfer of the value of goods to the exporter as that would be analogous to the importer borrowing the price of the goods from the bank at that rate. The Shariah-compliant way of executing the transaction is by means of a Musharakah.

The bank becomes the merchant's partner in the ownership of goods by purchasing a portion of the goods in foreign currency. Thereafter, each has the right to contract for a commercial partnership which accords both partners the right to dispose of all the goods and share profits on the basis of an agreement between them. In this way the merchant is able to transfer the price of the goods to the exporter in foreign currency paid by the bank. If a loss occurs, it is absorbed by partners in proportion to their share of investment capital.

**Sale Of Goods That Have Yet To Clear Customs**

*Is an export sale based on a sample of the goods lawful and will it be considered complete regardless of whether or not the goods have arrived at the port?*

An export sale based on a sample of the goods for approval by the importer is lawful whether or not the merchandise has arrived at the port.

**Islamic Bank Compelled To Deposit Money For Interest**

*In case local regulations require all banks to deposit a certain amount of money in a conventional bank at a specified interest rate, what does an Islamic bank do?*

In such a case, the Islamic bank has the option of entering into a Mudarabah contract with the conventional bank. The Islamic bank assumes the role of investor, while the conventional bank is the working partner. The working partner invests the money contributed by the investor in lawful investments, and the proceeds are divided as per the Mudarabah contract.

**Fees For Transfers**

*Is it permissible for the bank to charge a fee for the services it provides such as money transfers. Will it be lawful for the bank to increase its fee for this service in proportion to the amount transferred?*

It is permissible for the bank to charge a fee for services such as money transfers. The fee charged must be in proportion to the service being provided. Therefore, if the bank concludes that the costs differ with differences in the sums to be transferred, the bank may increase its fee with increases in the sums. If, however, the costs do not differ, then a higher fee for a larger sum may not be charged.

**Islamic Bank Depositing In Conventional Bank**

*Is it permissible for an Islamic bank to deposit funds in a conventional bank?*

Islamic banks should seek to maximize their dealings with other Islamic banks, but in case of genuine need an Islamic bank may deposit funds with a conventional bank provided no interest is taken or given. If its withdrawals exceed the deposited amount so that the conventional bank becomes the Islamic bank's creditor, under no circumstances should interest be paid.

**Tax Payments On Reserves**

*What is the Shariah ruling with regard to the bank's payment of income tax from the amount deducted annually for the investment risk reserve?*

Where applicable, the bank must pay tax from the amount deducted annually for the investment risk reserve.

**Mutual Loans**

*If a bank requires dollars for one month, is it permissible to request another bank to grant this amount as an overdraft on its account there, without a fee but in exchange for something of equal value, such as dirhams, on the basis that when the dollars are returned the dirhams will be returned as well?*

It is permissible to exchange these kinds of interest-free loans provided no fee, payment, or penalty is attached to them.

**Unclaimed Funds**

*What should the bank do with money held in accounts for extended periods of time for which there is no claimant?*

These amounts may be given away in charity. If the rightful owner returns, he must be informed of what was done. If he still demands the money, the bank is financially obligated to provide compensation from its charitable accounts.

**Unclaimed Cheques**

*What should the bank do with outdated, unclaimed cheques issued in favor of clients whose accounts are now dormant?*

It is permissible to give these funds away in charity after the bank has made every attempt to contact the client. If the owner returns after the funds have already been given away, he must be informed of what was done and if he still demands payment he must be reimbursed from the general shareholder's account.

**Repayment From Interest Bearing Accounts**

*If a client maintains accounts at an Islamic bank but also holds an interest-bearing account at a conventional bank, is it lawful for the Islamic bank to accept funds that have come directly from his interest-bearing deposits?*

It is lawful for the Islamic bank to accept these funds because there is no connection between the Islamic bank and the source of these amounts. The one dealing directly in interest is considered culpable.

**Assistance In Cash And Kind**

*Is it permissible for the bank to offer assistance in cash or kind to its current and investment account holders in return for the business they conduct with the bank?*

It is permissible for the bank to offer assistance in cash or kind to its current and investment account holders provided that this is not stipulated as a condition at the time of the opening of the account, or becomes an expectation or customary practice. It is only permissible for the bank to provide assistance as a gesture of goodwill.

**Charging Fees For Late Repayment**

*Some debtors have the ability to repay on time but continue to defer. Is the bank permitted to charge them a fee?*

It is not lawful to charge anything above the due amount for a delay in repayment regardless of whether the delay is intentional or not. Instead the bank should seek legal recourse against the debtor and at the time of entering into the transaction should include a charity clause entitling the payment of penalties to a designated charity.

**Purchase Of Business License**

*Is it lawful to purchase the business license of a company that operates on the basis of riba when it is being sold and none of its riba-based assets remain, with the intention to make its operations Shariah-compliant?*

It is lawful to purchase the business license of a business whose operations are riba-based for the purpose of making them Shariah compliant.

**Interest From Bank Deposits**

*What is the Shariah ruling in regard to a Muslim depositing his money in a conventional bank?*

It is unlawful for a Muslim to deposit his money in a conventional bank when it is possible to deposit the money in a comparable Islamic bank.

**Deposits In Conventional Banks In Muslim And Non-Muslim Countries**

*Is the prohibition of interest the same in whether one deposits in a bank located in a Muslim or a non-Muslim country?*

The ruling in regard to depositors taking interest is the same whether the bank is located in a Muslim or in a non-Muslim country. The interest earned on the deposits is unlawful for the Muslim to consume or use to his personal benefit.

**Profits And Losses To Overdrawn Accounts**

*Savings accounts in the bank are usually investment accounts. When the investments yield profit, the account holders share the profits in proportion to the amounts credited. Is it permissible for the bank to overdraw these accounts by allowing depositors to withdraw amounts greater than their current balances?*

It is permissible for the bank to allow the accounts to be overdrawn however, in the event that they are overdrawn such that no balance remains in them, then whatever the bank has paid out to the client will be considered an interest free loan and will not be a part of the profit or loss.

**Fee For Guaranteeing Operation**

*What is the Shariah ruling with regard to an agreement with a vendor in which he is required to inspect new cars for the bank and guarantee their operation for a certain period of time in return for charging a certain fee?*

It is lawful that a fee be paid to a vendor for the inspection of the cars and their repair when they break down. On the other hand, an agreement that a certain amount will be given to him for guaranteeing any damage sustained by each car during a period of time in addition to his pledging to repair the same is a contract for something undefined and therefore invalid.

**Commission For Finding Clients**

*Is it lawful for the bank to receive a commission for Takaful policies based on the number of policies taken out by clients having purchased cars through the bank?*

It is lawful for the bank to receive a brokerage fee for serving as an intermediary between the client and the insurance company. This fee is linked directly to the amount of the bank's effort, ascertainable through the insurance documentation.

**Transferring Right To Benefits**

*Is it lawful to transfer a right to benefits from a Takaful insurance plan to the purchase pledger at the conclusion of a Murabaha sales contract?*

It is lawful to transfer a right to benefits from a Takaful insurance plan to the purchase pledger at the conclusion of a Murabaha sales contract, where he also serves as the bank's agent in settling accounts with the insurance company. Once the damage or loss to the goods if any is recompensed, the client does not require recourse to the bank and may deal directly with the Takaful company alone.

**Two Accounts Into One**

*Is it permissible for the bank to join two accounts into one in the name of both individuals with the understanding that each of the two will have the right to withdraw the entire balance or a part of it even after the death of the other? Also is it lawful to grant a third person wishing to remain anonymous, a right to access the account as well?*

It is permissible for the bank to join two accounts into one in the name of both individuals with the understanding that each of the two will have the right to withdraw the entire balance or a part of it even after the death of the other. They are both agents and the agency of one will not be disrupted by the death of the other. With regard to adding a third member who wishes to remain anonymous, the bank requires that a document be produced with the signature of the present depositor in which he admits that the deposit also belongs to another person whose name is mentioned but must be kept in secret by the highest authorities of the bank.

**Permissibility Of Debit Card In Islamic Finance**

*Are Islamic Financial Institutions permitted to issue debit cards?*

The use of a debit card is permissible provided the user does not exceed the available balance. This avoids any resulting interest charges. It is also permissible for the Islamic bank to charge an annual fee for providing the debit card facility to the client. For the avoidance of doubt, by debit card we mean a card that allows the client to access his existing bank account to pay for products or services with available funds.

**Permissibility Of Charge Card**

*Are Islamic financial institutions permitted to issue charge cards?*

For the avoidance of doubt, by charge card we mean a credit accessing instrument for which the debt incurred is to be paid off to the bank within a month's time. The charge card does not provide a revolving credit facility and the card holder is obliged to repay within a stipulated period. If the card holder delays payment beyond the established period of free credit, an interest amount is imposed. The bank does not charge any percentage on purchases but receives a percentage commission from the party accepting the card for purchases made by the card holder. The bank charges its client a merchant service fee.

In Islamic finance, the charge card is permissible as long as the holder is not obliged to pay interest at any time. The financial institution is permitted to charge the card holder to pay a sum of money as a guarantee for providing the charge card facility.

The amount taken as a guarantee is accepted by the financial institution based on a Mudarabah. The profit earned from the Mudarabah is shared between the card holder and the institution according to an established ratio.

The institution must stipulate that the card holder may not use the card for any non-Shariah-compliant activity or purpose. The bank reserves the right to withdraw the card if it is used in contravention to Shariah rulings.

**Prohibition Of Credit Card In Islamic Finance**

*Are Islamic financial institutions permitted to issue credit cards?*

It is not permissible for an institution to issue credit cards that provide an interest bearing, revolving credit facility where the card holder pays interest to pay off debt in installments.

**Cash Withdrawal Using Card**

*Is it permissible to withdraw cash using a card?*

It is permissible to withdraw cash using a card for which only a flat service fee is charged. It is not permissible to withdraw cash using a card which charges a fee that varies with the amount withdrawn. This would be analogous to interest.

**Permissibility Of Benefiting From Privileges Offered By Card Issuing Authorities**

*Is it permissible to benefit from privileges offered by card issuing authorities?*

It is permissible to benefit from all Shariah-compliant privileges offered by card issuing authorities such as discounts to hotels and airline tickets. However, it is prohibited to avail non-Shariah-compliant privileges such as access to conventional life insurance, entrance to bars, and discounts at music concerts.

**Investment**

*In case of an investment opportunity to purchase and develop land into commercial units where the investors group is comprised of Muslims and non-Muslims, so long as one's capital is not from a ribawi source, does the probable ribawi source of investment of the other partners undermine the Shariah-compliance of the project?*

If you are a co-investor in a project, it is not a condition that other investors' money be attained by Shariah-compliant means. You are only responsible for ensuring that the project that you are investing into is Shariah-compliant. If the project developer secured the funds through ribawi financing (e.g. he purchased land through an interest-based bank loan), it is permissible to invest in the project provided that 1) your transaction be Shariah-compliant and 2) the project itself purchases something that in and of itself is Shariah-compliant (ie. no casinos, bars, etc.).

**Possibility of Making A Credit Card Islamic**

*How can a credit card be made Islamic?*

There are numerous structures currently prevailing in the market, most of which would not comply with AAOIFI. It would be difficult to make a credit card Islamic without turning the card into a pure debit or charge card. The provision of credit on acash for cash basis requires some aspect of unlike exchanges, which would be ribawi.

**Islamic Bank's Action in Case of Client's Inability to Pay Installments**

*If a person takes a car loan from an Islamic bank, goes bankrupt and is unable to repay half of the loan, what action does the Islamic bank take and how is it different from the conventional bank's?*

In Islamic finance there are no car loans. If you mean a car financing, this can be done in various ways, most commonly using Ijarah or Murabaha. The rulings for bankruptcy vary according to the product structure, but assuming it is an Ijarah, then if the lessee (the one using the car) goes bankrupt and is unable to pay for the remaining lease period, he is not required to pay the bank for the unused portion of the lease but, depending on the kind of Ijarah, he may be required to pay the bank for the direct loss between the price the bank paid for the car and the price when the bank goes back to the market to sell the car.

**Exchange Traded Notes**

*What is the Shariah ruling on exchange traded notes?*

Exchange traded notes are problematic for a number of reasons foremost of which are 1) they are debt securities, and 2) they do not take actual ownership in anything, where payment is for the linked performance of a particular index not for the price change in the equity ownership of a particular asset.

**Permissibility Of Conventional Car Lease**

*Is a conventional car lease permissible as the interest involved in the lease is similar to renting?*

Islamic leasing (Ijarah) and conventional leasing, while similar in many respects, differ enough that it would be misleading to simply say, as in the question, that it is permissible even if there is interest as leasing is similar to renting.

According to the resolution of the Islamic Fiqh Conference regarding impermissible lease-to-own contracts, in No.12, Vol. 1, p.698, Resolution 110 (4/12):

'Secondly - impermissible instances of the contract:

a) A rental contract that ends in the ownership of the rented corpus in return for the rental payments made by the lessee during the tenure without concluding a new contract such that the rental (contract) transforms spontaneously at the end of the tenure into a sale contract.

b) The rental of a corpus to a person for a known rental value for a known period of time, with a sale contract conditional on the complete payment of all rent agreed upon during the specified time or appended to sometime in the future.

c) A real rental contract which is concurrent with a sale with a condition option to the benefit of the lessor and which is deferred to a distant specified date (the end of the period of the rental contract).'

In addition to the above, there may be other impermissible conditions in the contract including, but not limited to:

1. Requiring the lessee to make major maintenance payments;
2. Requiring the lessee to take conventional insurance when Islamic insurance is available;
3. Requiring the lessee to pay the lessor late payment penalties rather than pay a designated Shariah-compliant charity;
4. Sub-leasing clauses that do not accord with the Shariah;
5. Interest-based securitizations of the car lease.

**Role Of Money**

*What is the role of money in an Islamic economy?*

Money is a medium of exchange for conducting Shariah-compliant transactions.

**Islamic Finance Career Opportunities In India**

*Are there any career opportunities in Islamic finance in India?*

Both India's Prime Minister and Central Bank have made public statements recently indicating their wish to explore Islamic finance as a possible parallel market in India. At present, there are no regulatory laws in place specifically designed to address Islamic finance, however, this may be changing soon as the country wishes to attract foreign capital through Sukuk and other financing structures. In terms of career opportunities, meeting key people in the industry, including regulators, bankers, lawyers, and scholars now may position you well for career opportunities at the "ground floor" of the industry as opportunities become available in the coming months and years. Prospective Indian employers of Islamic finance professionals will look at demonstrated interest in Islamic finance, such as work experience, internship experience, and practical certifications.

**Permissibility Of Day Trading**

*Is day trading permissible where the price position of a financial instrument is opened without purchasing it? A profit is made if the price goes in the suggested direction and there is a loss if it goes against it. It is also commonly referred to as spread betting in the UK.*

Speculating on the position of a price is not permissible. In Islamic finance, it is a condition when dealing in shares that actual equity come into the buyer's ownership.

**Shariah Audit**

*What is a Shariah audit?*

A Shariah audit is a review of a bank's products and transactions in light of the Shariah, usually conducted internally by the Shariah team consisting of a Shariah scholar(s) and a Shariah coordinator.

**Weightages**

*What is the Shariah basis for assigning weightages?*

Weightages are a permissible means by which banks are able to assign relative returns based on various tenures and investment tiers for large groups of account holders or investors. The Shariah basis is that for those products in which weightages are appropriate, it is permissible for both parties to pre-agree ratios on some equity based products.

**Permissibility Of Rebates And Rollovers**

*Can the installment amount be reduced for an early payment? In case of default, is it permissible for the bank to charge the client an increased installment amount?*

According to scholars, rebates for prepayments are not permissible if it becomes customary practice, or is stipulated in the agreement or becomes an expectation. In the case of default, rolling over is not permissible.

**Mortgaging An Asset**

*Can an asset be mortgaged in a Shariah-compliant way as giving something as security is a known concept in the Shariah?*

Assets may permissibly be used as security, however, mortgaging involves doing so based on interest so it would not be accurate to say that an asset may be mortgaged in a Shariah-compliant way.

**Permissibility Of Tawarruq/Monetization**

*What is the Shariah basis for the permissibility of Tawarruq? How do Islamic banks use it?*

Tawarruq is a permissible sale-based financing structure. AAOIFI distinguishes it from Bai al Inah, which is impermissible, in standard 30/2: "Monetization refers to the process of purchasing a commodity for a deferred price determined through Musawama or Murabaha, and selling it to a third party for a spot price so as to obtain cash. Whereas Inah refers to the process of purchasing the commodity for a deferred price, and selling it for a lower spot price to the same party from whom the commodity was purchased." There are detailed controls that AAOIFI enumerates in sections 30/4 and 30/5 that must be adhered to in order to ensure the validity of the transaction. In general, the fuqaha permit Tawarruq but caution that due to its nearness to an interest-based transaction it should be provided selectively only on an as needed basis. It is unfortunate that it has become one of the most popular transactions in Islamic finance for which the best way out is to limit Tawarruq and innovate into equity-based transactions such as Musharakah and Mudarabah.

**Investment In Commodity And Currency Funds**

*Why are Muslims not investing in commodity and currency funds despite their increasing popularity?*

If by commodity and currency funds what is meant is what is typically available in the conventional market, the reason is that most of these funds are based on futures contracts which are not permissible to buy and sell. It is important to note, however, that Muslims may, of course, buy and sell commodities and may trade in currencies provided the rules for these are followed.

**Concept Of Promise In Islamic Finance**

*What is the concept of the promise in Islamic finance?*

Although Islam prohibits the execution of a future sale, it is permissible to make a *promise* for a future sale. For instance, if a sales transaction for a car that will be delivered a month later cannot be executed, a promise may be made for its future sale. It is important to note that the promise and the

actual contract of sale be independent of one another. A promise is legally binding and accompanies stipulations which serve as deterrents to default. In turn, this requires the client to make good on any loss that the bank may face as a result of a breach.

**Perishables**

*What is the ruling with regard to the return of perishable goods like food stuffs carrying expiration dates, for compensation in cash or in kind?*

It is lawful to come to an agreement stipulating return of food stuffs after their expiration date in return for recompense either in cash or in kind.

**Unclaimed Funds**

*What should the bank do with money held in accounts for extended periods of time for which there is no claimant?*

These amounts may be given away in charity. If the rightful owner returns, he must be informed of what was done. If he still demands the money, the bank is financially obligated to provide compensation from its charitable accounts.

**Unclaimed Cheques**

*What should the bank do with outdated, unclaimed cheques issued in favor of clients whose accounts are now dormant*?

It is permissible to give these funds away in charity after the bank has made every attempt to contact the client. If the owner returns after the funds have already been given away, he must be informed of what was done and if he still demands payment he must be reimbursed from the general shareholder's account.

**Contests For Account Holders**

*Is it permissible for the bank to offer incentives such as contests for prizes to every lessee who opens an account with the bank and gives it the right to deduct lease payments directly from these accounts?*

It is permissible to offer incentives such as contests for permissible prizes to attract lessees to open accounts at the bank in order to have their lease payments deducted directly from them.

**Monthly Giveaways**

*Is it permissible for the bank to offer prizes through a drawing as an incentive to lease?*

It is permissible for the bank to offer prizes through a drawing as an incentive to lease.

**Privileges For Account Holders**

*Is it permissible for the bank to offer privileges to holders of certain types of accounts?*

It is lawful for the bank to offer account holders, whether in general or only to a specific group, special privileges such as gifts and prizes provided these privileges are not made conditional upon opening an account and are not mentioned at the time of opening an account.

**Trusts And Commissions**

*What is the status of trusts and commissions in the Shariah?*

Trusts and commissions are permissible as a general rule, but become recommended acts by the trustee or the agent intending something good thereby; offensive acts by the one suspecting that the trust might be betrayed, whether due to incompetence (e.g. an adolescent executing the merger of two companies), negligence (e.g. a traveler managing rental property) or incapacity (e.g. a person expecting to die while overseeing an equity fund) thereby; and unlawful acts by the one intending harm or expecting the betrayal of the trust thereby.

# GIFT

### Gift Giving Invalid Without Consent

*May a person coerce another into giving or accepting a gift?*

The giver and the recipient must agree to the gift; a gift coercively taken from the giver or forcefully given to the recipient is invalid; agreement may be written, spoken or unspoken (e.g. a nod).

### Impermissibility Of Restricting Gift's Usage

*May the giver of the gift attach restrictive conditions to the usage of the gift?*

It is impermissible for the giver to impose conditions on how the gift will be used by the recipient.

### Physical Possession Not Requirement For Valid Gift Giving

*Must the giver be in physical possession of the gift intended to be given?*

Physical possession by the giver is not a condition of valid gift giving; for example, it is permissible to gift an item that has already been entrusted to a trustee merely by stating so.

### Gifting To Children

*What is the ruling on gifts given to children?*

Gifts to children are of two types: 1) gifts given to the parent or guardian for the ostensive purpose of benefiting the child, are the property of the parent or guardian (who is closest in relationship to the giver) who may use the gift in any manner they choose; and 2) gifts given directly to the child, in which case the child owns the gift and the parent or guardian (in the order of guardianship) keep it on the child's behalf.

### Gift Should Leave Giver's Possession

*Must the gift be separated from the giver's property?*

The gift should be separated from the giver's property and until it is separated it remains the property of the giver, even if he considers the gift as having been given.

**Gifting One's Share In Undivided Property**

*Would it be permissible for an individual to gift his share in an undivided, shared property?*

It is impermissible to gift one's share in an undivided property shared by two or more individuals, unless all the owners of the property gift the entire property or the gift giver's property is divided from the rest, provided the property is dividable.

**Permissibility Of Taking Back Gift With Recipient's Agreement**

*Is it permissible to take back a gift?*

It is impermissible to take back a gift, unless the recipient agrees to its return (except for children and the insane, whose permission is invalid).

**Taking Back Gift In Which There Has Been Substantial Value Addition**

*The recipient has agreed to a gift's return, but the gift has increased considerably in its worth due to substantive value addition (e.g. gold turned to jewelry). Would it still be valid for the giver of gift to accept the gift's return?*

It is permissible to take back a gift that the recipient willingly returns, unless the value-addition to the gift is substantial enough to have increased the value of the item (e.g. gold turned to jewelry), in which case it is impermissible to do so even if the recipient is willing (though the recipient is entitled to gift the item). It is, however, permissible to take back a gift that the recipient willingly returns if the value-addition created by the gift is separable from the gift itself, such as the capital gains earned from gifted company stock or the offspring produced by a gifted animal; the original gift is returnable but not the value-addition (though the recipient is entitled to gift the item).

**Reclaiming Gift Before Possession**

*What is the exact time before which the giver may reclaim his gift?*

The giver may reclaim a gift before the recipient takes constructive possession of it, but not after, however insignificant the gift.

**Validity Of Mistakenly Given Gift**

*Is a gift given by mistake considered a valid gift?*

A gift given in error is still considered to have been given validly and may not be reclaimed by the giver unless the recipient agrees to its return. Once the gift is validly reclaimed, ownership rights return to the claimant.

**Gift Not Returnable Once Giver Or Recipient Dies**

*Would the gift be returnable if either the giver or the recipient dies?*

No gift is returnable once either the giver or the recipient dies.

**Rules Pertaining to Gift Giving**

*What are the rules pertaining to gift giving?*

Gifts, or hiba, must have an offer, an acceptance, and possession. The offer should be made in such a way that the intention of the person giving the gift should be clearly understood by the one receiving it. This may take place without the exchange of a verbal offer and acceptance.

The intention of the gift giver and the acceptance of the receiver may be expressed merely by their manner, such as a nod. Once a gift is sent to a person and he takes possession of it, it is equivalent to an exchange of an offer and acceptance between both parties.

In a sale and purchase transaction, the offer and acceptance must take place while both parties are present, however, in the offer and acceptance of a gift, the presence of both parties together is not a prerequisite. In the event that after an offer and before an acceptance has taken place either party passes away, the offer and acceptance is automatically annulled. A contract of gift may not be made for the future.

# GUARANTEE

### Circumstances That Discharge Guarantor Of His Obligation

*Under what circumstances is the guarantor discharged of his obligation?*

Guarantees last the duration of the obligation unless:

1. the creditor cancels the obligation;
2. the obligation transfers to another obligor, in which case the guarantee itself cancels; or
3. the creditor cancels the guarantor's obligation but continues to maintain the obligor's obligation.

### Situations When Guarantors Are Not Required To Fulfill Contract

*Under what circumstances are guarantors not obliged to fulfill a contract on behalf of an obligor?*

Guarantors are not obliged to fulfill a contract on behalf of an obligor unable to do so if either:

1. the obligation is not yet due, o
2. the creditor grants a period of respite and now asks for fulfillment of the obligation during the period of respite.

### Guaranteeing For Conventional Bank

*Is it permissible for an Islamic bank to guarantee the work a client intends to do for a conventional bank?*

It is not permissible for an Islamic bank to guarantee equipment, buildings or contracts for any form of work a client intends to do for a conventional bank.

### Charging For Guarantee

*Is it lawful to charge a fee for providing a guarantee?*

It is unlawful to charge a fee for providing a guarantee. If providing the guarantee actually incurs cost, such as for services, it is lawful to charge a fee but not for issuing the guarantee itself.

**Demanding Guarantee**

*When a client forwards a request for the purchase of goods and the bank decides that it requires a guarantee before going through with a Murabaha, is it permissible to seek a check of guarantee from the surety?*

It is permissible for the bank to seek a check of guarantee from the surety upon the receipt of which a letter will be issued to him explaining that the check will only be cashed in case of non-payment by the client. Even if one payment is delayed, all subsequent payments will fall due.

**Obtaining Guarantee From the Purchase Pledger**

*What is the Shariah ruling with regard to obtaining a guarantee from the purchase pledger in a Murabaha sale to ensure the arrival of merchandise in good condition?*

It is permissible from a Shariah perspective to obtain a guarantee from the purchase pledger in a Murabaha sale to ensure the arrival of merchandise in good condition.

**Guarantees From Conventional Banks**

*Is it permissible for an Islamic bank to request its client to present a guarantee from a conventional bank in order to close a deal?*

It is not permissible for an Islamic bank to request its client to present a guarantee from a conventional bank.

**Fees In Proportion To Value**

*May the fees of the bank increase or decrease with the value of a guarantee particularly when the services required for each guarantee differ in proportion to its value?*

It is not lawful to charge a fee for issuing a letter of guarantee since it is a contract for which compensation is not taken. It is permissible however to charge a fee for the effort expended by the bank in the process of issuing a letter of guarantee for actual services.

**Voluntary Guarantee In Mudarabah**

*Is it permissible for the manager in a Mudarabah to voluntarily guarantee the capital investment?*

It is not permissible for the manager to guarantee the capital investment in a Mudarabah because he cannot be held responsible for the loss of capital unless he is guilty of willful negligence or dishonesty. It is lawful, however, to have a third party guarantee the Mudarabah capital.

**Fees For Suretyship And Agency**

*Is it permissible to charge fees for both suretyship as well as agency covered in the letter of guarantee?*

A letter of guarantee covers both suretyship and agency. It is not lawful to charge a fee for suretyship however it is permissible to charge a fee for agency. Costs for issuing a letter of guarantee include the collection of information about the client and his business, a study of the project for which the guarantee is issued and related expenses customary in such practice.

**Fees In Proportion To Amounts Guaranteed**

*When issuing a letter of guarantee, is it lawful to link the fee to the value of the guarantee and the period for which it is to remain valid?*

It is not lawful to take a fee for merely providing a guarantee, however, it may be charged in return for actual services like the preparation of studies, professional consultation and the provision of administrative services.

**Guaranteeing Client's Payments**

*What is the Shariah ruling with regard to the bank issuing letters of guarantee on behalf of its clients to individuals or financial institutions?*

It is lawful for the bank to issue letters of guarantee on behalf of its clients, however, it is not lawful to take a fee in return for the guarantee unless the fee is based on actual expenses. The bank should take every measure to ensure that the letter of guarantee is not issued to institutions dealing in interest.

**A Surety's Sharing In Profits**

*Is it lawful for a client holding an investment account with the bank to stand surety for an institution seeking financing for a Murabaha deal from the bank? May he seek a share of the profits earned from the institution's commerce in the goods guaranteed to the bank?*

The client's suretyship for the institution is lawful. The bank freezes the client's account for the amount owed to it by the institution on the condition that the returns from the investment during the period of the freeze accrue to the client.

It is not lawful however for the client to share in the profits of the institution in return for its suretyship as suretyship is a voluntary contract.

**Percentage Based Fees**

*Is it lawful to charge a percentage based fee for documentary credit or letters of guarantee?*

It is not permissible for the bank to charge a percentage-based fee for letters of guarantee or documentary credit. It is lawful, however, for it to charge an amount for the services it offers to it clients. Such a sum may vary with the value of the guarantee or documentary credit in accordance to the differing degrees of administrative services required.

**Permissibility Of Two Parties Guaranteeing Each Other In Contract**

*Is it permissible for a party to guarantee the principal or profit of another party in a contract?*

It is impermissible for any party to guarantee the principal or profit of another party in a contract. A third party may, however, serve as guarantor.

**The Merchant's Request With Regard To Paying The Bank A Percentage Of The Value Of the Goods**

*Is it permissible for the merchant or the importer to pay the bank a 20% profit margin on the deal in order to guarantee the transfer of the value of the goods to the exporter within a month? If not, what is the Shariah compliant way of executing such a transaction?*

It is not lawful for the importer to pay the bank 20% as profit margin on the deal in order to guarantee the transfer of the value of goods to the exporter as that would be analogous to the importer borrowing the price of the goods from the bank at that rate. The Shariah-compliant way of executing the transaction is by means of a Musharakah. The bank becomes the merchant's partner in the ownership of goods by purchasing a portion of the goods in foreign currency. Thereafter, each has the right to contract for a commercial partnership which accords both partners the right to dispose of all the goods and share profits on the basis of an agreement between them. In this way the merchant is able to transfer the price of the goods to the exporter in foreign currency paid by the bank. If a loss occurs, it is absorbed by partners in proportion to their share of investment capital.

**Permissibility Of Guaranteed Capital**

*Are guaranteed capital products permissible, namely Euro funds with guaranteed capital in life insurance?*

No. Also conventional life insurance is impermissible. This is not to be confused with the allowance of third-party guarantees which are allowed in some cases. Please read AAOIFI's Shariah Standard on guarantees for more information.

# IJARAH

### Period Of Lease Begins With Delivery Of Property Or Service

*Does the lease, and the obligation of rent, begin with the finalization of the lease agreement or with the delivery?*

The lease itself, and the obligation of rent, begins with the delivery (and usability) of the leased property or service, not with the finalization of the agreement.

### Ijarah of Consumable

*May I create an Ijarah agreement of a consumable item?*

The leased asset should not be a consumable item, like food, whose quantity reduces with consumption, but rather a durable, like machinery or property, whose market value might depreciate, but quantifiably remains the same.

### Leased Property (Or Service) May Only Be Used For Intended Purpose

*Is it permitted to use the leased property or service for purposes other than the ones identified in the lease contract?*

The property (or service) may only be used for its intended purpose, or as agreed upon with the lessor.

### Leased Property

*May the lessor sell all or part of the leased property to a third party during an existing lease contract?*

The lessor may sell all or part of the leased property to a third party during the lease. The property may only be sold if ownership is also transferred to the new lessor. The original lessor may not sell only the right to receive rent and still maintain ownership.

### Ijarah: Basics Of Liability Distribution

*How is the liability for damage distributed between the lessor and the lessee in an Ijarah agreement?*

The lessee is liable for damage to the property caused by wear and tear, and other factors within the lessee's control while the lessor is liable for damage resulting from ownership, barring lessee negligence.

**Lease Period**

*When does the lease period begin?*

The lease, which may even be fixed for a future date, commences with the delivery (and usability) of the leased property or service.

**Sub-Leasing Leased Property Or Service**

*May the lessee sub-lease the leased property or service to a third-party?*

The lessee may sub-lease the property or service to a third party with the lessor's permission. In the Hanafi school the sub-lease may only be at a rate less than or equal to the original lease, though the lessee may charge a higher rent if, with the lessor's permission, he increases the property's value by developing it. In the Shafi'i and Hanbali schools no such condition applies and the lessee may agree any amount of rent with the sub-lessee, assuming the lessor permits sub-leasing.

**The Termination Of Lease**

*What events result in termination of the lease?*

The lease terminates when one or more of the following events occur:

1. the property or service becomes worthless;
2. both parties mutually decide to terminate the agreement;
3. one party unilaterally terminates the lease if the other party contravenes the agreement.

When the lease terminates:

1. the lessor reclaims physical possession of the leased asset and continues sole ownership;
2. the lessor may demand compensation from the lessee to the extent of any damage to the leased property;
3. the lessor may not demand that the lessee pay any of the remaining rent;
4. the contract may not stipulate in the agreement that the property transfers to the lessee upon termination, as a gift or otherwise, because the Shariah forbids that one contract condition another; in this case, a lease contract conditioned by a transfer of property contract.

Some scholars allow that, in a separate contract, the lessor may unilaterally promise to sell at a specified price or gift the leased property to the lessee. Upon termination, the lessee may opt to take

ownership of the property, but the lessor may not force the transfer. The lessee, on the other hand, may enforce the lessor's promise.

**Penalties On Late Rental Payments**

*In case of late payment, can the lessor charge the lessee a penalty?*

If the lessee is late in paying rentals, the lessor may not gain any benefit from a penalty, because the money becomes a debt, and any receipt in excess of a debt is riba. Rather, the contract may stipulate that in the event of delayed payment, the lessee must pay a certain amount to a specified charity.

**The Lessor's Obligation To Pay For Insurance**

*Whose responsibility is it to pay for any legally required insurance and who is entitled to receiving any payout from the insurer?*

The lessor is obligated to pay any legally required insurance on the leased property; any payout by the insurer should go to the lessor and the net amount (i.e. total payout less total premiums paid) should be given away in charity to avoid riba.

**Wrongfulness Of Trading Rental Claims Without Transferring Ownership**

*What is said of trading rental claims without transferring the proportionate ownership of the leased asset?*

Ownership, not the right to claim rent, represents the tradable portion of the certificate. The Shariah permits the trading of assets, not of money, for profit, and a rental claim is a receivable that represents money. So trading rental claims without first transferring ownership is forbidden. But it is acceptable for many buyers seeking ownership and many sellers seeking profit to trade Ijarah certificates like common securities in a capital market.

**Restrictions On Rental Usage**

*May the owner put restrictions on the usage of the rented property or service?*

The owner is entitled to specify how the property may or may not be used or the rented service conducted.

**Cancelling Rent**

*May one of the parties to the rental contract, before the expiration of the rental period, cancel the rental contract unilaterally?*

It is impermissible for the tenant or the owner to cancel the rental contract before the expiration of the rental period without the consent of the other party.

**Commencement Of The Lease**

*Is the commencement of the lease, and the resultant rental obligation, according to usage or according to the terms of the contract?*

The lease, and the resultant rental obligation on the lessee, commences according to the contract, not according to usage, provided the leased asset is usable at the time the lease period commences. If the rental period has begun, but the tenant has not begun using the property (provided the asset is available to use), the tenant is still obligated to pay rent.

**Lessor's Right To Withhold Leased Asset**

*Under what circumstances may the lessor exercise his right to withhold the leased asset?*

The lessor is entitled to withhold the leased asset if the lessee delays payment, as long as the benefit from the usufruct of the property or the execution of services has already occurred, unless parties on both sides agree.

**Events Resulting In The Cancellation Of The Lease Agreement**

*When is the lease agreement cancelled?*

The lease agreement is cancelled if:

1. the tenant or the owner pass away;
2. the tenant or the owner agree to cancellation;
3. the property or service rented out is of unacceptably low quality.

**Advanced Deposits**

*Is it permissible to pay an advanced deposit on a lease to the lessor and can the lessor withhold it if the lease agreement is cancelled before it begins?*

It is permissible to pay an advanced deposit to the lessor, but it is impermissible for the deposit to be withheld by the lessor if the lessee cancels the agreement before its commencement.

**Lessee's Liability For Loss**

*When is the lessee liable for loss?*

The lessee is responsible only for loss, damage or theft resulting from his own negligence, but not otherwise; it is improper for the lessee to make a general promise to pay for all loss, damage or theft before any even occurs, or to make such a promise after a loss, damage or theft occurs but when the cause is still unknown.

**Legality Of Ijarah**

*What are some of the legal bases for the permissibility of Ijarahs?*

The Quran states, "And if they suckle your (offspring), give them their recompense." (Al-Talaq: 6) And the Prophet Muhammad (Allah bless him and grant him peace) said, "He who hires a worker must inform him of his wage." (Al-Bayhaqi from Abu Hurayra)

Islamic jurists have been in consensus on the legal validity of Ijarah from the time of the Prophet (Allah bless him and grant him peace) stating that Ijarah makes it possible to lease assets to those who are in need of them, thereby making it a suitable and profitable transaction for both parties—the lessor gets consideration in exchange for leasing his asset while the lessee is able to acquire and use an asset that he would otherwise not have been able to.

**Usufruct As Subject-Matter Of Ijarah Contract**

*Why is usufruct, rather than the asset being leased, treated as the subject-matter of an Ijarah contract?*

Usufruct is treated as the subject matter of an Ijarah contract because its utilization is the purpose of leasing the asset. The contract is being drawn only so that the lessee is authorized to benefit from the usufruct of the asset being leased. The asset is not being transacted, the right to use the asset is.

**Timing Of Ijarah**

*When does the contract of Ijarah come into effect?*

Unless otherwise agreed, an Ijarah contract comes into effect immediately after the conclusion of the contract. It is permissible to defer an Ijarah to a future date agreed upon by both parties.

**Contingent Ijarah**

*Is it permissible to make an Ijarah contingent on the occurrence of a future event?*

It is not permissible to make the contract of Ijarah contingent on the occurrence of a future event. However, it is permissible to make specific provisions within the Ijarah contract contingent upon the behavior of either party. This entails, for example, that both parties may agree to reduce the rent in the event of early payments by the lessee.

**Leasing Usufruct Of Jointly-Owned Asset To Partner Or Third Party**

*Is it permissible for the owner of a jointly-owned asset to lease the asset to his co-owner?*

It is permissible for a co-owner to lease his share of the jointly-owned asset to another co-owner or to a third party.

**Ijarah Of Asset Providing No Independent Utility**

*Is the Ijarah of an asset permissible when it does not provide any utility independently but is only used in conjunction with another asset?*

It is permissible to lease assets that are not capable of giving benefit as independent units - such as machinery parts which do not function independent of the machine they belong to. However, if the lease is one that ends in ownership (Ijarah Muntahia Bittamleek), it would not be permissible to lease such assets.

**Ijarah Rental Payments In Kind**

*May Ijarah rental payments be made in kind?*

Similar to a regular sale transaction, Ijarah rental payments may be made in cash or in kind. Any valid consideration in a contract of sale may be agreed upon as rent in a contract of Ijarah.

**Deferred Ijarah Rental**

*Is it permissible to defer Ijarah rentals to a mutually agreed upon date?*

It is permissible to defer Ijarah rentals by mutual consent of the contracting parties.

**Usufruct As Consideration For Ijarah Rental**

*Is it permissible to agree upon usufruct to be used as consideration for an ijarah rental?*

It is permissible for Ijarah rentals to be paid in the form of usufructs.

**Benchmarking Ijarah Rentals**

*Is it permissible to benchmark Ijarah rentals?*

This relates to whether it is permissible to omit specifying the Ijarah rentals at the time of executing the contract; instead, agreeing on an "equivalent rent" that is either benchmarked against a known and acknowledged standard or is identified by expert appraisal. Islamic jurists are at a consensus that, while it is necessary to fix the amount of rental for the first period of rental payment, the rentals for the remaining period may be benchmarked against known and acknowledged standards or be open to expert appraisal.

**Altering Ijarah Contract To Modify Rental Period**

*Is it permissible to alter an existing Ijarah contract in order to change the period of rentals from yearly to monthly and so forth?*

It is permissible to alter an existing Ijarah contract in order to change the frequency of rentals. However, this should not have any effect on any liabilities outstanding from the date of the contract.

**Obligation Of Lessor To Deliver Leased Asset**

*What is the lessor's obligation with regards to delivering the leased asset?*

The lessor is obliged to deliver the asset and all associated leased items necessary to transfer the usufruct to the lessee and leave it to the lessee's disposal until the end of the lease term. Any accident that hampers the lessee from utilizing the usufruct—not being an accident caused by the lessee—must be corrected by the lessor.

**Defect In Leased Asset**

*What is the liability of contracting parties in case any defect is found in the leased asset?*

A defect is defined as a compromise or diminishment of the usufruct. In such a case, the lessee has the option to rescind the contract. The lessee may, however, continue to use the usufruct provided he is paying the agreed-upon rentals.

**Obligations On Lessee Regarding Leased Asset**

*What are the obligations of the lessee regarding the usage of the leased asset?*

The lessee should utilize the leased asset according to the customary practice by which similar assets are used. He should take all measures to preserve it from any damage or defect. The lessee is entitled to derive benefit from the usufruct in the manner provided for in the contract. The lessee may not utilize the usufruct in a manner that is beyond the scope of the Ijarah contract.

**Liability Of Lessee Regarding Damage To Leased Asset**

*What is the liability of the lessee regarding damage to the leased asset?*

The leased asset is in the possession of the lessee as a trust and damage resulting from the lessee's negligence is borne by the lessee.

**Leased Asset Being Used For Unlawful Purposes**

*What should a lessor do upon becoming aware of a lessee's intention to utilize a leased asset for unlawful purposes?*

If the lessor becomes aware of a lessee's intention to utilize a leased asset in unlawful ways, he should rescind the contract. Any rental payments earned before rescission are lawful for him to accept, while all subsequent rentals are unlawful. However, if the core purpose of the Ijarah contract is lawful—such as leasing a car—the Ijarah is not rendered unlawful by any sins on the part of the lessee.

**Maintenance Of Leased Asset**

*What is the liability of the lessor and the lessee regarding the maintenance of the leased asset?*

The leased asset is in the ownership of the lessor and is rented to the lessee as a trust in return for its usufruct. Therefore, the maintenance of the leased asset is the responsibility of the lessor. The lessee is entitled to reimbursement of all maintenance expenditures made by him with the permission of the lessor, either in the contract or otherwise. However, if the lessee pays for maintenance of the leased asset without the permission of the lessor, he is not entitled to compensation. It is important to note that maintenance here is referred to as major maintenance (ie. engine overhaul) according to customary practice for that particular asset. Minor maintenance (ie. cleaning) would typically be the responsibility of the lessee, depending on the customary practice of that particular asset.

**Maintenance Responsibility On Lessee**

*What is the legal status of a lease contract that makes maintenance of the leased asset the responsibility of the lessee?*

An Ijarah contract that makes the lessee responsible for the maintenance of the leased asset is considered void.

**Responsibility Of Lessor and Leased Asset Defect**

*What is the responsibility of the lessor if a defect is found in the leased asset?*

It is the responsibility of the lessor to undertake all necessary repairs that enable the lessee to make use of the asset in accordance with the terms of the Ijarah contract. Whether the defect occurred after the execution of the contract, or was present on the contract date unbeknownst to the lessee, is of no consequence.

**Repair Of Known Defect In Leased Asset Existing At Contract Date**

*What is the liability of the lessor regarding defects in the leased asset existing on the contract date and known to the lessee?*

The lessor is not obliged to repair any defects existing on the contract date and known to the lessee unless stipulated otherwise in the Ijarah contract.

**Rights Of Lessee In Case Of Default In Repair Of Leased Asset**

*What are the rights of the lessee in case the lessor refuses to repair the defects in the leased asset?*

The lessee has the right to rescind the Ijarah contract in case the lessor refuses to repair any defects in the leased asset that occurred either after the contract date or were existing at the contract date but were unknown to the lessee.

**Charging Lessee With Insurance Of Leased Asset**

*Is it permissible for the lessor to charge the lessee with the insurance of the leased asset?*

It is permissible for the lessor to include a clause in the Ijarah contract making the lessee responsible for insuring the leased asset.

**Maximum Term Of Ijarah Contract**

*What is the maximum term of an Ijarah contract?*

There is no maximum time limit for an Ijarah contract.

**Obligation Of Rent In Case Usufruct Does Not Meet Expectations**

*Is the lessee obliged to pay lease rentals if the usufruct does not meet expectations?*

The lessee is obliged to pay lease rentals as long as the usufruct of the leased asset is at his disposal. However, he reserves the right to rescind the contract in the event that the usufruct does not comply with the terms of the Ijarah contract, after which no monthly rentals are due.

**Withholding Lease Asset In Case Of Default In Lease Rental**

*Is it permissible for the lessor to withhold the leased asset if the lessee defaults on his lease payments?*

It is permissible for the lessor to reclaim the leased asset if the lessee defaults on lease payments, though he would not be required to do so and could grant respite.

**Lessee Sub-Leasing Leased Asset**

*Is it permissible for the lessee to sublet the leased asset?*

It is permissible for the lessee to sub-lease the leased asset if the Ijarah contract does not prohibit it. The lessee is free to sublet at any rate, whether the same, higher, or lower.

**Rescission Of Ijarah Contract In Case Of Damage Or Theft Of Leased Asset**

*Is it permissible for the lessor to rescind the Ijarah contract in case of damage or theft of the leased asset?*

The lessor reserves the right to rescind the Ijarah contract in case of excessive damage to or theft of the leased asset.

**Multiple Ijarah Contracts For Single Leased Asset**

*Is it valid to have multiple Ijarah contracts for a single leased asset? What is the status of such contracts?*

It is permissible for contracting parties to draw multiple, concurrent, independent and periodical Ijarah contracts for the same leased asset, without any one being contingent on the other. Only the first contract is binding upon both parties. The subsequent contracts are considered supplementary and may be rescinded unilaterally.

**Rescission Of Ijarah Contract In Case Of Defect In Leased Asset**

*What are the rights of the lessee regarding the rescission of an Ijarah contract when the leased asset contains defects?*

If the leased assets contains or develops defects, the lessee may rescind the Ijarah contract, return the leased asset to the lessor and demand compensation for the period of defect. However, if the defect does not hinder utilization of the usufruct, the lessee may not rescind the Ijarah contract.

Similarly, if the defect is removed immediately by the lessor, before the lessee rescinds the contract, the lessee may not rescind. An expert technical opinion may be taken to determine whether the contract may be rescinded due to a particular defect in the leased asset. The lessee is permitted to exercise his above mentioned rights only in the case of an Ijarah of a specific leased asset.

**Lease Rentals Upon Rescission Of Contract**

*What is the status of lease rentals due to the lessor at the time of the rescission of the contract?*

The lessee is obliged to pay all lease rentals that were accrued up to the point of rescission, but not those outstanding after rescission.

**Differentiating Between Invalid And Void Ijarah Contract**

*Is there any difference between an invalid Ijarah contract and a void Ijarah contract?*

Islamic jurists have not differentiated between the two. A contract is prohibited if it does not fulfill the requirements of the Shariah, and prohibition necessitates non-existence of the contract. In an invalid or void contract, if the lessee benefits from the usufruct, or if time elapses during which the leased asset could have been utilized, the lessee pays equivalent rent, assessed as being the rent of similar usufruct.

**Termination Of Ijarah Contract**

*When is the Ijarah contract deemed to have terminated?*

The Ijarah contract is deemed to have terminated either by the contractual terms, one of the party's rescission, or the termination of the possible usufruct of the leased asset through theft, destruction, or the like.

**Leasing Of An Asset To Multiple Lessees**

*Is it permissible for the lessor to contract an Ijarah with more than one lessee for the same asset?*

It is permissible to lease the same asset to more than one lessee. If the lease terms are of identical duration, both lessees are entitled to utilize the usufruct during that period.

**Status Of Advance Payment By Lessee In Contract Of Ijarah Involving Gradual Sale**

*What is the status of advance payments in a contract of Ijarah involving the gradual sale of an asset to the lessee?*

Advance payment by the lessee in such a contract is considered a trust which the lessee gives in order to convey his seriousness to fulfill his promise of purchasing the leased asset at the end of the

lease term. It is not considered part of the rental payment. If allowed for in the contract, the lessor may keep this advance payment should the lessee fail to honor his promise.

**Charging First Month's Rent In Advance In Ijarah**

*Is it permissible for the lessor to charge the first month's rent in advance from the lessee?*

The lessor may charge the first month's rent in advance only provided that the leased asset was purchased and received at the time of the contract.

**Absolving Lessor From Responsibilities**

*Is it permissible to include a clause in an Ijarah contract absolving the lessor of all responsibilities towards the leased asset such as maintenance?*

It is not permissible to include provisions in an Ijarah contract that absolve the lessor from his responsibilities towards the leased asset.

**Recourse In Case Of Delayed Lease Payment By Lessee**

*What recourse is available to the lessor if the lessee delays lease payments?*

The lessor has the right to charge late payment fees. This charge may consist of an administrative charge and a late-payment penalty where administrative charges are the right of the lessor while the late-payment penalty is paid to a designated charity.

**Making Lessee Liable To Pay Future Rentals Upon Rescission**

*Is it permissible to include a clause in an Ijarah contract that makes the lessee liable to pay all remaining rentals in the event of rescission?*

It is impermissible to include any clause that forces the lessee to pay all remaining rentals in the event of rescission. The proper procedure is to either continue with the contract until the end of the stipulated lease term or for the lessor to approve rescission, take back possession of the leased asset and relinquish claims to any further lease rentals.

**Promise To Purchase Leased Asset At End Of Lease Term**

*Is it valid to include in the Ijarah contract a promise from the lessee to purchase the leased asset at the end of the lease term?*

A promise to purchase a leased asset should be kept independent of the contract of Ijarah. However, if done separately, it would be permissible to enter into this unilateral promise at the same time as the Ijarah.

**Registering Leased Asset In Name Of Lessee**

*Is it permissible to register the leased asset in the name of the lessee?*

In general, the leased asset is owned by the lessor and should be in his name. However, in certain cases, the asset may be registered in the name of the lessee. This may be done for regulatory reasons or to make use of available exemptions. However, in such a case, a counter-bond is customarily taken from the lessee.

**Time-Share Leasing Contracts**

*What is a time-share leasing contract and is it permissible?*

A time-share lease contract is a permissible leasing structure where the lessor leases the same asset to multiple lessees for different time-periods, with none of the time periods overlapping with one another.

**Assigning Of Usufruct By One Lessee To Another In Time-Share Lease Contract**

*Is it permissible for a lessee to assign the usufruct of the leased asset to another lessee of the same asset in a time-share lease contract?*

The lessee may transfer the usufruct of the leased asset to another lessee of the same asset with the permission of the lessor. In such a case, the original contract between the lessor and the lessee to whom the usufruct is transferred is considered rescinded and a new contract is entered into.

**Responsibility Of Lessor In Ijarah**

*In relation to the leased asset, what is the lessor responsible for?*

With regards to the leased asset, the lessor is responsible for:

- The risk associated with the leased asset, during the entire period of lease, belongs to the lessor. It is the lessor's responsibility to replace the leased asset in case of any damage to it barring negligence on the part of the lessee.
- The major maintenance and insurance of the asset during the period of lease and the resulting expense is the lessor's responsibility entirely.
- At the time of the establishment of lease rentals, the lessor may cover his insurance cost, however, once the rentals have been fixed, any increase in the insurance premiums cannot be adjusted in the rental amounts to be paid by the lessee. The lessor will have to bear the additional insurance expense himself or adjust it to the rentals of the next ijarah term.
- The lessor may assume responsibility for insurance by making the client his agent to deal with the insurance company.

**Rent In An Ijarah**

*What are the criteria for determining rent and remuneration in an Ijarah?*

To determine rent and remuneration, the following criteria must be fulfilled:

- The Ijarah rental must be known and clearly defined. Different rentals may be established for different periods within an Ijarah or linked to a well known benchmark.
- Rental may be determined by the total cost of acquiring the leased asset. Once the rental amount has been fixed for a term of the Ijarah, there cannot be an increase in insurance costs.However, the rent for the remaining period may later be adjusted by mutual agreement to include the increased cost.
- The rental begins to accrue from the time the leased asset is delivered to the lessee and he is able to use it.
- Remuneration for a service Ijarah is determined in relation to time.

**Floating Rental In Ijarah**

*What is a floating rental and what are the prerequisites for charging it?*

A floating rental in an Ijarah refers to charging different rentals for different periods within the term of an Ijarah contract based on a well known and acknowledged standard or benchmark. In order to float rentals:

- The rent for the first period must be known. For instance, in the case of a 5 year lease for which the rent is to be paid quarterly, the rent for the first quarter must be known. Rent for subsequent periods may be set as floating rentals.
- The floating rental must be linked to a well known and appropriate benchmark and should be subject to a floor and a cap. For example the floor may be set at 9% and the cap at 18%. The rent may be allowed to float within these two limits.
- The rent based on the benchmark, must be decided at the beginning of each period, not at its end.
- It may be that during the period of lease, the benchmark ceases to be a reference any more as a result of a shift in market preference. In order to deal with such a situation, it is decided at the time of the agreement that in such a case, a new benchmark will apply.

**Security In An Ijarah**

*How is an Ijarah secured?*

The promise of the lessee to enter into a contract after the arrival of the asset is secured by the payment of a deposit known as the Haamish Jiddiah.

The Haamish Jiddiah is either set aside or deposited in a profit bearing account based on a Musharakah or a Mudarabah. The profit earned on it is given to the lessee.

If the client backs out from entering a lease contract, the bank may make up for its loss by entering into a new lease with another party or by selling the purchased asset.

If a new lease is established with another party, the difference between the cost of the asset and the sum of all the rentals with the new client are paid by the former lessee. If the asset is sold in the market, the lessee is expected to pay for the difference between the cost of acquiring the asset and its market price.

Furthermore,  it is mandatory for the lessor to possess the asset or the usufruct of the asset in order to execute an Ijarah.Ifthe bank is not in possession of the asset or its usufruct required on lease, it must acquire it from a third party.

The insurance of leased goods is an ownership related cost and is the lessor’s liability throughout the period of the contract.

**Rulings On Title Of Ownership Of Leased Assets**

*What is the ruling regarding the title of ownership of the leased asset?*

Upon acquiring an asset, particularly for the purpose of an Ijarah Muntahayya bi Tamleek, the bank assumes the title of ownership.

When the lease expires, the ownership of the goods and their title is transferred to the client.

In certain cases, the asset may be registered in the name of the lessee early in the contract. This may be done for regulatory reasons or to make use of available exemptions. In such a case, a counter-bond is taken from the lessee to authenticate actual ownership.

The bank, as the owner, is responsible for the asset throughout the period of the lease. The client merely possesses the legal title of ownership for purposes of practicality alone. The insurance of leased goods is an ownership related cost and is the lessor's responsibility throughout the period of the contract.

**Transfer Of Ownership Of Leased Asset**

*What are the ways by which the leased asset may be transferred to the lessee?*

If a transfer of ownership is to take place at the end of an Ijarah, a document separate and independent of the Ijarah contract must be prepared.

The transfer of ownership may take place in one of the following three ways:

1. The lessee may undertake to buy the asset at the end of the period of lease for a certain amount that is mutually decided between both parties at the beginning of the contract. This amount may be the actual cost of the asset or any other nominal value.
2. The lessor may undertake to gift the asset to the lessee at the end of the Ijarah period.
3. The lessee may even purchase the asset during the period of the lease by making a complete payment of all the rentals owed by him or alternatively, the lessor may allow the lessee to purchase the asset at its market value.

**Default In Ijarah**

*How does a financial institution deal with default in an Ijarah?*

Like all other Islamic financial contracts, a penalty for a default in payment cannot be enforced. It is permissible for the lessor to maintain a security or collateral which can be liquidated in order to recover any outstanding debt. The creditor is permitted to make up for direct and actual costs through this liquidation.

**Advance Rent In Ijarah**

*Is it permissible for the lessor to receive advance rent for an Ijarah?*

It is permissible for the lessor to receive advance rent for an Ijarah. The advance rental is called arbun and may be retained by the lessor if the lessee backs out of the lease agreement before the expiry of its term. Although it is preferable that only the actual loss be made up for from the advance rent by calculating the difference between the rental received and the rental that would have been received had the lease remained effective.

**Transfer Of Corpus And Usufruct In Ijarah**

*What is the difference between the transfer of the corpus and the transfer of usufruct in an Ijarah?*

The transfer of the corpus refers to a change in ownership, while the transfer of usufruct refers to a change in the right to use something. The transfer of ownership of an asset to a third party refers to the transfer of both its corpus and its usufruct. If the usufruct is already leased to another party it may not be transferred, however, the rent based on this usufruct may be received by the new owner. The owner of the usufruct (ie. the lessee) may share the usufruct with a sub-lessee with the lessor's consent.

**Responsibility Of Maintenance Of Leased Asset**

*Who is responsible for the maintenance of the leased asset?*

There are two types of maintenance in an Ijarah:

- Major Maintenance: This refers to the maintenance that is necessary to ensure that the leased asset continues to exist and provide intended use.
  This type of maintenance is the lessor's responsibility.

- Periodic Maintenance: This refers to the regular maintenance related to the use of the asset. For instance, for a car given on lease, it is the lessee's responsibility to maintain proper oil and fuel levels.

If the leased car's engine ceases, it needs to be investigated whether the problem is a result of a manufacturing default, in which case it is the lessor's responsibility to have rectified, or if it is a result of gross negligence on the lessee's part, in which case the lessee is liable to pay.

**Leasing To Riba-Based Bank**

*Is it permissible to lease to an interest-based bank so that it may open a branch?*

A lease to a bank that is not Shariah-compliant must be avoided because such a lease would directly facilitate in an impermissible act, in this case interest-based banking.

**Leasing To Companies Dealing Primarily In Interest**

*What is the Shariah ruling with regard to the lease of property to companies or institutions whose primary business is transacting by means of interest?*

It is unlawful for a Muslim to aid in the impermissible, and leasing property to a company whose primary business is interest-based would be considered impermissible.

**Leasing To Retailers Of Prohibited Items**

*What is the Shariah ruling with regard to leasing real estate to supermarkets, restaurants, hotels or tourist shops whose products may include Islamically prohibited items?*

If the purpose of the lease is purely prohibited, like a bar or a nightclub, then the lease contract is prohibited because the subject of the contract itself is prohibited. It is lawful, however, to lease property to a business concern whose primary business is in lawful goods and services even if it is to a lesser degree supplemented by income from unlawful goods and services.

**Dissolution Of Ijarah Contract**

*If the lessee returns an item that has been leased during a period for which payment has already been made in advance, is it lawful for the bank to again lease the item before the period of the previous lease has expired?*

If the lessee returns the item as a result of compelling circumstances, the remainder of the lease payment must be returned to the lessee since the lease will be considered to have been dissolved for a valid reason.

If the lessee returns the item merely because he wants to and the bank agrees to the return, the remainder of the lease payment must be returned to the lessee based on a mutual dissolution of the lease.

If the lessee stipulates that the item must remain in his name until the completion of the lease period

and not be leased to another then the remainder will not be returned and the item will remain at the disposal of the lessee until the lease expires.

**Seeking Dissolution Of Contract After Lease Has Begun**

*If a lease contract is mutually dissolved before it expires, is it permissible for the bank to deduct a part of the lease and insurance payments?*

If there are compelling circumstances that leave the lessee with no choice but to dissolve the contract then the Ijarah will be considered dissolved from that date. The lessor will be entitled to receive payment for the period of the contract's validity whereas the rest will be returned to the lessee.

**Gifting Leased Asset To Lessee On Completion Of Lease Payments**

*Is it lawful for the lessor to promise the lessee to gift him the leased asset on condition that the lease is paid in full?*

It is lawful in an Ijarah to promise to make a gift of the leased asset to the lessee when the lease expires on condition that all payments are made in their entirety.

**Offering To Sell The Leased Asset At Specified Time For Specific Price**

*Is it permissible to issue an offer in which a time is specified for the sale of the leased asset at a certain price?*

It is permissible to issue an offer in which a time is specified for the sale of the leased asset for a certain price. The one making the offer is legally bound to honour the offer for the duration specified and the other party may accept or refuse it during the same period.

**Sub-Leasing At Higher Rate**

*Is it permissible to lease something for a certain rate and then to sub-lease the same to another for a higher rate?*

It is lawful to lease something for a certain amount and then sub-lease it to another for the same amount or for more or less so long as the lessor permits it.

Once the right to the usufruct passes from the first lessee's disposal by means of a later contract of

lease it is no longer lawful for the first lessee to use what has passed from his ownership and become a debt owed to him by another.

**Leasing At A Daily Increasing Rate**

*Is it permissible for the lessor and the lessee to agree on a contract of lease for a daily rent amount which increases such that each day the rent is higher than the day before?*

Such an Ijarah contract is lawful since the increase is a part of the original contract and does not arise as a result of  a delay in payment, which would be prohibited.

**Reverting Of Part Ownership**

*Is it permissible for the bank to lease automobiles to a company for a specified period of time on the condition that half the ownership of the automobiles will revert to the company after the lease period has been completed?*

It is permissible for the bank to lease automobiles to the company however to revert half the ownership of the cars to the lessee company after completion of the lease period is subject to rules concerning the promise to purchase. A new sales contract, separate and independent of the previous lease agreement, must be entered into in the event that the cars are to be sold.

**Leasing Shares In Projects**

*What is the Shariah perspective with regard to the bank leasing out shares in projects to its investors in return for a variable monthly or yearly lease?*

The Shariah permits the bank to lease out its shares in projects to its investors in return for a variable monthly or yearly lease so long as it is against tangible assets such as real estate and equipment. The bank must also ensure its understanding of the principles of lease and the benefit it may gain by making the monthly or yearly rent variable.

**Purchasing Leased Asset Before Termination Of Period Of Lease**

*Is it lawful for the bank to agree from the beginning of the lease that the lessee will purchase supplies and equipment from the bank at the end of any year from among the years of a lease contract?*

It is not lawful for the bank to agree from the beginning of the lease that the lessee will purchase supplies and equipment from the bank at the end of any year from among the years of a lease

contract since it would create gharar (contractual ambiguity leading to dispute) about the duration of the lease period and when it is to begin. This, however, does not prevent the two parties from agreeing that the second party will have an option to choose at the end of the first year and at the end of each subsequent year within the lease period, to consider purchasing the leased equipment. If the lessee decides to purchase the leased equipment, he must agree to make the installment payments for the entire period he benefited from the usufruct of the goods. With the exercise of such an option by the lessee, the lease contract will stand immediately terminated.

**Leases As Financial Rights**

*Is it lawful for the bank to sell leases considering these contracts represent financial rights?*

It is not lawful for the bank to sell leases because it does not own the right to the usufruct of the leased goods which is the financial right possessed by the lessee during the period of the lease.

**Transferring Ownership Of Corpus Of Leased Asset To New Buyer**

*Is it lawful for the bank to sell leased equipment and supplies to a new buyer who will continue to honour the lease concluded between the bank and the lessee?*

It is lawful for the bank to sell the leased equipment and supplies to a new buyer since doing so does not affect the lease contract. Ownership of the usufruct is transferred by way of a lease whereas ownership in the object or corpus is transferred by way of a sale contract; each is separate and independent of the other. It must be ensured however that the sale does not affect the rights of the original lessee in any way.

**The Purchase Of Leased Equipment**

*What is the ruling with regard to the bank purchasing a leased asset?*

It is permissible for the bank to purchase a leased asset that is already under lease. The bank as the new owner assumes the responsibility of the owner's share of the maintenance which includes everything essential to the running condition of the leased item so that the usufruct it was contracted for remains available to the lessee.

**When To Begin Payments In A Lease**

*The bank leases land for the purpose of building a branch office. The improvements on the land and the construction of the branch office require two years before it can be opened for business. When is*

*the bank required to begin lease payments on the land; from the time of possession or from the time the branch office is opened?*

Payments are required from the lessee from the time of taking possession of the item leased from the lessor. In the case mentioned, payments will be due as soon as possession of the land is assumed by the lessee.

**Payment Before Receipt**

*Is it lawful for the lessor to demand payment before delivering the leased asset to the lessee?*

It is not lawful for the lessor to demand any payment from the lessee before the asset of lease is delivered to him and he is able to benefit from its usufruct.

**Demanding Payment Prior To Asset Delivery**

*Is it lawful for the lessor to demand payment before delivering the leased asset to the lessee?*

It is not lawful for the lessor to demand any payment from the lessee before the asset of lease is delivered to him and he is able to benefit from its usufruct.

**Leasing Something Not Yet Existent**

*Is it lawful to lease a building for which detailed architectural plans exist before it is built, on the understanding that it will be handed over as soon as it is completed?*

It is not lawful to lease a building for which detailed architectural plans are drawn but has not yet been constructed as such a lease would be the lease of something not yet existent. Such ambiguity about the description of the building and the time it will be ready for occupancy may lead to dispute.

**Property In Leasing Funds**

*Will it be lawful to offer previously leased properties in an investment fund?*

Leased properties are not suitable for offering in an investment fund since the usufruct of the real estate becomes the possession of the lessee with the signing of the lease contract and there is no way thereafter for the owner of the property to sell his share in the usufruct or for a partner to have a right to the earnings on his share of it. This is because what the owner retains after the lease is the

counter value of the usufruct or the debt that has become the liability of the lessee and it is not permissible to sell debt.

**Leasing And Managing Leases**

*Is it lawful for Islamic companies to lease equipment like airplanes and heavy machinery to other institutions for a certain period of time, i.e. ten years and then after two years, sell the equipment along with the leases to another company, all the while continuing to manage the equipment for the life of the leases, collecting the lease payments and delivering them to the new owners?*

It is permissible for Islamic companies to purchase equipment that carries already concluded lease contracts for it. The lease will continue for as long as was specified in the Ijarah agreement, which is a binding contract. The first lessor is permitted to manage the equipment by collecting the payments from the lessee and guaranteeing that the lessee will honour his financial obligations.

**Conditions For A Sublease**

*What are the conditions that must be met in order to sublease an asset?*

The usufruct of an asset may only be subleased by the lessee with the owner's consent. The revenue generated by the sublease is distributed among the lessees proportionate to their ownership in the usufruct of the leased asset. At the end of the lease period, the asset is retrieved by the lessees from the sub-lessees and then eventually from the lessees by the lessor.

**Permissibility Of Sale And Lease Back**

*When is a transaction of sale and lease back permissible?*

In order for a sale and lease back transaction to be Shariah-compliant, and not be analogous to a buy back, the period of lease before the asset is repurchased should be at least one year and the agreement to sell the asset must be separate from the contract of lease. Such a transaction is not ideal but is permitted in certain circumstances to facilitate the genuine needs of customers seeking to avoid interest-based transactions.

**Difference Between Conventional Hire Purchase And Islamic Lease With Option To Purchase**

*Are the concept, structure and features of a hire purchase the same or legally and fundamentally different from an Ijarah Thumma Al-Bai, i.e. lease with the option to purchase?*

No they are not the same. A conventional hire purchase is not permissible in Shariah because the sale occurs at the end of the hire period although it is entered into at the beginning of the hire period. The Shariah-compliant version of the hire purchase avoids this by either transferring ownership through a conditional promise or by a promise to sell on the part of the owner at a nominal price. So in short they are different legally and structurally.

**Ijarah Asset Possession**

*In an Ijarah contract who has the asset's possession and ownership and when is it transferred and on what consideration?*

In an Ijarah, the lessor is the sole owner of the asset. The lessee is given usufruct of the asset for a particular usage over a particular period of time. Depending on the Ijarah, ownership may either remain with the lessor after the lease period, or the lessor may enter into a separate contract to transfer ownership to the lessee.

# INHERITANCE

**Using Estate Before Division Among Heirs**

*Is it permissible to make use of the estate before division among the heirs?*

Before dividing the estate among the heirs, it is impermissible to use any part of the estate without the unanimous permission of all the sane, adult heirs.

**Permissible Deductible Expenses From Estate Before Division**

*What are the expenses permissible to deduct from the estate before its division among the heirs?*

Before calculating the market value of the entire estate, expenses are taken out obligatorily in the following order:

1. Burial: The material, labor and related (e.g. transportation) costs associated with preparing and burying the body should be taken from the deceased's estate; it is impermissible to use any of the deceased's estate to give charity (even if given with an intention to benefit the deceased) or to pay for funeral expenses unrelated to burial (e.g. feeding and accommodating mourners);
2. Zakat: Unpaid zakat should be paid from the deceased's estate, when it is known that the deceased did not pay for any year he was obligated to pay; zakat is not paid for the current year because at least an entire lunar year must pass over the property for zakat to be obligatory, and death before the passing of an entire year removes the obligation thereby;
3. Collateral: Property that currently serves as collateral for an existing transaction must be removed from the estate in order to maintain the contractual obligation to which it is attached;
4. Property: Any property that is not owned by the deceased, whether due to renting, borrowing, non-payment, or the like, should be taken from the deceased's estate; if the property is lost, damaged, stolen or diminished in a way to undermine its usefulness, it is paid for at its market equivalent price;
5. Estate Taxes: Any estate taxes payable in relation to the division of the deceased's estates should be taken from the deceased's estate;
6. Debts: All financial debts (e.g. marriage payment, personal loans, unpaid bills, etc.) other than those mentioned above should be taken from the deceased's estate;
7. Bequests: Bequests are allowable up to one-third of the estate, though with the unanimous consent of the sane, adult estate heirs, as much as the entire estate (i.e. the combination of the one-third allotted to bequests and the remaining two-thirds allotted to the estate heirs) is bequeathable;
8. Pilgrimage: If an individual obligated to perform the pilgrimage dies before fulfilling the obligation, it becomes obligatory to pay someone to perform a posthumous makeup on

behalf of the deceased by deducting money from the deceased's estate if one-third of the estate covers the cost of the pilgrimage; if it does not, it is permissible for the inheritors to leave the deceased's obligation unfulfilled; it is also permissible for the inheritors to fulfill the deceased's obligation from the remaining inheritance (of the sane, adult inheritors) if all the sane, adult inheritors so agree.

After deducting expenses from the deceased's estate for the categories above, the estate is divided among the heirs.

**Giving Or Taking Stolen Property In Estate Division**

*Is it permissible to give or take stolen property in an estate division?*

It is impermissible to give or take stolen property in an estate division when one is certain that the property is stolen; if there is doubt then it is permissible to give or take the property, though it is always superior to avoid the doubtful.

**Prohibitiveness Of Forgoing Share In Inheritance**

*Is it permissible for a person to forgo his share of inheritance to benefit his siblings?*

It is not permissible for a person to forgo a share in inheritance to benefit his siblings. On the other hand, he may receive his share and then later gift it to them in a desired proportion.

# INSURANCE

**Conventional Insurance**

*Are conventional insurance contracts permissible in Shariah?*

Abu Hurayra (Allah be well pleased with him) said, "The Messenger of Allah (Allah bless him and give him peace) prohibited sales of 'whatever a pebble thrown by the seller hits' and sales in which there is gharar (contractual uncertainty leading to dispute)." (Muslim) Insurance is a contract between two parties in which an insured party pays an insurance premium in order to secure a compensatory payment by the insurer in the event of loss or damage to an insured entity. The contractual uncertainty inherent to insurance renders all forms of insurance buying, selling, dealing and investing unlawful. An investment is a cooperative effort combining labor and capital inputs to create goods, services and profits, while undertaking shared risk. Insurance is not an investment because there is nothing in which to invest. Insurance trades in risk; but risk is just a measure, not a saleable commodity.

**Compulsory Insurance**

*What does the Shariah say about compulsory forms of insurance in some countries?*

As for the sin of compulsory forms of insurance in some countries, namely automobile, medical, property, and the like, the sin devolves to the one making the law. In many countries auto, property and personal insurance, among others, are legal requirements. One avoids these to the extent legally possible, but pays the amount necessary to fulfill the minimum legal requirement; the ones imposing the laws, not the ones forced to comply, ultimately bear the burden of having contravened the Shariah. If one is legally obligated to purchase insurance, it is permissible to exceed the minimum legal insurance requirement if this means paying a lower insurance premium (e.g. one purchases comprehensive insurance instead of third party insurance because it is less expensive eventhough it provides more coverage), but it would be impermissible to exceed the minimum legal insurance requirement if this means paying a higher insurance premium (e.g. one purchases comprehensive insurance and third party insurance in order to receive fuller coverage); the general principle being that one purchases the minimum legal requirement of insurance at the minimum cost to oneself.

**Working For Insurance Company**

*May I work for an employer whose primary business is insurance?*

It is unlawful to work for an employer whose primary business is insurance (even if one does not participate directly in the transactions), unless one has absolutely no other means of supporting

one's dependents (such as selling the excess of one's saleable wealth or accepting work at a low-paying job), in which case one may remain with the unlawful work as long as one is actively looking for another source of income and seeking Allah's forgiveness and help in the process.

**Purchasing Healthcare Insurance**

*Is it permissible to purchase healthcare insurance, keeping in view high healthcare costs?*

It is not permissible to purchase insurance when one is not legally obligated to purchase insurance (e.g. for property, goods, travel); though healthcare costs in some countries are so high that scholars now permit one to purchase medical insurance provided there is no social healthcare program in one's country (e.g. United States), though scholars still deem healthcare insurance impermissible in those countries that provide social healthcare programs (e.g. Canada). It is permissible to receive the benefits, including cash payment, of a health insurance plan if one's employer or government offers the plan as a part of their policy.

**Insurance Claim On Compulsory Insurance**

*May I obtain any monetary benefits on compulsory insurance?*

If one is legally obligated to purchase insurance, it is an obligatory condition that if the policyholder receives any monetary benefits from the insurer, the total payments that exceed the total premiums paid to the insurer (i.e. during the entire policy period, adding premiums paid for other insured items as well) must be distributed in charity; this excess amount constitutes riba because there is an unequal exchange of money (in the form of premiums) for money (in the form of monetary compensation); the principle being that the monetary relationship between the two parties (i.e. the insurer and the policyholder) must be equalized. In the event of a mishap, the aggrieved party is entitled to the current market value of the entire loss *directly* from the party at fault, with no intermediary (e.g. insurer) paying either party for insured losses; if the intermediation of an insurer is a legal requirement, it is permissible for the aggrieved party to take payment from the insurer.

**Insuring Cash, Cheques And Trade Bills**

*Is it lawful for the bank to insure valuable property, like sums of cash, cheques and trade bills against fire, theft, loss or destruction?*

It is permissible to insure such items on the condition that the amount of Takaful coverage is commensurate with the amounts of the trade bills and cheques etc, actually maintained in the safes of the bank so that the benefit payments to be made by the Takaful company are kept in proportion to the actual amount of loss and no more.

**Insuring Buildings**

*Is it permissible to insure buildings against fire?*

It is lawful to insure buildings against fire so long as the benefit payments are commensurate to the amount of actual damage.

**Indemnity Insurance For Banks**

*Is it permissible for the bank to seek indemnity insurance policy covering risks such as theft, cash in transit, fraud, forged documents, valuables and the like?*

It is permissible for the bank to seek Takaful against the types of losses mentioned so long as the amount of repayment does not exceed the amount of actual loss or damage.

**Automobile Insurance**

*What is the Shariah ruling with regard to automobile insurance?*

Automobile Takaful is lawful provided the benefit paid out to the insured is equivalent to the amount of actual damage and not more.

**Insuring A Client's Payments**

*Is it lawful for the bank to seek coverage from an insurance company for the payment of a client's installments within the limits of actual losses incurred as a result of the client's inability to make scheduled payments?*

Insurance for payments owed by a client is a form of suretyship or kafalah for debt. In this case the surety is the insurance company and since it is given in return for an insurance premium it is unlawful to seek, as suretyship may only be given without charge.

**The Client's Insurance Of Murabaha Goods**

*Is it permissible for the client to have the goods he pledges to purchase by way of a Murabaha through the bank, insured at his own expense?*

It is not lawful for the client to insure the goods at his own expense since the goods are the property of the bank. It is only permissible that he insure them in the capacity of the bank's agent with the

understanding that he will recover the amount spent on insurance from the bank either by means of credit to his account or by having it deducted from the price of the goods in the Murabaha.

**Accepting Benefits Greater Than Actual Loss**

*Is it permissible to accept insurance benefits greater than the amount of actual losses incurred based on the annual payment of premium covering a greater loss than the one experienced?*

It is not lawful to accept benefits greater than the amount of actual losses incurred based on the annual payment of premium that insures a greater loss than the one suffered. According to Islamic law, insurance benefits received must be commensurate to the amount of actual loss undergone.

**Returning Benefits In Excess Of Expenses**

*When the goods for a Murabaha deal are completely damaged or lost the Takaful company pays the bank a benefit equal to the value of the goods plus ten percent. Is it permissible to accept this excess and may it be used to pay for legal expenses?*

It is lawful for the bank to use the benefits paid out to it by the Takaful company to make a direct payment for expenses associated with the insured goods or through its client as an agent on its behalf. The remaining amount if any must be returned to the Takaful company.

**Market Or Replacement Value**

*In the case of receiving Takaful benefits for goods lost in a fire, is it permissible to seek the market value of the goods on the day they were destroyed or their replacement value?*

The insured is entitled to receiving benefits equal to the actual amount of damage experienced based on the market value of the goods on the day of the accident or fire.

**Entitlement To Policy Benefits**

*Is it permissible for a person to receive benefits for the value of his car that has been destroyed in an accident even though he is in the process of making some remaining payments for the price of the car?*

It is lawful for the person to receive benefits for the value of the destroyed car since ownership was transferred to him without his putting up any collateral. However, in the event that the person who purchased the car previously granted the bank the right to reserve any amount coming into its

possession, then the amount of benefit transferred from the Takaful company to the bank falls under the ruling of a guarantee in which the remaining payments are to be made on time unless a new agreement is concluded.

**Returning Excess Collected For Premiums**

*Takaful insurance is purchased for a project to construct headquarters for a certain amount of premium giving coverage for labour and materials etc. Additional contracts are concluded with subcontractors for safety, electricity, air-conditioning and elevators based on the agreement that they will pay a part of the insurance premiums for the project each in proportion to the value of their work. In the event that the amount collected from them is greater than the cost of the premiums to be paid is it lawful for the bank to keep the excess amount?*

It is not lawful for the bank to keep any amount in excess of the premiums to be paid; it must be returned to the subcontractors.

**Insuring For More Than Value**

*Is it permissible to seek Takaful insurance for the value of goods plus 10% in order to include shipping expenses in addition to the cost of premiums?*

Takaful coverage is not lawful for an amount greater than the actual value of goods. It should be a sum that represents actual value, inclusive of expenses.

**Does Client Have The Right To Determine Coverage**

*Is it permissible for the client in a Murabaha to determine the sort of Takaful coverage the goods are to receive, particularly when he wants to exclude coverage that raises the price of the premiums when such coverage might be important to the bank?*

The client is not in a position to determine the type of coverage that will be sought for Murabaha goods purchased through the bank.

**A Fee For Guaranteeing Operation**

*What is the Shariah ruling with regard to an agreement with a vendor in which he is required to inspect new cars for the bank and guarantee their operation for a certain period of time in return for charging a certain fee?*

It is lawful that a fee be paid to a vendor for the inspection of the cars and their repair when they break down. On the other hand, an agreement that a certain amount will be given to him for guaranteeing any damage sustained by each car during a period of time in addition to his pledging to repair the same is a contract for something undefined and therefore invalid.

**Commission For Finding Clients**

*Is it lawful for the bank to receive a commission for Takaful policies based on the number of policies taken out by clients having purchased cars through the bank?*

It is lawful for the bank to receive a brokerage fee for serving as an intermediary between the client and the insurance company. This fee is linked directly to the amount of the bank's effort, ascertainable through the insurance documentation.

**Transferring A Right To Benefits**

*Is it lawful to transfer a right to benefits from a Takaful insurance plan to the purchase pledger at the conclusion of a Murabaha sales contract?*

It is lawful to transfer a right to benefits from a Takaful insurance plan to the purchase pledger at the conclusion of a Murabaha sales contract, where he also serves as the bank's agent in settling accounts with the insurance company. Once the damage or loss to the goods if any is recompensed, the client does not require recourse to the bank and may deal directly with the Takaful company alone.

**Islamic Alternative To Conventional Insurance**

*Conventional banks offer insurance premium financing, what is the Islamic alternative to such a service?*

Conventional insurance is not permissible. Islamic cooperative insurance or Takaful is a possibility but offered as a stand-alone product.

**Permissibility Of Health Insurance**

*Does health insurance provided by a mutual or non-profit organization fall under Takaful and therefore permissible?*

Whether an insurance arrangement is mutual or non-profit does not make it Islamic. What makes Takaful Shariah-compliant is the overall structure which must adhere to specific guidelines such as those outlined in AAOIFI's Shariah Standard on cooperative insurance

# INTEREST

### Goods

*When are goods considered unlike each other for purposes of avoiding riba?*

If substantive value addition to the good entirely transforms its original form and content (e.g. oak wood and oak furniture), then the goods are considered unlike, regardless of weight. In cases where the end product is inherently similar to the original product, such as with gold jewellery, scholars advise that the gold should first be denominated in cash before exchanging it for jewellery.

### Occurrence Of Riba

*When does riba most commonly enter into a transaction?*

Riba occurs when there is an unequal exchange of like goods or mediums of exchange, where "like" is defined as goods that are inherently similar however much they differ in quality (e.g. 1kg of high quality dates and 1kg of low quality dates).

### Unlike Goods - Cash

*Are two amounts of cash, each in a different currency, considered a "like good" for purposes of avoiding riba?*

As regards cash, "like" refers only to the same currency.

### Increment Over Lent Amount

*May I charge an increment over a loan?*

It is forbidden to charge any increment, however small, over the principal lent amount, regardless of the duration of the loan.

**Charging Interest**

*Is it lawful to charge interest on a sum of money?*

It is unlawful to charge any kind of interest rate, whether floating or fixed, on a sum of money, though it is lawful to agree before transacting that a good or service (but not money) transacted on spot is priced at x, and the same good or service transacted in future is priced at x + y (or x - y), where y is the pre-agreed premium (or discount); but an obligatory condition for such an agreement is that both parties must agree on spot whether the transaction will be executed on spot or in future and for the price to be fixed on spot; it would be impermissible to agree open-endedly that the buyer is entitled to make a future choice of whether to buy on spot or not and for the price not to be fixed.

**Monetary Penalty**

*May I charge a monetary penalty on a monetary payment?*

It is unlawful to charge a monetary penalty on any form of monetary payment (e.g. fees for late rental payments, car payments, loan installments, etc.), though it is permissible to enter into a separate parallel contract beforehand whereby the one paying late is legally compelled to give money to a specified charity in the event of late payment, thereby fulfilling the lender's need to create a deterrent.

**Direct Involvement In Interest-Based Transactions**

*What constitutes a direct involvement in interest-based transactions?*

Unlawfulness depends on how direct one's involvement is to the interest dealings: direct involvement entails that one participates in the actual execution of an unlawful transaction; the one who buys, sells, trades, witnesses, records, calculates, recommends, instructs or in any way directly assists in an interest-based transaction *during* its execution is culpable (e.g. car buyer who contracts an interest-based lease; homeowner who takes a mortgage; futures and options trader; insurance salesman; loan officer); if an accountant, for instance, merely records a transaction that has already taken place, the involvement is not considered "direct," and therefore remains permissible, though it is always superior to avoid the doubtful.

**Interest Dealings Of Counterparty**

*Am I liable for any interest dealings of the party I am transacting with?*

One is not answerable for the interest dealings of the party with whom one transacts unless one is also directly involved in the interest dealings; for example, the real estate agent who assists in the purchase of a house is not answerable for the interest-based mortgage the buyer acquires later unless the real estate agent also assists in acquiring the mortgaging, at minimum, by merely providing the buyer with guidance.

**Involvement In Interest**

*What must I do if I am involved in interest?*

If one is already involved in interest, one is obligated to leave all such transactions as soon as reasonably possible; if leaving the transaction is not possible such that one anticipates harm to oneself, one's dependents, one's property or one's religion, then one is obligated to take all necessary means to conclude the transaction (e.g. repay all interest-based loans) as soon as possible; the goods transacted in an interest-based transaction and the resulting profits earned thereby are themselves lawful to own and use (e.g. a house purchased on an interest-based mortgage and sold at profit), but the imperative to leave all interest-based transactions remains.

**Permissibility Of Interest-Bearing Accounts**

*Are interest-bearing accounts permissible?*

All interest-bearing bank accounts, however low the interest rate, are impermissible to maintain; in the rare event that there is absolutely no access to an interest-free account, there is a dispensation to maintain an interest-bearing account for the individual who seeks the additional financial security of a bank; this is only permitted on the condition that no other option exists (even if reasonably accessible outside one's city) and that the interest that one earns is returned to the bank or given to a Muslim or non-Muslim charity or a zakat-eligible recipient (with the intention of eliminating the unlawful wealth rather than with the intention of earning reward) accompanied by a sincere repentance.

**Paying Service Fee To A Bank**

*May I pay the bank fee for services rendered by it on my behalf?*

It is permissible to pay a bank fee or transaction fee for such services as maintaining an account, using an automated teller machine, purchasing or selling stocks, Internet trades and the like, but not for the service of providing a loan.

**Interest-Free Account In A Conventional Bank**

*May I maintain an interest-free bank account in a conventional bank?*

It is recommended to maintain bank accounts at Islamic banks, though it is permissible to maintain an interest-free account in a conventional bank.

**Transacting With A Person Whose Income Is From Impermissible Means**

*May I enter into a transaction with someone whose income is from impermissible means?*

It is impermissible to enter into a transaction (e.g. partnering in a business, borrowing, receiving a gift, etc.), even if a Shariah-compliant one, with an individual whose worth derived directly from interest or other unlawful means is greater than 50**%** when this is certain, where interest involvement for this purpose is measured as the financial extent of the interest dealings (e.g. if 5% of a $100 transaction is interest, $5 of the transaction, not the entire $100, will be considered unlawful for the purposes of determining the unlawfulness of the person's wealth, even though the entire transaction is unlawful); it is offensive to enter into a transaction with an individual when there is doubt about whether the worth that he derived directly from interest or other unlawful means is greater than 50%.

**Doubt Whether Earnings Are Lawful**

*May I transact with someone who I suspect earns from impermissible means?*

The permissibility of transacting with a source whose earnings might be unlawful depends on the extent to which the source's wealth is unlawful and the degree of certainty to which one determines the extent of this unlawfulness. One should determine the unlawfulness of the source's earnings according to that which is reasonably apparent; it is neither recommended nor preferred to seek out information about the unlawfulness of a source's earnings.

**Conditionality In Impermissibility Of Interest**

*Does interest become permissible in extreme circumstances?*

Interest is absolutely impermissible in any situation except when one anticipates extreme harm, where the extremity of the need would be analogous to eating unslaughtered meat when dying of hunger and nothing else is available; any extremity less than this degree would not permit one to deal in interest; too often Muslims mistakenly believe that dealing in interest-bearing loans is an "extreme need" these days in order to buy a home instead of renting, purchase educational loans, or finance car purchases, to name a few common examples; but unless the need is life-threatening, (which the need for home ownership, a car or an education is not) the impermissibility of dealing in interest remains.

**Modifying An Interest-Based Sale According To Shariah Principles**

*How can I convert a conventional interest-based sale into one acceptable in Shariah?*

When a good or service (not cash, gold, silver, securities or similar tradable instruments) is offered for sale through an interest-based transaction (e.g. car loan, property mortgage, education loan, etc.), it is permissible for the buyer to propose to the vendor the following: that the vendor combine all future principal and interest payments into one lump-sum amount and divide this new amount into installments, provided any late payment charges go to a designated charity rather than to the vendor (e.g. a house sells for $150,000 with a 7% interest payment payable in monthly installments over a 20 year period; the buyer proposes that the bank negotiating the transaction add the $150,000 principal to all future interest payments, and divide the new amount into monthly installments); it would be permissible to vary the installments (i.e. flat, increasing or decreasing installment sizes) provided all the amounts are pre-agreed; such a transaction avoids the riba created by interest payments and penalty charges, allows the seller to sell at any price he chooses, and permits the buyer to pay in installments.

**Giving Interest Income In Charity**

*May I deal in interest with the intention of giving it away in charity?*

It is impermissible to deal in interest with the intention of giving the benefit away in charity (the forbidden always takes precedence over the recommended).

**Interest On Credit Card**

*May I use a credit card that charges interest?*

It is impermissible to use a credit card that charges an interest rate, unless one is certain that one is able to repay borrowed amounts before incurring the interest charge, in which case it is permissible; it is permissible to use a debit or automated teller machine card (i.e. that draws cash directly from one's existing account); it is permissible to accept "points rewards" from one's credit card (e.g. frequent flyer mileage, vendor discounts, etc).

**Selling Interest-Based Credit Card**

*May I sell or assist another in buying a credit card that charges interest?*

It impermissible to assist in the purchase of a credit card that charges an interest rate, and offensive to assist in the purchase of a credit card that only charges an interest rate after a reasonable grace period; in the former case one directly assists in the sin because the interest rate is a direct consequence of owning the credit card, whereas in the latter case one indirectly assists in the sin because the onus of prompt repayment is on the credit card owner.

**Interest Dealings With Non-Muslims**

*May I make interest-based transactions with non-Muslims?*

The impermissibility of dealing in interest remains even when transacting with non-Muslims or in non-Muslim lands.

**Investing Capital In Expectation Of Percentage Payout**

*May I take a loan in which the lender makes a monetary investment in expectation of a percentage payout?*

It is impermissible to take any kind of loan in which the lender makes a monetary investment in expectation of a percentage payout, because invariably some difference will occur between the investment and the payout, a difference that constitutes riba (e.g. a home equity loan that invests $10,000 in a property in return for 10% of the property's selling price); it would be permissible to instead ascribe a percentage figure to a monetary investment and make a payout at the same percentage (e.g. a home equity loan that invests $10,000, or 10%, in a property in return for 10% of the property's selling price), provided both lender and borrower share in any damages (not caused by any particular individual's negligence) to the property to the extent of their ownership share.

**Logic Behind Prohibition Of Interest**

*What is wrong with charging a moderate excess over the principal, as with commercial interest rates, if participants mutually agree that a dollar is worth more today than it is tomorrow?*

The argument is that because any unit of capital is worth more today than it is tomorrow, providers of capital should be compensated for foregoing the opportunity to use their capital for that time. But the problem with this arrangement is that the borrower of capital is compelled to guarantee (often at a considerable price) the return of this capital, in addition to a fixed premium, while the lender incurs no risk (in so far as the loan collateral compensates his risk). There is no mutual participation of risk: the lender's motivation is not the mobility of capital for the sake of investment; the lender's motivation is the commitment of capital for the sake of preservation. In a risk-oriented investment, the principal (lender) is rewarded for his business acumen; in an interest-based transaction, the lender is rewarded simply for the ownership of capital.

It is this imbalance of benefit that Islam addresses. The equal participation among borrowers and lenders in a commercial market is entirely illusory. The source of capital value is not determined by the subjective desire of the participants in the market, but rather by the financial competition of the lenders in the market. In a competitive market, lenders will always extract the highest possible interest rate from their borrowers. It is this asymmetry between the economic advantage of the lender and the economic disadvantage of the borrower that Islam seeks to address by ensuring that market participants are equal stakeholders in risk capital. In the absence of investment risk there is a tendency for the market to focus on repayment of loans rather than the enhancement of investments.

**Prohibition Of Riba As Applying To The Poor**

*Doesn't the prohibition of riba apply only to lending to the poor who are forced to borrow at high rates?*

Besides the fact that the prohibition refers to everyone, at a practical level it is impossible to apply a quantitative standard (interest rates) to a qualitative circumstance (poverty). Who determines who is poor? Does one set a poverty line based on zakat eligibility? Will banks be forced to lend to these poor? Will the "risky" poor be charged higher rates than the regular poor? Before long the standards by which money is allocated become identical to conventional interest-based standards. Because there necessarily can be no quantifiable cut-off between what is an "interest rate" and what is a "usurious rate" further supports the Islamic view that the term riba does not distinguish between interest and usury in the Quran.

**Notarizing Interest-Based Transaction**

*Are Islamic bank's permitted to notarize interest-based transactions?*

Notarizing an interest-based transaction is impermissible since those who assist in an interest-based transaction are as culpable as those who deal directly in the interest.

**Fees For Transfers**

*Is it permissible for the bank to charge a fee for the services it provides such as money transfers? Will it be lawful for the bank to increase its fee for this service in proportion to the amount transferred?*

It is permissible for the bank to charge a fee for services such as money transfers. The fee charged must be in proportion to the service being provided. Therefore, if the bank concludes that the costs differ with differences in the sums to be transferred, the bank may increase its fee with increases in the sums. If, however, the costs do not differ, then a higher fee for a larger sum may not be charged.

**Islamic Bank Depositing In Conventional Bank**

*Is it permissible for an Islamic bank to deposit funds in a conventional bank?*

Islamic banks should seek to maximize their dealings with other Islamic banks, but in case of genuine need an Islamic bank may deposit funds with a conventional bank provided no interest is taken or given. If its withdrawals exceed the deposited amount so that the conventional bank becomes the Islamic bank's creditor, under no circumstances should interest be paid.

**Repayment From Interest Bearing Accounts**

*If a client maintains accounts at an Islamic bank but also holds an interest-bearing account at a conventional bank, is it lawful for the Islamic bank to accept funds that have come directly from his interest-bearing deposits?*

It is lawful for the Islamic bank to accept these funds because there is no connection between the Islamic bank and the source of these amounts. The one dealing directly in interest is considered culpable.

**Assistance In Cash And Kind**

*Is it permissible for the bank to offer assistance in cash or kind to its current and investment account holders in return for the business they conduct with the bank?*

It is permissible for the bank to offer assistance in cash or kind to its current and investment account holders provided that this is not stipulated as a condition at the time of the opening of the account, or becomes an expectation or customary practice. It is only permissible for the bank to provide assistance as a gesture of goodwill.

**Charging Fees For Late Repayment**

*Some debtors have the ability to repay on time but continue to defer. Is the bank permitted to charge them a fee?*

It is not lawful to charge anything above the due amount for a delay in repayment regardless of whether the delay is intentional or not. Instead the bank should seek legal recourse against the debtor and at the time of entering into the transaction should include a charity clause entitling the payment of penalties to a designated charity.

**Purchase Of Business License**

*Is it lawful to purchase the business license of a company that operates on the basis of riba when it is being sold and none of its riba-based assets remain, with the intention to make its operations Shariah-compliant?*

It is lawful to purchase the business license of a business whose operations are riba-based for the purpose of making them Shariah compliant.

**Interest From Bank Deposits**

*What is the Shariah ruling in regard to a Muslim depositing his money in a conventional bank?*

It is unlawful for a Muslim to deposit his money in a conventional bank when it is possible to deposit the money in a comparable Islamic bank.

**Deposits In Conventional Banks In Muslim And Non-Muslim Countries**

*Is the prohibition of interest the same in whether one deposits in a bank located in a Muslim or a non-Muslim country?*

The ruling in regard to depositors taking interest is the same whether the bank is located in a Muslim or in a non-Muslim country. The interest earned on the deposits is unlawful for the Muslim to consume or use to his personal benefit.

**The Definition Of Riba**

*What is the definition of riba?*
The word riba refers to any excess, increase or additional compensation that is not in exchange for a due consideration.

There are two main types of riba: Riba Al Nassiya and Riba Al Fadal

Riba Al Nassiya

Any transaction of credit earning profit for the granter of the loan is referred to as *Riba Al Nassiya*. The establishment of a pre-determined amount in excess of the original loan, whether called a premium or interest, or whether its rate is high or low, falls into this classification.It is the type of riba that conventional interest-based banking is based on.

Riba Al Fadal

Any excess granted or received in an exchange between inherently similar commodities is referred to as Riba Al Fadal.

The Prophet (God bless him and give him peace) said:

"….gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, equal for equal, and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to hand."

This means that 10kg of wheat may only be exchanged for 10kg of wheat.

In the exchange of unlike commodities an excess is allowed, however, deferment is prohibited. The exchange must take place at spot.

For instance an exchange of 10 kg of wheat for 12 kg of barley is permissible at spot.

This hadith may also be related to the practice of currency exchange.

In order to avoid riba, the same currency must always be exchanged at spot. In an exchange involving different currencies, at least one consideration must be paid (at spot) and the payment of

the other may be deferred. However, the exchange must take place at the market rate prevalent at the time the first consideration is paid.

**Amwaal E Ribawiya**

*What are Amwaal e Ribawiya?*

Goods which, when exchanged with one another, result in the accrual of interest by either party are referred to as Amwaal e Ribawiya. Six such items have been classified in a Hadith: gold, silver, wheat, barley, salt and dates. These items may only be exchanged for each other in equal measure and at spot.

**Islamic Financing From Interest Based Fund**

*Can a company offer Shariah-compliant financing if its fund sources are interest-bearing?*

No, it would not be permissible for the company to engage in borrowing on interest and providing financing Islamically.

**Using Riba Based Income as Capital**

*Can a person who receives a riba based sum of money as part of a divorced settlement use the cash to buy houses to rent?*

It would be permissible to keep the money because the sin of the riba returns to the person dealing in the riba, not the one receiving the money. The money may be used in any permissible way. For the divorce settlement, though the specificity of the issue takes us beyond the scope of a simple answer, one must always ensure that the divorce was Islamically settled since conventional financial settlements following a divorce are not permissible.

# ISTISNA

### Financier's Rejection Of Goods In Istisna

*Can the financier cancel the Istisna contract in case the goods delivered do not conform to the specific instructions given by the financier?*

The financier reserves the right to reject products not manufactured to specification, though must accept items manufactured equal to or superior to expectations. The contract may be cancelled unilaterally by either party before manufacturing commences, but not after.

### Tying Price And Delivery In Istisna

*May the price of the istisna good be linked to the timeliness of its delivery?*

Both parties may agree to link the price of the product with the timeliness of its delivery; and the financier is entitled to unilaterally cancel the contract if the production period exceeds some pre-agreed duration, though it is recommended for the financier to grant the manufacturer respite.

### The Financier May Also Be Manufacturer In Istisna Agreement

*May the financier in an Istisna agreement play the role of a manufacturer?*

It is permissible for the financier to play the role of manufacturer: for example, a financial intermediary like a bank can enter into an Istisna agreement with a home buyer whereby the bank agrees to build the house (by hiring a contractor in a separate agreement) and the buyer agrees to buy the house; the bank assesses its cost and adds its profit and sells the house to the buyer, whether in installments or as a lump-sum before, during or after production.

### Istisna For Natural Products

*Is it permissible to sell agricultural products under an Istisna contract?*

The Istisna contract is valid for manufactured goods, not agricultural products. However, if agricultural products are subjected to manufacturing that transforms them from their natural state—such as juice extracted and processed from fruit—it would be permissible.

**Responsibility Of Seller In Istisna**

*What is the seller responsible for in an Istisna with respect to the asset prior to delivery?*

The seller bears all responsibility related to ownership of the asset prior to its delivery to the purchaser. This includes responsibility towards any damage to the asset, maintenance expenses, and, if necessary, insurance.

**Deferred Sale Under Istisna Contract**

*Is it permissible to contract with a party and accept advance payments for an asset that is under construction and will be delivered upon completion?*

It is permissible to contract an Istisna agreement in which an under-construction sale asset will be delivered in the future upon completion, while the sale price is paid in installments from the date of the contract.

**Receiving Share Of Manufactured Product As Consideration In Istisna Contract**

*Is it permissible to finance a party by manufacturing a mutually agreed upon item and retaining part of the manufactured product as consideration?*

It is permissible in an Istisna to manufacture a mutually agreed upon item and retain, as consideration, a specified share of the manufactured product. This share may be sold in the market, with the difference between the financing and the sale representing the profit.

**Agent Managing Construction Work In Istisna**

*Is it permissible for a bank to appoint a third-party as an agent to manage and hand over a construction assignment in an Istisna?*

It is permissible for a bank to appoint an agent to oversee the construction project, approve payments to the contractor, and receive the completed work and deliver it to the bank's client.

**Construction Work Under Istisna Contract**

*Is it permissible for a landowner to hand over his land to someone who promises to construct on the land—undertaking all expenses and related costs—and hand over the completed project?*

Such an arrangement is permissible under an Istisna contract, based on the following procedure/ conditions:

The land owner would hand over his land to the other party (the 'contracting party') who will build over the land any structure mutually agreed upon.

Both parties to the contract (i.e. the land owner and the contracting party) agree on a lump sum price that is to be paid, without separately specifying the cost and the profit. Part of the price may be paid beforehand as advance with the remainder being paid upon completion of work—in bulk or in installments.

In general it should be noted that Istisna allows for a lot of flexibility on price, so that if mutually agreed upon by the parties involved, virtually any payment schedule can be arranged, as long as the price is known and established beforehand.

The contracting party will bear all expenses relating to building and construction, including all expenditure on project execution.

The contracting party will be solely responsible for arranging and managing all agreements with contractors, and for the supervision of the work carried out by these contractors.

The contracting party will be responsible for handing over the completed project to the land owner.

Handover of the complete project would constitute providing delivering the project in the absolute final completed form embodying all the major and minor specifications as agreed upon between the land owner and the contracting party.

As an example, let us assume the contract between the land owner and the contracting party specified the construction of a fully-finished building of apartments.

Hence, upon delivery, the building and all of its apartments must be fully complete in every way, as must be all other aspects of the building, such as for example the parking facilities, all utility provisions (electricity/gas/water/telephone/internet/TV/cable connections, etc), and in general all features of the building that were agreed upon in the Istisna contract.

**Supervising Of Construction Work Under Istisna**

*In the case of a bank carrying out construction work for a client under an Istisna, is it permissible for the bank to make a separate agreement with the client agreeing to supervise the contractor's implementation of the contract?*

It is permissible for a bank to draft a separate contract agreeing to represent the client in supervising

the contractor's implementation of the contract, provided that such a contract is kept separate from the bank's contract with the contractor and the bank's Istisna contract with the client.

**Profit As Percentage Of Cost In Istisna Contract**

*Is it permissible to set profit as a percentage of cost in an Istisna?*

It is not permissible to measure profit as a percentage of the cost in an Istisna contract.

**Offering Istisna Customer Lower Spot Price And Higher Deferred Price**

*Is it permissible for a bank to offer an Istisna customer the option to pay either a lower spot price or a higher deferred price?*

Only prior to the final agreement, it is permissible for the bank to give its customer the option of either paying a standard spot price or a higher deferred price. The customer must choose one option prior to execution and the contract must explicitly mention the chosen contract price and corresponding manner of payment, whether spot or deferred.

**Deferred Delivery Of Published Works Purchased Under Istisna**

*Is it permissible to purchase published works under an Istisna contract with deferred delivery and advance payment?*

It is permissible to purchase published works under an Istisna contract and to defer delivery. Payment may be either advance or deferred. It is also permissible to lower the price for deferring delivery.

**Istisna Requestor Being Appointed As Manufacturer**

*Is it permissible for the Istisna requestor himself to manufacture what he requests?*

It is not permissible for the Istisna requestor himself to manufacture what he requests.

**Bank Appointing Requestor As Contractor**

*Is it permissible for a bank to appoint the Istisna requestor as the contractor?*

It is not permissible for a bank to appoint the Istisna requestor (its client) as the contractor, since this would be akin to the Istisna requestor being appointed as the manufacturer, which is impermissible.

**Post-Contract Government Regulation Causing Additional Costs In Istisna**

*Which party in an Istisna bears any additional costs imposed by government regulation after the contract is signed?*

It is permissible to add a clause in an Istisna contract stating that additional financial commitments resulting from new government regulations imposed during the contract are the liability of the Istisna requestor.

**Bank Obtaining Discounts From Contractor In Istisna**

*Is it permissible for a bank to obtain discounts with a construction contractor in an Istisna without passing the discounts on to the requestor?*

It is permissible for the bank to obtain discounts from the contractor without passing them on to the requestor since these are two separate contracts: one contract between the bank and the Istisna requestor and the other between the bank and the contractor.

**Bank Obtaining Discounts From Subcontractor In Istisna**

*Is it permissible for a bank to take a share in discounts offered by a subcontractor to a lead contractor in an Istisna?*

The subcontractor is hired by the lead contractor and the bank is not a party to the contract between them. It would not be permissible for the bank to benefit from such discounts.

**Contracting With Client Who Failed To Honor Previous Contracts With Other Parties**

*Is it permissible for a bank to contract with a client to finance construction on land owned by the client in case the client had already contracted with a contractor to construct on the same land but failed to honor that contract?*

It is permissible to contract with such a client. The client must first be asked to rescind its previous contract with the contractor according to the terms and conditions set out in that contract. The bank has absolutely no liability with regards to the previous contract since it was not a party to it.
Any outstanding debts are considered the responsibility and liability of the customer. Once the previous contract is terminated, the bank shall draft a fresh contract with the client. Due care should be taken to verify solvency of owner and ability to pay on due date. The bank is under no obligation to hire the contractor who was previously hired by the client.

**Advance Payment To Contractor In Istisna**

*Is it permissible for a bank to make advance payment to a contractor in a contract of Istisna while the Istisna requestor, upon completion of the contract, pays the bank the contractor's fee plus an additional agreed-upon percentage as the bank's profit?*

Such a transaction is not permissible since the additional percentage is akin to interest. The correct method of payment in an Istisna contract is for the bank to contract an independent Istisna contract with the client for an agreed lump sum amount, while contracting with a contractor to undertake manufacturing for an agreed amount which is lower than the amount receivable from the client. The difference between the amount due to the contractor and the amount receivable from the client is the bank's profit.

**Cost Of Subsequent Changes To Asset Manufactured Under Istisna**

*In the event that a bank's Istisna client requests changes to a manufactured asset, who pays?*

The parties to the Istisna contract may alter the contract and clearly specify the amount payable for the agreed-upon changes. The bank should not commence such changes before revising the Istisna contract and agreeing upon the price.

**Conditions For Reducing Price Of Istisna Subject Matter Due To Delay In Delivery**

*What are the conditions for which the price of the Istisna subject matter may be reduced as a result of a delay in delivery?*

The conditions for which the price of the subject matter of an Istisna may be reduced as a result of a delay in delivery are

1. The delay must not be a result of circumstances outside the seller's control.
2. The calculated amount of reduction in price per day of delay and per unit of the subject matter must be fair and appropriate.

# LOAN

### Agreeing Repayment In Loan

*Is it permissible to borrow interest-free money without both the parties agreeing to a fixed repayment date?*

It is impermissible to borrow money without both parties agreeing a fixed repayment date (or fixed repayment schedule).

### Benefiting From Loan

*Is it permissible for the lender to derive any monetary benefit from the disbursement of a loan?*

The loan should not derive any benefit to the lender, whether monetarily, in-kind, gifted, as a favor, or in the form of a service; unless the borrower does so voluntarily and the lender accepts once the loan is made.

### Repaying Principal With Something Extra

*Would it be permissible for the borrower to repay the loan amount with some extra value above the principal?*

It is permissible for the borrower to repay an amount greater than the size of the loan as a gesture of goodwill (without letting such a gesture become customary practice), but impermissible for the borrower to promise to pay a greater amount at the time of borrowing or for the lender to demand a greater amount.

### No Binding Conditions In Loan Contract

*What is the ruling on attaching conditions to the loan contract?*

The loan should be free of binding conditionality (not including the conditions of collateral or guarantor, which are permissible); forbidden are conditions that compel the borrower to do something or refrain from something outside of the agreement to repay the loan; the lender may, however, inquire about repayment and insist on timeliness.

**Respite For Loan Default**

*If due to a genuine cause the borrower is unable to repay a loan, what course of action should the lender take?*

The lender is obligated to grant respite to the borrower if it is established that the borrower is unable to repay the loan on time due to a genuine excuse (e.g. bankruptcy, unemployment, emergency expenditures).

**Lending: When One Suspects Unlawful Usage**

*May one lend money or property when one suspects unlawful usage?*

It is impermissible to lend money or property when one is certain that it will not be used lawfully, and offensive when one doubts whether it will be used lawfully.

**Early Payment Discounts**

*Is the borrower entitled to any early payment discounts?*

It is impermissible for the borrower and lender to agree a discount on the loan if the borrower repays before the due date.

**Money Lending Should Be Unconditional**

*When lending money, may the lender specify how the borrower is permitted to use the money?*

The lender is not permitted to specify how the money may be used or impose restrictions on how it may not be used.

**Repaying Loan In Kind**

*Can borrowed money be repaid in kind instead of in cash?*

Provided the lender agrees, the form of repayment can be different from the form of the original loan (e.g. a cash loan repaid in its equivalent in wheat).

**Restricting Use Of Lent Property**

*May the lenders restrict how lent property is used?*

The lender is entitled to specify how the property may be used and impose restrictions on how it may not be used.

**Damage To Lent Property**

*Who is responsible to pay for damage to lent property?*

The lender is responsible for paying for any damages caused by normal wear sustained during the property's intended use. The borrower is responsible for paying for any damages caused by himself, a third party, or acts of God during the property's use, whether the damage occurs during usage intended by the lender or not.

**Permissibility Of Lending Property On Rent-Free Basis**

*May property be lent free of rent?*

It is permissible to lend property free of rent while stipulating that the borrower pay for repairs related to his use.

**Correct Intentions For Borrowing**

*What should the borrower's intention be at the time of borrowing?*

At the time of borrowing the borrower must have a firm intention to repay the lender; to borrow without such an intention is impermissible and to benefit from the borrowed item unlawful.

**Borrowing Must Be Accompanied With Fixed Repayment Schedule**

*May one borrow from a lender without there being an agreement on a fixed repayment date?*

It is impermissible to borrow money without both parties agreeing a fixed repayment date (or fixed repayment schedule).

**Duties Of Borrower With Regard To Borrowed Item**

*What protective measures must the borrower take with regard to the borrowed item and its return?*

It is obligatory for the borrower to safeguard the borrowed item and return it in its complete form; if the item is unique and irreplaceable (e.g. animals, jewelry) the item itself must be returned; if the item is replaceable (e.g. money, oil, sugar) then an equivalent amount must be returned, regardless of the duration of the loan or the change in market value. When returning a replaceable item, it is permissible to return the same item of a superior quality (e.g. long grain rice instead of short grain rice) if the lender accepts, but not an item of inferior quality; to avoid riba, it remains a condition that the amount returned be equal in quantity (i.e. weight, measure, count, etc.) if not identical in quality.

**Guidelines For Borrower**

*What guidelines are there for the borrower regarding the consumption of money, replaceable items, and irreplaceable items?*

The borrower may consume the money or replaceable goods in any manner he chooses provided this consumption does not hinder his ability to make a timely repayment or to return irreplaceable goods in the condition he borrowed them.

**Delaying Repayment Without Valid Excuse**

*May the borrower delay repayment of the loan which is due for purchasing a non-essential?*

The borrower is obligated to repay the loan once it becomes due and is forbidden from purchasing non-essentials; delaying repayment without a valid excuse is a major sin.

**Repaying Loan With Extra**

*May the borrower repay the loan with an amount greater than the borrowed loan (the excess being a gesture of goodwill)?*

It is permissible for the borrower to repay an amount greater than the size of the loan as a gesture of goodwill (without letting such a gesture become customary practice), but impermissible for the borrower to promise to pay a greater amount at the time of borrowing or for the lender to demand a greater amount.

**No Early Payment Discounts**

*May the borrower receive an early payment discount on the loan?*

It is impermissible for borrower and lender to agree a discount on the loan if the borrower repays before the due date.

**Extent Of Borrower's Liability**

*What is the liability for the borrower in relation to the borrowed item?*

The borrower is responsible only for loss, damage or theft resulting from his own negligence, but not otherwise; the borrower is responsible for any loss, damage or theft occurring after the item was due to be returned, whether due to his own negligence or not.

**Guaranteeing Creditor Against Loss**

*May the borrower, before borrowing, guarantee the creditor against loss, damage or theft?*

It is impermissible for a borrower to guarantee against loss, damage or theft before borrowing; responsibility for loss, damage or theft is determined at the time it occurs, whether due to the borrowers negligence, in which case the borrower is liable, or otherwise, in which case the lender is liable.

**Placing Stipulations On How A Borrowed Item Is Used**

*Can a lender stipulate how a borrowed item is used?*

The restriction of unconditionality does not include valid stipulations for irreplaceable borrowed items relating to usage of the item, since a condition of using an irreplaceable item is that it is returned in the same condition, and certain kinds of usage affect the condition of a borrowed item (e.g. it is permissible to say: "you may only drive the car during daylight hours" if the lender feels that driving it at night may be dangerous); the borrower is liable for loss, damage or theft resulting from disobedience to a valid stipulation; it is impermissible, however, to restrict the usage of replaceable borrowed goods (e.g. it is impermissible to say: "you may only use this money to buy food"), because unlike trusts, commissions, and investments, the borrower is not bound under any obligation other than a general one to return what is borrowed.

**Transferring Borrowed Item To Third Party**

*Does the borrower have the authority to transfer the borrowed item to a third party without the lenders permission?*

A borrower may not transfer borrowed item to another party unless he receives prior permission from the lender.

**On Returning Item To Heir's Of The Lender**

*If the lender passes away or becomes insane, to whom should the borrower return the borrowed item?*

If the lender passes away, or becomes insane or incapacitated, the borrower is responsible for returning the item to the lender's heirs (if the lender passes away) or the lender's guardian (if the lender becomes insane or incapacitated).

**Delaying Repayment Of Loan**

*Is it permissible to intentionally delay repayment of loan?*

It is impermissible for a debtor possessing the means to pay the creditor to delay payment unnecessarily beyond the agreed upon date.

**Loan Bringing Benefit**

*Is it permissible to make an interest-free loan to a client on condition that he deal exclusively with the bank when buying and selling foreign currency or at least use it as an intermediary?*

It is not lawful for the bank to make a loan and attach any condition that provides the bank with direct or indirect benefit.

**Government Loans**

*(i) Is a government loan that uses the consumer price index and increases by about 3% almost every year based on the rising cost of living considered ribawi or is such a change in the loan amount permissible as it merely reflects current market values? (ii) If an individual has taken such a loan without knowing of it being ribawi what should he do if he hasn't paid any riba yet as the government requires the loan be repaid once the individual's yearly income is above a certain*

*threshold and he has not reached that threshold? (iii) Should he only pay the amount borrowed or the riba as well?*

(i) Such a loan would be ribawi. Increasing a loan to reflect inflation, movement on an index, a change in the cost of living, or the like, is not permissible. (ii) For ribawi loans already incurred, the individual should make every effort to get out of them as soon as possible, even if it means taken on a second or third job. (iii) He has to pay off whatever he owes, regardless of it being ribawi or not.

**Loan Transfers Are Absolute And Final**

*Are loan transfer's absolute, freeing the transferor of the obligations it owed to the lender?*

Transfers are complete and final (unless they are transferred back in a new agreement) and once the transfer is effected the lender cannot hold the borrower accountable for the new party's actions.

**Mutual Loans**

*If a bank requires dollars for one month, is it permissible to request another bank to grant this amount as an overdraft on its account there, without a fee but in exchange for something of equal value, such as dirhams, on the basis that when the dollars are returned the dirhams will be returned as well?*

It is permissible to exchange these kinds of interest-free loans provided no fee, payment, or penalty is attached to them.

# MAINTENANCE

### Giving Or Taking Stolen Property As Maintenance

*Is it permissible to give or take stolen property as maintenance?*

It is impermissible to give or take maintenance from stolen property one is certain is stolen; if there is doubt then it is permissible to give or take the maintenance, though it is always superior to avoid the doubtful.

### Unpaid Maintenance As Financial Debt

*Is unpaid maintenance during marriage considered a financial debt upon the husband?*

Unpaid maintenance from during the marriage is not a financial debt the husband owes the wife unless there is a judgment from a legal authority to that effect or if the couple had mutually agreed during marriage to postpone maintenance to some later date; if there is neither judgment nor agreement, the husband will still be rewarded for paying the wife unpaid maintenance payments from the past.

### Claiming Back Maintenance Provided

*Is the husband entitled to claim maintenance already provided?*

The husband is not entitled to claim any portion of the obligatory or non-obligatory maintenance that has already been provided.

# MUDARABAH

**Mudarabah: Investment Financing**

*How does Mudarabah work as an Islamic mode of financing?*

A Mudarabah agreement creates a partnership business whereby an investing partner (rab al maal) brings capital and a working partner (mudarib) brings time and effort to share in profits according to a percentage agreed upon beforehand.

The investor has no direct involvement with the management of the business after the investment is made, though there are restricted Mudarabahs that specify the kind of venture intended, and unrestricted Mudarabahs that leave all discretionary powers in the hands of the worker to invest capital in the most productive manner possible.

The investor has the right to oversee business activities and, to the extent agreed upon by the mudarib, work directly with the mudarib. The worker has a fiduciary responsibility to the investor to maximize profits, within the parameters of the Shariah, because the investor is the one owning all the assets and bearing all the losses. There is no salary for the worker in a Mudarabah; he takes only that share of the profits to which he is entitled, while expenses relating to the business come from the business itself.

**A Mudarib Is Entitled Only To Profit, Not Salary**

*May a mudarib earn a salary in addition to his share of profit?*

There is no salary for the worker in a Mudarabah; he takes only that share of the profits to which he is entitled.

**Profit Shares Preset As Percentage Figure**

*How are the profit shares determined under a Mudarabah agreement?*

Profit shares must be known as a percentage, not as an absolute term, of earnings (ie. net income or profit) beforehand.

**Prohibition Of Pooling Profits In Mudarabah**

*Is it permissible to pool the profits of working partners?*

It is forbidden to pool the profits of working partners, though it is acceptable for individual working partners to share their profits after distribution.

**Liability For Losses In Mudarabah**

*In a Mudarabah agreement, who has the primary liability for loss?*

The investor bears all losses barring negligence, in which case the negligent party is financially liable.

**Prohibition Of Spreading Losses By "Distributing" Negligence**

*Is it permissible to "distribute" negligence to spread loss?*

It is impermissible to "distribute" negligence by holding all the working partners liable for the mistakes of a few.

**Responsibility Of The Working Partner**

*What is the responsibility of the working partner in a Mudarabah?*

The working partner accepts the investment capital of the Mudarabah in the capacity of a trustee. Unless the capital is lost due to his negligence, he is not liable to replace it. Once the business commences, the working partner as agent conducts all business activities. The working partner assumes the status of an employee if the Mudarabah is rendered invalid. In such a case he is remunerated for his services for the period he has worked based on the going market rate. The working partner may assume partnership in a Mudarabah by making a capital contribution. His status as co-investor is independent of his role as the working partner. In case he ceases to be a working partner he remains an investor and vice versa.

**Mudarabah: Permissibility For Working Partners To Act On Behalf Of One Another**

*May working partners, engaged in a Mudarabah agreement, act on each other's behalf?*

If working partners provide a service, they may act on behalf of one another as agreed upon (e.g. buying, selling, managing, etc.) and no partner may refuse participation in the provision of any agreed upon services.

**The Extent Of Working Partner's Authority In Mudarabah**

*May a working partner, or a number of them, act on behalf of the Mudarabah, without authorization from the rest of the partners?*

It is impermissible for working partners to act on behalf of the Mudarabah or to use, buy or sell the property of the Mudarabah without the permission of all the other partners, unless the other partners have specified the manner and extent to which assigned partners may do so.

**No Profits For Providing Intangible Benefits In Mudarabah**

*May an investor claim a share of the profit for having provided intangible benefits like guarantees?*

The investor must have invested some form of capital into the Mudarabah; it is forbidden to partake in profit in exchange for something other than capital, such as one's "guarantee," "connections," "reputation," and the like.

**Immediate Cancellation Of Invalid Mudarabah**

*What should be done in case the Mudarabah is found to be invalid?*

If a Mudarabah is found to be invalid, it is cancelled immediately; the partners are then entitled to enter into a new agreement that is valid.

**Loss, Damage, Or Theft Before Capital Distribution**

*In the event that a Mudarabah's capital is lost, damaged, or stolen before its distribution among the working partners by the investor, what happens to the Mudarabah partnership?*

The partnership is cancelled and, if so agreed, renewed.

**The Form Of Capital Investment**

*In what form should capital investment be contributed for a Mudarabah?*

Capital investment may be contributed in cash or in kind.

### Different Profit Ratios For Different Partners In Mudarabah

*Can different profit ratios be agreed for different working partners in a Mudarabah?*

It is permissible to agree different ratios of profit for different working partners in a Mudarabah.

### Fixing Different Profit Margins For Different Business Areas

*Is it possible to vary profits margins by business area?*

Before finalizing an agreement in a restricted Mudarabah, the investor may stipulate that some areas of the business earn the worker higher profit margins than others, for instance, the mudarib's profit share is 20% in textile businesses and 30% in electronics businesses.

### The Dos And Don'ts Of Profit And Loss Distribution

*How is profit and loss distribution measured in a Mudarabah?*

It is central to the validity of the Mudarabah that distributions be measured as a percentage of profit and loss, not as a fixed amount, percentage of total capital, total revenue or some other absolute amount.

For wholly-owned Mudarabahs, profits and losses are netted against one another, whereas for different businesses, as differentiable by the fact that they hold separate Mudarabah agreements, profits and losses are treated separately for separate businesses.

At any point during the agreement's tenure, either the investor or the worker can give notice and leave the Mudarabah. Of whatever remains of the business, non-liquid assets are liquidated and combined to yield a total value for the business. In order, the investor has first rights to his principal amount, the remainder of which is divided between the investor and mudarib(s) according to their respective shares.

If the business incurs only losses, and only a portion of the original principal remains, the amount goes entirely to the investor and the mudarib receives nothing.

**Types Of Mudarabah**

*What are the different types of Mudarabah?*

There are two types of Mudarabah: restrictive and unrestrictive.

Restrictive Mudarabah means that the investor has specified investment details in the Mudarabah contract and has restricted the working partner within the scope of such specifications. Due care and precaution must be taken by the working partner to honor the restrictions imposed by the investor.

Unrestrictive Mudarabahs mean that the investor has granted the working partner the right to undertake any lawful investment. The working partner has the right to invest in any suitable investment that is reasonably expected to yield profits. It is the responsibility of the working partner to avoid unlawful and high-risk investments, and the working partner is liable for any losses suffered from such investments.

**Stipulating Time In Mudarabah**

*Is it permissible to restrict the time-period of investment in a Mudarabah contract?*

It is permissible for the investor to restrict the time-period of investment in a Mudarabah contract. At the end of the specified time-period, all transactions cease and the profit or loss is divided as per Mudarabah contract.

**Investor Receiving Percentage Of Each Investment From Working Partner**

*Is it permissible for the investor to demand from the working partner a certain percentage of each investment to be made, in addition to his share of proceeds of investment?*

It is not permissible for the investor to demand such money from the working partner. The role of the working partner is that of a trustee, and a trustee cannot be required to pay any amount to the investor except in case of the trustee's negligence.

**Utilization Of Money Collected As Surety**

*Is it permissible for a bank to use the money collected as a surety for investments under a Mudarabah contract?*

It is permissible for a bank to use the money collected as a surety for investments under a Mudarabah contract.

**Investor Acting As Working Partner**

*Is it permissible for an investor in a Mudarabah to also act as working partner?*

It is permissible for the investor in a Mudarabah to assume the role of working partner as well. This is particularly relevant in Mudarabah transactions involving multiple banks, where each bank is an investor and one bank is an investor and a working partner.

**Appointment Of Agent By Working partner**

*Is it permissible for the working partner of funds in a Mudarabah to transfer the funds collected to an agent for investment?*

It is permissible for the working partner to appoint an agent for investing the money collected.

**Expanding Mudarabah Investment Portfolio**

*Is it permitted for a bank to expand its Mudarabah investment portfolio without informing the investors?*

It is not permissible for the working partner (the bank, in this case) to expand its investment portfolio without consultation with the investors. The investors who agree to the expansion are treated as investors under an Unrestrictive Mudarabah, while the investors who do not agree to the expansion are treated as investors under a Restrictive Mudarabah and funds contributed by the latter are invested as before.

**Reserve Fund Out Of Mudarabah Investors' Funds**

*Is it permissible for a bank to set aside a certain percentage of investors' money for the creation of a reserve fund as a remedy against investment risks?*

It is permissible to create a fund out of the investors' money in order to mitigate risks arising out of investments. The terms and conditions of the investors' contribution, including the percentage to be deducted, are mentioned in the Mudarabah contract.

The money so contributed by each investor is in the form of a gift, such that the investor will have no further claims on that money. The reserve fund is managed by the bank (working partner) and will be used either when the investors' money is at risk or when the return on investment is so low that it adversely affects the bank's reputation. It is the bank's responsibility, as working partner of the reserve fund, to invest the fund's resources in suitable and profitable ventures.

All yields from such investments are added to the reserve fund. The bank continues to operate the fund for as long as it remains in operation. In the event of the bank's winding up, the fund is dissolved and all proceeds are donated to charity.

**Categorization Of Profit Rates In Mudarabah Investment**

*Is it permissible to categorize investors in a single Mudarabah, with different profit rates for each category?*

It is permissible to categorize investors in order to have different profit rates for each category of investors. The categories may be made on any just and sound basis, such as the period of investment or the amount of investment. However, it is necessary that the investor and the working partner both agree and understand the implications of such categorization, and that it is mentioned clearly in the Mudarabah contract.

**Restriction On Investments By Investor In Mudarabah**

*Is it permissible for an investor to place restrictions on the working partner of Mudarabah regarding investments?*

The investor is entitled to impose restrictions on investments and the working partner will be obliged to comply with such restrictions.

**Withdrawal By Investor In Mudarabah Before Due Date**

*Is it permissible for an investor to withdraw his contribution in a Mudarabah before the due date of distribution of profits? What right does he have to profits earned up to that date?*

It is permissible for an investor to withdraw his contribution before the due date of distribution of profits. The investor will be entitled to the profit earned on his investment up to the date of his withdrawal.

**Forfeiture Of Profit Due To Withdrawal Before Maturity**

*Is it permissible to include a clause in a Mudarabah contract that would require the investor to forfeit all profit earned on his investment in case of early withdrawal?*

It is permissible to include such a clause in the Mudarabah contract, and in such a case, the investor will be obliged to forfeit all profit earned on his investment. The amount of profit forfeited will be credited to the Mudarabah Reserve Fund.

**Expenses Of Mudarabah Operation**

*Who is responsible for expenses in a Mudarabah operation: the investors or the bank (working partner)?*

The bank will be responsible for such administrative expenses as are required for its general activities as a manger, but not for those expenses that are wholly unrelated to the bank's role as working partner.

**Mudarabah Investment In Other Than Cash**

*Is it permissible for investors in a Mudarabah to contribute wealth other than in cash, such as goods or equipment?*

The majority of Islamic jurists are in agreement that Mudarabah investments may only be made in cash. Therefore, the investors in a Mudarabah should be called upon to make their full investment in cash.

**Termination Of Mudarabah And Disposal Of Assets**

*In case of termination of a Mudarabah through the investor buying all the assets of the partnership, is it permissible for that investor to sell such assets under a Murabaha?*

In the case described above, the Mudarabah operation has ceased to exist and all assets belonging to the Mudarabah operation are now in the custody of the investor. It is permissible for the investor to dispose of the assets in any manner he deems suitable, including Murabaha. However, care must be taken to comply with all the requirements of a valid Murabaha sale, including disclosure of the exact purchase price of goods from the partnership, as well as any ancillary expenses.

**Combining Multiple Mudarabah Operations**

*Is it permissible for a bank to combine all its Mudarabah operations and invest the money as a whole?*

It is permissible to combine multiple Mudarabah operations, provided that the yield from investment be distributed to all investors in accordance with the agreed upon proportions.

**Zakat On Mudarabah**

*Is it permissible for the working partner to deduct zakat on Mudarabah operations on behalf of the investors?*

It is permissible for the working partner to deduct zakat from Mudarabah operations from the investors' accounts, provided that he has been authorized to do so by the investors.

**Project Evaluation Charges Prior To Contract**

*In case a client approaches a bank to finance a particular project, is it permissible for the bank to charge a fee for evaluating the profitability of the project prior to entering into a financing arrangement?*

It is permissible for the bank to charge a fee for evaluation of the project, provided that such fee is charged before entering into a financing arrangement.

**Multiple Working Partners In Mudarabah Contract**

*Is it permissible for the working partner in a Mudarabah contract to bring in another working partner?*

It is permissible for the working partner in a Mudarabah contract to appoint another working partner with the approval of the investors. However, the investors will not be liable to pay the second working partner. The proportion of yield payable to the working partner will remain same and will be shared by the two working partners.

**Distribution Of Profits Prior To Allocation Of Expenses**

*Is it permissible to distribute profits from a Mudarabah contract before expenses have been allocated and netted off from the profits?*

It is not permissible to distribute profits before the allocation and net-off of expenses. The amount that remains subsequently will be termed net profit and will be distributed among the investors.

**Deduction Of Salary Expense From Mudarabah In Two Stages**

*Is it permissible to deduct salaries from the Mudarabah in two steps: the first deduction being along with other administrative expenses, while the second being the salary of the bank's shareholders out of the net profits?*

It is permissible in the Shariah to deduct salaries from the Mudarabah in the mode described. The second deduction represents nothing more than the bank's share in the profits of the Mudarabah operation, in its capacity as working partner, and such profit is to be paid to the bank's shareholders. Care should be taken to ensure that the second deduction is according to the share of the bank as prescribed in the Mudarabah contract.

**Division Of Investment Yield Not Commensurate With Capital Investment**

*Is it permitted for the investors to mutually agree upon a formula of division of investment yield that is not commensurate with the capital invested?*

This returns to whether there is profit or loss on the investment. In case of profit, it is permissible to divide it according to any mutually agreed ratio. The investors are not bound to divide profits in proportion to their capital investment. This entails, for example, that two investors may have a 1:1 ratio of capital investment, and 2:3 ratio of division of profits.

However, loss on investment may only be divided in proportion to capital invested. Losses are charged directly to the capital itself, therefore their division must be according to the proportion of capital invested by each investor. Any stipulation that states to the contrary will be considered void.

**Working Partner's Share In Loss On Investment**

*In case there is loss on investment, is it permissible to make the working partner liable to bear a percentage of that loss?*

The working partner may not be held financially responsible for any loss on investment unless it can be proved that he acted with negligence or incompetence. This is because the working partner has not invested any capital and will not be required to bear any negative consequences. If the Mudarabah contract stipulates that the working partner will be financially responsible for loss, such a condition will be void, though the Mudarabah contract itself will remain valid.

**Early Distribution Of Profits**

*Is it permissible for the investors in a Mudarabah contract to decide to distribute profits before the conclusion of the Mudarabah contract?*

It is permissible for investors to mutually decide to distribute profits before the conclusion of the Mudarabah contract.

**Alteration Of Mudarabah Contract**

*Is it permissible to alter the Mudarabah contract in order to change the profit percentages or any other clause?*

It is permissible to alter the Mudarabah contract if all the parties agree to the change. The alteration may pertain to profit percentages or any other clause.

**Fixed Payment To Investor**

*Is it permissible to include a clause in the Mudarabah contract that entitles the investor to receive a periodical fixed payment in addition to the profit distribution, regardless of whether the investment profits or loses?*

It is not permissible for the investor to demand such a fixed payment in addition to his entitlement to profit. This would entail making the working partner financially liable, which is impermissible.

**Promising Additional Profits To Working Partner**

*Is it permissible for the investors to promise additional profits to the working partner as a form of motivation?*

It is permissible for the investors to reach such an agreement with the working partner, provided that the division of profits is according to the Mudarabah contract.

**Profit Distribution In Long-Term Mudarabah Contracts**

*In case of long-term Mudarabah contracts, is it permissible to periodically distribute profits among investors instead of a bulk distribution at the conclusion of the Mudarabah contract?*

It is permissible, with mutual agreement among investors, to periodically distribute profits instead of a bulk distribution at the conclusion of the contract.

**Converting Mudarabah Into Musharakah**

*Is it permissible for the parties to a Mudarabah contract to convert it into a Musharakah, and subsequently attract more capital through the issue of Shariah-compliant financings?*

It is permissible to convert a Mudarabah into a Musharakah and to raise capital through financings. It should be noted, however, that before entering into a contract, all parties should agree on definite objectives of their Mudarabah partnership in order to avoid any future ambiguities.

**Termination Of Mudarabah**

*How is a Mudarabah terminated?*

In a Mudarabah any of the partners may leave the business at any time. If a time limit is agreed upon, then such an agreement must be strictly adhered to by both parties. At the time of termination, the business is liquidated, whether through the sale of assets or through their constructive liquidation. All expenses directly related to the Mudarabah operation are paid for from its earnings. All other expenses ensuing from the running of the business as is the market norm, are the working partner's responsibility.

**Mudarabah Costs**

*What costs are categorized as the Mudarabah's running business costs and what costs is the Mudarib personally liable for?*

An example of costs strictly related to running a business include direct costs like raw material and direct labor while an example of indirect costs not billable by the Mudarib to the Mudarabah include the Mudarib's rent and utilities expenses, though the Mudarib and Rabb al Maal may agree a higher profit share for the Mudarib to offset these indirect costs.

**Profit Distribution Ratios In Musharakah And Mudarabah**

*Why does the ratio of profit distribution differ in Musharakah and Mudarabah contracts?*

Profit distribution in a Musharakah is between partners who are both providing investment capital, while in a typical Mudarabah one party provides the capital and the other party only provides the work.

# MURABAHA

**Definition Of Murabaha**

*What is a Murabaha?*

A Murabaha is a sale transaction where the cost of acquiring the asset and the profit to be added are disclosed to the client. The buying client typically repays in installments or as a deferred lump sum.It is a necessary condition that the seller own and constructively possess the Murabaha asset.

Typically, the client is made the bank's agent for purchasing the subject matter of the Murabaha where the agent's possession of the asset is considered the principal's possession of the asset. It is not permissible to earn profit from a sale without first assuming all the risk associated with the asset.

**Purchase Requisition In Murabaha**

*What are the rulings related to the purchase requisition in a Murabaha?*

A client sumbits the purchase requisition when the financial institution approves a credit limit for a Murabaha. A bank may refuse to execute a Murabaha for an asset that is not Shariah-compliant or is against the bank's policy to promote in the market. The client's request and unilateral promise to purchase the Murabaha asset may be placed in combined or separate documents. If separate documents are created, the unilateral promise to purchase is made after the master Murabaha facility agreement is signed.

The purchase requisition is evaluated as follows:

1. The bank must first ensure that the commodity is Shariah complaint and sellable in the market.
2. If the bank is to purchase the goods of the Murabaha, then it must ensure that the client has not already made the purchase from the supplier.
3. If he has, the deal between the supplier and client must be cancelled.
4. The supplier must not be the client himself but must be a third party. If the supplier is the client, the transaction will be a *buy back* which is prohibited.

It is impermissible to execute a Murabaha if:

- The client is the supplier's agent;
- The supplier is the client's agent; or
- They are both substantial shareholders in the transacting company.

**Consumption Of Murabaha Asset While Acting As Agent**

*How does the consumption of the Murabaha asset by the client while he serves as an agent affect the transaction?*

If the client takes possession of the asset and consumes it, a Murabaha cannot be executed for it any more. For instance, consider raw material as the subject matter of a Murabaha. The client processes it into a finished product, for instance, sugar cane into sugar. In such a situation if the client acting as agent consumes the asset before the Murabaha's execution, the financial institution must cancel the contract, recover the principal amount and enforce the charity clause established at the time of the contract's execution.

**Breach In Promise To Purchase In Murabaha**

*What happens if there is breach in a promise to purchase in a Murabaha?*

Once the goods are purchased from the supplier and the client backs out on entering into a Murabaha with the bank, the bank may sell the goods in the market and make up for its actual loss. If the goods sell for a price lower than their cost to the bank, the client is expected to make up for the difference provided it is established at the time of the contract's execution.

**Distribution Of Murabaha Profit Before Maturity**

*How does the distribution of profit take place in a Murabaha before maturity?*

If a bank only conducts a Murabaha and possesses only liquid assets, and the closing of accounts is to take place after 6 months, and a depositor wishes to make a withdrawal after 3 months, the depositor will only be returned his principal amount. After 6 months, at the time of the Murabaha's maturity, his profit for 3 months is calculated and disbursed to him. If a depositor wishes to withdraw after 3 months while a bank conducts an Ijarah in addition to a Murabaha for a term of 6 months, and possesses liquid assets as well as fixed assets, the bank may take one of the following two steps:

1. The depositor may be given an amount decided mutually by the business partners.
2. The depositor may be given only his principal amount in addition to the profit rate announced for the period of 3 months.

At the time of maturity of the business, once the total profit and loss is calculated, the amount that is owed to him by the bank is disbursed. Alternatively, the amount owed to the bank from him is retrieved.

The bank must determine its course of action from the aforementioned options in advance in order to deal with a business partner who wishes to withdraw before maturity.

**Financing With Murabaha**

*What's the typical way of financing using Murabaha?*

A client approaches a bank to enter into a Murabaha agreement to purchase an asset. The bank agrees and promises to sell the asset at its list price and an additional profit. The buyer in turn promises to make installment payments. The bank purchases the asset from a vendor and then sells the asset with the agreed profit in installments (or lump-sum in future). It is imperative that the bank first own the asset before selling to the client. Sometimes clients make the mistake of approaching the bank with an invoice of an asset after the client has already purchased, which would preclude a Murabaha.

**Essential Features Of Murabaha**

*What are the essential features that must be present in a Murabaha transaction?*

In a valid Murabaha transaction, the seller must clearly and unambiguously stipulate the nature, origin and kind of goods to be sold and any other necessary description of the goods that must be mentioned in order to make the contract unambiguous. The amount of benefit accruing to the seller must be mentioned. With regards payment of contract price in installments, what must be specified is a) when each installment would be due, b) the total duration of installments, and c) the amount of each installment.

**Financing Construction Under Murabaha**

*A client approaches a bank with a request to finance the construction of a building over land owned by the client. The bank gets a specified percentage of mark-up as profit. Is such a transaction permissible under Murabaha contract?*

Murabaha is a contract of sale in which the owner of an asset sells the asset to the buyer at a known mark-up. The transaction described does not fall under the category of Murabaha since there is no asset to sell. However, such a transaction may be financed under an Istisna mode of financing.

**Identification Of Sale Asset In Murabaha Contract**

*Is it a condition in a Murabaha contract that the asset be known and identified?*

It is a condition in a Murabaha contract that the asset be known and identified and that its original price and all costs incurred by the original buyer to obtain the asset also be declared.

**Possession Of Goods With Seller In Murabaha Contract**

*Is it necessary for the goods to be in the possession and under the name of the seller in a contract of Murabaha?*

It is necessary for a Murabaha contract to be valid that the goods be in the name of the seller and in the seller's possession as of the date of the contract.

**Murabaha Contract For Foreign Trade**

*What is the correct mode of executing a Murabaha contract for purchase of foreign goods?*

A Murabaha contract for purchase of foreign goods would include the following parties:

- The Islamic Bank ("Bank")
- Bank's client ("Buyer")
- Foreign exporter ("Exporter")

The Murabaha transaction would include the following steps:

1. The buyer requests a Bank to purchase goods from a foreign exporter
2. The bank opens a documentary credit under its own name.
3. The exporter ships the goods to the bank and simultaneously dispatches shipping documents to the bank.
4. The bank, upon receipt of shipping documents, sends them to the buyer against an interim promissory note.
5. The buyer inspects the goods on arrival, and communicates his satisfaction to the bank.
6. The bank pays the exporter.
7. The bank and the buyer execute a sale contract. The buyer signs a promissory note which states the buyer's promise to pay the bank the cost of the goods plus a specified markup. In case of payment in installments, multiple promissory notes may be drawn.
8. The buyer pays the bank on the due date of promissory note.

**Additional Costs Incurred In Murabaha Contract**

*In case additional costs are incurred in procurement of goods under Murabaha contract, who shall be liable to bear such costs?*

It is permissible to stipulate in the contract that any additional expenses incurred in buying and procuring the goods may be added to the purchase cost mentioned in the contract. However, the amount of profit may not be increased.

**Appointing Agent For Receipt Of Goods Bought Under Murabaha**

*Is it permissible for the buyer to appoint an agent to receive goods bought under Murabaha contract on the buyer's behalf?*

It is permissible for the buyer to appoint an agent to act on his behalf.

**Purchase Of Goods For Sale Under Murabaha Before Execution Of Murabaha Contract**

*Is it permissible for a bank to purchase goods requested by a Murabaha client without first executing the Murabaha contract?*

It is necessary for the bank to first contract with its client to ensure the client's commitment to purchase the goods.

**Purchase Of Murabaha Asset**

*If the client acts as an agent in a Murabaha, can the Murabaha asset be purchased by the client before he becomes the agent?*

The Murabaha asset may only be purchased by the client after he becomes the bank's agent. If the asset is bought before, it will be considered a buy-back transaction, which would be prohibited.
In order to ensure that the client as agent makes an actual purchase of the Murabaha goods, the bank must issue a pay order in the supplier's name, receive an invoice from the client confirming the purchase, and carry out a visual inspection of the goods.

**Selling Independently-Bought Goods Under Murabaha**

*Is it permissible to sell goods under Murabaha that were bought before entering into any Murabaha contract with the seller?*

It is not permissible to sell goods under Murabaha that were bought before entering into any Murabaha contract with the seller. Murabaha is a special kind of sale in which the seller is bound to buy and sell the client only those goods that were specifically requested by the client.

**Damage To Goods Bought Under Murabaha Before Delivery To Buyer**

*In case goods bought by a bank under a Murabaha agreement with a client are damaged before delivery to the client, who is liable to make good the loss?*

In case goods bought by a bank under a Murabaha agreement with a client are damaged before delivery to the client, the bank is liable to make good the loss.

**Client's Rejection Of Goods Bought Under Murabaha**

*Is it permissible for a client to reject goods bought by a bank under Murabaha agreement due to a defect in the goods?*

The client may reject such goods, as it is the right of the buyer to reject goods due to a defect in them.

**Delivery Of Goods Bought Under Murabaha To Client**

*What is the preferred mode of delivery of goods bought under Murabaha to the client?*

It is preferable for the bank to have its own storage space where the goods are stored up until they are delivered to the client. However, in the absence of such a facility, it is permissible for the bank to request the client to collect the goods from where the bank purchased them under an agency agreement.

**Down Payment To Bank In Murabaha Contract**

*Is it permissible for a bank to request the client for a down payment in a contract of Murabaha?*

A down payment from the client to the bank is permissible in a Murabaha contract. In case of default by the client in purchasing goods, the bank is entitled to deduct the value of actual damage incurred as a result of the default.

**Liability Of Bank As Regards Goods To Be Sold Under Murabaha**

*At what stage does the liability of the bank as regards goods to be sold under a Murabaha contract end?*

The liability of the bank as regards goods to be sold under a Murabaha contract ends once the goods are delivered to the client. In case of imported goods, the bank's liability ends once the goods arrive at the port and the client receives the shipping documents.

**Responsibility Of Bank As Regards Purchase Of Goods Under Murabaha**

*What is the responsibility of the bank as regards purchase of goods under Murabaha?*

The bank is bound to acquire the goods exactly as requested by the buyer. Due care and precaution should be exercised in buying the goods. The bank should obtain multiple quotations in order to obtain the best possible offer.

**Delivery Of Goods To Client In Installments**

*Is it permissible for a bank to deliver to its client in phases the goods bought under a Murabaha agreement?*

Both parties to the Murabaha agreement may mutually agree as to the mode and phasing of delivery of goods. In such a case, if the delivery of goods will be complete in a short period of time, there shall be no need to draft a separate contract upon each delivery.

**Goods Imported Under Murabaha Delivered In Installments**

*In case goods imported in a Murabaha contract are delivered in installments, is one Murabaha contract sufficient for the arrival of each installment?*

In such a case, separate Murabaha contracts should be drafted for each installment date.

**Delivery Of Imported Goods To Client Without Shipping Documents**

*In case goods imported by a bank under a Murabaha agreement are delivered before the shipping documents, is it permissible for the bank to deliver the goods to its client?*

It is permissible for the bank to deliver the imported goods bought under a Murabaha agreement to the client in case they arrive before the shipping documents. In such a case, the bank is required to issue a customs clearance certificate to the client. In order for the issue of such a certificate to be valid, the following conditions should be met:

- The documentary credit should be in the name of the bank.
- The invoice should be in the name of the bank.
- The documentary credit should require the beneficiary to notify the bank of the details of the shipment and invoice.
- In case the client requests the issuance of customs clearance certificates while the bank has not received notification from the beneficiary, the bank will endeavor to obtain such notification. The customs clearance certificate should not be issued before the receipt of such notification, except to avoid imminent harm.

Furthermore, it is permissible in such a case to change the mode of sale from Murabaha to a bargaining sale. Since documents have not arrived and cost is not decisively known, both parties may bargain to a suitable price.

**Conversion Rate In Case Of Imported Goods**

*In case of goods imported by a bank under a Murabaha agreement, which currency conversion rate should be used to determine the contract price?*

In case of goods imported under a Murabaha, the bank should use the conversion rate prevailing on the day of purchase from the exporter.

**Importing Goods On Basis Of Quotation Addressed To Buyer**

*Is it permissible for a bank to import goods under Murabaha agreement based on a quotation issued under the name of the client?*

It is permissible for the bank to import goods under a Murabaha agreement based on a quotation issued under the name of the client. However, it is preferable that the quotation be addressed to the bank.

**LC For Import Of Goods Opened In Name Of Client**

*In case of import of goods under Murabaha agreement, is it permissible for the documentary credit to bear the name of the client along with the bank, or the client's name alone?*

In general, it does not affect the validity of the Murabaha transaction if the documentary credit mentions the client as the co-importer or sole importer. However, this is against the essence of the Murabaha transaction and should be strictly avoided.

**Charging Of Murabaha Price Before Delivery Of Goods**

*Is it permissible for the seller to charge the contract price from the buyer—either in whole or in installments—before delivery of goods under a Murabaha?*

It is not permissible to charge from the buyer any portion of the price until the goods have been delivered.

**Invoice For Purchase Of Goods Under Murabaha Issued In The Name Of The Client**

*What is the status of a Murabaha contract where the bank purchases the goods requested but the payment invoice received by the bank, instead of being addressed to the bank, bears the name of the client?*

In a Murabaha contract, the bank purchases goods requested and sells them to the buyer. It is an integral of the contract that the bank purchases such goods, and the invoice bearing the name of the bank is the only documentary evidence the bank possesses of such purchase. Therefore, in case the invoices do not bear the name of the bank, they should be returned, and the goods should not be delivered to the client until the bank receives revised invoices bearing its name.

**Murabaha As A Sale Of Unpossessed Items**

*Some people declare Murabaha to be invalid based on the opinion that it is a sale of unpossessed items. What is the correct opinion?*

A Murabaha is not a sale of an unpossessed item because the contract of sale with the buyer is only concluded once the actual possession and ownership has been transferred to the buyer.

**Importing Goods In Name Of Buyer In Murabaha Contract**

*A bank orders goods from abroad in pursuance of a Murabaha transaction. The exporter sends the goods in the name of the bank's client (promising buyer). Is this valid?*

A Murabaha transaction is one in which the seller buys goods requested by the buyer and sells them to the buyer at a cost plus an agreed upon mark-up. It is necessary that the goods be dispatched or shipped in the name of the bank, as this is an integral of the contract and the only documentary evidence that proves that the seller (bank) actually bought the goods itself.
In such a case, all issued contracts or procedures entered into between the bank's client and the exporter should be cancelled, and a new transaction should be initiated between the exporter and the bank.

**Procedures To Be Adopted By Bank To Ensure Valid Murabaha Transaction**

*What are the essential procedures that must be adopted by a bank to ensure the validity and substance of its Murabaha transactions?*

A Murabaha is a permissible mode of financing in the Shariah. However, it is often misused, such that, in substance, it takes the form of conventional financing. In order to ensure a valid and substantial Murabaha transaction that conforms to the spirit of the Shariah, the bank should, at the very least, undertake to carry out the following procedures:

1. Purchase goods in its own name or through an agent.
2. Pay the price of goods directly to the seller, without the involvement of the client.
3. Receive the goods and place them in its custody before transferring to client.
4. Keep in its possession all relevant documentation that proves purchase in its own name and attach them to the Murabaha contract.

In addition to the above, the bank should ensure that the staff dealing with Murabaha clients is suitably trained in the above procedures.

**Murabaha Contract Bound By Time**

*Is it permissible to set a time period for a Murabaha sale contract made with a promising buyer?*

It is permissible to set a time period for a Murabaha sale contract made with a promising buyer if agreed upon by both parties.

**Seller's Amendment Of Murabaha Contract Without Approval Of Buyer**

*Is it permissible to include a clause in a Murabaha contract where the seller has the authority to amend all conditions mentioned in the contract—including profit ratios—without recourse to the buyer?*

It is impermissible to unilaterally amend a Murabaha contract. Any amendment made must be with the full knowledge and approval of both parties to the contract. Therefore, the profit ratios may be changed in the future but only with the consent of the buyer.

**Murabaha Transaction In Foreign Currency**

*Is it permissible to execute a Murabaha transaction in a foreign currency? Furthermore, is it permissible for the invoices of the purchase of goods by the seller to be in a foreign currency?*

It is permissible to execute a Murabaha transaction in a foreign currency. It should be converted to the local currency on the date of purchase of goods from the exporter. It is also permissible that the purchase invoices are in a foreign currency.

**Accounting For Foreign Currency Fluctuations For Payment Of Murabaha Contract**

*How should the seller account for foreign currency rate fluctuations that take place throughout a day, for the purpose of making payment to the exporter for goods ordered from abroad?*

Foreign currency should be converted to the local base currency on the date of purchase of goods from the exporter. As for the fluctuations in foreign currency exchange rates, one should apply the rates being used by local banks in dealing in documentary credits with their clients on that particular day.

**Expenses To Be Included In Cost Of Goods Purchased For Murabaha Transaction**

*What expenses may be added to the cost of goods purchased by the seller in pursuance of a Murabaha contract? Can staff salaries be added to the cost?*

The cost of goods sold in a Murabaha contract should only be increased by expenses that directly relate to those goods and contribute to the value of the goods. Staff salaries and other general and administrative expenses may not be added to the cost of goods.

**Customs Clearing Agent Salary Accounted For In Cost Of Goods**

*Is it permissible to add the salary of customs clearing agents in the cost of goods purchased in pursuance of a Murabaha contract?*

With regards to customs clearing agents working for the seller in a foreign country in order to facilitate the import of goods by the seller, all money paid to them may be added to the cost of goods. However, if such agents are part of the seller's staff, only that portion of money paid to them for clearance of the specified goods may be added to the cost.

**Determining Price Of Murabaha Contract**

*What factors should the seller consider in determining the price of a Murabaha contract?*

The Murabaha price is mutually agreed upon between the parties to the contract. The seller should honestly state the cost incurred in purchasing and acquiring the goods and should propose a fair profit margin that the buyer agrees to.

**Increasing Profit Rate In Return For Advance Payment To Exporter**

*Is it permissible for the seller in a Murabaha contract to increase the profit rate in consideration of making an advance payment to the foreign exporter for purchase of goods?*

The profit margin in a Murabaha contract is decided on the basis of mutual agreement and the Shariah has not prescribed any limits barring artificial intervention.

**Commission From Foreign Bank In Consideration Of Opening LC**

*A bank executing a purchase under a Murabaha contract opens documentary credit in a foreign bank and receives a commission. Should such a commission be given to the client or is the bank entitled to keep it?*

The bank should, first of all, notify the client of such a commission. If it is agreed with the client that the bank is entitled to receive the commission, the amount of commission is deducted from the principal amount per the provisions of the Murabaha contract. If the receipt of the commission is not declared by the bank, then the commission will be held to be the client's property.

**Adding Bank's Inter-Departmental Commission To Cost Of Murabaha**

*Is it permissible to add to the cost of the Murabaha commissions levied by one department of a bank on another department of the same bank?*

It is not permissible to add inter-departmental bank commissions to the cost of goods in a Murabaha contract. Such a commission is not considered to be an additional direct expense.

**Decreasing Price Of Murabaha By Insurance Compensation Received**

*In the event of damage to goods under a Murabaha contract, is it necessary to decrease the price of the contract by the amount of insurance compensation received? Will it suffice to hand over the compensation amount to the client without decreasing the price?*

It is obligatory to decrease the price of a Murabaha contract by the amount of any insurance compensation received in lieu of damage to the goods. Changes in price that take place subsequent to the Murabaha contract should be immediately notified to the client. It is not sufficient to hand over the compensation amount to the client without decreasing the price.

**Decreasing Murabaha Price By Discount Received By Seller**

*In case the seller receives a discount in goods purchased in pursuance of a Murabaha contract, is the Murabaha price decreased by the value of the discount?*

Any discount earned by the seller in the course of buying and acquiring goods to be sold under a Murabaha should be netted off from the cost of goods. The discounted price is considered the base price.

**Including Insurance Charges To Cost Of Goods Under Murabaha**

*Is it permissible to include insurance expenses to the cost of goods being sold under a Murabaha?*

It is permissible to include insurance expenses to the cost of goods being sold under a Murabaha. However, the insurance expense is not considered when calculating profit.

**Murabaha Sale Of Goods Not Bought By Seller**

*A client approaches a bank and requests it to finance under a Murabaha contract goods bought by the client itself. The bank should pay the price of goods according to the invoice submitted by the client and charge the same to the client along with a profit margin. Is such a transaction permissible?*

The described transaction is not a valid Murabaha transaction and, furthermore, is unlawful in the Shariah. A Murabaha entails selling a particular commodity that the seller owns, disclosing its cost and adding a profit margin mutually agreed upon by both parties. A Murabaha is not valid for goods that have neither been bought nor received by the seller nor are in his possession.

**Ownership Of Goods To Be Sold Under Murabaha**

*Is it necessary for the seller in a Murabaha contract to have personally seen or received the goods, or have them stored at a location other than the site of sale?*

It is a necessary condition that the seller have legally enforceable possession of the goods, even if it is constructive possession.

**Importing Goods Under Special Permission To Be Sold Under Murabaha**

*Is it permissible to sell such goods under Murabaha that are not generally allowed for import but special permission has been granted from the government to a promising buyer to import?*

It is permissible to import goods to be sold on Murabaha the import of which is generally restricted but has specifically been permitted by the authorities for the promising buyer. However, care should be taken to ensure that all conditions and integrals of a Murabaha are fulfilled.

**Insurance Cover On Goods Ordered Under Murabaha**

*Is it permissible for a bank acquiring goods as a seller in a Murabaha to obtain insurance cover on such goods?*

It is permissible to obtain insurance cover on goods to be sold under Murabaha, though it is not necessary in the Shariah. However, if the applicable laws and regulations make it mandatory to insure the goods, the bank should comply accordingly. It should be noted that irrespective of whether insurance cover has been obtained or not, the bank (seller) is responsible for any damage to the goods prior to delivery to the buyer.

**Murabaha Sale Of Commodity Owned By Promising Buyer**

*Is it permissible for a bank to contract a Murabaha in order to sell the client goods that are owned by the client himself?*

A Murabaha is a sale in which the seller sells goods owned by himself at a known cost plus profit. The transaction described in the question is not a valid Murabaha transaction. Furthermore, the said transaction is not valid in Shariah under any mode of financing, since it involves buying and selling for oneself, which is forbidden. It is among the essentials of a valid contract that there be two distinct and separate persons who transact in terms of offer and acceptance.

**Guarantee By Buyer For Goods Imported By Seller Under Murabaha**

*In case of goods being imported by a bank for sale under Murabaha, is it permissible for the promising buyer (client) to guarantee the imported goods?*

In general, the bank—who is the buyer of the goods—should accept responsibility and liability for the goods and ensure their safe arrival. However, there are a number of limitations a bank may face, such as inability to deal with defects and shortages in goods and correspondence with exporters with whom the bank is not acquainted.

In view of such limitations, it has been held permissible for the buyer to act as guarantor for goods being acquired by the seller. However, such contracts of guarantee are completely independent and separate from the Murabaha contract. The guarantee given by the client would cover defects in goods, shortages in quantity of goods and any irregularity affecting the value of goods. In the event of any of the aforementioned, the bank may claim its entitlements from either the exporter or client.

However, in instances where the client is willing to absolve the bank of all liabilities resulting from the purchase, it may be prudent to execute the transaction under a different mode of financing, such as a Musharakah or Mudarabah.

**Selling Impermissible Items Under Murabaha**

*Is it permissible to sell goods under Murabaha that are impermissible in Shariah?*

It is not permissible to trade in anything that is impermissible in Shariah—be it under Murabaha or any other mode.

**Deferring Payment Of Goods Bought To Be Sold Under Murabaha**

*Is it permissible for the bank to defer payment to the seller of the goods until such goods have been delivered to the buyer?*

It is permissible for the bank to defer payment until goods have been received and approved by the buyer. However, this is contingent upon the fact that the sale contract between the bank and the seller has been concluded.

**Storage Charges Of Goods As Part Of Cost**

*Is it permissible to add storage charges to the cost of goods being sold under a Murabaha?*

It is permissible to add storage charges incurred to the cost of goods.

**Floating Murabaha Installments Based On Market Price Of Goods**

*Is it permissible to benchmark Murabaha installments on the market price of the goods prevailing at the due date of each installment?*

It is not permissible to benchmark Murabaha installments on the current market price of goods. A Murabaha is a sale of goods in which the cost and profit is unambiguously decided at the time of contract.

**Ambiguity In Identity Of Buyer**

*Is it permissible for the buyer of property under a Murabaha to request that the sold property be registered at a later date either in his name or any person nominated by the client?*

It is a condition of a sale contract that the buyer be unambiguously specified. Therefore, such a request is not valid and it is necessary to demand that the identity of the buyer be disclosed at the time of contracting. Moreover, registration of a property in the name of the buyer should be carried out at the time of execution of the sale contract.

**Seller's Ignorance Of Goods' Specifications**

*Is it permissible to undertake a Murabaha transaction if the seller is not fully aware of the specifications of goods to be acquired and sold?*

Goods should be thoroughly and unambiguously described in the contract of Murabaha. This should make the seller fully aware of what is to be sold. In case of any discrepancy in the goods, the buyer under Murabaha has the option to reject the goods and recover any amount paid.

**Selling Air Tickets Under Murabaha**

*Is it permissible to sell air tickets under a Murabaha contract?*

It is permissible to sell air tickets under a Murabaha contract. It is best, however, to seek a Shariah opinion on the specific contract before its execution.

**Deficiency In Goods Discovered Subsequent To Murabaha Contract**

*In case some defect is discovered in goods to be sold under a Murabaha subsequent to signing the Murabaha contract, who is liable to make good the loss?*

Any defect discovered in the goods is the liability of the seller. It is of no consequence if such defect is discovered subsequent to signing the Murabaha contract.

**Selling Damaged Goods Under Murabaha**

*Is it permissible to sell goods under a Murabaha that were damaged in transit, considering such damage is disclosed to the promising buyer?*

It is permissible to sell all permissible goods under Murabaha, provided that both parties to the contract agree upon the terms and the contract is lawful in the Shariah.

**Goods Bought For Own Use Being Sold As Murabaha**

*Is it permissible to sell under Murabaha goods that were bought for one's own use?*

It is permissible to sell such goods under a Murabaha. The intention at the time of purchase does not affect the validity of the Murabaha contract.

**Advance Payments Of Murabaha Installments**

*Is it permissible to make advance payments of Murabaha installments?*

It is permissible for the seller to accept advance payments of Murabaha installments. It is further permissible to reduce one's profit in consideration of receiving such advance payments; however, this may not be stipulated or implied as a condition.

**Discount On Advance Payment Of Murabaha Installments**

*Is it permissible for the seller to give a discount to the buyer on advance payments of Murabaha installments?*

A discount on advance payments is permissible. However, this is left at the sole discretion of the creditor (i.e. seller). It is not permissible to bind the seller into giving a discount. Therefore, such a discount may not be stipulated or implied either orally or in writing. At the same time, there is no harm in the seller forming a policy whereby one gives a discount upon early payment and makes such a policy known to all customers.

**Penalty On Promising Buyer For Default In Purchase Of Goods**

*Is it permissible to impose a penalty on the promising buyer if he defaults in purchasing the goods he ordered?*

Such a penalty is not permissible as it falls within the definition of riba. Instead, the bank may choose to sell the goods to another buyer, and recover from the promising buyer any expenses and depreciation in value of goods caused by his default.

**Murabaha Installments In Foreign Currency**

*Is it permissible to stipulate that Murabaha installments be payable in foreign currency at the rate prevailing on the due date, in consideration of the fact that the bank has to pay for such goods in installments in foreign currency?*

It is a condition for the validity of a contract that the contract price be known to both parties. In such a case, both the seller and buyer do not know the contract price, as it is contingent upon the currency rate prevailing in the future. Due to this and other ambiguities, such an arrangement is not permissible in the Shariah and should be avoided. Permissible alternatives to such a transaction would be:

- Executing and concluding Murabaha transactions in foreign currency. Foreign currency would be converted to the local currency on the date of purchase of goods from the exporter.

- To convert a Murabaha sale into a simple bargaining sale, where the bank estimates a price and enters into a contract with the customer based on this price. Later, this price can be changed with mutual consent of both contracting parties.

**Increased Profit Rate For Past Defaulters**

*Is it permissible to increase one's profit rate on Murabaha transactions when dealing with past defaulters?*

It is permissible in the Shariah to charge different profit rates from different customers. The profit rate is a matter of mutual consent between the parties and may be decided and changed on a case-by-case basis.

**Confiscating Earnest Money Upon Default**

*Is it permissible to confiscate earnest money received if the promising buyer defaults in purchasing goods?*

It is permissible to confiscate earnest money in such a situation, provided that this was mentioned in the Murabaha contract.

**Selling Asset To Insolvent Client**

*In a Murabaha transaction, is the seller obliged to sell the asset to a client who, after promising to purchase, becomes insolvent?*

In case the seller comes to know of a client's insolvency before delivery of the asset he has the right to withhold delivery.

**Amending Murabaha Contract**

*Is it permissible to amend Murabaha contracts before the conclusion of the sale?*

It is permissible in the Shariah to amend the Murabaha contract prior to its execution with the consent of both parties. However, unilateral amendment is not permissible for either party.

**Payment By Promising Buyer At The Time Of Promise**

*Is it permissible for the seller to accept part of the Murabaha contract price from the promising buyer at the time of making a promise to purchase?*

It is permissible to make a part payment at the time of the promise. However, in case the transaction of sale is not concluded, such an amount must be returned in full to the promising buyer.

**Profit Recognition In Murabaha**

*For accounting purposes, how is profit recognized in a Murabaha transaction?*

Since Murabaha is a cost-plus sale, profits are measurable and known at the contract date. Therefore, it is permissible to accrue the total amount of profit from a transaction on the date on which the Murabaha contract was executed.

**Profit On Murabaha Contract Linked To Time**

*Is it permissible to make the profit on Murabaha contracts contingent upon the time the customer takes to make payment?*

It is impermissible to link profit to time. Profit is part of the Murabaha price and cannot be separated over time. It is permissible to take into consideration the time a particular client takes to make payment for future dealings with that client.

**Deferring Profit Determination Until Delivery Date In Murabaha**

*Is it permissible to enter into a Murabaha contract where the determination of profit is deferred until the date of delivery of the goods?*

It is impermissible to defer profit determination in Murabaha contracts until the date of delivery.

**Increasing Profit Margin Due To Late Purchase By Promising Buyer**

*In case the promising buyer unilaterally extends the date for the purchase of the goods from the bank, is it permissible for the bank to increase the profit rate in consideration for this late purchase?*

It is not permissible for the bank to increase the profit margin if the promising buyer unilaterally postpones the purchase. The bank should take measures to ensure that the client purchases the goods on the date agreed-upon, since the promise to purchase is considered binding.

**Participating In Profits Of Murabaha Client**

*Is it permissible to share in the business profits of a client who has been sold goods under a Murabaha?*

It is impermissible to receive any share of the profits of a Murabaha client and it is not permissible to add any such clause in a Murabaha contract.

**Appointment Of Guarantor In Murabaha Sale**

*Is it permissible to appoint a guarantor in a Murabaha sale?*

It is permissible to appoint a guarantor in a Murabaha sale on credit. The guarantor should be provided a letter which stipulates that guarantees should not be evoked except upon default of the party. The bank should always exercise prudence and caution in evoking a guarantee and should consider it a last resort.

**Post-Dated Cheques For Murabaha Installments**

*Is it permissible for the buyer to submit post-dated cheques for Murabaha installments?*

It is permissible for the buyer to submit post-dated cheques for Murabaha installments.

**Murabaha Transaction With An Interest-Based Bank**

*Is it permissible to enter into a Murabaha transaction with an interest-based bank on behalf of their client?*

Such a transaction is permissible in principle. However, in practical execution, there are a number of Shariah considerations involved. Therefore, it is strongly advised that any such contract be vetted by a competent Shariah advisor or Shariah board.

**Appointment Of Shipping Company As Agent To Receive Goods**

*Is it permissible for a bank to appoint a shipping company as its agent to receive imported goods that are to be sold under a Murabaha?*

It is permissible in the Shariah for a bank to appoint a shipping company as its agent to receive imported goods that are to be sold under a Murabaha.

**Title Deed Issued In Name Of Promising Buyer**

*In the case of an item to be sold under a Murabaha, is it permissible to issue the title deed in the name of the promising buyer?*

It is not permissible to issue the title deed in the name of the promising buyer. The title deed is proof of ownership and should be in the name of the present owner.

**Appointment Of Bank As Agent On Behalf Of Client**

*Is it permissible for a bank's client to authorize the bank or an employee of the bank as an agent to conclude a Murabaha transaction?*

It is permissible for a bank's client to grant agency to the bank or any of its employees to conclude a Murabaha transaction between the bank and such client.

**Commission To Murabaha Client In Event Of Agency**

*In case a bank's client under a Murabaha is also its trade agent, may the bank pay agency commissions to clients in cash and add such commissions to the value of goods for profit calculation?*

In such an event, the bank may pay its client agency commission in cash and add its value to the price of goods to be sold. The profit of the contract may be calculated on the price of goods either inclusive or exclusive of such commission.

**Buying Goods Under Murabaha From Lessee**

*Is it permissible for a lessor to buy goods from a lessee under a Murabaha, with a bank as an intermediary?*

Such a transaction is permissible in principle. However, it should be verified that the lessee is the actual owner of the goods being sold and that the actual transfer of goods takes place. Due to the sensitivity of such a transaction, it is strongly recommended that a Shariah opinion be sought on the actual contract in question.

**Unregistered Property Sold Under Murabaha**

*A bank purchases an asset which is required to be registered with the government. Before such registration is completed, a client approaches the bank to buy such an asset under Murabaha. May the bank sell the asset even though it is not registered?*

It is permissible to sell the asset in such a circumstance. The buyer may get the asset registered directly in his own name. However, it is imperative that the title of such an asset be in the name of the bank.

**Financing Concluded Deal Between Client And Owner Of Goods**

*Is it permissible for a bank to finance a concluded deal between a client and a third-party (owner of goods) under a Murabaha?*

Such a transaction is impermissible since it would amount to interest-based financing. For a Murabaha to be valid, it is necessary that the bank acquires and takes possession of goods and subsequently resells them to a client at cost plus profit.

**Promising Buyer Having Previous Contract With Owner Of Goods**

*A client approaches a bank to purchase goods under Murabaha. However, the client has a previous contract of purchase with the owner of the goods. May such a contract be unilaterally terminated by the client in order to proceed with the Murabaha contract?*

Dealing with a client who has a previous contract with the owner of the goods depends on the nature of such a previous contract. If the contract is a general agreement and does not cover a specific transaction, then a Murabaha may be entered into. If, however, the contract is for a specific transaction, then this contract should be terminated before entering into a Murabaha transaction. As proof of termination, the client should provide the bank written evidence indicating that the client and owner of the goods have terminated their previous contract.

**Return Or Replacement Of Goods Sold Under Murabaha**

*In a Murabaha transaction, is it permissible for the buyer under the Murabaha (client) and the owner of the goods to agree that the buyer will return the goods or have them replaced in case they are not sold?*

It is permissible for the buyer and owner of goods to enter into such an agreement, as it is independent from the Murabaha transaction. Such a contract has no relation to the seller under a Murabaha.

**Collusion Between Buyer And Owner Of Goods In A Murabaha**

*A client approaches a bank to buy goods under a Murabaha. The buyer agrees to buy the goods at a price less than the market value. At the same time, the buyer contacts the owner of goods and promises to pay the difference between the sale price and market price. Is such a transaction permissible?*

The transaction described in the question is not permissible, as it amounts to an interest-based financing by the bank. If the bank becomes aware of such an agreement between the client and owner of goods, it should refuse to provide financing.

**Earnest Money Paid By Client To Owner Of Goods**

*Is it permissible to enter into a Murabaha transaction with a client who has paid earnest money to the original owner of the goods?*

It is impermissible to contract a Murabaha transaction with a client who has paid earnest money to the owner of the goods. It is necessary that all previous contractual relations of the client with the owner of the goods be extinguished before entering into a Murabaha transaction. The bank must demand proof of cancellation of the contract, which amounts to a letter of termination and return of earnest money.

**Shipment Of Goods In Name Of Promising Buyer**

*In case of an import Murabaha transaction, is it permissible that goods be shipped in the name of the promising buyer?*

It is not permissible for goods to be shipped in the name of the promising buyer. This would render the Murabaha transaction a mere interest-based financing. In case of such an event, the existing

transaction should be terminated and a new contract should be entered into between seller and owner of goods.

**Selling Endowments (Waqf) Under Murabaha**

*Is it permissible to sell endowments (Waqf) under Murabaha?*

It is not permissible to sell endowments in the Shariah since they are not owned by any specific person, and for a sale to be valid a seller must be unambiguously identified.

**Financing Labor Cost Under Murabaha**

*Is it permissible to finance labor cost under Murabaha?*

It is impermissible to finance the cost of labor under a Murabaha. For such a financing, other permissible methods such as a Musharakah or a Mudarabah may be used.

**Profit Rate Contingent Upon Repayment Period**

*Is it permissible to make the profit rate in a Murabaha contract contingent upon the period of repayment?*

It is permissible to make profit contingent upon the repayment period. However, the amount of profit should be decided at the time of contracting. In other words, this entails that, at the time of contracting, the client be given an option of different repayment periods, each with different profit rates from which the client may select one.

**Profit Distribution In Event Of Cancellation Of Murabaha**

*In the case of a cancellation of a Murabaha contract and return of a sold asset to the bank, is the bank entitled to the profits accrued for the period before cancellation?*

It is permissible for the bank to retain profits accrued for the period up to the cancellation of the Murabaha contract.

**Murabaha Subject Matter Prerequisites**

*What are the prerequisites for the subject matter of a Murabaha?*

The subject matter of the Murabaha must meet the following conditions:

- The subject matter must exist. An asset that does not yet exist cannot be sold, as it would involve the element of uncertainty leading to dispute between contracting parties.
- The subject matter should be owned by the seller.
- The subject matter must be in the physical or constructive possession of the seller.

**Constructive Possession In Import Murabaha**

*When does constructive possession take place in an import Murabaha?*

In an import Murabaha when the bill of lading is received the party having received it is considered to have constructive possession of the goods.

**Price Of Murabaha**

*What are the factors that need to be considered in determining the price of a Murabaha?*

The following factors must be taken into consideration in determining the price of a Murabaha:

- The price must be established as a lump sum or determined in addition to a percentage.
- The price of the asset of a Murabaha may be paid at spot or its payment may be deferred.
- For a deferred Murabaha, the dates for installments must be fixed.
- The price of the Murabaha may not be decreased or increased based on an early or a late payment by the client.
- It is not permissible to allow the price of a Murabaha to fluctuate on the basis of changes in market rates. Once a price is fixed, it cannot be changed. At the time of signing the master financing agreement, a formula for pricing may be developed. At the time of the exchange of the offer and acceptance, the price may be fixed based on this formula. A new formula cannot be made at this point.
- The cost of the asset, namely the direct expenses involved in acquiring it and the profit to be earned from it must be taken into consideration while establishing the price.

**Insignificant Damage In Murabaha**

*In the event that the value of the damage to some Murabaha goods is insignificant, is it necessary for the bank to deduct the amount of damage from the price or is it sufficient to pay the purchase*

*pledger the amount of recompense received from the Takaful company?*

If credit is extended for a Murabaha deal, then it is necessary to deduct the amount of damage however insignificant, from the price in addition to paying the purchase pledger the amount of recompense received from the insurance company. This is because a Murabaha is a sale of trust and the client must be informed of any change in price.

**Limitations Of Rebate In Murabaha**

*Is it permissible to grant a rebate in a Murabaha?*

The bank may grant a client a rebate on the price of the Murabaha at its own discretion. However, this cannot be made a practice, stipulated as a condition within the contract or even demanded by the client. In order to avoid mishandling, rebates are generally disallowed. Nevertheless, under certain unavoidable circumstances a special dispensation may be requested from a qualified Shariah scholar.

**Investment Stage In Murabaha**

*What is the investment stage in a Murabaha?*

This is the stage that begins after signing the agency agreement. It is the time period during which the bank disburses the money for purchasing the asset from the supplier but has not yet acquired possession of it in order to sell it. The money disbursed at this stage is referred to as the advance against Murabaha. A profit will not accrue on this amount until the goods are received and handed over to the client.

**Financing Stage In Murabaha**

*What is the financing stage in a Murabaha?*

From the time that the goods are received and the document of the offer and acceptance is signed, until the Murabaha price is recovered from the client, is referred to as the financing stage. It is during this period that the bank has the right to accrue profit.

**Bank's Liabilities Before Murabaha Asset Sale To Customer**

*What are the liabilities of the bank in a Murabaha contract before the asset is sold to the customer?*

Once the bank takes constructive possession of the asset in a Murabaha contract, the bank assumes all the rights and responsibilities pursuant to ownership of the asset.

**Murabaha Application**

*What is the Murabaha mostly used for?*

Murabahas are used for everything from auto finance to home finance. Generally, they are more suited to short term financings because the repayment schedule is not changeable.

**Murabaha Asset Sales Tax**

*Is the bank liable to pay sales tax as the Murabaha asset's seller?*

In a Murabaha the bank sells the object of sale for its initial price plus a profit, or the initial price plus any expenses plus the profit. In either case the contract is valid with a condition that the bank informs the client of the breakdown that they are using.

**Murabaha Agency**

*Is the client entitled to remuneration as Murabaha agent?*

If the client agrees to do it for nothing, he is not entitled to anything. However, banks usually give the client a small nominal fee for acting as agent so that the agency contract is binding. If the agent does not receive a stated remuneration in the contract, he is not obliged to carry out his part (i.e. he can unilaterally cancel the agency contract. If he receives any remuneration, even if only nominal, the contract is binding).

**Security In A Murabaha**

*What form of security is permitted in a Murabaha?*

According to AAOIFI Shariah Standard 8 (Murabaha), Clause 5: "The institution should ask the customer to provide lawful security…the institution may receive a third party guarantee or the pledge of the investment account of the customer or the pledge of any item of real or moveable

property…" Sections 5/2, 5/3, and other sections in clause 5 provide further detail on the terms and conditions associated with securing a Murabaha which we recommend that you read.

**Down Payment For Murabaha**

*Is it permissible for the buyer in a Murabaha to contribute a down payment towards the purchase price? If so, should he pay it to the bank or to the supplier or is it permissible to do either?*

It is permissible for the buyer in a Murabaha to make a down payment towards the purchase price of the asset. Payment may be made either to the bank or directly to the supplier on behalf of the bank (i.e. as an agent to the bank) depending on how the Murabaha is structured.

**Murabaha Asset As Security**

*Mortgaging is impermissible, however, in the example of a Murabaha home financing, is it correct that the bank sells the house to the client, the sale is concluded, the debt remains outstanding and the house serves as security to the bank? If the debt is not repaid, the bank would have recourse to the asset, sell it and make up for the remaining outstanding debt?*

AAOIFI, the most widely followed Islamic finance standard in the world, provides detail on this question in its Shariah standard on Murabaha. The following is excerpted from standard 5/4 in the Murabaha section. Other parts of the standard, in particular those in section 5, should also be consulted for particulars on charity clauses, pledges, guarantees, and other risk mitigants: "It is not permissible to stipulate that the ownership of the item will not be transferred to the customer until the full payment of the selling price. However, it is permissible to postpone the registration of the asset in the customer's name as a guarantee of the full payment of the selling price. The institution may receive authority from the customer to sell the asset in case the customer delays payment of the selling price, in which case the institution should issue a counter deed to the customer to establish the latter's right to ownership. If the institution sells the asset as a result of the customer's failure to make a payment of the selling price on its due date, it must confine itself to recovering the amount due to it and must return the balance to the customer."

**Murabaha Security**

*In case of default, when the financial institution sells the asset to recover the amount due to it and there is no balance to return to the customer (as a result of a decrease in the value of the house) wouldn't the customer's payment prior to default have been for nothing in return?*

Typically, a Murabaha is used for short-term financings while for long-term financings Ijarah, Musharakah, and other structures are used. You may be getting confused with ownership. After the

Murabaha is executed, the debt is owed but the customer is now the owner of the property. So the bank would not be able to seize and sell the house all things equal.

**Murabaha Security Deposit**

*What is the difference between Arbun and Haamish Jiddiah?*

Arbun refers to a down payment and Hamish Jiddiah refers to a collateral. Both are permissible to ask the client to provide in a Murabaha. In the case of Arbun, the down payment may be used toward the purchase of the good, and if the purchase is cancelled, part of the down payment may be used for the institution to recoup direct and actual costs associated with the transaction according to the guidelines outlined in AAOIFI's standard on Murabaha.

**Purchasing Murabaha Goods**

*Is it permissible to purchase Murabaha goods after the acceptance of the purchase requisition and before the signing of the Master Murabaha Agreement?*

The Master Murabaha Agreement contains the general terms and conditions of the transaction. There is a high risk that in the absence of a signed agreement there is no legal recourse in the event of an exigency.

**Master Murabaha Facility Agreement**

*Does the sample MMFA assume the bank already has the goods?*

If what is meant is the Agreement available at https://ethica.institute, in section 2.01 it says "Upon receipt by the Institution of the Client's Purchase Requisition advising the Institution to purchase the Goods and making payment therefore, the Institution shall acquire the Goods either directly or through the Agent." This shows that the Agreement does not assume the bank already possesses the goods.

**Assigning Ownership Of Murabaha Goods**

*Is it permissible for the bank to assign the ownership of Murabaha goods to the client before the exchange of offer and acceptance in order to avoid double taxation?*

One should have a scholar look at the documentation for the specific transaction to ensure that it is AAOIFI-compliant and one should also ensure that it is legal for the jurisdiction, however, in general, it is permissible for the bank to assign the name either to itself or to the client in order to avoid double taxation provided that the exchange of offer and acceptance/Murabaha sale afterwards takes place between the bank and the client not in the latter's capacity as bank's agent but as customer/buyer of Murabaha goods.

# MUSAWAMAH

**Definition Of Musawamah**

*What is a Musawamah?*

A Musawamah is an ordinary transaction of sale in which neither the cost of acquiring the asset nor the profit to be earned from it are disclosed to the client. The asset is sold based on the payment of a lump sum price.

# MUSHARAKAH

**Definintion Of Musharakah**

*What is a Musharakah?*

A Musharakah is the partnership of two or more individuals engaged in the rights and ownership of an asset or a service. It is a business partnership set up to make profit, where all partners contribute capital and effort to run the business.

There are two types of Musharakah partnerships: *Shirkat ul Haq* and *Shirkat ul Ayn*. *Shirkat ul Haq* is the partnership of individuals in sharing the benefits of an asset and *Shirkat ul Ayn* is a partnership between individuals for the purpose of property ownership. There are two types of Shirkat ul Ayn:

1. *Shirkat ul Milk* refers to participating in the ownership of property that is consumed or is meant for individual use. It begins in one of two ways: either by the compulsion of law, as in the case of inheritance, in which the legal heirs of the deceased are the joint owners of the property; or by the willful act of the partners, as in the case of most financings.
2. *Shirkat ul Aqd* is a partnership for the purpose of a joint venture of trade. In addition to the above it is also important to note the following: It is only permissible to execute a Musharakah with a client once his credit worthiness is established.This credit worthiness is determined by the credit assessment department of the bank and serves to mitigate credit risk. This is a key aspect of a partnership because one partner cannot guarantee the principal or the profit of another partner in a Musharakah.

**Musharakah: Partnership Financing**

*What is a Musharakah agreement?*

A Musharakah agreement creates a partnership of shared capital, management and risk in which partners share profit according to an agreed upon percentage, and share loss according to the proportion of their initial capital investment.

Musharakah are a kind of Shirkah, or sharing, agreement. Shirkahs are of different kinds of which Musharakahs are one. Musharakahs enjoy greater popularity among the class of Shirkah products because the Muslim investor increasingly seeks a means to share in a joint commercial enterprise with capital, rather than with more traditional forms of partnership.

**Shirkah tul Milk**

*What is meant by Shirkah tul Milk? How does it work in practice?*

Shirkah tul milk is partnership in property. Two or more individuals may jointly purchase or inherit land or equipment in such a partnership. They may choose to divide the property, either physically by distributing it equally among owners (e.g. land is divided into 4 parts among four individuals), or sequentially by sharing the number of days that the property is used (e.g. a tractor is used one day by one owner and the next day by the other owner).

The owners may also choose to share the asset without any clear division if it can be done so amicably. In the event of an agreed upon sale, proceeds distribute in proportion to ownership.

**Shirkah tul Aa'maal**

*What is meant by Shirkah tul Aa'maal? How does it work in practice?*

Shirkah tul Aa'maal is a partnership in services. Under Shirkah tul Aa'maal, two or more individuals enter into a partnership to provide a service. While there may or may not be an initial capital contribution to determine the size of the partners' share, an agreed-upon ratio determines how profits distribute.

For example, ten partners enter into an agreement to publish a magazine. The six freelance writers and four full-time managers may decide to distribute profits so that writers receive 8% each of profits and the managers receive 13% each of profits.

In a service partnership partners may act on behalf of one another as agreed upon (e.g. buying, selling, managing, etc.) and no partner may refuse participation in the provision of agreed upon services.

***Profit Shares Need Not Be Proportionate To Investment Ratios***

*Must profit shares be proportionate to investment amounts, as is the case with the sharing of loss?*

Profit shares need not be proportionate to investment amounts and may reflect varying amounts of time, effort and risk undertaken by different partners, but silent partners may not take a greater percentage than their investment amount, though they may take less. For example, two working partners each provide 50% of the capital, and one may take 60% of the profits while the other takes 40%. If one partner were to remain silent having provided 50% of the capital, he may take up to, but not more than 50% of the profits.

***Rules Of Profit Distribution For Silent Partners***

*May a silent partner receive profit in a ratio more than the ratio of his investment?*

Silent partners may not receive more profit than is proportionate to their investment, but they may receive less. For example, it will be invalid if one silent partner invests $90,000 (as 90% of the initial investment) while a working partner invests $10,000, but agrees to pay 95% of all profits to the silent partner.

**Rules Of Profit Distribution For Working Partners**

*May working partners receive profit proportionately higher than the ratio of their investment?*

Working partners may receive more profit than is proportionate to their investment, as agreed beforehand with other partners. For example, one silent partner puts up 90% of the investment while the working partner puts up the remaining 10%. It is agreed that the working partner receives 70% of all profits.

**Liability For Loss May Not Be Absolute**

*May one of the parner's willingly agree to bear all the losses?*

It is impermissible for any partner to bear all losses, even if done so willingly, unless there is negligence.

**Immediate Cancellation Of Invalid Partnership**

*What should be done if a partnership is found to be invalid?*

If a partnership is found to be invalid, it is cancelled immediately. Profits and losses are distributed in proportion to investment sizes rather than agreed upon amounts (due to the invalidity of the agreement); the partners are then entitled to enter into a new agreement that is valid.

**No Investment, No Musharakah**

*One of the partners promises to bring her capital to a halal farming business, without having specified the quantity, and an exact date the capital will be brought into the business, but would like to share in profits and losses immediately?*

It would be invalid for her to do so, without having specified the quantity of the capital, and the exact date it will be brought into the business.

**Guidelines For Capital And Commodity Investment**

*Of what form should the capital investment be?*

Capital investment may be contributed in cash, in kind, or a mix of both to be used in the business, in which case the in kind asset's market value is assessed and agreed upon, forming the contributing partner's share in the business.

**Guidelines Regarding Mixing Of Capital**

*What are the basics of the mixing of capital in a Musharakah arrangement?*

Capital may be mixed or left unmixed between partners when invested. It is valid if partners decide to mix the capital by holding a joint account, or leave it unmixed by holding separate bank accounts. However, it will be invalid if two partners, both acting as managers, deposit capital into a pool but only one of them is allowed access. Non-fungible, unmixed capital should not be divided until all the partners (or their representatives) are present, though mixed capital or fungible, unmixed capital may be divided in the partners' absence.

**Division Of Capital: Before Loss/Damage/Theft**

*What guidelines are to be followed in the event of loss, damage or theft before the distribution of capital among partnership?*

In the event of loss, damage or theft before capital is distributed among the partnership or before partners invest their capital, the partnership is cancelled and, if so agreed, renewed; because the loss occurs before mixing capital, partners sustain losses individually.

**Division Of Capital: After Loss/Damage/Theft**

*What guidelines are to be followed in the event of loss, damage or theft after the distribution of capital among partnership?*

In the event of loss, damage or theft after capital is distributed among the partnership, partners share in the loss in proportion to their partnership stake; though for unmixed capital, only the partner whose capital is lost, damaged or stolen is responsible.

**When Good Or Service Contributed Is Unrelated To Business**

*Can a Musharakah be formed with one of the partners contributing a good or service unrelated to the business?*

For a partner to form a valid partnership, the commodity he brings has to be directly related to the direct affairs of the business. Three partners bring $1,000 each to set up a medical dispensary. A fourth partner agrees to spend $1,000 in fuel transporting the other three. This arrangement is invalid because the transportation, while helpful to the partners, is not a commodity related directly to the business of dispensing medicine.

**Events That Terminate Musharakah For Partner**

*What are some of the factors that render the Musharakah terminated for a partner?*

Among the partners, death, insanity and incapacity to conduct business render the Musharakah terminated for that person.

**Right Of Heirs Of Deceased Partner To Continue Partnership**

*In case of a partner's death, can heirs of the deceased continue the Musharakah?*

Yes. The heirs of the deceased are entitled to remain partners in the Musharakah if they decide not to liquidate their share and exit the Musharakah, though the remaining Musharakah partners are entitled to purchase the share.

**Musharakahs As Going Concern**

*What do scholars recommend to ensure that a Musharakah remains a going concern?*

Since every going concern relies on some level of stability and continuity, scholars recommend that the Musharakah contract clearly state at the outset:

1. That individual parties may not compel the entire partnership to terminate the business unless there is a majority favoring such a move; and

2. Whether the Musharakah terminates after a fixed period of time or whether the Musharakah terminates after the fulfillment of a specific objective, like the sale of an inventory of goods or the construction of a building.

**Home Financing Through Diminishing Musharakah**

*How does one finance the purchase of a home using Diminishing Musharakah?*

Two partners, one a client and the other a financier, buy a home for $100,000. The client makes a deposit of $10,000 and lives in the home, while the financier invests $90,000. We assume that the two agree to the client paying a monthly rent as a percentage of the financier's share. It is also agreed that every six months the client buys $10,000 of the financier's share. The rent can be pegged as a percentage where the rent is calculated as 1% of the financier's share, or some other amount that reflects the client's increasing ownership. After 54 months, or four and a half years, the client owns the house entirely.

**Leasing Out Property And Equipment In Diminishing Musharakah**

*May the property or equipment held in a Diminishing Musharakah be leased out to one of the partners, or to a third party?*

The property and equipment may be leased out to one of the partners, but not to a third party.

**Musharakah With Party Engaged In Interest-Based Transactions**

*Is it permissible for a bank to enter into a Musharakah agreement with a party that is known to deal in interest-based transactions, in particular borrowing funds on interest?*

It is permissible to enter into a musharakah agreement with such a party provided that:

- Proceeds from capital purchases should be divided according to the share in the partnership, thus freeing the bank from any responsibility with regards to the manner in which the partner is utilizing his funds.
- No guarantee on proceeds or principal should be provided.
- The bank may purchase the shares of the other party according to the principles of diminishing Musharakah
- The bank may not enter into a borrowing transaction whether as a borrower or guarantor of an interest-based loan.
- The bank may not provide resettlement agreements for an interest-based loan.

- No mortgage agreement should be entered into for the benefit of an interest-based loan.

**Deposit Of Bank's Investment In Musharakah**

*Is it necessary for a bank entering into a Musharakah to contribute its share of capital when entering into the contract?*

It is necessary for a valid Musharakah that all partners deposit their contributions when entering into the contract.

**Investment In Musharakah In Form Of Letter Of Surety**

*Is it permissible for a bank to contribute letters of surety as its share of investment in Musharakah?*

It is not permissible for the bank to consider letters of surety as investment in Musharakah. Musharakah capital may take only two forms: cash and in-kind investments.

**Converting Debt Into Musharakah Capital**

*Is it permissible for a Musharakah to accept a person as partner in exchange of liabilities owed to that person?*

It is not permissible for a partner to be admitted in exchange for money owed to him. Investment in a Musharakah may only be made in either cash or kind. Debts may not be converted into capital.

**Accruing Expenses Based On Capital Invested**

*Is it permissible for partners to charge expenses to the Musharakah by estimating the expenses as a percentage of the capital?*

It is not permissible to charge expenses to a Musharakah based on the capital invested. Rather, expenses may only be charged in accordance with prevalent market prices.

**Investment In Musharakah Capital In Form Of Murabaha**

*Is it permissible for a client of a bank to contribute his share of investment in a Musharakah by means of a Murabaha, while the bank makes its investment in cash?*

It is not permissible for a client to contribute his share of investment in the Musharakah by means of a Murabaha. It is a condition for a valid Musharakah that both parties make investment in either cash or in-kind, whereas a Murabaha is a sale transaction. In such a case, the bank will be considered the sole investor, with all investment yields accruing to it alone. The Murabaha transaction, if entered into with the client, will be kept entirely separate from Musharakah.

**Musharakah With Conventional Bank**

*Is it permissible to enter into a Musharakah with a conventional bank?*

It is permissible to enter into a Musharakah with a conventional bank, provided that the business conducted is lawful in the Shariah and no impermissible transactions are entered into.

**Partners' Individual Liability In Respect Of Transactions Of Musharakah**

*Is it permissible to hold a partner in a Musharakah personally liable for a transaction entered into on that partner's recommendation or judgment in case the Musharakah suffers a loss due because of the transaction?*

In such a case, it will be determined whether the partner exercised due care and diligence. If the partner made a gross error in judgment or did not take due precautions, he will be held responsible. If the partner omitted consultation with an expert for a transaction that is ordinarily referred to experts, the partner will be held liable. If however, the shortcoming in the transaction was undetectable, or if the transaction was prudent at the time it was entered into, the partner may not be held liable and the Musharakah will bear the loss.

**Property Bought Under Musharakah Registered In Name Of Partner**

*In the case of a Musharakah contracted for the purpose of financing the purchase of property, is it permissible that the property be registered in the name of the partner who will be the eventual owner?*

It is permissible to register such a property in the name of one of the partners to the Musharakah contract. This will not affect the validity of the Musharakah contract.

**Registration Expenses Of Property Bought Under Musharakah**

*In the case of a Musharakah contracted for the purpose of financing the purchase of property, is it permissible to make the partner who will be the eventual owner liable to bear registration and other ancillary expenses?*

It is permissible to make such a partner liable to bear registration charges and other ancillary expenses in light of the fact that such a partner will be the eventual owner of the property.

**Insurance Of Property Bought Under Musharakah**

*In the case of a Musharakah contracted for the purpose of financing the purchase of property, is it permissible to make the partner who will be the eventual owner liable for insuring the property?*

Insurance is the responsibility of both partners and it will not be permissible to make one of the partners liable to bear insurance premiums. However, the bank may consider recovering its insurance expense by building them into the amount of rent payable to it by the other partner.

**Definition Of Diminishing Musharakah**

*What is a Diminishing Musharakah?*

A Diminishing Musharakah is a temporary partnership where an asset or property is jointly purchased by two partners. Eventually, one partner acquires ownership of it through a series of property share purchases. The title of ownership of the property in a Diminishing Musharakah should ideally be in both the co-owners names. However, for regulatory reasons or to make use of available exemptions, it may be in the client's name since he will be the eventual owner at the end of the tenure. Islamic banks use Diminishing Musharakahs to extend long term financing to consumers and corporate clients. It substitutes conventional mortgage financing by providing fixed asset financing, capital project financing and home financing. The return on investment in a Diminishing Musharakah is calculated based on the frequency of the established tenure with the client. For instance if in a five year Musharakah, payments are made on a quarterly basis, the bank establishes its profit ratio as three month LIBOR. On the other hand, it is permissible to make early payments for a Diminishing Musharakah in order to gain complete ownership of the bank's share before the contract term ends. The price of the Diminishing Musharakah is a combination of the payment for the client's utilization of the usufruct of the Musharakah asset and the price of the bank's unit shares of ownership.

**Home Financing Under Diminishing Musharakah**

*What is the method of home financing under a Diminishing Musharakah?*

Home financing under Diminishing Musharakah is as follows:

The bank and the client contract a Musharakah agreement under which the property is purchased, with each party contributing a specified percentage of funds. The bank subsequently sells its share of

the property to the client in installments spread over a number of years.

The bank's earnings will be accounted for yearly and will be calculated on the basis of usufruct of its share of the property that is in the client's use. In case of default by the client, the bank will have the option of either selling the property in order to realize its share in the investment, or annulling the transaction.

**Musharakah For Construction Of Property**

*Is it permissible to contract a Musharakah for construction of property, where the client share is the value of land he owns and the bank's share is the value of the building to be constructed? Furthermore, is it permissible to contract an agreement that the bank will sell its shares to the client upon completion of the contract and that the client will be appointed contractor for the project?*

It is permissible to enter into a Musharakah contract for construction on the property that is in the ownership of the client. The client's share in the Musharakah will be equal to the value of the land while the bank's share will be equal to the value of the building to be constructed. It is further permissible that both parties agree that the bank will sell its share of the Musharakah to the client upon completion of the project, making the client the sole owner of the land and building. Both parties may also agree to appoint either one of them—in this case, the client—as contractor for the purpose of construction, provided that such a contract will be completely independent and separate from the Musharakah contract.

**Accounting Of Musharakah**

*Is it permissible to account for a Musharakah in the way that conventional banks account for their financing, which would consist of operating an account with debits and credits, and netting these off at the end of the period to arrive at either profit or loss?*

It will not be permissible to account for a Musharakah in the same manner as conventional banks account for their financing, for the latter is debt-based and the former is equity-based. The method described in the question is not permissible.

**Minimum Account Balance**

*Is it permissible to fix the minimum Musharakah account balance so that if the balance were to fall below a specified level, the client would not be entitled to profits?*

It is permissible to fix the minimum Musharakah account balance. If the balance falls below that level, the account will be treated as a current account with no profit or loss.

**Guarantee In Musharakah**

*In case of a Musharakah contract, is it permissible for the bank to require the client to submit guarantees?*

Each partner in a Musharakah has the right to make use of the collective funds of the Musharakah in a way that is of benefit to partners. Therefore, in general, no partner may be held liable for any loss that accrues from a transaction that partner entered into, unless it is established that the partner acted with negligence or committed fraud.

Therefore, the bank may require a guarantee from its client but only to the extent of fraud or negligence on the part of the client. In pursuance of such a guarantee, it will be permissible for a bank to require collateral from its client, provided that the collateral will remain in the possession of the client, with the bank having a claim on it.

**Third Party Guarantee**

*Can a third party guarantee be obtained in a Musharakah?*

A third party guarantee may be obtained in a Musharakah as long as it has not been stipulated as a condition in the contract. The third party may not possess 50% or more of a share in the ownership with the party it is serving as guarantor.Since it is a voluntary contract, remuneration for it may not be received.  However, administrative costs for providing it may be charged.

**Liability Of Expenses Of Musharakah**

*In a Musharakah that is managed by a single partner is it permissible to make this partner liable for administrative expenses of the Musharakah in return for a certain fee in consideration of his management?*

It is not permissible to make one of the partners liable for the expenses of the Musharakah. Such expenses will be charged to the Musharakah in actual, whenever possible, or a reasonable estimate.

**Profit Distribution In Proportion To Capital Investment**

*Is it permissible to grant a partner in a Musharakah a percentage of profits that is greater than his investment in capital?*

It is permissible for the partners in a Musharakah to agree upon any formula for distribution of profits that is a percentage of returns. It is not necessary that each partner receive profits only in proportion to his investment in capital.

**Fixing Amount Of Profit To Be Distributed**

*Is it permissible for the partners in a Musharakah to agree to a clause which states that profits up to a specified amount will go to one partner, while any profits exceeding that specified amount will be divided among all the partners according to an agreed-upon formula?*

It is permissible to agree upon a clause as described in the question. This entails that a threshold of profits is specified, up to which only one partner will profit. Any amount of profit exceeding that threshold will then be divided among all partners. For example, in a Musharakah between A and B, if the amount of profit earned is 30 and the threshold for Partner A is 10, Partner A will receive 10, while the remaining 20 will be distributed among both partners A and B according to any agreed-upon ratio.

**Purchase Of Machinery For Running Business**

*Will the purchase of machinery for a running business be considered a partnership for assuming ownership or one for trade?*

If a commercial enterprise wishes to purchase a machine for using it in its business activity and not for sale, the Diminishing Musharakah that will be executed for it will fall into the category of a partnership for assuming ownership and not a partnership for trade.

**Silent Partner's Profit Share In Business**

*What proportion of profit may the silent partner be granted in a business?*

The silent partner's proportion of profit may be any ratio that does not exceed his ratio of investment in the business.

**Investment Capital In A Musharakah**

*What are the restrictions for investing capital in a Musharakah?*

The share capital of a Musharakah may be in the form of cash or as a commodity.
If the capital is a commodity, its market availability and value must be determined in order to establish the ratio of investment.

The restrictions for establishing investment capital in a Musharakah are:

- Debt may not be established as capital in a Musharakah
- One partner may not guarantee the return on capital for another partner
- The ratio of profit received by the working partner may exceed his investment capital. The maximum ratio of profit for the silent partner may be equivalent to but not exceed his investment capital

Additionally, there are criteria to be followed for the sharing of profit and loss:

- The profit share cannot be stated as a lump sum or a percentage of the investment capital
- The proportion of profit is allocated between partners based on mutual consent. However, the silent partner may not receive a proportion of profit greater than his capital investment
- Loss in a Musharakah is shared based on the ratio of capital investment of each partner

**Early Termination In A Shirkat Ul Milk Or Shirkat Ul Aqd**

*Will a Shirkat ul Milk or a Shirkat ul Aqd be terminated by the withdrawal of one partner?*

In the case of a Shirkat ul Milk, the withdrawal of one partner does not terminate a partnership.
On the other hand, in the case of a Shirkat ul Aqd, the withdrawal of one partner does terminate the partnership. His share is liquidated and sold at market value.

**Termination Of Musharakah**

*How is a Musharakah terminated?*

A Musharakah may be terminated unilaterally provided that a term has not been specified for it.
Alternatively, in some cases it may only be terminated by mutual consent if unilateral termination is disallowed at the time of the contract's execution.

**Difference Between Musharakah And Mudarabah**

*What is the difference between a Musharakah and a Mudarabah?*

Both the Musharakah and the Mudarabah are partnership contracts. In a Musharakah, all the members make a contribution to the business and have the right to work for it. In a Mudarabah, one partner makes the investment and the other partner provides the investment management expertise. Furthermore, the investor in a Mudarabah is not permitted to actively participate in the running of the business.

**Musharakah Capital**

*Why can Musharakah partners make unequal capital investments and why must the Musharakah use existing currencies?*

Capital is unequal to enable partners with different financial capacities to invest, and using an existing currency allows departing partners to monetize easily.

**Role Of Musharakah Partners**

*What is the Musharakah partner's role in the Musharakah contract? What are the permissible and impermissible parameters of the contract?*

There are numerous preconditions and integrals in a Musharakah contract which you can review in Ethica's CIFE™ program. In brief, partners all invest capital in various forms (i.e. cash, in-kind, etc.) and profit may be agreed upon between partners while losses must be proportionate to capital invested.

**Practical Application of Musharakah**

*What are the practical applications of the Musharakah at the Islamic bank?*

Musharakah structures are used by Islamic banks in investment accounts where depositors act as investors and the bank acts as a partner in identifying and investing in various target investments (e.g. project financing, client businesses, shares on the capital markets, etc.)

**Profit Ratio For Sleeping Partner**

*Why is the profit ratio for a sleeping partner not allowed to exceed his investment ratio in a joint venture contract?*

The wisdom behind such rulings may encompass several explanations; however one explanation may be that limiting the ratio of the sleeping partner ensures that one party is not overly rewarded for the mere provision of capital, while work may be rewarded with an increase commensurate with the amount of work done.

**Profit Distribution Ratios In Musharakah And Mudarabah**

*Why does the ratio of profit distribution differ in Musharakah and Mudarabah contracts?*

Profit distribution in a Musharakah is between partners who are both providing investment capital, while in a typical Mudarabah one party provides the capital and the other party only provides the work.

**Suitable Islamic Finance Mode**

*What Islamic finance mode is most suitable to sustain an IT business/software company which must meet working capital needs such as salary and remuneration and vendor payments?*

Only Musharakah and Mudarabah.

# MUTUAL FUNDS

**Mutual Funds**

*Are mutual funds permissible in the Shariah?*

Mutual funds represent groups of investors who assign a professional investment manager (also known as the mutual fund) to invest in diversified securities; whereas individuals invest in individual securities, mutual funds allow individuals to invest in many securities through a single investment, offering diversification, professional management, and cost efficiency for the individual investor.

Mutual funds are lawful provided:

1. the mutual fund invests exclusively into lawful companies using lawful securities (see conditions for investing in stocks);
2. the investor invests directly into companies, not just into the mutual fund, which is merely pooled money; the distinction being that investment into a company entitles the investor to an actual shareholding of non-liquid assets, whereas investment into a pool of money represents a stake in a collection of money, which is a liquid asset and creates riba at anything other than face value;
3. the investor knows in which companies the mutual fund invests to be able to ascertain their lawfulness; if the investor is not able to ascertain the lawfulness of the companies invested in (by knowing the names of the companies), it is not permissible to invest in the mutual fund.

# PLEDGE

## Difference Between Guarantee And Pledge

*Is a guarantee different from a pledge?*

A guarantee is a commitment that is made by one party in a contract whereas a pledge constitutes a fixed asset, reserved for the purpose of claiming a debt. It is not permissible to furnish a guarantee or a pledge in amanah, or trust, contracts such as Mudarabah, Musharakah and Wadia. However, a guarantee may be provided to mitigate risk in case of negligence or misconduct of either of the contracting parties.

## Redemption Of Pledge

*When can a pledge be redeemed?*

The creditor is entitled to retain the entire pledge for any part of the unpaid debt unless partial redemption has been agreed upon. This also suggests that if a partial payment of debt has been made by the client, the creditor may retain the pledged asset unless stipulated otherwise in the contract.
It is important to note that it is not permissible for the one maintaining the pledge to benefit from it while it is in his possession.

In case the pledged asset is destroyed, it is retained by the creditor as a trust. Any damage or destruction of the asset without any negligence on the part of the creditor does not affect the debt obligation in any way. In the case of loss or damage to the pledged asset due to the negligence of the creditor or a third party, the debt still remains. In such a case, both parties are entitled to agree on a set-off between the remaining debt and the amount of compensation due with respect to the pledged asset. It is also permissible for the debtor to have the pledged asset insured Islamically.

## Liability Of A Pledged Asset

*Who pays for the maintenance of a pledged asset?*

The expense incurred in the maintenance of a pledged asset is borne by its giver while the necessary measures for the safe-keeping of the pledged asset are the responsibility of its keeper.

# RISK MITIGATION

**The Definition Of Arbun**

*What is Arbun?*

Arbun is a down payment that is made at the time of the execution of a contract. It is considered a part of the price of the asset in the contract in the event that the client makes all his payments on time. If he fails to do so, the contract stands annulled and this amount is retained by the financial institution. Whether this down payment makes up for the institution's loss completely or not, the client may not be charged an extra amount to make up for the difference.

**The Definition Of Haamish Jiddiah**

*What is Haamish Jiddiah?*

The term Haamish refers to margin and Jiddiah refers to sincerity. Haamish Jiddiah is a security deposit taken before the execution of a contract. It is deposited by the purchaser to ensure that if he fails to keep his "promise to purchase," it compensates the financial institution for expenses incurred. Once the bank makes up for its loss, any remaining amount is returned to the client. If the financial institution experiences a loss that is greater than the amount of security deposited, the client is required to make up for the difference.

**Shart e Jazai**

*What is the Shart e Jazai?*

The Shart e Jazai is a penalty that allows for a reduction in the price of manufactured goods if there is a delay in the delivery. Such a penalty is permitted in manufacturing contracts since the buyer requires goods at a fixed time. Without such a deterrent, a delay on the manufacturer's part could have far-reaching consequences. This is particularly the case when the buying party is not the ultimate end user and will have follow-on commitments to third parties.

# SALAM

**Salam: Forward Sales**

*How does Salam financing work?*

A Salam transaction is a means by which party A advances money, in full and on spot, to party B, and party B promises to deliver an item on a specified date in the future. The Prophet (Allah bless him and give him peace) said: "Whoever wishes to enter into a contract of Salam, he must effect the Salam according to the specified measure and the specified weight and the specified date of delivery."

A Salam is the exception to the Islamic rule forbidding forward sales and stipulating that party B possess the item to be sold in the present. The Salam agreement has the dual benefit of providing liquidity to party B, who normally would not realize any income until he invests large sums of capital in advance over extended periods of time, like farmers preparing seasonal crops; and benefiting party A because the Salams are priced lower than spot sales because the money is paid in advance.

When entering into a Salam, there should be certainty about the item's quantity, quality, deliverability and availability at the time of delivery, including agreement on the date and location of delivery; quantitative descriptions should be specified in a manner proper to the item, whether by weight, volume, size or count (ie. it would be impermissible to sell in volume something customarily sold in weight); in the Hanafi school it is a condition of a valid Salam agreement that the item be readily available in the market at the time of contracting and expected to be readily available at the time of delivery; in the Shafi'i, Maliki and Hanbali schools it is sufficient that the item be readily available in the market at the time of delivery only.

**Permissibility Of Providing Security In Salam Contract**

*Is the buyer permitted to ask the borrower to provide security in a Salam contract?*

The buyer in a Salam contract may ask the seller to provide security.

**Buy-Backs In Salam**

*May the seller buy back the Salam commodity from the buyer?*

The seller may not buy back the commodity from the buyer. This effectively creates riba, in which one amount of money is exchanged for a higher amount of money at a later date.

**Salam For Items Permitted Only For On-Spot Sales**

*May one create a Salam agreement for items that are only meant to be sold on spot?*

It is impermissible to create a Salam agreement for items that are only permissible to sell on spot, such as silver for gold.

**Considering A Previous Loan As Price For Salam**

*Is it permissible to consider a previous loan as the sale price for the Salam sale?*

In case a loan has been advanced from one party to another, it is permissible for the Salam purchaser to agree with the Salam seller that the received loan amount be considered as Salam price.

**Price Hike At Time Of Delivery In Salam Contract**

*Does the seller have any recourse in case the price of items contracted for in a Salam sale increase between the time of the contract and the date of delivery?*

The seller is bound to deliver the goods without demanding any excess money, since the contracted item becomes the property of the purchaser once the contract is signed.

**Default In Delivery Of Contracted Item In Salam Sale**

*What recourse is available to the buyer in a Salam sale in case of default in delivery of contracted goods?*

In such a case, the buyer has the right to rescind the contract and receive the contract price from the seller without there being any increase or decrease in the contract price. The buyer also has the option to carry on with the contract for future delivery of goods.

**Selling Goods Bought Under Salam Contract Before Delivery**

*Is it permissible for the buyer of goods in a salam contract to sell the goods before their delivery?*

It is not permitted for the buyer of goods under a Salam contract to sell goods before their delivery, as it is not permissible to sell what one does not constructively possess.

**Subject Matter Of Salam**

*Which items qualify as possible kinds of subject matter for a Salam?*

The subject matter of a Salam must be a fungible commodity a substitute for which is readily available in the market.

The following items do not qualify as the subject mater for a Salam:

- Items that have specific, unique attributes that make them different from one another. For instance, with livestock, no two animals are alike and can only be compensated for by a payment of price. Or with precious stones, each possesses unique, irreplaceable characteristics.
- The yield of a particular piece of land or the fruit of a particular tree. The quantity in a Salam may be specified but the place from where it is to be obtained may not be specified.
- For any kind of property, including a house, a building, or a particular piece of land.
- Items produced in small quantities that may not be available at the time of the contract's maturity.
- Currency, gold and silver are classified as mediums of exchangeSince they cannot be specified in terms of their physical characteristics, a Salam cannot be executed for an exchange between them.

**Delivery Of Salam Subject Matter**

*What are the requirements for the delivery of the subject matter of a Salam?*

The time and place of the delivery of Salam goods must be clearly specified. In case the place of delivery is not established, Salam goods must be delivered at the place of the contract's execution.

Additionally, it is not permissible to sell the subject matter of a Salam before its constructive possession. The subject matter cannot be short sold, forward sold or discounted either. For instance, if a person is to receive a quantity of wheat after one month, he may not sell it or have it discounted . He may, however, execute a parallel Salam for it with a third party. The actual sale may take place once the subject matter is in the seller's possession.

**Change In Subject Matter Of Salam**

*Can the subject matter of the Salam be changed?*

The subject matter may be changed at the time of the contract's maturity and not before based on the following conditions:

1. Provided the *option of change* is not stipulated as a condition at the time of the contract's execution.
2. The replacement commodity is permissible to establish as the subject matter of the Salam.
3. The market value of the replacement commodity is equivalent to or less than that of the original subject matter.

A Salam contract may be cancelled based on mutual agreement between the contracting parties, and the price of the subject matter may be returned to the buyer.

A partial cancellation of a Salam is also possible, where the delivery of the remaining quantity of the subject matter is cancelled and the remaining price is paid back.

**Quality Of Salam Subject Matter**

*What happens if the Salam goods surpasses the specifications established at the time of the contract's execution? What if they fail to meet expectations?*

If the subject matter surpasses the specifications, the seller may not charge a higher price and the goods must be accepted by the buyer.If the buyer does not require goods of a higher quality than specified within the contract, he is within his rights to refuse them. Similarly, if the goods do not meet specifications, the buyer is within his rights to refuse them unless the seller agrees to reduce the price.

**Delay In Delivery Of Salam Subject Matter**

*How is a delay in the delivery of the subject matter dealt with in a Salam?*

If the seller is unable to deliver the subject matter at maturity, the buyer may grant him respite.
A penalty may not be charged against a delay. The bank may enforce a pre-agreed charity clause in which the seller pays a designated charity.

**Default In Delivery Of Salam Subject Matter**

*How is a default in the delivery of the subject matter dealt with in a Salam?*

If at maturity the seller is unable to deliver the subject matter, the buyer may exercise one of the following three options:

1. Wait until the seller is able to make the delivery.
2. Cancel the sale and ask for a refund of the original price.
3. Agree to a change of subject matter based on certain conditions.

If the buyer wishes to cancel the contract and the seller defaults in refunding the price, the bank liquidates the security and recovers its costs.

**Salam For Precious Metals**

*Is a Salam for gold and precious stones permissible?*

Salam transactions are typically for fungible items. According to AAOIFI Shariah Standard No. 10 "Salam and Parallel Salam," section 3/2/4: "It is not permissible for al-Muslam fihi to be an amount of currency or gold or silver, if the capital of the Salam contract was paid in the form of currency or gold or silver." This is because the rulings pertaining to the exchange of currency, gold, and silver stipulate that amounts be exchanged at spot, and Salam entails deferment.

# SALE

### Post-Sale Repair And Replacement

*What are the basic guidelines for the seller who agrees to repair or replace an item after the sale takes place?*

If before the sale the seller agrees to repair or replace an item after the sale takes place, he is obligated to do so; if after the sale it turns out that due to expense or inconvenience the seller is unable to repair or replace the item, he is minimally obligated to choose whether to repair the item until it functions satisfactorily, replace the item with an equivalent new or used item, or mutually agree with the buyer a monetary compensation that enables the buyer to repair or replace the item.

### Rules Of Pricing

*What are the guidelines regarding product pricing?*

It is permissible to sell items at any price the seller chooses, whether at a discount or for a profit, as long as the discount or profit does not create (or is created by) artificial pricing, such as that created by hoarding, collusion, monopoly, and the like.

### Discount On Accepted Defective Items

*If the buyer decides to keep a low quality, or a defective, item as it is, would he be entitled to a compensatory discount?*

If the buyer decides to keep the item as it is, the buyer is not thereby entitled to a compensatory discount, though it is still permissible for the seller to offer a discount.

### If Returning An Item Is Not Possible

*What options are available to the buyer if returning the defective item is practically impossible?*

If returning the defective item becomes impracticable or impossible, then the buyer is entitled, at the seller's discretion, to either:

1. a replacement; or
2. a monetary compensation.

**Damages Covered By Seller**

*What damages does the seller compensate for?*

The seller only compensates for the defect and its related damages, including those damages necessary for the discovery of the defect. If the buyer damages the item and *then* discovers a separate defect, the buyer is no longer entitled to return the item (because of the new damage) but is entitled to compensation for the previous defect.

**Conditions Of Sale**

*What are the conditions for the sale of goods and services?*

Conditions for the sale of goods and services include: 1) a valid buyer and seller; 2) an offer and acceptance; 3) unconditionality; 4) immediacy; 5) the disclosure of all details pertaining to the sale's execution; and 6) an option to cancel.

**Unknown Or Contingent Price In Contract Of Sale**

*Is it permissible to keep the price unknown or contingent upon a separate event?*

It is forbidden to sell goods and services in which the price is unknown or is contingent or conditioned upon the occurrence of a separate event; though while conditioning one contract on another is forbidden (e.g. the monthly payment on a bank's car lease depends on the amount of money deposited into the bank), joining two or more contracts into one contract is permissible (e.g. a contract to lease a car and a contract to deposit money with a bank as part of one contract).

**Indefinitely Deferred Or Contingent Payment In Contract Of Sale**

*Is it permissible to indefinitely defer payment or make it contingent on a future event?*

It is impermissible to sell goods whose payment is deferred to an unknown date and contingent on the occurrence of a future event (e.g. paying for an unborn calf on the date of its birth); deferred payment is permissible as long as the date is specified in the agreement.

**Multiple Agreements As Part Of One Agreement**

*Is it permissible to agree upon multiple agreements as part of one agreement?*

It is impermissible to sell goods and services in which the seller (or buyer) offers the buyer (or seller) a choice of two or more possible agreements as part of the same agreement. For example, the seller contracts that a certain good is purchasable for $10 today, $5 tomorrow and $3 the day after. This is different from a valid negotiation which occurs before the finalization of a contract.

**Trading In Impermissible Goods And Services**

*May I trade in impermissible goods and services?*

It is impermissible to trade in goods and services that are impermissible in themselves (e.g. buying futures contracts or selling life insurance) or a means to the impermissible where causality is suspected or known (e.g. selling sound equipment to a nightclub).

**Trading In Non-Existent Item**

*May I trade in an item that is not in existence on the date of transaction?*

It is impermissible to trade in the non-existent (e.g. unharvested crops or an unborn calf); though, it is worth making a distinction between something not yet *naturally* existent from something not yet manufactured (e.g. undeveloped property), where a purchase is legitimate because one does not speculate on the outcome of an event but rather invests in the production of a good; the exception occurs when the non-existent is purchased *as a consequence* of purchasing something that may instrumentally cause the existence of something non-existent (e.g. purchasing a cow that expects to give birth to a calf), which is permissible, as long as they are not sold separately.

**Trading In Goods Naturally Connected To The Site Of Their Origin**

*May I trade in goods that are naturally connected to the site of their origin?*

Goods that are still naturally connected to the site of their origin are impermissible to sell until they are first separated, including, for example, fruit on the tree (unless the tree is first sold or the fruit first picked), wool on the sheep (unless the sheep is first sold or the wool first sheared), steel beams in a building (unless the building is first sold or the beam dismantled), milk in the udder (unless the animal is first sold or the udder first milked).

**Selling Goods Without Ownership**

*May I sell goods that are not in my ownership?*
It is impermissible to sell goods that are not owned by the seller, or when the seller is not the owner, the seller lacks authorization; permissible ownership includes constructive ownership, where the seller might not physically possess the good, but is liable for the risk associated with it (e.g. permissible stocks traded on the Internet).

**Selling Defective Goods**

*May I sell defective goods by intentionally withholding information about their defect?*

It is impermissible to sell goods that are defective, where the seller intentionally withholds information about a defect; though if the defect was not known by either buyer or seller at the time of the sale, the sale may still be cancelled within the specified period of cancellation; qualitative or quantitative misrepresentation of any aspect of a good or service is impermissible and constitutes fraud, grounds for the aggrieved party to rescind the agreement at any time. The buyer, nevertheless, still has the choice of whether or not to accept the defective good.

**Selling Goods That Support The Enemies Of Islam**

*May I sell goods and services that support the enemies of Islam?*

It is impermissible to sell goods and services that support (e.g. with weaponry) the enemies of Islam.

**Selling Inherently Filthy Goods**

*May I sell goods that are inherently filthy?*

It is impermissible to sell goods that are inherently filthy (e.g. the milk of animals forbidden to eat) or affected with irremovable filth (e.g. wine in food).

**Underbidding**

*Is underbidding permissible? May I buy goods and services sold by underbidders?*

Goods and services that are sold by underbidders who lower prices in order to attract buyers away from (even verbally) agreed upon sales are forbidden, as is underbidding, unlike competitive bidding where prices have not yet been agreed upon; similarly, it is forbidden for a buyer to leave an (even

verbally) agreed upon sale for a transaction with more favorable terms, even during the period of cancellation; it is also forbidden to artificially bid up a price on behalf of a seller.

**Partly Impermissible Transaction**

*What is the liability of the buyer in the case of a partly impermissible transaction?*

When a transaction is partially permissible and partially impermissible the buyer has the right to choose whether he wants to refund the whole amount or refund just the impermissible portion.

**Trading Without Consent Or Knowledge Of Parties**

*Is it permissible to trade without consent or knowledge of both parties?*

It is forbidden to purchase an item without the seller's knowledge or consent, or to force a seller to sell an item, even if the buyer leaves money.

**Forced Renegotiation Of Finalized Contract**

*Is it permissible to force renegotiation of an already finalized contract?*

It is forbidden to force a seller to renegotiate an already finalized contract, even if market conditions change, or if immediately after closing the first sale the seller agrees more favorable terms with another buyer.

**Essentials Of Valid Transaction**

*What are the essentials of a valid transaction?*

The essentials of a valid transaction in Islam are:

1. Item
2. Price
3. Valid buyer and seller
4. Offer and acceptance
5. Unconditional agreement
6. Immediate execution
7. Ownership

**Existence Of Item Being Transacted**

*Is it a condition for a valid transaction that the item being transacted exist at the date of transaction?*
The good or service in question must exist at the time of agreement, and its qualitative and quantitative attributes openly known. For those cases where the nature of the transaction itself makes this impossible, both parties should agree the amounts of all future exchanges of goods, services, and money; such as istisna, where the good remains to be manufactured; or mudarabah, where the service remains to be rendered; or ijarah; where the usufruct remains to be transferred.

**Arbitrary Sale Of General Nature**

*Is an arbitrary sale of a general nature valid?*

An arbitrary sale of a general nature is invalid, such as selling fish in the water (assuming the seller owns the body of water as in a fish farm), whose quantitative and qualitative value is unknown at the time of the contract.

**Trading Visible But Unquantifiable Item**

*Is it valid to transact a visible but unquantifiable item?*

It is permissible to sell an item that is visible even if it is unquantified, such as a heap of grain whose weight is unknown or a basket of fruit whose number is unknown, when both buyer and seller agree to the transaction.

**Buying Item Without First Seeing It**

*Is it permissible to buy an item without having seen it?*

It is permissible to buy something without having seen it (e.g. mail-ordered purchases).

**Transacting Item Of No Value**

*Is it permissible to transact an item that has no intrinsic value?*

It is not permissible. The item should be worth something based on intrinsic value, such as an asset or service.

**Transacting Unusable Item**

*Is it permissible to transact an item that is effectively useless?*

The item should not be of such a negligible amount that it is effectively useless (e.g. a drop of petrol) and the contract's execution must not deem the item unusable. It is invalid, for example, to sell one-half a car or one-fourth a horse because the usefulness of the car or horse is based on the physical integrity of the entire object.

**Transacting Items Impermissible In Shariah**

*Is it permissible to transact an item that is impermissible according to the Shariah?*

The item's intended purpose must be permissible by the standards of the Shariah because trade in forbidden goods and services is itself forbidden, even if sold in relatively small quantities alongside something permissible.

**Selling An Item One Does Not Own**

*May I sell an item that is not in my ownership?*

The seller must own the item in question, because a sale is effectively the transfer of ownership, where ownership is measured by risk liability, not necessarily by physical possession. One party may possess an item physically, such as a leased car, and not own the risk, while another may own an item's risk, such as a stock transacted over the Internet, and not possess it physically. The seller must possess the entire portion of the risk liability of an item before its sale. If the item is being used as collateral for a separate contract, the seller must obtain prior approval for the sale from the party for whom the collateral is put up.

**Ambiguous Or Unknown Price**

*Is a transaction that keeps the price ambiguous or unknown valid?*

The price and the currency must be known to both buyer and seller, without any conditions linking future events with price; the following statements are invalid:

- "Buy this now and pay me later when you know the price"
- "The item is yours. Just pay me whatever he paid"
- "Pay that man whatever he charges and take delivery now."

**Integrals Of Contract**

*What are the integrals of a contract?*

A contract includes at least two legitimate parties; a buyer offering and a seller accepting, or a seller offering and a buyer accepting; an agreement that neither conditions nor is conditioned by another agreement; and an immediate execution.

**Validity Of Buyer And Seller**

*What are the conditions of validity for a buyer and seller?*

The buyer and seller must both be:

- Sane;
- Adult, meaning both buyer and seller should have reached puberty (with some exceptions made based on customary practice, such as a responsible child selling fruit);
- Free from duress; meaning they should not be forced by an outside party to conduct transactions against their will;
- Acting in accordance with the Shariah; meaning that the permissibility of the transaction itself must not be obviated by the intention of the buyer or the seller. For instance, a Muslim weapons manufacturer must not sell weapons to a buyer at war with Muslims; a Muslim publisher must not offer printing services to an author spreading lies against Muslims; a Muslim computer programmer must not offer services to an aeronautics firm supplying weaponry to bomb Muslims; and so on;
- The seller must constructively own the item to be sold, or be legally authorized to represent the actual owner.

**Types Of Offer**

*What are the different types of offer in Shariah?*

Whether an offer from the buyer to the seller or from the seller to the buyer, an offer is of three types:

1. Written offer: Contracts involving any level of detail and complexity require a written offer;
2. Spoken offer: Suffices for transactions involving a straightforward purchase, such as buying food from a vendor at a market;
3. Unspoken offer: The three most common types of unspoken offer are the *indicated offer*, by hand signal (or other form of signaling) between two parties familiar with the transaction, such as in a stock exchange; the *implied offer*, a transaction whose details are understood beforehand by both parties, such as at a supermarket; and the *credited offer*, in which payment occurs at the end of a designated period, such as a utility charge at the end of the month to a homeowner.

**Disclosure On Part Of Seller**

*What are the obligations of the seller as regards disclosure of the item being sold?*

The seller is obligated to disclose, as accurately as possible, the item's relevant qualities, defects and irregularities; any willful misrepresentation, whether directly, by stating so explicitly, or indirectly, by allusion, regarding the price of the item or the item itself, constitutes fraud.

**Payment Of Transaction**

*What are the rules regarding payment - whether in cash or in kind - in case of spot and deferred transactions?*

The amount and timing of payment must be agreed upon before delivery, whether the transaction is on spot or deferred:

- Cash for Goods: If the sale is a spot transaction and involves the payment of cash (or a like monetary instrument) for the delivery of goods, the seller is entitled to receive payment before delivery, though he may choose to waive this right;
- Goods for Goods: If the sale is a spot transaction in which only goods are exchanged, the two parties must make the exchange at the same time;
- Deferred Payment: Payment is deferrable when the seller agrees, as long as the payment date is known beforehand.

**Damage In Item During Execution Of Sale**

*What is the liability of both parties in case the item being transacted is damaged during the execution of the sale?*

If during a sale's execution, the item is damaged, destroyed, wrongfully consumed, or in any way reduced in value from the time the sale was agreed upon, then responsibility (and the payment of the item's price) is as follows:

- before the buyer takes possession it is the seller's responsibility, unless the buyer causes the damage, in which case the buyer is responsible;
- before the buyer takes possession, if a third party (known or unknown) causes the damage, the buyer chooses whether to cancel the deal, thereby holding the third party responsible to the seller, or maintain the deal, thereby holding the third party responsible to himself;
- before the buyer takes delivery, if the cause of damage is not attributable to any party, whether buyer, seller or third party, the seller is responsible (e.g. water damage from rain);

- once the buyer takes possession, it is the buyer's responsibility.

**Dispute Resolution**

*How should one proceed to resolve disputes regarding the terms and conditions of an agreement?*

In order of precedence, disputes regarding the terms of an agreement should be resolved according to the following:

- evidence and witnessing;
- swearing of oaths by either buyer or seller, where the word of the one swearing the oath takes precedence over the word of the one not swearing an oath;
- swearing of oaths by both buyer and seller, creating a deadlock; all else equal, it is recommended for a statement of denial to take precedence over a statement of affirmation (e.g. "this sale is not invalid" takes precedence over "this sale is invalid", because the former statement supports the status quo (i.e. a valid sale) and denies a need for change);
- failing an agreement on terms, the buyer and seller have the right to agree new terms;
- failing an agreement on terms and any subsequent resolution, the buyer and seller have the right to cancel the sale between themselves amicably;
- if no amicable solution is possible, the relevant authority (e.g. judge) cancels the agreement and returns any exchanged property to its original owner.

**Ownership Transfer In Contract Of Sale**

*When does ownership transfer to the buyer in a contract of sale?*

Once a valid sale occurs, the buyer owns the item. The validity of the sale is a condition for ownership to transfer to the buyer; an aspect of the sale that invalidates the transaction also nullifies the transfer of ownership. This transfer occurs precisely when the new owner assumes the risk associated with the item's ownership.

**Ownership And Possession**

*What is the difference between ownership and possession?*

The difference may be explained as such: something that is possessed might not be owned (e.g. rental property), while something that is owned might not be physically possessed (e.g. one's stolen vehicle). Further, ownership can be both physical and what is often termed "constructive" ownership. Constructive ownership means that the *consequences* of physical ownership *risks* return to the owner and that the owner be able to sell the item (ie. one would not be permitted to sell a shipped good while it is at sea). A common example of constructive ownership without physical possession is a stock purchased over the Internet.

**Returning Transacted Item**

*Is it valid to return a transacted item due to defective quality or misrepresentation by the seller?*

It is permissible for the buyer to return an item of low or defective quality, or one misrepresented by the seller, and obligatory for the seller to accept the return. The purchased item should be returned in its entirety, even if the satisfactory portion is easily separable from the unsatisfactory portion (e.g. rotten fruit and good fruit), though the seller is entitled to let the buyer purchase only the satisfactory portion. Once the buyer agrees to retain the item, the seller is no longer compelled to accept its return. The seller who fulfills the sell-side conditions of a valid transaction without misrepresentation is not obligated to accept a return when the buyer who fulfills the buy-side conditions of a valid transaction misinterprets an aspect of the transaction.

**Compensation In Case Of Return Of Sold Item**

*What compensation is the buyer entitled to in case a sold item is returned?*

The buyer is entitled to either a replacement or the original payment at the seller's discretion.

**Return Of Sold Item In Case Of No Pre-Sale Inspection**

*Is the buyer entitled to return an item if he neglected to inspect the item before the sale?*

If before the execution of the sale the seller instructs the buyer to first check the item (when practicable; for example, it would be difficult for a single buyer to individually check the quality of 10 kilos of apples) and the buyer fails to do so, the seller is no longer obligated to accept a return, though it is permissible for him to do so.

**Return In Case Of Misunderstanding About Price**

*Is the buyer entitled to return an item if the seller claims the sale is at cost but subsequently makes a profit?*

If the buyer is told by the seller that an item is being sold at "cost" (where cost may include any value additions to the item made by the seller), and the buyer learns after the sale that the seller had actually made a profit, the buyer is entitled to return the item, but not entitled to compel the seller to sell the item at a lower price, though the seller may opt to do so.

**Compensation In Case Return Of Sold Item Is Impossible**

*What compensation is the buyer entitled to if returning the item is not possible?*

If returning the defective item becomes impracticable (e.g. partially eaten food in a restaurant) or impossible (e.g. appliance destroyed in fire by faulty electrics), then the buyer is entitled, at the seller's discretion, to either:

1. a replacement; or
2. a monetary compensation, measured as the percentage of the total price of the item equivalent to the percentage that the defective portion would reduce the value of a similar item in the market, where the market item used for comparison would be the one with the lowest value (as measured during the time between the sale's execution and the buyer's possession). The seller only compensates for the defect and its related damages, including those damages (and only those damages) necessary for the discovery of the defect (e.g. the defective power supply of a computer damages the central processing unit, but not the monitor; but the buyer accidentally breaks the monitor screen; the seller is only obligated to replace the power supply and the central processing unit, not the monitor).

**Expiry Of Cancellation**

*Under what circumstances does it become impermissible to cancel a contract?*

The possibility of cancellation expires under three circumstances:

1. A buyer is no longer entitled to return an item of low or defective quality if, upon discovery of the fault, he delays the item's return without a valid excuse, unless the seller agrees to accept the item back;
2. Once a buyer's ownership in an item ends, whether by sale, transfer or disposition, the buyer may not demand compensation for a defect; though if the original buyer sells the item and after a time is returned the item due to a defect from the original sale, he may demand compensation;

3. If the buying and selling parties agree a period of time during which the buyer is entitled to cancel a contract for reasons agreed upon explicitly (e.g. the buyer agrees to sample a magazine subscription for 3 months) or understood implicitly (e.g. the item is of low or defective quality), the buyer is no longer entitled to cancel a contract if the period expires, unless the seller agrees to accept the item back.

**Deferring Payment**

*Is it permissible to defer payment?*

It is permissible to defer payment as long as the seller agrees and the payment date is known beforehand. The sale is invalid if the buyer makes the following general statement *before* the purchase: "I will buy this now if I am allowed to pay later," without specifying a time period for the deferral. The sale is valid if this same statement is made *after* the purchase, but the seller is then entitled to demand the money immediately, though he may waive this right by merely inquiring about the date of payment. It is a condition for the validity of a deferred payment that the seller knows the date of payment, and invalid for even the seller to allow for an open-ended deferral (e.g. "Pay me whenever you are able").

**Charging Higher Price In Case Of Deferred Payment**

*Is it permissible for the seller to charge a higher price in case of deferred payment?*

It is permissible to charge a higher price for goods paid on deferral than for goods paid on spot in cash, as long as the buyer is aware before the sale's execution.

**Extending Payment Date In Case Of Deferred Payment**

*Is it permissible to extend the date on which deferred payment is due if the buyer is unable to pay?*

In a sale for which payment is deferred and the debtor (buyer) is unable to pay even on the payment date, it is recommended for the creditor to grant the debtor an extension.

**Delay In Making Payment**

*Is it permissible for a debtor to delay payment unnecessarily?*

It is impermissible for a debtor possessing the means to pay the creditor to delay payment unnecessarily beyond the agreed upon date.

**Actual and Abstract Receipt In Sale Of Commodities**

*May the customary method of ledger entries used by banks in regard to debits and credits be considered mutual receipt in the exchange of commodities?*

It is not lawful for a seller to conduct a sale for a commodity that is not in his constructive possession; the only exception being the Salam sale.

**Options In A Sale**

*What are the different options that may be exercised in a sale?*

The different options that may be exercised in a sale are:

*Khayaar al Shart*
Khayaar al Shart is an option in a sale's contract giving one of the two parties a right to cancel the sale within a stipulated time. In case of death, the option is non-transferable to his heirs and the sale is automatically annulled.

*Khayaar al Rooyat*
Khayaar al Rooyat is the option of refusal based on which the buyer may decline to accept the goods of a sale because of their non-conformity to specifications.

*Khayaar al Aib*
This option may be exercised in case of a defect in the purchased asset. If the buyer finds that the asset is defective in any way, he is within his rights to demand a replacement for it or terminate the sale.

*Khayaar al Wasf*
The provision of this option is in reference to the quality of the purchased asset. If the asset fails to meet required quality specifications, the buyer is within his rights to exercise this option and demand a replacement of the asset.

*Khayaar al Ghaban*
The provision of this option is in reference to the price of the asset. If the seller sells an asset at a price that is much higher than the market price, the buyer possesses the right to return the asset and terminate the sale.

**The Sale Of Goods That Have Yet To Clear Customs**

*Is an export sale based on a sample of the goods lawful and will it be considered complete regardless of whether or not the goods have arrived at the port?*

An export sale based on a sample of the goods for approval by the importer is lawful whether or not the merchandise has arrived at the port.

**Compensation For Defective Goods Damaged By Buyer**

*Is the buyer entitled to compensation for defective goods if they have been damaged, separately from the defect, by the buyer?*

If the buyer damages the item and *then* discovers a separate defect, the buyer is no longer entitled to return the item (because of the new damage) but is entitled to compensation for the previous defect.

# SECURITY

**Permissibility Of Maintaining Asset As Security In Contracts**

*Is it permissible to maintain security in contracts?*

It is permissible to stipulate that the client furnish a security to ensure payment for debt whenever it becomes due. This security may be in the form of an asset.

The prerequisites that need to be met for the asset to be maintained as a security are the following:
A pledged asset must be of value and be Islamically lawful to own, use, or sell. All its specifications must be clearly defined and it should be deliverable to the creditor. If a property held in common is pledged, then it is necessary that the percentage of pledge be clearly specified.

- It is permissible to grant more than one pledge on the same property. These pledges rank equally if registered on the same date. The recovery of debt from the value of the pledges may take place on a pro-rata basis . If the pledges are registered at different times then the priority in recovering debt is based on the dates of registration.
- The pledged asset may be maintained by the creditor or the debtor. All expenses related to a pledged asset excluding the expense for safekeeping are borne by the one giving the pledge (debtor). In case the one maintaining the pledge (creditor) incurs any expense on it, it may be claimed for from the one having given it.

In case of a default in the payment of debt, the creditor is entitled to sell the pledged asset in order to make up for the actual loss . He is not entitled to assume ownership of the pledged asset unless already mutually decided with the debtor. The creditor may stipulate that the debtor authorize him to sell the asset in case the debt is not recovered in time. In this way, a loss may be made up for without any recourse to a court of law.

# STOCKS AND SHARES

**Equity Trade On Stock Exchange**

*Conventional trading on the stock exchange is not based on Islamic principles of sale and transfer of possession. Among the prerequisites of a valid sale are the existence of the (i) buyer and seller, (ii) a mutually agreed price, (iii) payment of price, and (iv) transfer of goods to the buyer. However, transactions take place in the stock market every second without actual payment or delivery.*
*(1) How can we consider some stocks on it permissible to trade in while others are impermissible?*
*(2) Similarly, isn't commodity trade impermissible as well where, for instance, possession of commodities such as gold and silver does not transfer either?*

(1) The four conditions mentioned for a valid stock market transaction are correct and among the conditions that apply. However, it is not correct to state that because transactions are happening every second without actual delivery that they are impermissible thereby. If the sale is at spot, it is not a condition that delivery be immediate for many stocks because the concept of constructive possession applies in such cases, where the rights and responsibility are handed over even if delivery of the actual asset is not immediate. To use a common example, there are many large ticket items that we purchase at spot but do not take delivery immediately such as furniture, property, automobiles, and so on. You can read more about the concept of constructive possession in AAOIFI's Shariah Standards, Mufti Taqi Usmani's Introduction to Islamic Finance, and elsewhere.

(2) Exchange traded stocks, where what is traded is the "price" of an exchange, are not permissible because, among other reasons, no asset or service is trading hands.

**Investing in Shares And Government Securities**

*Is it permissible to invest in shares and government securities?*

*Mufti Taqi Usmani: Principles of Shariah governing investment in shares and equity funds*
Dealing in equity shares can be acceptable in the Shariah subject to the following conditions:

1. The main business of the company is not in violation of the Shariah. Therefore, it is not permissible to acquire the shares of the companies providing financial services on interest, like conventional banks, insurance companies, or the companies involved in some other business not approved by the Shariah, such as the companies manufacturing, selling or offering liquors, pork, haram meat, or involved in gambling, night club activities, pornography etc.
2. If the main business of the companies is halal, like automobiles, textile, etc. but they deposit there surplus amounts in a interest-bearing account or borrow money on interest, the share

holder must express his disapproval against such dealings, preferably by raising his voice against such activities in the annual general meeting of the company.

3. If some income from interest-bearing accounts is included in the income of the company, the proportion of such income in the dividend paid to the share-holder must be given charity, and must not be retained by him. For example, if 5% of the whole income of a company has come out of interest-bearing deposits, 5% of the dividend must be given in charity.

4. The shares of a company are negotiable only if the company owns some non-liquid assets. If all the assets of a company are in liquid form, i.e. in the form of money that cannot be purchased or sold, except on par value, because in this case the share represents money only and the money cannot be traded in except at par.

What should be the exact proportion of non-liquid assets of a company for the negotiability of its shares? The contemporary scholars have different views about this question. Some scholars are of the view that the ratio of non-liquid assets must be 51% at the least. They argue that if such assets are less than 50%, the most of the assets are in liquid form, therefore, all its assets should be treated as liquid on the basis of the juristic principle: The majority deserves to be treated as the whole of a thing. Some other scholars have opined that even if the non-liquid asset of a company or 33%, its shares can be treated as negotiable.

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

First, the non-liquid part of the mixture must not be of a negligible quantity. It means that it should be in a considerable proportion. Second, the price of the mixture should be more than the price of the liquid amount contained therein. For example, if a share of 100 dollars represents 75 dollars, plus some fixed assets the price of the share must be more than 75 dollars. In this case, if the price of the share is fixed as 105, it will mean that 75 dollars are in exchange of 75 dollars owned by the share and the rest of 30 dollars are in exchange of the fixed asset. Conversely, if the price of that share fixed as 70 dollars, it will not be allowed, because the 75 dollars owned by the share are in this case against an amount which is less than 75. This kind of exchange falls within the definition of "riba" and is not allowed. Similarly, if the price of the share, in the above example, is fixed as 75 dollars, it will not be permissible, because if we presume that 75 dollars owned by the share, no part of the price can be attributed to the fixed assets owned by the share. Therefore, some part of the price (75 dollars) must be presumed to be in exchange of the fixed assets of the share. In this case, the remaining amount will not be adequate for the price of 75 dollars. For this reason the transaction will not be valid.

However, in practical terms, this is merely a theoretical possibility, because it is difficult to imagine a situation where a price of the share goes lower than its liquid assets.

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

Shariah scholars have different views about whether the purification is necessary where the profits are made through capital gains (i.e. by purchasing the shares at a lower price and selling them at a higher price). Some scholars are of the view that even in the case of capital gains the process of purification is necessary because the market price of the share may reflect an element of interest included in the assets of the company. The other view is that no purification is required if the share is sold, even if it results in a capital gain. The reason is that no specific amount of price can be allocated for the interest received by the company. It is obvious if all the above requirements of the halal shares are observed, most of the assets of the company are halal and a very small proportion of its assets may have been created by the income of interest. This small proportion is not only unknown, but also negligible compared to the bulk of the assets of the company. Therefore, the price of the share, in fact, is against the bulk of the assets, and not against such a small proportion. The whole price of the share therefore, may be taken as the price of the halal assets only.

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

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

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

The second option of the management is to act as an agent for the subscribers. In this case, the management may be given a pre agreed fee for its services. This fee may be fixed in lump sum or as a monthly or annual remuneration. According to contemporary Shariah scholars, the fee can also be based on a percentage of the net asset value of the fund. For example, it may be agreed that the management will get 2% or 3% of the net asset value of the fund at the end of every financial year. However, it is necessary in the Shariah to determine any of the aforesaid methods before the launch of the fund. The practical way for this would be to disclose in the prospectus of the fund on what basis the fees of the management will be paid. It is generally presumed that whoever subscribes to the fund agrees with the terms mentioned in the prospectus. Therefore, the manner of paying the management will be taken as agreed upon on all the subscribers.

**Permissibility Of Gold ETF GLD**

*Is the gold ETF GLD traded on the New York stock exchange Shariah-compliant?*

More details about the specific documentation of the fund is required for an accurate answer. However, for your information, exchange-traded funds that invest in commodities, or exchange-traded commodities, track the performance of an index and their prices rise and fall like a stock. The entity investing on behalf may own the commodity, but the investor in the entity's shares does not directly own anything except a share that tracks the index. It is a condition for an Islamic investment to be Shariah-compliant that the investor have direct ownership in the asset or service. For example, a stock in a permissible company provides direct ownership in that company, whereas a stock in an exchange-traded commodity only provides ownership in a share that tracks, not owns, the asset.

# SUKUK

### Sukuk For Liquid Assets

*Is it permissible to issue Sukuk for liquid assets?*

It is permissible to issue Sukuk for liquid assets, however, they may only be sold on face value and not for a greater or lesser amount as that would constitute riba.

### The Conditions For Sale Of Sukuk

*What minimum percentage of a Sukuk must be fixed assets?*

If the Sukuk represent a combination of fixed and liquid assets, it is imperative that the fixed assets make up at least 25% of the entire business.

### Definition Of Sukuk

*What is the definition of Sukuk?*

Sukuk is an Arabic term and a plural of the word Sakk which means 'certificate.' Sukuk are defined as certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services. Sukuk may be issued for various Islamic banking products such as Ijarah, Musharakah, Murabaha, Salam and Istisna.

### Ijarah Sukuk

*What are the different forms of Ijarah Sukuk?*

Sukuk may be issued for the following Ijarah categories:

*Sukuk for the transfer of ownership of the leased asset*
These Sukuk are issued for the eventual transfer of ownership of the leased asset to the lessee at the end of the period of lease.

*Sukuk for the ownership of the usufruct of an asset*

These are issued with the aim of leasing the asset so that the holder of the Sukuk becomes the owner of the usufruct of the asset.

*Sukuk for the ownership of services*
The purpose of these Sukuk is to provide services so that the holder of the Sukuk becomes the owner of these services.

Ijarah Sukuk can be traded at market price or any other price mutually agreed upon by the lessor and the lessee.

**Musharakah Sukuk**

*What are Musharakah Sukuk?*

These Sukuk are issued with the aim of using funds for the establishment of a new project, the development of an existing project or financing a business activity on the basis of a partnership contract. Every subscriber is given a Musharakah certificate which represents his proportionate ownership in the Musharakah asset. This certificate can be bought and sold in the market. The profit in a Musharakah is shared according to an agreed ratio whereas loss is shared in proportion to the ratio of investment. A Takaful reserve is created for the Musharakah to mitigate the risk of loss to Sukuk holders.

**Diminishing Musharakah Sukuk**

*What are Diminishing Musharakah Sukuk?*

These Sukuk represent the proportionate share of partners in the joint ownership of an asset. The financial institution or investor leases and gradually transfers its share of ownership of the asset to the client. The lessee uses the investor's share and by the end of the Musharakah, redeems and assumes ownership of it.

**Murabaha Sukuk**

*What are Murabaha Sukuk?*

The Murabaha is a sale in which the cost of acquiring the asset and the profit to be earned from it are disclosed to the client. Murabaha Sukuk are issued for the purpose of financing the purchase of goods through the Murabaha so that the certificate holder becomes the owner of the Murabaha commodity.  Murabaha Sukuk cannot be sold or purchased in the secondary market.

**Salam Sukuk**

*What are Salam Sukuk?*

The Salam is a sale for which the price is paid in full for goods to be delivered at a future date.
Holders of the Salam Sukuk are owners of the Salam goods and are entitled to receive income generated from their sale or the sale of Salam certificates. It is prohibited to trade Salam Sukuk during the term of the Salam as the underlying asset is a debt that is created based on an advance payment of the sales price.

**Guaranteeing Sukuk Assets**

*Is it permissible for a Sukuk originator to guarantee the Sukuk assets and profit distribution shortfalls given the Sukuk issuer/SPV, is a subsidiary/related company?*

No, however it is allowed only if a third party that is not related to the Sukuk issuer guarantees it.

# TAXES

**Impermissibility Of Cheating On One's Taxes**

*Is it permissible to practice tax-evasion (i.e. by lying), especially, if the recipient is a non-Muslim government?*

It is impermissible to lie on one's taxes, even if the recipient is a non-Muslim government. It is permissible to take any legal measure to reduce one's taxes; all unpaid taxes must be paid.

**Tax Payments On Reserves**

*What is the Shariah ruling with regard to the bank's payment of income tax from the amount deducted annually for the investment risk reserve?*

Where applicable, the bank must pay tax from the amount deducted annually for the investment risk reserve.

# USHR

**Ushr**

*What is ushr?*

"It is He who produces gardens trellised, and untrellised, palm-trees, and crops diverse in produce, olives, pomegranates, like each to each, and each unlike to each. Eat of their fruits when they fructify, and pay the due thereof on the day of its harvest; and be not prodigal; God loves not the prodigal"(6:141).

Ushr is the zakat equivalent for agricultural produce, charged at a rate of 5% or 10% depending on the means of irrigation by which the crop is produced.

**Who Pays Ushr**

*Who is obliged to pay ushr?*

Ushr payment is obligatory on any landowner, lessee or tenant, adult or minor, sane or insane, who receives monetary benefit, regardless of the agricultural output of the land or the nisab eligibility of the individual.

**Ushr Payment In Case Of Shared Land**

*What is the liability of the partners who jointly own an ushr-qualifying land?*

If more than one individual owns, leases or rents ushr-qualifying land, each individual pays ushr according to the proportion of monetary benefit received, regardless of the individual's participation in capital investment, costs and expenses. If one individual owns the land, while another individual owns the produce from the land and all the resultant monetary benefit, then ushr is paid only by the one owning the produce.

**Ushr In Non-Muslim Lands**

*Am I liable to pay ushr for crops grown in non-Muslim lands?*

Ushr is payable whether the crop is grown on Muslim lands or non-Muslim lands.

**Rate Of Ushr**

*What rate is ushr charged at?*

Ushr is payable at the rate of 10% of total output on agricultural produce irrigated naturally, whether by rain or by natural bodies of water such as rivers, springs, streams, or the like. Ushr is payable at the rate of 5% of total output on agricultural produce irrigated artificially, whether by canals, wells, sprinkling, dams, motorization, or the like. When a single crop is irrigated by both artificial and natural means, the predominant method relied upon, whether artificial or natural, determines the rate of ushr of either 5% or 10% (or a weighted average).

**Ushr On Non-Tradable Crops**

*Is ushr due on crop that is not meant for trade?*

Ushr is due on all tradable crops but not on non-tradable crops used for one's household consumption, such as fruits and vegetables grown in one's garden.

**Kinds Of Crop Ushr Is Due On**

*What kinds of crop is ushr due on?*

Ushr is payable on every kind of fruit, vegetable, grain, nut, and honey product.

**Ushr On Waqf**

*Is ushr due on a waqf (endowment property)?*

Ushr is payable on a waqf (endowment property).

**Ushr On Crops Purchased For Trade**

*Is ushr due on crops purchased with the intent of reselling?*

Ushr is not due on crops purchased with the intention of selling, in which case the zakat of tradable goods is paid on them; rather ushr is paid on crops raised with the intention of harvesting.

**Ushr On Minerals And Buried Treasure**

*Is ushr due on minerals, metals and hidden treasure?*

Twenty percent of unearthed solid minerals and metals (e.g. gold, iron, etc.) and hidden treasure belongs to the public treasury (bait-ul-mal) and the remainder with the property owner, and no ushr payment is made.

**Ushr On Precious Stones And Liquid Minerals And Metals**

*Is ushr due on precious stones and liquid minerals and metals?*

All precious stones and liquid minerals and metals (e.g. oil, mercury, etc.) belong to the property owner, and neither payment to the public treasury nor ushr payment is made.

**Ushr On Destroyed Property**

*Is ushr due on destroyed property?*

There is no ushr on property that is destroyed before or after assessment.

**Stolen Property As Ushr**

*Is it permissible to give or take stolen property as ushr?*

It is impermissible to give or take stolen property as ushr one is certain is stolen; if there is doubt then it is permissible to give or take the ushr, though it is always superior to avoid the doubtful.

**When Ushr Becomes Due**

*When does ushr become due?*

Ushr is due at the time of harvest before any portion of the crop becomes usable, whether as food or otherwise; ushr assessment is obligatory before any portion of the crop is used, and the crop owner must account for any portion of the crop that is used before assessment.

**When Ushr Is Paid**

*How often is ushr paid?*

Unlike zakat which is paid annually, ushr is paid by harvest, only once, whether the harvest occurs once a year or more than once a year, even if the produce remains stored with the owner for more than a year.

**Ushr On Unusable Crop**

*Who is liable to pay ushr for crop that is sold before it becomes usable?*

For crop that is sold before it becomes usable, the onus of ushr payment rests on the buyer (i.e. new owner) once the crop actually becomes usable, not on the seller (i.e. original owner).

**Recipients Of Ushr**

*Who is eligible to receive ushr?*

Ushr recipients are the same as zakat recipients; the eight categories of zakat recipients are: 1) the poor; 2) those short of money; 3) zakat collectors; 4) those whose hearts are to be won over; 5) the slave seeking ransom; 6) the indebted; 7) those fighting for the cause of Allah; and 8) the needy traveler.

**Ushr From Person With Unlawful Earnings**

*Is it permissible to accept ushr from a person whose earnings are unlawful?*

The permissibility of taking ushr from a source whose earnings might be unlawful depends on the extent to which the source's wealth is unlawful and the degree of certainty to which the ushr recipient determines the extent of this unlawfulness. The ushr recipient should determine the unlawfulness of the source's earnings according to that which is reasonably apparent; it is neither recommended nor preferred to seek out information about the unlawfulness of a source's earnings.

**Ushr To Non-Muslims**

*Are non-Muslims entitled to receive ushr?*

Non-Muslims may not receive ushr.

**Ushr To Members Of Prophetic Household**

*May I pay ushr to members of the Prophet's family?*

Members of the Prophet's Family (Allah bless them and give them peace) and their descendants may not receive ushr, even as remuneration for collection, though they may collect and distribute ushr without compensation.

**Ushr To Recipients Who May Use It In Unlawful Ways**

*Is it permissible to give ushr to recipients who would use it in unlawful ways?*

It is impermissible to give ushr to an eligible recipient when one is certain it will not be used lawfully, and offensive if one doubts whether it will be used lawfully.

**Ushr In Cash Or Kind**

*Is ushr paid in cash or in kind?*

Ushr is payable in kind or in its cash equivalent.

**Measuring Ushr-Chargeable Property**

*How is ushr-chargeable property measured?*

Ushr is calculated from total agricultural output, not net of operational costs and expenses (i.e. labor cost, seed cost, equipment depreciation, property tax, etc.).

# ZAKAT

## Zakat

*What is zakat?*

“And perform the prayer, and pay the alms; whatever good you shall forward to your souls’ account, you shall find it with God; assuredly God sees the things you do.”(2:110) Zakat is an Islamic tax paid by qualifying Muslims to deserving recipients, and a means to purify one's wealth. It is not charity. Rather, it is a portion of one's property that needy Muslim members of society already own by virtue of it having been in one's possession for one lunar year.Zakat therefore, is *distributed*, not *donated*. Unlike charity (sadaqah), which is recommended to give, zakat is obligatory, whose non-payment or late payment is an enormity.

## Obligation Of Zakat

*Who is obliged to pay zakat?*

Zakat is obligatorily due on every sane, adult Muslim male and female. Zakat is due on those possessing the minimum nisab and are free of debt obligations; financial obligations (where the net worth of the individual is below the nisab amount because he owes more than he is worth) exempt one from paying zakat only if the individual exhausts all reasonable means to repay these debts using other forms of surplus wealth (i.e. wealth that exceeds what is normal considered a requirement for living).

## Exceptions To Zakat On Estate Of Deceased

*When is zakat not paid on the deceased’s estate?*

Unpaid zakat is not taken from the estate of the deceased unless a bequest specifies that zakat should be paid posthumously, in which case zakat is paid on one-third of the estate, regardless of whether this amount covers the zakat obligation or not; it is permissible, though not obligatory, for the inheritors of the remaining two-thirds of the estate to fulfill the balance of the zakat obligation from their own portion.

**Zakat-Deduction On Taxable Income**

*Is it permissible to deduct zakat from one's taxable income when preparing a tax filing?*

It is permissible to deduct zakat from one's taxable income as one would a charitable donation when preparing a tax filing.

**Money Changers' Zakat**

*Is zakat payable on money changers' capital exchanged within one lunar year?*

There is no zakat on money changers' capital exchanged within one lunar year.

**Giving Total Zakat To Single Person**

*May I give all my zakat to a single person?*

It is permissible to give all of one's zakat to a single person, but this becomes offensive, though no less valid, if the recipient exceeds the nisab minimum as a result of having received this amount.

**Distributing Zakat In One's Area**

*Is it necessary to distribute zakat only in one's area?*

It is recommended to give zakat in one's area (and offensive not to), unless recipients in another area are more deserving (such as victims of war, zakat eligible relatives, students of Sacred Law, military jihad soldiers fighting intruders, etc.).

**Obligation Of Zakat On Non-Muslims**

*Is zakat obligatory upon non-Muslims?*

Non-Muslims and apostates to Islam do not pay zakat, even in Muslim lands, nor do they pay zakat for the time spent out of Islam if they later decide to become Muslim.

**Zakat Of One Unable To Pay In Person**

*Who is responsible for the zakat of one unable to pay in person?*

A guardian or trustee must pay zakat from the wealth of a qualifying individual who is unable to pay in person, such as a traveler, prisoner or incapacitated person.

**Zakat On Behalf Of Insane Individual Or Minor**

*Is it obligatory to pay zakat on behalf of an insane individual or a minor?*

There is difference of opinion about the obligatoriness of zakat payment by a guardian on behalf of an insane person or a minor. Imams Shafi'i and Malik hold that it is obligatory while Imam Abu Hanifah holds that it is not.

**Unpaid Zakat Of Deceased**

*Should unpaid zakat be deducted from the estate of a deceased?*

Unpaid zakat is not taken from the estate of the deceased unless a bequest specifies that the zakat should be paid posthumously, in which case zakat is paid on one-third of the estate, regardless of whether this amount covers the zakat obligation or not; it is permissible, though not obligatory, for the inheritors of the remaining two-third of the estate to fulfill the balance of the zakat obligation from their portion.

**Obligation Of Zakat On Children**

*Must children pay zakat?*

Children do not pay zakat; neither is the guardian obligated to pay zakat on behalf of the child from the child's wealth, nor is one expected to pay zakat for one's childhood; zakat is only obligatory on the zakat-eligible child upon puberty, where actual payment is due one lunar year after puberty.

**Zakatable Property And Zakat Rates**

*What property is zakatable and what are the zakat rates?*

One must pay zakat annually on the following items held for at least one lunar year:

*Gold and Silver:* Gold exceeding 87.479 grams (about 0.2 lbs) at 2.5% (or 1/40th), in gold or its cash equivalent; Silver exceeding 613.35 grams (about 1.35 lbs) at 2.5%, in silver or its cash equivalent; includes all forms of gold and silver jewelry;

*Cash and other exchangeable monetary instruments* exceeding the equivalent of the silver nisab at 2.5%;

*Tradable goods:* Tradable goods such as stocks, inventory and merchandise for resale that exceed the equivalent of the silver nisab at 2.5% if the goods were bought with silver or a monetary instrument (e.g. cash, stock, goods); or exceeding the equivalent of the gold nisab at 2.5% if the goods were bought with gold;

*Agricultural products:* (search "Ushr");

*Animals and livestock:* equal to or exceeding 40 head of sheep and goat, 30 head of cattle or 5 head of camel.

Nisab is measured either 1) separately (for gold, silver, cash, stocks, and other exchangeable monetary instruments, and trade goods), by measuring the nisab separately for each zakatable category; or 2) if individual measures fall below the nisab amount, it is obligatory to combine individual measures from each category (of gold, silver, and so on) to determine the total amount of zakatable property; livestock is always measured separately.

Zakat is only obligatory on property possessed for at least one lunar year, though if during the year while the value of the property exceeds the nisab and more property which is held for less than one year is added to the original amount, zakat is paid on the new amount (i.e. zakat is paid on the original property held for one year plus new property held for less than one year).

**Nisab**

*What is nisab?*

Nisab is a measure of the minimum property one owns that obligates one to pay zakat, and is measured in addition to (not as a part of) the typical requirements necessary for living. Typical requirements necessary for living includes such items as food, clothing, housing, means of conveyance, tools for trade and household and personal effects, regardless of their cost.

### Zakat On Items Containing Gold Or Silver

*Is zakat due on jewelry, ornaments and other items containing gold or silver?*

Zakat is due on jewelry, bars, decorations, ornaments, thread woven into cloth and all other items containing gold or silver regardless whether the items are used or not; for items containing a mix of gold and silver, or a mix of gold or silver with another metal in which the mixture is not accurately measurable, the predominant metal is assumed to comprise the whole (e.g. a bracelet made mostly of gold containing some silver ornamentation should be valued as if made entirely of gold, while a bracelet made mostly of steel containing some gold should be valued as if made entirely of steel).

### Zakat On Tradable Goods

*Is zakat due on anything purchased with the intention of reselling?*

Zakat is due on anything purchased with the intention of reselling the item (e.g. business inventory, real estate, car, clothing), regardless of how much time elapses or how the item is used before resale (e.g. lent, rented out, put up as collateral); if there was no firm intention to resell at the time of purchase, but rather the individual considered resale only one possibility among others, such as using the item for personal use, then zakat is not due on the item; once the item is sold, zakat is payable on the proceeds after one lunar year elapses on the money.

If an individual does not make a firm intention to resell an item at the time of purchase, but later decides to resell the item, zakat is due once the item is sold and at least one lunar year elapses on the money. Tradable goods are zakatable at all stages of production, regardless of whether they are raw material, work in progress or finished product.

### Zakat On Means Of Production

*Is zakat due on means of production such as machinery?*

Zakat is not due on an investment's means of production (e.g. property, plant and equipment).

### Zakat On Uninvested Cash

*Is zakat due on uninvested cash?*

Zakat is due on uninvested cash or cash that is returned to the investor for the period of time that it remained uninvested.

**Zakat On Investment Income**

*Is zakat due on investment income?*

Zakat is due on the returns that one receives from an investment.

**Zakat On Items Given In Charity**

*Is zakat due on items held for one lunar year and subsequently given in charity?*

Zakat is due on items held for at least one lunar year before being given away in charity, because after a year zakat becomes a debt obligation that remains unfulfilled even by charity.

**Zakat On Disbursed Loans**

*Is zakat due on disbursed loans?*

Zakat is due on loans that have been disbursed where there is a reasonable expectation of receiving repayment.

**Zakat On Waived Loans**

*Is zakat due on loans waived even though the debtor is able to pay?*

Zakat is due on loans that are waived when the debtor is able to pay; the poor are due a share of the loan and waiving it unnecessarily amounts to misappropriating another's wealth.

**Nisab Fluctuations During The Year**

*Am I liable to pay zakat if my property drops below nisab during the year?*

Zakat is due even if one's property value falls below the nisab minimum and rises back above it during the year.

**Zakat Amount In Relation To Nisab**

*Do I calculate my zakat on the full amount of the property, or the full amount less the minimum nisab?*

Zakat is due on the full amount of the above properties rather than the full amount less the nisab measure.

**Nisab Of Business Owner Or Business**

*Is zakat paid on the nisab of an individual business owner or on the nisab of a business or property?*

Zakat is measured in relation to an individual business owner's nisab, not on a business's or property's nisab, so business partners or owners of shared property pay zakat according to their respective nisab only, not for the nisab of the business or property in aggregate; the Shafi'i school calculates nisab on the basis of the entire business or property, even if individual partners do not qualify for nisab; the Maliki school exempts partners who have been with the business or shared in the property for less than one lunar year or who do not qualify for nisab.

**Zakat On Gifts**

*Is zakat due on gifts?*

Zakat is due on qualifying property that has been received as a gift and been in possession for at least one lunar year.

**Zakat On Unlawful Wealth**

*Is zakat due on wealth acquired through unlawful sources?*

Zakat is due on both one's lawfully and unlawfully acquired wealth, though it is obligatory to eliminate the impermissible portion of one's wealth, regardless of how long ago it was acquired and whether one did so knowingly, unknowingly, mistakenly or was given to against one's will.

**Zakat On Household Items And Personal Effects**

*Is zakat due on household items and personal effects?*

Zakat is not due on the typical requirements necessary for living, including such items as food, clothing, housing, means of conveyance, tools for trade, the books and utensils of a student or teacher, and household and personal effects, regardless of their cost.

**Zakat On Revenue-Generating Livestock**

*Is zakat due on revenue-generating livestock?*

Zakat is not due on farm animals that constitute the means of production itself (e.g. there is no zakat on egg-laying chickens and dairy cows), but there is zakat on their product (e.g. egg and milk inventories).

**Zakat On Animals For Personal Use**

*Is zakat due on pets and other animal for personal use?*

Zakat is not due on animals owned for personal use, even if ownership entails material benefit, such as the use of the animal for transport (e.g. horses, camels) or food (e.g. livestock).

**Zakat On Stolen, Lost Or Destroyed Property**

*Is zakat due on zakatable property that is stolen, lost or destroyed?*

Zakat is not due on zakatable property that is accidentally stolen, lost or destroyed before its zakat is distributed; though zakat is due on property destroyed intentionally, which amounts to misappropriation because zakat is a debt obligation to the deserving recipient.

**Zakat On Hobby Items**

*Is zakat due on hobby items?*

Zakat is not due on hobby items, like collectibles, pets, and toys, until they are employed for trade.

**Zakat On Unrecoverable Loans**

*Is zakat due on bad debts and unrecoverable loans?*

Zakat is not due on loans disbursed when there is no reasonable expectation of repayment; if the loan is ever repaid, the creditor is obligated to retroactively pay zakat for each of the zakatable years the loan is outstanding.

**Zakat On Rented Property**

*Is zakat due on property rented out?*

Zakat is not due on property rented out, including residential property, vehicles and equipment, but zakat *is* due on the rental income exceeding nisab earned for at least one lunar year.

**Zakat On Property Already Charged With Ushr**

*Is zakat due on property that is subject to ushr?*

Zakat is not due on property that is already charged ushr (payment on farm produce).

**Zakat On Precious Stones**

*Is zakat due on precious stones?*

Zakat is not due on pearls and precious stones, until they are employed for trade.

**When Property Becomes Zakatable**

*When does property become zakatable?*

Zakat is due on zakatable property possessed for at least one lunar year; zakat calculations must obligatorily be based on the lunar year because payment intervals on the solar calendar are longer.

**Late Payment Of Zakat And Unpaid Zakat Liability**

*Is late payment of zakat allowed? What is my liability regarding unpaid zakat?*

Late payment of zakat is an enormity and any unpaid zakat, even for previous years, must be calculated and paid immediately, accompanied by a sincere repentance; if one is unable to determine exact amounts, one should estimate a bit on the higher side.

**Zakat On Tradable Goods**

*Is zakat due on tradable goods?*

Zakat is due on tradable goods one lunar year from the date the total inventory exceeds the nisab minimum, even if individual items within this inventory are replaced by buying, selling or exchanging (assuming that the total inventory never falls below the nisab minimum, because if it does, a new valuation date is set for when the nisab minimum is exceeded).

**Value Assessment Of Tradable Goods For Zakat**

*How do I assess the value of tradable goods for zakat payment?*

Tradable goods are assessed at the end of every zakat year according to their current market value rather than their historical cost basis (i.e. the original price of the asset). The current market value of tradable goods is measured as their market value if all the goods were sold at once, rather than if they were sold individually at their retail or wholesale price, entailing a higher zakat amount; it is superior, though not obligatory, to measure the current market value of tradable goods at their individual wholesale price.

**Unpaid Zakat**

*When does unpaid zakat become payable?*

Unpaid zakat is payable immediately.

**Zakat On Property Held Less Than One Year**

*Is there any zakat on property held less than one lunar year?*

There is no zakat on property owned for less than one lunar year, including loss of ownership even if for a moment during the year, and loss of ownership caused by death.

**Zakat On Lost And Found Items**

*Is zakat due on lost and found items?*

Zakat is not due on lost property for either the one who loses or the one who finds and, if found, zakat payments are only made upon the resumption of possession and not made for the time the property was lost. Though in the Shafi'i school zakat is paid on qualifying property that is absent from the zakat payer (e.g. lost, lent or stolen money) for the period of time that it is absent, on the condition that this property is eventually recovered and that it still exceeds the nisab amount upon recovery.

**Sale Of Property Just Before End Of Lunar Year To Avoid Zakat**

*Is it valid to sell property just before the end of the lunar year to avoid paying zakat on it?*
Sale of property intended to avoid zakat payment is considered unlawful, though if the timing of the sale happens to coincide with the payment of zakat it is lawful.

**Timing For Payment Of Zakat**

*What is the optimal timing of zakat payment?*

One must pay zakat as soon as it becomes due (or, optionally, before) assuming the conditions exist, namely that at least one of the eight categories of deserving recipients exists, and that one does not await a more deserving recipient than the one currently available, in which case some delay becomes permissible.

**Advance Payment Of Zakat**

*Is advance payment of zakat valid?*

Two conditions must be satisfied for the advance payment of zakat to be valid. At the end of the zakat year during which payment was made in advance: 1) the zakat recipient must still qualify for

zakat, namely that he or she is living and still a valid recipient, after having deducted the amount by which he or she is enriched by the original advance zakat payment; and 2) the zakat payer must still qualify for zakat payment, namely that he or she is living and still a valid payer. If the advance payment is found to have been invalid at the end of the year based on these two conditions, the money is returned by the recipient at the rate at which it was received.

**Zakat Recipients**

*Who is entitled to receive zakat?*

The eight categories of zakat recipients are:

1. The poor: generally includes individuals unable to provide for themselves and their families for the foreseeable future (as some jurists note, for the year ahead) with the typical requirements necessary for living for individuals of a similar social standing of their locality, either due to an insufficiency of wealth or an inability to work; for those permanently unable to provide for themselves, such as the incapacitated poor, or the widow without support, an ongoing zakat-based pension may be arranged;
2. Those short of money: includes individuals whose temporary circumstances cause them to become poor, in which case the general guideline for determining "poverty" is followed (as above, "the poor"), such as those who do not have access to their money, whether due to separation or being owed money, and thereby become poor;
3. Zakat collectors: includes individuals and institutions authorized to distribute zakat, provided the entire zakat amount is given to the poor and not deducted from to pay for administrative expenses;
4. Those whose hearts are to be won over: includes Muslims whose faith may be weak and whose service to the ummah may be improved by a monetary incentive; Hanafis and Malikis consider this category to be unique to the early generations of Muslims when the ummah was in a state of tremendous expansion; its abrogation during the time of Hazrat Abu Bakr and Hazrat Umar (Allah be well pleased with them both) is believed to be final, but other jurists still regard its validity as applicable to, for instance, new converts to Islam estranged from their families;
5. The slave seeking ransom: includes providing a slave the funds to purchase freedom; it is worth noting that the practice of slavery, which began before the coming of Islam and which Islamic rulings themselves helped to phase out, is entirely distinguishable from the colonial variety which provided slaves with neither legal right nor legitimate recourse to freedom, as this zakat provision does;
6. The indebted: includes those whose debts exceed their zakatable wealth and thereby become "poor" or "short of money" because they are burdened with a debt, and neither their work nor their surplus wealth is sufficient to repay the debt;

7. Those fighting for the cause of Allah: includes salaries, weaponry, clothing, equipment, and the like for individuals actively participating in military jihad for the establishment of Islam, and their non-participating dependents, who have no other source of income, such as from their government;
8. The needy traveler: includes individuals traveling 81km or more from their city's limits (or what is normally considered to be the limits of one's area of residence) who are short of money (having spent or lost it, or having been stolen from) and are reasonably unable to access their money and require expense for food, travel and other necessities, whether they qualify for nisab when resident or not, and even if they are otherwise wealthy.

**Allocation Of Zakat**

*May I allocate my zakat to different categories of recipients?*

Individual zakat payers may allocate their zakat to one, a few, or all of the above eight categories.

**Recommended Recipients Of Zakat**

*Who are the recommended recipients of zakat?*

It is recommended to give zakat to deserving (non-dependent) family and relatives, including brothers, sisters, uncles, aunts, nephews, nieces, step-parents and foster parents; which carries the dual reward of paying zakat and assisting one's kin. It is recommended to give zakat in one's area (and offensive not to), unless recipients in another area are more deserving (such as victims of war, zakat eligible relatives, students of Sacred Law, military jihad soldiers fighting intruders, etc.)

**Zakat As Gift**

*May zakat be given in the guise of a gift?*

Zakat may be paid in the guise of a gift rather than as an ostensible zakat payment.

**Wages And Expenses Of Zakat Collectors**

*Is it permissible for zakat collectors to deduct wages and other expenses from zakat itself?*

In modern times, when no Islamic state exists, it is impermissible for zakat collectors to deduct wages and administrative expenses from the zakat itself for the service of distributing zakat among

recipients; it is a condition for the validity of a zakat collector to deduct wages that the zakat recipient appoint the zakat collector to act as an agent on behalf of the recipient; in an Islamic state, the head of the state is obligated to act on behalf of zakat recipients by appointing zakat collecting agents, so zakat collectors are effectively appointed by the recipients in an Islamic state; but in a modern state, zakat collectors act on behalf of zakat givers, not zakat recipients, so it would be impermissible for a zakat collector to deduct wages and administrative expenses from the zakat. It is permissible, however, for zakat collectors to take charity, not zakat, to cover wages and administrative expenses related to zakat collection.

**Benefit In Lieu Of Zakat Payment**

*Is the zakat payer entitled to any benefit in lieu of his zakat payment?*

No worldly benefit, whether of goods, services or otherwise, should accrue to the zakat payer in relation to the zakat payment itself.

**Stolen Property As Zakat**

*Is it permissible to give or take stolen property as zakat?*

It is impermissible to give or take stolen property as zakat one is certain is stolen; if there is doubt then it is permissible to give or take the zakat, though it is always superior to avoid the doubtful.

**Zakat Given Through Intermediary**

*Is zakat deemed paid when given to an intermediary/zakat collector?*

Zakat given to an intermediary, like a collecting individual or institution, is deemed to have been paid once the intermediary is given the zakat, not necessarily when the intermediary actually distributes the zakat.

**Verifying Legitimacy Of Zakat Collector**

*Is the zakat payer responsible to check the legitimacy of the zakat collector?*

The zakat payer is responsible for verifying the legitimacy of the collecting intermediary before payment, though additional checking is not necessary after payment.

**Zakat To Students Of Sacred Law**

*May I pay zakat to students of Sacred Law?*

Students of Sacred Law may be considered poor, and therefore eligible to receive zakat, if they fall below the nisab minimum *and* their pursuit of Sacred Law precludes their ability to earn a livelihood; though students of non-Islamic knowledge are only considered poor if they fall below the nisab minimum.

**Zakat In Lieu Of Wages**

*May I pay zakat to my employee in lieu of wages?*
Zakat may be given to one's zakat eligible employee as a gift (while intending zakat in one's heart), but not in lieu of wages.

**Zakat To Woman Denied Marriage Payment**

*May I pay zakat to a woman who has been denied the marriage payment by her husband?*

Zakat may be given to the woman whose husband is unable (or unwilling) to pay the marriage payment.

**Zakat To Charitable Institutions**

*May I pay zakat to charitable institutions such as hospitals?*

Institutions such as hospitals, orphanages and charitable schools that serve needy zakat recipients may receive zakat, for which the entire zakat amount must be appropriated directly to the poor; it would be impermissible for any of the zakat funds to be used for wages and administrative expenses.

**Zakat To Individuals Exceeding Nisab**

*Are individuals exceeding the nisab entitled to zakat under any circumstance?*

Individuals exceeding the nisab may not receive zakat unless they are: 1) zakat collectors; 2) of those whose hearts are to be won over; 3) a slave seeking ransom (where the price of freedom exceeds the nisab); 4) indebted (where the debt exceeds their surplus wealth) 5) fighting for the cause of Allah; or 6) a traveler in need.

**Zakat To Non-Muslims**

*May I pay zakat to non-Muslims?*

Non-Muslims may not receive zakat, though they may receive charity.

**Zakat In Lieu Of Separate Obligation**

*May I pay zakat in lieu of an independent, separate obligation?*

Zakat may not be used to pay for something already obligatorily established as due from another source, such as burial expenses or the fulfillment of a deceased's unpaid debts, which come from the deceased's estate.

**Zakat For Members Of Prophetic Household**

*May I pay zakat to members of the Prophet's family?*

Members of the Prophet's Family (Allah bless them and give them peace) and their descendants may not receive zakat, even as remuneration for collection, though they may collect and distribute zakat without compensation.

**Zakat To One's Dependant Family Members**

*May I pay zakat to my dependant family members?*

Members of one's dependant family and relatives (or one's spouse's dependant family and relatives) may not receive zakat, since these individuals are already obliged to receive one's support (assuming the necessary conditions exist), including one's spouse, parent, grandparent, great grandparent, and their direct ascendants; and child, grandchild, great grandchild and their direct descendants.

**Zakat To Former Zakat Recipients**

*May I pay zakat to former zakat recipients who have now exceeded the nisab?*

Individuals previously eligible to receive zakat, but upon receiving zakat exceed the nisab, should not receive zakat.

**Paying Zakat To One Using Money Unlawfully**

*May I pay zakat to an eligible recipient who will use the money in unlawful ways?*

It is impermissible to give zakat to an eligible recipient when one is certain the money will not be used lawfully, and offensive when one doubts whether the money will be used lawfully.

**Zakat To Projects And Institutions**

*May I pay zakat towards development projects and institutions?*

Zakat may not be given to projects (e.g. building masjids, hospitals, schools, etc.) but rather must be given to eligible individuals, unless the project also operates as a collector and allocates the zakat funds directly to the poor.

**Zakat Allocation Towards Payment Of Salaries And Other Expenses**

*Is it valid to use zakat money to pay for operating costs of the zakat-collecting institution, such as salaries?*

Zakat may not be used to pay for operating costs (e.g. salaries, utilities, administration, etc.) even if the institution taking zakat directly benefits zakat eligible individuals; a condition of valid zakat distribution is that the zakat is given in its entirety directly to the eligible recipient, so that the recipient actually owns the zakat; it is permissible to give zakat to recipients and to charge them a fee for a service, from which an operating cost may be paid (e.g. a hospital gives zakat to a needy patient; the patient gives the money to the hospital for treatment; the hospital allocates a portion of the money for the doctor's salary).

**Intention When Paying Zakat**

*What intention must I have when paying zakat?*

Zakat payers must have an intention to pay zakat prior to its payment for it to be considered zakat, whether the intention is spoken, unspoken or written; one may not, for instance, retroactively label a payment "zakat," though if the giver establishes with certainty that the recipient still possesses the very money that one has given and it has not yet been spent, the payer may make the intention of zakat; it is valid for the intention to be made well before the time of disbursement; this intention is necessary from the original payer, not from the one authorized on behalf of the payer to distribute zakat.

**Zakat Payment In Kind**

*May I pay zakat in kind instead of cash?*

Zakat may be paid in kind by taking the appropriate percentage from the zakatable good itself (e.g. 2.5 grams of gold paid for 100 grams of gold owned) or by paying separately with durables (e.g. clothing, shoes, blankets).

**Subtracting Debts Owed From Zakatable Wealth**

*Is it valid to subtract debts from one's total zakatable wealth?*

Debts are subtracted from one's total zakatable wealth; if the net amount is greater than the nisab minimum, zakat is owed; if the net amount is less than the nisab minimum, zakat is not owed.

**Amount Of Zakat Per Recipient**

*Is there any bar on the amount of zakat I may give to a single recipient?*

The amount of zakat given depends on the recipient. For instance, one looks at the needs of the person's trade for the working poor, the extent of the household requirements for the non-working poor, the size of the loan for the indebted, the needs of the traveler, and so on.

**Assessing Value Of Non-Cash Zakatable Items**

*What is the appropriate time to assess the market value of non-cash zakatable items?*

Non-cash zakatable items for which it is decided that cash will be paid should have their market value assessed on the valuation date, not before or after, in order to avoid inaccurate payment caused by price fluctuation (e.g. zakat on stocks is paid as of the valuation date regardless of the rise and fall in price).

**Valuation In Case Of Advance Payment Of Zakat**

*In the event of advance payment of zakat, am I obliged to value my wealth on the termination of one lunar year?*

If zakat is paid in advance, the payer must still ascertain on the valuation date that his zakatable property, and therefore his zakat obligation, did not increase after the original payment for which he would still be liable to pay.

**Zakat Payment In Advance Of Zakat Qualification**

*May I pay zakat in advance of my wealth being equal to or greater than the nisab?*

Zakat may be paid in advance of one's zakat valuation date, but not in advance of one's nisab qualification.

**Zakat Payment In Installments**

*Is it valid to pay zakat in installments?*

Zakat must be paid in its entirety as soon as it becomes due, but if it is paid in advance of one's zakat valuation date, it may be paid in parts.

**Informing Recipient Of Zakat Payment**

*Must I inform the recipient of zakat that the payment is zakat?*

Zakat payers need not necessarily inform the recipient that the payment is zakat, though they may do so if they wish; payment may be made in the guise of a gift rather than as a zakat payment.

**Waiving Unpaid Debt In Lieu Of Zakat**

*Is it valid to waive unpaid debt in lieu of zakat payment?*

Unpaid debt may not be waived in lieu of paying zakat; if a person owes money and is eligible to receive zakat, it is permissible to pay the person zakat first (so that the money is in his constructive possession) and then ask for the loan to be repayed; it is impermissible to condition the payment of the zakat on the repayment of the loan; it is at the borrower's discretion whether to repay then or later, though the borrower should be aware that delaying repayment of a loan when the means are available is blameworthy.

**Intending Zakat While Ostensibly Making Loan**

*Is it valid to intend paying zakat while ostensibly making a loan?*

It is permissible for a zakat payer to intend to pay zakat while ostensibly making a loan, and thereby fulfill his zakat obligation, provided the recipient is eligible to receive zakat and that if the recipient returns to repay the money, the zakat payer must refuse to accept the repayment by waiving the ostensive loan obligation.

**Contingencies Or Stipulations In Zakat Payment**

*Is it valid to place stipulations or make zakat payment to an individual contingent on a particular event?*

Zakat payment, whether in cash or in kind, is paid in its entirety to the recipient (or the intermediary handling zakat distribution) without contingencies (e.g. it is unacceptable to say: "I will give you this zakat only if you use it to send your children to school" or "This zakat is being given to build this school"; rather, recipients may be advised about a course of action without imposing stipulations on the manner in which the property, which is effectively the recipient's, is spent).

**Paying Zakat To Undeserving Recipient By Mistake**

*What is my liability if I unknowingly pay zakat to an undeserving recipient?*

Zakat unknowingly paid to an undeserving recipient (e.g. the recipient actually exceeds the nisab requirement) is deemed to have fulfilled the obligation of zakat if the payer realizes the mistake afterwards, though the onus of returning the zakat rests with the recipient.

**Inadvertent Zakat Payment To Non-Muslim**

*Is inadvertent zakat payment to a non-Muslim considered zakat paid?*

Incorrect payment to a non-Muslim is not considered zakat paid.

**Doubts Regarding Zakat Eligibility Of Recipient**

*What must I do if I doubt the zakat eligibility of a recipient?*

When the zakat payer doubts the zakat eligibility of a recipient, it is better to refrain from giving zakat; if zakat is given and the payer later confirms the eligibility of the recipient, the zakat obligation will have been fulfilled.

**Setting Off Losses With Zakat**

*Am I allowed to set off my losses against my zakat payment?*

Regardless of one's losses (e.g. in stock market investing, real estate speculation, business ventures, etc.), one is obligated to pay zakat on the entire net amount (i.e. zakatable property less current liabilities); losses may not be calculated *against* the zakat itself (e.g. if one's zakatable property

comes to $100,000, and one thereby owes $2,500 in zakat, it would be impermissible to take, for instance, a $500 loss in the stock market and reduce one's zakat to $2,000).

**Zakat As An Allowable Tax Deduction**

*Am I allowed to deduct zakat as a charitable donation from my tax return?*

Depending on the tax jurisdiction, from a Shariah perspective it would be permissible to deduct zakat from one's taxable income as one would a charitable donation when preparing a tax filing.

**Authorizing Third-Party To Distribute Zakat**

*Is it permissible to authorize a third-party to distribute my zakat?*

Just as it is permissible to give zakat to those authorized to collect and distribute zakat, so too it is permissible to appoint a third party to distribute one's zakat.

**Zakat Collector Authorizing Another To Distribute Zakat**

*Is it permissible for a zakat collector to authorize another party to distribute zakat?*

The authorized distributor is entitled to authorize another party to distribute the zakat; it is permissible, though not a necessary requirement, to disclose the identity of the original zakat payer, unless the zakat payer instructs otherwise.

**Intention In Case Of Third-Party Distributor Of Zakat**

*Is it necessary for a third-party distributor of zakat to make the intention of zakat when distributing?*

When the zakat payer appoints a distributor (or the distributor appoints another party), only the intention of the original zakat payer is required, not that of the authorized distributor (or of subsequent parties).

**Third-Party Distributing Very Same Notes Of Zakat As Received**

*Is it necessary for a third-party distributor of zakat to pay the very same cash notes as received from the original zakat payer?*

It is not a condition that the very same cash notes (or similar fungible and transferable property) given by the zakat payer be the ones that are distributed.

**Zakat Payment On One's Behalf Without One's Knowledge Or Permission**

*Is it valid for another to pay zakat on my behalf without my knowledge or permission?*

It is impermissible (and the payment invalid) if zakat is paid on one's behalf without one's knowledge or permission, even if from a distributor authorized to perform other financial and legal functions on behalf of one, and even if one later agrees to the zakat having been paid without one's knowledge (because the payment was not preceded by an intention); there is no obligation to repay the third party making the unauthorized disbursement.

**Zakat Distributor Paying Zakat To Eligible Family And Friends**

*Is it valid for the zakat distributor to pay received zakat to his eligible family members and friends?*

Unless instructed otherwise, the zakat distributor may give the zakat payment to those of his friends and relatives that are eligible to receive zakat.

**Zakat Distributor Keeping Zakat For Himself**

*Is it valid for a zakat distributor to keep received zakat for himself if he is eligible?*

A zakat distributor may not keep any received zakat for himself or his immediate family.

**Inability Of Zakat Distributor To Disburse Zakat**

*What is the liability of the zakat distributor in case of his inability to disburse the full amount of zakat?*

When an individual or institution assigned with the task of distributing zakat is unable to distribute the entire zakat amount, the remaining zakat should be returned to the zakat payer or, with the permission of the zakat payer, be given in charity to a recipient according to the payer's instructions; if contacting the original zakat payer is not possible, the money should be given as zakat to a similar cause.

**Zakat Al-Fitr**

*What is zakat al-fitr?*

Zakat on 'Eid Al-Fitr is a specific kind of zakat, distributed upon the termination of the month of fast (Ramadan), obligatory on every nisab qualifying individual. Zakat al-fitr not only provides the social benefit common to other forms of zakat, but also provides a spiritual benefit as a means of atoning fasters for errors and sins committed during the month of Ramadan.

**Zakat Al-Fitr Rate**

*What is the rate of zakat al-fitr payment?*

Zakat al-fitr payment equals 2.03 liters of the locality's staple food (i.e. equal to or superior to the local staple's quality), though it is also permissible to give its monetary equivalent in cash or in another staple.

**Recipients Of Zakat Al-Fitr**

*Who is entitled to receive zakat al-fitr payment?*

Recipients eligible to receive ordinary zakat are eligible to receive zakat al-fitr.

**Measurement Of Nisab For Zakat Al-Fitr**

*When do I measure my nisab for zakat al-fitr payment?*

Unlike the nisab minimum for ordinary zakat, which must be possessed for an entire year, the nisab minimum for zakat al-fitr is measured at dawn on 'Eid day, the first of Shawwal (the day after the final day of Ramadan).

**When Zakat Al-Fitr Becomes Obligatory**

*When does zakat al-fitr become obligatory on me?*

Zakat al-fitr becomes obligatory from the sunset of the final day of Ramadan to the dawn of the following day, meaning 'Eid day, when it is recommended to be paid before prayer.

**Appropriate Time To Pay Zakat Al-Fitr**

*What is the appropriate time to pay zakat al-fitr?*

It is permissible to pay zakat al-fitr anytime during Ramadan and the ‘Eid day, though impermissible after the ‘Eid day sunset, though no less obligatory.

**Zakat Al-Fitr In Relation To Ramadan Fasts**

*Is zakat al-fitr due on one who did not fast during the month of Ramadan?*

Zakat al-fitr is obligatory whether one fasted during Ramadan or not.

**Zakat Al-Fitr On Behalf Of Dependants**

*Am I obliged to pay zakat al-fitr on behalf of my dependents?*

One is only obligated to pay zakat al-fitr for oneself, not on behalf of those dependents one is obligated to support, though if the dependent exceeds the nisab qualification and is unable to pay zakat al-fitr (e.g. a child, an insane or incapacitated person), one should pay from their wealth on their behalf.

**Non-Muslims Receiving Zakat Al-Fitr**

*May I pay zakat al-fitr to non-Muslims?*

Non-Muslims may not receive zakat al-fitr.

**Zakat Al-Fitr To Prophetic Household**

*May I pay zakat al-fitr to members of the Prophet’s family?*

Members of the Prophet’s Family (Allah bless them and give them peace) and their descendants may not receive zakat al-fitr, even as remuneration for collection, though they may collect and distribute zakat without compensation.

**Distributing Zakat Al-Fitr Among Multiple Recipients**

*May I distribute zakat al-fitr among more than one eligible person?*

It is permissible to give all of one's zakat al-fitr to one person or to distribute it among many.

**Zakat On Business In Debt**

*Is zakat liable to be paid for a business that is repaying debt?*

There is no zakat on a business that is in debt. You will have to pay zakat at the time the business is out of debt.

**Role Of Zakat In Islamic Economy**

*What is the role of zakat in Islamic economics?*

It would be difficult to give a brief answer about the role of zakat in Islamic economics. Generally, zakat can be used to provide social uplift and poverty alleviation as a parallel function to a financing sector, which is more about seeking profits.

**Zakat On Corporate Equity**

*Does corporate equity qualify for zakat? If so is it due on net profit or assets of the company?*

Yes, one must pay zakat on corporate equity. One treats all shares as cash and pays zakat on them accordingly. So, on the day that zakat is due you would calculate the total value of the shares according to the market value of the shares on that day, and then pay 2.5% of that amount in zakat.

**Zakat On Savings**

*Is zakat due on an individual's £5,000 worth of savings or does a debt owed through the Diminishing Musharakah property plan exempt him from it considering the value of the property exceeds his savings and is £200,000?*

The Diminishing Musharakah plan is not a debt that is owed and so it cannot be considered in zakat calculations. The individual has purchased a portion of the property and the Bank owns the rest, which he will purchase from it in installments. These installments are not 'debts' that he owes; they are (usually) unilateral promises to purchase at specified dates in the future. They only become a

debt when the Bank asks him to fulfill his promise on those dates in the future. Given this, he cannot consider the outstanding of his Diminishing Musharakah a 'debt' and hence should pay zakat on the £5,000.

**Zakat In Advance**

*If a person asks one to make a payment for him and one knows he is eligible to receive zakat, is it permissible to waive the debt owed and ask him to consider it a gift?*

This would be permissible if and only if the intention for zakat is made before agreeing to make the payment on behalf of the other person.

**Converting Loan To Zakat**

*If a person given a loan is unable to return it due to his straitened financial circumstances, can the lender convert the loan into zakat without the borrower's knowledge and deduct it from his current year's zakatable amount and in the future when he pays back, give the amount away as zakat?*

No. The loan must be returned before the new zakat is given.

**Zakat Eligibility**

*An irresponsible husband depends on his relatives to pay for his living expenses or sells his property to cover his family's expenses. His wife has some gold which she does not want to sell but in fact safeguard for her children's future. Can the woman be given zakat without telling her it is zakah so she can save her assets for her children?*

If she is being supported by her husband, she is not eligible to receive zakat.

**Zakat Calculation**

*An individual's account balance a year ago was an amount A, now the balance has increased to an amount B. Will zakat be calculated on amount A or the new balance?*

The zakat for the previous lunar year will be calculated on the new balance.


# YOUR BRIEF GUIDE TO ISLAMIC FINANCE

## MUFTI ISMAIL DESAI

# Acknowledgements

I would like to take this opportunity to express my utmost appreciation to my mentor, my beloved father and brilliant teacher, Hadhrat Mufti Ebrahim Desai Saheb (Hafizahullah) for his unwavering support in my academic pursuits. It is through his spiritual effulgence and drive that we are encouraged to serve the people by imparting the sacred knowledge of Deen. I make Du'a that Allah Ta'ala accepts this humble work as a means of dissemination of His pristine Shariah solely for His pleasure and Ridwan. Ameen.

Your Brief Guide to Islamic Finance

First Edition

Published in 1436 AH – 2015.

Editor: Mufti Ismail Ebrahim Desai.

## Table of Contents

# Chapter One

## Islamic Finance - Introduction and Background

### Early History of Islamic Finance

Muslims established a complex economic system in the early stages of Islam. Business partnerships, private equity funds, deferred trading, Islamic futures sales, leasing, agency and other advanced financial techniques formed the backbone of the Islamic financial market even then. Interest-free finance was an integral part of this system.

Early Islamic bankers - or 'sayarifa' - conducted business on a macroeconomic level. They established powerful economic markets. They financed international markets, sank large pools of liquidity into various investment funds, engaged in foreign exchange transactions, created boutique finance houses, and developed a vast array of complex and intricate banking transactions.

The public sector consisted of water resources, energy resources such as animal-driven machinery, and unexploited lands and forests. The public treasury - or Bayt al-Mal – distributed zakat - or obligatory alms - and voluntary charity to the poor and needy while paying the salaries of government workers and public servants such as the chief justice, judges, head mufti and central bank governors.

The Islamic market was regulated and monitored by a central reserve bank.

At its height, this ideal Islamic economic market stretched from Morocco and Spanish Andalusia in the west, to India and China in the east, Central Asia in the north, and Africa to the south.

The Islamic economic system was largely displaced by the medieval period due to various historical, political, social and other factors. Islamic financial institutions only re-emerged during the 1970s. The Dubai Islamic Bank in the United Arab Emirates and the Islamic Development Bank, or IDB, in Saudi Arabia both started operations in 1975.

The theory of establishing an ideal Islamic Capital Market, or ICM, was largely developed between 1955 and 1975. Since then, Islamic banking & financial institutions have expanded in both number and size around the world.

### The Difference between Islamic & Conventional Finance

The fundamental difference between Islamic finance and conventional finance is that of market regulation and monetary utility.

*Market Regulation*

Conventional banks operate within the framework of the free market economy.

An open market economy attracts speculative behaviour, complex derivative transactions, pyramid schemes, gambling, interest, unbridled profit maximization and other unethical practices, which have severe consequences for the social, political and monetary well-being of a society.

Islamic economic activity, on the other hand, is regulated by divine injunctions prohibiting interest, speculative behaviour, obscurity, market monopolization, gambling, and trading in unlawful or prohibited commodities and services. This leads to a just and stable economic system.

*Intrinsic Utility*

In conventional finance, money is considered as a commodity having intrinsic utility and value. Profits are earned through interest and by dealing in money and monetary papers.

In Islamic finance, however, money is merely a medium of exchange. Financial transactions are backed by assets and services, and profit is earned by exchanging illiquid assets for money.

An asset cannot be compounded like interest-based loans. Asset financing creates assets. Illiquid assets and equities can only have one owner at any given time, unlike conventional loans, which compound into large artificial cash flows.

Interest creates artificial cash supplies with no backing in assets or services, resulting in economic volatility, inflation, and the poor getting poorer while the rich get richer.

The practices of the free market economy contribute widely towards economic injustice and financial oppression.

*Sovereign Debt – Example*

Many developing countries take out mega loans from banks and other financial institutions which they then repay many times over due to the compounded interest that accumulates on such loans.

How would an Islamic bank finance the needs of developing countries?

- An Islamic bank could finance the construction of infrastructure projects such as highways, schools and hospitals and deliver the completed projects to the government via an ‘istisna’ contract.
- The bank could take an equity stake in a government project and share in any profits or losses using ‘musharaka’ or ‘mudaraba’ partnership arrangements.
- It could purchase assets and lease them out with an option to buy in an ‘ijara wa iqtina’ contract.
- The bank could establish Islamic Finance Microfinance initiatives to help alleviate poverty.

*John the Factory Owner – Example*

John owns a factory where business is booming. He needs capital to buy the machinery and equipment that will allow him to increase production to meet the growing demand. John takes out a loan from his bank for $50,000 over a tenure of five years. He begins paying out the loan at a rate of

$15,000 per year. It takes him ten years to pay off his loan and in all he pays the bank $150,000 – triple the original amount.

How would Islamic finance fulfil John's needs?

An Islamic bank could structure a mudaraba partnership arrangement. Under this, the Islamic bank would be the investor while John would be the investment manager or working partner. The Islamic bank and John initially agree to a fixed percentage ratio on the returns of the partnership. The bank and John may then terminate their partnership arrangement with mutual agreement.

*Mark the Homeowner – Example*

In 2012, Mark lost his job, his house, and everything he had spent in paying off his mortgage as a result of the infamous Global Financial Crisis.

The primary causes of the crisis were imprudent lending, subprime mortgages, mezzanine financing, complex derivative schemes and unethical financial practices.

Because conventional financial institutions deal in monetary papers without backing in assets or services, they lend out money many times above their real cash reserves. This creates a false and deceptive market economy.

How can Islamic finance fulfil Mark's needs?

An Islamic bank always limits financing to actual assets and services. Therefore the bank could take direct ownership of the asset and arrange financing for the client on the basis of an ijara wa iqtina (Islamic lease with an option to buy), or draw up a normal purchase and sale agreement, or a diminishing musharaka agreement.

'Musharaka' is the Arabic term to describe a partnership. In a diminishing musharaka, the Islamic bank & Mark purchase the home on an Islamic partnership basis. The bank's equity stake diminishes throughout the financing tenure, while Mark's percentage increases until he becomes the sole owner.

The bank never charges Mark interest. The homebuyer pays for just two things:

- The equity in instalments over a fixed financing tenure
- Rental amounts paid to the bank based on ownership proportions.

**What roles can Islamic Finance play?**

Islamic finance is a global phenomenon. It provides answers to many of the problems created by the conventional economic system. It offers a wide variety of financial solutions with a high degree of coherence and adaptability.

Conventional financial products can be broadly divided into four categories:

1. Equity

2. Trading

3. Leasing

4. Debt

Islamic finance covers the first three forms of conventional but not debt financing, which is prohibited in Islam.

Islamic financial institutions offer the following three types of banking products and financial instruments:

1. Equity – Mudaraba (see Chapter 6)/Musharaka (see Chapter 5)

2. Trading – Murabaha (see Chapter 8), Salam (see Chapter 9)

3. Lease – Ijara (see Chapter 7)

## Chapter Two

## Ethics in Islamic Finance

Islam is a complete way of life according great emphasis to ethical values and moral codes. Allah (the most high) says in the Holy Qu'ran:

"I have perfected your religion today and I have completed my bounty upon you and I am pleased with Islam as your religion".

*Definition of Ethics*

Ethics is defined as a set of moral principles that distinguish between right and wrong. Ethics is also used to describe morality, and codes of ethics to describe codes of morality. The word 'ethics' stems from the Greek 'ethos', or 'character'.

*Definition of Business Ethics*

Business ethics examines the ethical principles and rules of commercial and financial institutions. Business ethics define what is good and bad and what is just and unjust in business.

*Objective of Business Ethics*

The fundamental objective of business ethics is to enable individuals to make the right moral choice between different business options or to provide prescriptive advice on how to act morally in any given situation.

### Basic Islamic Business Ethics

*Truthfulness*

Islam encourages truthfulness in all commercial activities. The last prophet of Allah (the most high) has stated that "an honest, truthful businessman will be among the prophets, sincere believers and martyrs." (hadith of al-Tirmidhi)

The prophet also said, "Indeed, the traders shall be resurrected on the day of resurrection as sinners except those who exercised religious restraint (taqwa), were pious and truthful." (Tirmidhi)

*Free Enterprise*

Islam to a certain extent allows freedom of economic enterprise, profitization and private ownership. However, Islam has set certain economic restrictions and regulations that allow for distributive justice and economic equitability while preventing monopolization and other economic malpractices.

*Trustworthiness*

Trustworthiness is the fundamental element of business ethics. Without trust, people cannot engage in sustainable commercial ventures and partnerships. Islam promotes trust.

Allah (the most high) says:

"And do not betray those who trust you"

The prophet said:

"Discharge the trust to those who have entrusted you, and do not deceive one who has not deceived you" (Tirmidhi)

*Generosity and Leniency*

Generosity and leniency are the fundamental pillars of a socially and morally coherent society. They are inherent elements of good character.

Allah (the most high) says:

"And if the debtor is in difficulty then grant him respite until easier times"

The prophet said:

"Allah loves one who is lenient in selling, buying, and in requesting payment" (Tirmidhi)

The prophet also said:

"He who gives respite to the person in difficulty or wipes out the debt, Allah shall shade him under his throne on the day when there shall be no shade save His" (Tirmidhi)

*Honouring Obligations*

Islam accords much importance to fulfilling and honouring contracts and promises.

Allah (the most high) says:

"Oh you who believe, fulfil your obligations."

The prophet said:

"Muslims are bound by their conditions." (hadith of al-Bukhari)

*Just and Fair Labour Relations*

Governments, legislators and legal experts around the world are striving to protect the poor from financial exploitation, social degradation and other inhumane and immoral practices. Islam strongly encourages employers to fulfil their religious duty and social and moral obligations by treating employees in a fair, just and equitable manner. Islam promotes a relationship of brotherhood between the employer and employee.

The prophet said:

"I will be the disputing party with the following three persons, one of them being he who employs a person who despite having completed his tasks and duties does not give him his due wage…" (Bukhari)

The prophet said:

"Give the labourer his wages before his sweat dries"

"Look after them as you look after your own children. Feed them with whatever you personally eat"

The rights of employees are clearly elucidated in the above traditions.

*Deception and Fraud*

Much of the global financial crisis was caused by sometimes fraudulent misrepresentations by financial brokers which encouraged a dramatic rise in imprudent lending of financial reserves.

Islam, on the other hand, prohibits all forms of deceptive and fraudulent behaviour.

The prophet said:

"If anyone sells a defective article without drawing attention to it, he will be under Allah's anger and the angels will continue cursing him." (hadith of Ibn Majah)

*Financial Exploitation*

Financial exploitation, or fiduciary abuse, is defined as the improper use of another person's resources for one's personal benefit. There are many types of financial exploitation, such as trickery, intimidation, coercion and misinformation.

Islam prohibits all forms of unjust and unethical financial exploitation.

The prophet prohibited a number of methods of financial and market exploitation that had been prevalent during the pre-Islamic era such as the exploitation of rural dwellers who knew little of the more sophisticated practices of an urban market.

*Price Fixing*

In 2007, Tiger Brands, a South Africa-based multinational company, was fined 98.8 million rand ($7.2 million) by the South African Competition Tribunal after admitting to collusion with rival brands to bread prices. The fine represented 5.7 % of Tiger Brands' annual bread sales.

Islam allows free trade and economic activity. Financial managers, investment firms and retail traders are allowed to set reasonable market prices. However, Islam considers the economic wellbeing of the wider population and thus regulates the market to prevent price fixing and other forms of financial manipulation. It is the duty of the central reserve bank or central monetary agency to monitor the market for such exploitative financial practices.

**Conclusion**

Business ethics has become an important topic of discussion among global financial institutions and regulators. Where promoted by secular and Western principles, ethical codes tend to be utilitarian, oppressive, situational and devoid of spiritual backing or power.

Islamic ethics has the solution to much of the financial, social and moral decay currently being witnessed in the world.

## Chapter Three

## Principles of Islamic Finance

Every economic system is based on certain fundamental elements and founding principles.

Similarly, Islamic finance is based on a body of fundamental principles which form the backbone of any Shariah-compliant banking product. Islamic banking transactions must be interest-free, not open to dispute, be non-speculative, share profits and losses and back financing with assets and services; and be ethical:

### Transactions must be interest free

*Definition of Interest*

'Riba' is an Arabic word meaning 'increase, extend or add'. According to Shariah law, riba, or interest, is defined as "any premium that must be paid by the debtor to the creditor with the principle amount as a condition of a loan or for an extension of its maturity."

Riba has been strictly prohibited in Islam. However, this prohibition is not only confined to Islam. The world's other major religions – Christianity, Judaism and Hinduism – also prohibit interest.

In Islam, the Qu'ran and prophetic traditions make clear the strict prohibition on interest.

Allah (the most high) says:

"Those who devour usury will not stand except as one who stands with madness. That is because they say: 'Trade is like usury.' But God has permitted trade and forbidden usury."

The prophet (may peace be upon him) cursed the receiver of interest, the payer of interest, the recorder of interest and the witness to such a transaction. (hadiths of Muslim, Tirmidhi, Ahmad ibn Hanbal)

Islamic jurists, who have particular expertise in Islamic jurisprudence and law, have classified riba into two broad categories: riba al fadl, and riba al nasi'a.

### *Riba al Fadl*

'Fadl' is an Arabic word meaning 'excess' or 'surplus'. According to Shariah law, riba al fadl refers to a surplus in any of the two commodities of exchange: goods and currency. Riba al fadl is also known as 'riba al hadith' this form of usury has been described in the various collections of sayings and acts of the Prophet Muhammad known as the hadith.

While only six commodities are mentioned in the hadith (gold, silver, dates, wheat, salt and barley), classical jurists have made this inclusive of certain commodity transactions through the medium of 'qiyas' – or 'legal analogy' – in which they have determined a specific characteristic of each of the

six commodities, or 'amwal al-ribawiya'. Each school of thought has interpreted these common characteristics differently.

*Zaid the vegetable shop owner - Example*

Zaid, a vegetable shop owner, wishes to exchange 1,000 bags of high-grade potatoes for Amr's 1,500 bags of low-grade potatoes. This would be an impermissible transaction since the surplus amount of goods measured by volume and weight is considered as riba and interest.

*Imran the car owner – Example*

Imran has just bought a brand new Mercedes Benz car. He is, however, unhappy with the purchase and wishes to exchange the Mercedes for a used BMW. This transaction is permissible as although the commodities are different, cars are measured by number rather than volume and thus the transaction is equal.

***Riba al-Nasi'a***

Riba al-nasi'a is also termed riba al-jahiliyya (jahiliyya refers to pre-Islamic times), or riba al-Qu'ran, as this type of riba has been specifically mentioned in the Qu'ran.

'Nasi'a' is an Arabic word meaning 'credit or delay'. Shariah scholars define riba al-nasi'a as a "loan where a specific repayment period and a premium amount in excess of the capital is pre-determined."

It makes no difference whether the premium is a fixed or variable percentage of the principle or an absolute amount to be paid in advance or on maturity.

**Unopen to Dispute**

Any contract which is open to future dispute is not Shariah compliant.

*ABC Technologies, a professional software company – Example*

ABC Technologies wishes to sell banking software to an Islamic bank, though the bank has failed to provide detailed specifications. The vagueness of the contract means the deal is not Shariah compliant.

*BHM Financial Advisory – Example*

BHM Financial Advisory enters into an arrangement with BPS Shariah Bank to conduct annual Shariah and financial audits. However, the tenure, audit scope, Shariah check list and other key points are not specified. This arrangement is not Shariah compliant as, again, there is the possibility of future dispute between both the contracting parties.

**Non-Speculative (Gharar)**

'Gharar' is an Arabic word meaning 'uncertainty' or 'vagueness". Shariah scholars broadly define gharar as future contractual uncertainty.

Gharar refers to the sale of a commodity or good which is not present at hand, of which the consequences of the sale are unknown, or which present such risk that it is impossible to determine the future existence of the commodity at all.

Where an integral element of a contract is left vague or uncertain, then such an arrangement is considered non-Shariah compliant. Contracts must have contractual certainty in order to be Shariah compliant.

**Profit and Loss Sharing and Asset-Backed Financing**

The profit and loss sharing, or PLS, system of Islamic banking is based on the principle: "No return without risk".

Islamic financial institutions earn profits on direct equity positions. An Islamic bank cannot earn profit without having a direct equity stake. One of the fundamental principles of Islamic banking is: "Entitlement to returns is linked to the liability of loss."

Islamic banks earn profits on actual equity stakes instead of merely dealing in financial papers. Islamic banks take asset or ownership risk before making an ijara wa iqtina transaction or a diminishing musharaka.

**Ethical**

Social morality is of pivotal and critical importance in Islam. Trading, buying and selling carrion, wine, pornography, pork and other forbidden matter is impermissible according to Shariah law.

The Prophet (may peace be upon him) said:

"Indeed Allah and his messenger have made the trade of intoxicants, carrion, pig and idols unlawful and illegal."

## Chapter Four

## Islamic Law of Contracts

An Islamic sale – or 'bay' – is defined as: "The exchange of an item of value for another item of value by mutual consent". An Islamic contract essentially refers to the exchange of items of value between the contracting parties.

### Conditions of a Valid Sale

An Islamic contract of sale must have the following four elements:

- Contract (Aqd)
- Subject of Sale (Mabee)
- Price (Thaman)
- Possession (Qabd)

These are the fundamental elements of any Shariah-compliant contract of sale.

### Contract (Aqd)

*Offer and Acceptance*

An Islamic legal contract is sealed by an offer and its acceptance. For example, Zaid proposes to sell one hundred barrels of crude oil to Amr, who in turns accepts this proposal and thus concludes the deal. This is a legally binding Islamic contract.

An offer and acceptance can be effected in the following two ways:

- Verbally
- By Implication

*Contractual Capacity*

According to classical Shariah law, both contracting parties must be:

- Sane
- Mature

There are certain circumstances that can affect contractual capacity:

- Insanity or Dementia
- Unconsciousness / Sleep
- Intoxication
- Serious Incompetence or Foolishness
- Insolvency
- Death or Life-Threatening Illness

*Conditions of Contract*

Every Islamic contract must fulfil certain conditions and legal criteria in order to be Shariah compliant. Contracts must be:

a. Non-Contingent

Contractual certainty plays a key role in determining the Shariah compliancy of a contract. Shariah scholars state that the delivery of the commodity of sale must be fixed and non-dependant on future contingencies or uncertain events. For example, Zaid sells his motor vehicle to Amr on condition that the vehicle will only be delivered if the US dollar exchange rate exceeds $1.50 to the British pound. Such a sale would not be Shariah compliant as exchange rates are subject to constant change.

b. Unconditional

Islamic contracts must be unconditional. For example, John sells two hundred travel vouchers to Mark on condition that Mark employs John's son at his travel agency. This would not be Shariah compliant.

c. Attach Reasonable Conditions

A contract can have conditions attached provided they don't go against other essential elements of the contract. For example, Muhammed sells two holiday apartments to Ahmed on condition that the holiday apartments be legally transferred to Ahmed's company.

d. Common Market Practice

Unreasonable conditions may be accepted so long as they conform to general market practice. For example, Yasir, a hardware store owner, buys a thousand bags of cement from Yusuf on condition that Yusuf delivers the bags to Yasir's international storage depot.

e. Immediately Effective

Each contract of sale must be concluded and effectuated with immediate effect. Future sales, forward cover and the like are not Shariah compliant. For example, Salih, a clothing manufacturer, requires vital cash flows to pay his suppliers in Beijing. He agrees a forward exchange contract, or FEC, with his bank. However, this transaction is not Shariah compliant as the FEC exchange contract only concludes some months later when Salih's shipments arrive.

**Subject Matter of Contract (Mabee)**

The subject matter of a Shariah compliant contract of sale must be:

*a. Existent*

The subject matter of a sale must exist at the time of the sale. A non-existent commodity cannot be sold. For example, John sells an unborn calf to Mark. This is not Shariah compliant since the subject of the sale does not yet exist.

*b. Valuable*

The subject matter of a sale must be regarded as an object or commodity of value. Shariah scholars use the term 'mal mutaqawam' to refer to any commodity having value in Islam. For example, Zaid sold a leaf to Bakr. The sale is not Shariah compliant as a leaf is not considered to be of value.

*c. Legally Usable*

The subject matter of a sale should be Shariah compliant and must not be 'haram', or prohibited in the Qu'ran – for example, wine.

*d. Ownable*

The subject matter of a sale should be a commodity that can be owned. For example, one cannot sell the sky as it is not a commodity that can be legally owned.

*e. Deliverable*

The subject matter of a sale must be something that can be possessed and delivered. For example, Zaid wishes to sell an off-plan building to Bakr. This transaction is not Shariah compliant since the building does not yet exist.

*f. Specific and Quantified*

The subject matter of the sale must be specifically determined and quantified, otherwise it is not Shariah compliant. For example, Zaid owns a large real estate company offering apartments of

different sizes and architectural designs. Zaid wishes to sell three unspecified apartments to John. This sale is not Shariah compliant as the object of the sale is too ambiguous.

**Price (Thaman)**

The selling price of the sale is called the 'thaman', while the market value is called the 'qima'.

The thaman must be:

*a. Quantified (Maloom)*

Both parties must agree on a numeraire, being one particular currency which serves as the standard of value through which the sale is executed. This is usually the local standard currency.

*b. Specific (Muta'ayyan)*

The price must be specific. If not, the sale is not Shariah compliant.

**Possession**

The subject matter must be in the physical or constructive possession of the seller at the time of the sale. This rule applies only to movable items.

*Physical Possession*

Physical possession is defined as having control and power over an object on one's person or around one's person. For example, John purchased 1,000 barrels of refined oil from TradeCor, a large Gulf oil company. John has not yet received the shipment. However, he wishes to sell the oil to Global Freight, a multinational transport company. This sale is not Shariah compliant since John does not have physical possession of the oil.

*Constructive Possession*

Constructive possession refers to having control, risk and the assumption of all rights and liabilities for the commodity of sale.

For example, Al-Nakheel Bank, an international Islamic financial institution, purchases ten heavy duty vehicles from Global Motors, a Japanese vehicle manufacturer. Global Motors deliver the vehicles to Al-Nakheel's central warehouse. The bank then sells the vehicles to ABS Freight Company while they sit in its warehouse. This transaction is Shariah compliant as Al-Nakheel had constructive possession of the vehicles.

## Primary Islamic Contracts

Islamic Contracts are primarily categorized as follows:

**Bay Sahih – Valid Sale**

A valid Shariah compliant sale is deemed to have met the above stated requirements concerning contract, or aqd; subject of sale, or mabee; price, or thaman; and possession, or qabd)

**Bay Batil – Void Sale**

A sale becomes void if it does not meet the stated Shariah requirements. Both seller and purchaser have no legal title to the item of sale nor the purchase price in a void sale as the transaction is considered non-existent in Shariah.

**Bay Fasid - Voidable Sale**

A voidable sale refers to any sale containing certain non-Shariah compliant elements. If these elements are removed from the contract, the sale will become Shariah compliant. It is wajib – or obligatory – for the contracting parties in a voidable sale to cancel the sale and remove the non-compliant elements.

**Bay Mawquf – Suspended Sale**

'Mawquf' is an Arabic word meaning 'suspended'. Bay mawquf is a suspended sale. For example, Luke sells Mark's offshore property holdings to John without Mark's permission. This sale is suspended subject to Mark's approval.

**Bay Makruh (Disliked)**

Shariah accords great importance to ethical behaviour in financial dealings and economic activities. Shariah considers a sale to be 'makruh' – or 'disliked' – if it goes against ethical requirements. For example, transactions after the Friday call to prayer, false bidding, etc.

## Some Common Contracts

**Bay Musawama**

This is a normal sale made without reference to cost price and where the mark-up is unknown. 'Musawama' means 'bargaining'.

**Bay Muqayada**

A barter sale or counter-exchange of goods. Currency exchange or sale does not fall under bay muqayada.

**Bay Mu'ajjal**

A sale on a deferred payment basis. Bay mu'ajjal is valid if the payment date is specified and fixed. Shariah scholars state that the purchase price in a bay mu'ajjal can be more than for a cash sale.

*Security in Bay Mu'ajjal*

Since the seller is owed the purchase price of the subject matter of the sale, he has a legal Shariah right to obtain security from the client. This security must be well defined and in accordance with Shariah guidelines on securities.

*Promissory Agreement*

The seller may request the purchaser to sign a promissory note stating that he shall pay the full purchase price in order to secure the seller's rights. Promissory notes cannot be sold to third parties.

**Bay Ta'ati**

A sale concluded by the conduct of the contracting parties, where, for example, goods are presented at a shop's till and the shopkeeper takes the money without any discussion of price having taken place or any contract being signed. The offer and purchase is implied in the conduct of the buyer and seller.

**Bay al-Inah**

The sale of a commodity on credit and repurchasing it for a lesser amount in cash.

For example, Zaid purchases 1,000 designer garments from his local bank for $50,000 on a deferred payment basis. Zaid immediately sells the garments back to the bank for $40,000 cash. This is clear interest, hence the transaction is not Shariah compliant.

**Bay Tawlia**

A sale in which there is a clear and explicit reference to the cost price between the buyer and seller.

## Chapter Five

## Musharaka (Islamic Investment Partnerships)

Musharaka is an Arabic word meaning 'to share'. It is derived from the Arabic 'shirka', meaning 'partnership'. The terms 'shirka' and 'musharaka' are used interchangeably.

A musharaka is a partnership between two or more parties, usually for the purpose of conducting business or trade. Musharakas are created by an investment of capital or pooling together of expertise.

Investment partners mutually share profits based on capital investment ratios, management duties and business capacities and they share losses according to proportionate capital investment.

A musharaka can be terminated by any of the business partners provided that prior notice is given to the other partners.

Musharaka or shirka can be broadly categorized as follows:

- Shirkat al-milk
- Shirkat al-aqd

### Shirkat al-Milk

Shirkat al-milk is a partnership between two or more persons in the joint ownership of assets or properties for non-commercial purposes.

*Zaid the equity purchaser – Example*

Zaid, a recent college graduate, wishes to purchase a home. However, like most recent graduates, he has limited financial resources. Zaid approaches Al-Nakheel Islamic Bank to finance the equity purchase. Zaid and the bank jointly purchase the home on a 20:80 acquisition ratio.

Shirkat al-milk is further divided as follows:

*a. Ikhtiyari (Optional)*

Two or more parties decide to pool resources to fund a joint venture. For example, Luke and David jointly purchase properties for their expanding real estate portfolio.

*b. Ghair Ikhtiyari (Automatic/Non-Optional)*

An automatic joint partnership without any intention or effort from the parties involved. For example, Yusuf and Bakr are the only heirs of their father. They jointly inherit their father's real estate portfolio.

**Shirkat al-Aqd**

Shirkat al-aqd is a partnership between two or more parties in a joint commercial enterprise on the basis of mutual agreement.

Business partners pool resources to engage in profit-seeking ventures.

Every shirkat al-aqd has shirkat al-milk embedded within it, namely the joint ownership of the assets and property.

**Basic Differences between Shirkat al-Aqd and Shirkat al-Milk**

Two fundamental differences between shirkat al-aqd and shirkat al-milk are:

1. Shirkat al-aqd is a direct joint commercial partnership or profit-driven contract agreement, whereas shirkat al-milk is formulated for non-commercial purposes. Shirkat al-milk is a simple partnership of ownership without the intention to profit.

2. Ownership proportions cannot be fixed in a shirkat al-milk, while they must be pre-determined and specified in a shirkat al-aqd.

**Shirkat al-Aqd Categories**

*Shirkat amal*

This is a joint partnership in providing services to clients. 'Amal' means 'services'. The fees charged by the business partners are distributed according to mutually agreed ratios.

*Shirkat al Amwal* what does amwaal mean?

This is the most common musharaka used by Islamic banks and financial institutions. Shirkat al amwal is a partnership between two parties who invest resources in a joint commercial enterprise. 'Amwal' means 'wealth'.

*Shirkat al Wujooh*

'Wujooh' is an Arabic word derived from 'wajaha', meaning 'goodwill'.

Shirkat al wujooh is a joint partnership between two or more parties who purchase commodities on credit on a basis of goodwill and mutual trust with the supplier. These commodities are then sold in the market for a profit.

Each of the above three categories fall under the following two broad classifications:

*1. Shirkat al-Mufawada*

'Mufawada' means 'equal'. In a shirkat al-mufawada, all business partners share equally in the fundamental aspects of capital, investment management, profit ratios and risk profiles. If any of these elements are deficient, the partnership is automatically categorized as shirkat al-inan. (Inan means 'unequal') All the partners are trustees and agents unto each other.

*2. Shirkat al-Inan*

In this, capital, investment management and profit-sharing ratios need not be equally shared amongst the business partners. Losses are always based on capital investment ratios and not mutually agreed ratios.

**Duration of Musharaka**

*Permanent Musharaka*

This is the most common form of musharaka. It is also referred to as an ongoing or open-ended musharaka. A permanent musharaka refers to a partnership which has no intention of terminating at any time in the future.

Partners are, however, allowed to exit the partnership at any point should they so wish provided they give sufficient notice to the other business partners. Contracts may also have a lock-in clause to prevent parties terminating their participation for a specific tenure.

The remaining partners may purchase the exiting partner's musharaka portfolio shares.

*Temporary Musharaka*

A partnership arrangement formulated with the intention of at some point winding up, at which point its assets are realised in cash and distributed along with any cash reserves on a pro-rata basis.

**Musharaka Capital**

All Shariah compliant commodities of value may be pooled in the musharaka portfolio. Debt cannot form part of the portfolio.

Shariah scholars state that the investment contribution can be in the form of liquid cash or illiquid commodities of value. For example, Zaid has a thriving business enterprise but is short of cash. He enters into a musharaka with a private equity fund. Zaid contributes his financial stocks while the private equity fund contributes much needed cash to the Musharaka portfolio.

Business evaluations of commodity contributions or contributions in kind must take place before musharaka execution.

Capital investment ratios, profit ratios, master agreements and all other partnership documentation must be well defined and determined before the musharaka is formed.

**Musharaka Management**

As a general principle, all business partners in a musharaka have the right to engage in the direct administration and management of the partnership. Partners may agree for practical reasons to appoint certain individuals from the investment partners to manage the financial and administrative affairs of the partnership. They may even decide to appoint an external investment or financial manager.

Partners who are not directly involved in the management and administrative affairs of the partnership are known as silent or sleeping partners. Since they do not participate in the actual business, they cannot receive a greater profit ratio than their original capital contribution ratio. Working partners can receive more than their investment capital ratios.

Working partners are tasked with running the musharaka portfolio but cannot receive a fixed remuneration for their investment management services. However, working partners may be given an increased profit ratio out of consideration for their management duties.

Working partners serve as agents on behalf of their co-investors.

An external investment manager can only receive a fixed remuneration for his services but cannot receive profit from the portfolio. External business managers do not share in profits or losses.

An external business manager may invest in the musharaka portfolio under a completely separate and independent contract and may receive profits and share losses in the capacity of investor and receive a fixed and defined remuneration for his management services in the capacity of business manager and employee of the partnership.

The Shariah supervisory board (SSB) should ensure that the sleeping partners of an Islamic bank's musharaka portfolio do not infringe on the duties of the working partners, who would generally be the bank itself. This would enhance the Shariah compliance of an Islamic bank.

**Profit and Loss Sharing**

According to Shariah, profits cannot be fixed, whether as a stipulated number or percentage of the invested capital or any other fixed amount.

For example, Zaid and Bakr enter into a musharaka partnership. Zaid and Bakr cannot fix $100,000 as a fixed monthly profit since the partnership has yet to declare any profits. What if the partnership runs a loss?

Neither can they fix a monthly profit of 10% of their investment amount. This would result in an absolute fixed number, which again is not Shariah compliant.

Also, if Zaid and Bakr agree on a fixed percentage of the partnership revenue, this would not be Shariah compliant as there is a fixed absolute number.

Profit in a musharaka should:

- not be guaranteed or fixed in any absolute terms
- be distributed to every partner according to pre-agreed profit ratios
- not exceed the silent partner's capital contribution ratio
- have well determined and fixed profit ratios and mechanisms
- allow for voluntary surrender of all or part of the profit share of any of the investors. This provision is strictly voluntary and should not be pre-agreed at partnership execution.

Loss in a musharaka can only be shared according to capital contribution ratios.

**Profit Calculation**

The musharaka portfolio cannot declare returns before the actual realization of profit. The portfolio can, however, announce expected returns and may declare returns upon actual profit realization.

Profits are only realized with the combination of surplus and principle.

Balance sheets do not represent profits.

**Modern Application of Musharaka**

Many Islamic businesses require cash flows to fund their operations. They cannot go to conventional banks as they charge interest on credit. An Islamic bank would offer a temporary musharaka finance facility in order to fulfil the financing needs of the business. The bank would contribute the running finance facility funds while the client contributes the business he owns. Profit-sharing mechanisms must be well defined and structured in accordance with standard profit-sharing guidelines.

A typical Shariah-compliant musharaka facility:

The Islamic bank and the client agree on financing limits, profit-sharing ratios, managerial roles and financing tenure. The bank conducts a detailed investigation into the client's credit rating and also evaluates the client's commodity contribution.

The bank then opens an Islamic current account to finance the client's needs and to hold the client's cash deposits.

The Islamic bank and client share the profits according to pre-agreed ratios. In the case of a loss, the bank and client share the loss according to capital contribution ratios.

The bank gradually sells its shares to the client upon the termination of the musharaka tenure. The bank eventually sells all its shares and exits the musharaka.

**Common musharaka products include:**

- Diminishing musharaka
- Project financing
- Import financing
- Inter-bank liquidity management
- Musharaka securitization
- Working capital financing

**Dispute Resolution**

The Master Musharaka Contract Agreement (MMCA) should have a special clause for dispute resolution stating that the parties agree to take any and all disputes to an external Shariah Review Council for adjudication. The Shariah Review Council should be completely independent of the bank and the client so as to remove all suspicions of financial prejudice. The Shariah Supervisory Board should not be allowed to adjudicate in such disputes.

**Termination of Musharaka**

Partners may unilaterally terminate partnership participation at any time provided that suitable prior notice is given.

If any party becomes insane, or becomes otherwise incapable of effecting business transactions, the musharaka is automatically terminated.

**Actual Liquidation**

If the musharaka is terminated and the assets are realized as cash, they are distributed to the partners on the basis of capital contribution ratios. Profits are distributed on pre-agreed profit-sharing ratios.

**Constructive Liquidation**

Illiquid assets are either distributed by granting them to the partners in lieu of the profit they have earned or liquidated in the market and the proceeds then distributed to the partners.

Partners can demand a separation of the assets instead of liquidating them. Certain assets have to be liquidated since they cannot be separated, such as machinery or houses.

## Chapter Six

## Mudaraba (Financial Investment Partnership)

Mudaraba is partnership between two or more persons for investment and business purposes. One party contributes the capital while the other contributes financial management expertise.

The rab al-mal, or financier, (plural arbab al-mal) contributes the capital, while the mudarib – or investment manager, monitors and manages the invested capital while securing profitable investment portfolios.

The Arabic term for 'investment capital' is 'ras al-mal'.

Mudaraba is also known as 'qirad' or 'muqarada'. Mudarabas belong to the same family of musharaka partnerships.

'MM' is a short form used in Islamic finance for 'musharaka and mudaraba'.

### Differences between Musharaka and Mudaraba

a. The rab al-mal provides the investment capital to the mudaraba portfolio, whereas all parties must contribute capital in a musharaka. The mudarib may only contribute capital to a mudaraba portfolio with the consent of the rab al-mal.

b. Only the mudarib manages a mudaraba portfolio, while all partners have a right to manage a musharaka portfolio.

c. In a mudaraba partnership, the rab al-mal alone is responsible for any losses, while the mudarib only loses the work he put into managing the portfolio. (The mudarib would be responsible for a loss, however, if it was found he was negligent in his duties.) In a musharaka, all parties bear losses according to their capital investment ratios.

d. The mudarib does not have a share in the mudaraba portfolio; therefore the mudarib's share of the profit does not rise if there is an increase in value of the mudaraba assets. However, all partners jointly own a musharaka portfolio, and therefore all benefit from an appreciation in value of the assets even if they did not receive any profits through trading.

e. The mudarib has no liability in a mudaraba. However, all partners have unlimited liability in a musharaka. All remaining liabilities would have to be borne by the musharaka partners in the event of a liquidation.

**Similarities between Mudaraba and Musharaka**

Both musharaka and mudaraba are partnership based. Each party contributes either management expertise or capital in a mudaraba, or capital only in a musharaka.

The mudarib or rab al-mal is permitted to voluntarily surrender all or part of his capital to the mudaraba portfolio. Similarly, any partner in a musharaka partnership can voluntarily surrender all or part of his capital to the musharaka portfolio or a co-investor.

**Scope of the Mudaraba**

Mudarabas can be restricted or unrestricted in terms of the scope of business.

*Mudaraba Muqayyada (Restricted Mudaraba)*

In this, the rab al-mal restricts the mudarib's investment management role to particular economic areas and financial dealings. The mudarib's role may even be restricted by geographical location.

*Mudaraba Mutlaqa (Unrestricted Mudaraba)*

Here, the mudarib is permitted to invest in any Shariah compliant business. However, the mudarib is not permitted to lend money to anyone without the prior consent of the rab al-mal.

**Mudaraba Capital**

All Shariah-compliant commodities of value may serve as the capital input in a mudaraba portfolio. The investment capital may be in cash or in kind.

Business evaluations of commodity contributions or contributions in kind must take place before mudaraba execution or at the latest before the portfolio realizes any profit.

Capital investment ratios, profit ratios, master agreements and all other partnership documentation must be well defined and determined before the mudaraba execution.

All partners must agree on one particular numeraire to serve as a standard value for the mudaraba business.

Debt cannot serve as the mudaraba capital.

*Example:*

Zaid and Yusuf set up a mudaraba partnership to invest in a business buying and selling cars.

Zaid, the rab al-mal, invests $50,000 in the portfolio. Zaid and Yusuf agree a profit ratio of 65% for the rab al-mal and 35% for the mudarib.

The partners agree that the common numeraire will be the US dollar.

**Mudaraba Duration**

*Permanent Mudaraba*: This is the most common form of mudaraba. It is also referred to as an 'ongoing' or 'open-end' mudaraba.

Permanent mudaraba refers to a partnership where there is no intention of terminating the joint venture at any time in the future. A partner may exit the venture at any point provided sufficient notice is given to the other partners.

*Temporary Mudaraba*: This a partnership formed with the intention of termination at some point in the future. The partnership is dissolved and the assets realized in cash, which are then distributed along with any other cash reserves on a pro-rata basis.

**Mudaraba Management**

The mudarib alone manages a mudaraba portfolio. The rab al-mal does not have any right to manage the portfolio. The mudarib's managerial responsibilities can in no way be restricted or encroached upon.

The mudarib receives a share of the profit from the mudaraba portfolio but cannot receive a fixed wage for his managerial duties.

He can, however, become an employee with a fixed remuneration provided that his role as mudarib is terminated.

The mudarib can invest in the mudaraba portfolio provided this is done under a completely separate contract agreement between the mudarib and rab al-mal or arbab al-mal. Each role must be clearly distinguished and defined.

**Mudaraba Profit and Loss Sharing (PLS)**

According to Shariah, profits cannot be fixed, whether as a stipulated number, a percentage of the invested capital, or any other fixed amount.

All profit-sharing ratios and mechanisms must be clearly specified by all partners before execution of a mudaraba partnership.

Any partner can voluntarily surrender all or part of his profit share to another partner on condition that this was not a pre-condition of the partnership agreement.

Partners in a mudaraba portfolio may agree on various fixed profit ratios. For example, Zaid, the rab al-mal, and Yusuf, the mudarib enter into a partnership to sell agricultural produce. They agree on the following profit-sharing ratios:

| Commodity | Zaid - Yusuf |
|---|---|
| Wheat | 34% - 66% |
| Rice | 50% - 50% |
| Beans | 25% - 75% |
| Cabbages | 65% - 35% |

Similarly, the partners can agree on profit mechanisms based on geographic location. For example, Mark, the rab al-mal, and John, the mudarib, enter into a mudaraba partnership to trade in luxury apartment suites. They agree on the following profit-sharing mechanism:

| Location | Mark – John |
|---|---|
| Cape Town | 50% - 50% |
| Dubai | 60% - 40% |
| Berne | 30% - 70% |
| New York | 40% - 60% |
| Riyadh | 38% - 62% |

The rab al-mal can pay the mudarib a performance bonus from time to time. This bonus is termed 'hiba' (gift). Performance bonuses are non-obligatory and cannot be pre-agreed in the mudaraba partnership agreement.

If the Shariah board declares the mudaraba partnership 'fasid' – or not viable – then the mudarib:

- serves merely as an employee of the mudaraba portfolio,
- is not entitled to any business or travel allowances,
- only receives the 'ujra al-mithl', or fair market rate, wage for services offered to the mudaraba portfolio. The rab al-mal or arbab al-mal bear the entire loss based on capital contribution ratios.

The mudarib does not bear any loss except if it is proven that he was grossly negligent.

If the mudaraba business has incurred losses in one portfolio, the profits from the other portfolios will be used to offset the loss, after which profits shall be distributed according to pre-agreed profit-sharing ratios.

**Mudaraba Termination**

Partners may unilaterally terminate their partnership participation at any time provided that suitable prior notice is given. However, a 'lock-in' clause may be drafted into the Master Mudaraba Agreement (MMA) stating that the mudaraba shall remain operational for either a fixed or unlimited tenure except in the case of force majeure or natural unexpected events such as death.

If the mudaraba is terminated, assets in the form of cash are distributed to the partners on the basis of capital contribution ratios. Profits are distributed on pre-agreed profit-sharing ratios. Illiquid assets are realized as cash and then the actual profits and cash are distributed according to capital contribution ratios and profit-sharing ratios.

**Mudaraba Application**

*Mudaraba Deposit Account Facility (MDAF)*

Islamic banks offer clients a 'Mudaraba Deposit Account Facility'. In this, the bank receives depositors' money in the capacity of mudarib, or investment partner. The depositors are the arbab al-mal, or investors.

The Islamic bank forms a mudaraba pool, which it uses to invest in Shariah-compliant investment portfolios. Musharaka and mudaraba pools serve as strategic and important liquidity tools for Islamic banks.

The MDAF is offered in various denominations such as term deposits or general cheque and savings accounts.

Islamic banks generally provide clients with an ROI (return on investment) rate. This is simply a financial forecast and what clients or account holders can typically expect to receive.

Islamic banks cannot guarantee return rates, however, as that would not be Shariah-compliant.

**Combined Musharaka and Mudaraba**

As a general rule, the mudarib cannot invest in the mudaraba business. However, he can invest on the basis of a combined musharaka and mudaraba. In this, the mudarib remains an investment manager as part of the mudaraba agreement, while becoming a business partner under the musharaka partnership.

*Nick – Example*

Nick, a specialist investment manager, and Al-Yusra Private Equity enter into a mudaraba partnership. Nick serves as mudarib while Al-Yusra is the capital investor. Nick also wishes to invest in Al-Yusra Private Equity. He invests $50,000 in Al-Yusra Private Equity as business partner under a separate musharaka agreement.

**Parallel Mudaraba**

The mudarib can invest the mudaraba capital in other mudaraba portfolios as a parallel investment. Should this be here? It was in the middle of the previous section for some reason, which didn't make sense. It is very hazy. Could it be expanded a little or should it be disposed of altogether?

**Mudaraba Capacity**

1. Amin: One who is entrusted with an item or goods.

2. Wakil: Agent on behalf of the bank.

3. Sharik: Business partner.

4. Dhamin: All legal implications of a transfer of ownership are now on the client.

5. Ajir: Lessee

## Chapter Seven

## Ijara (Islamic Leasing)

'Ijara' is an Arabic word for 'lease', 'rent' or 'wage'. According to Islamic jurisprudence, ijara is defined as the transferral of the usufruct of specific assets or provision of services to the client for a fixed tenure in lieu of a fixed rent or remuneration.

In an Islamic lease, the usufruct of the leased asset is transferred to the client and not actual ownership of the asset. Ownership is generally transferred in an Islamic contract of sale.

### Ijara Types

There are two broad categories of Ijara:

- Ijara al-manafi
- Ijara al-amal

### Ijarah al-Manafi

'Manafi' is an Arabic word meaning 'benefit'. Ijara al-manafi is a lease contract in which the benefits or usufruct of an asset are transferred to the client in exchange for a fixed rental. For example, Nakheel Property Investments leases out 100 luxury suites in exchange for a fixed rent of $10,000 per month for a fixed tenure of one year.

### Ijara al-Amal

Ijara al-amal refers to a lease contract to engage the services of a person for a fixed remuneration over a specific tenure. For example, Zaid hires Bakr to carry his luggage to the airport.

In an ijara al-amal, the 'ajir', or labourer, provides his services to the 'mustajir', or employer. The 'ujra' is the wage or rental fee.

### Usufruct Lease Categorization

Usufruct leases can be further categorized as follows:

- Quantified Asset Lease: A lease of a known asset type not specifically identified by the lessee. For example, the leasing out of an unspecified boat.
- Specific Lease Asset: A lease of a specific asset indentified by the lessee. For example, the leasing out of a five bedroom house with an indoor swimming pool, servants quarters, garages, and tennis courts.

**Ijara Models**

*Standard Ijara*

The lessee benefits from the usufruct of the leased asset without eventual transfer of ownership. The asset remains in the ownership of the lessor even during the tenure of the lease.

*Diminishing Ijara*

The lessee buys the shares of the leased asset from the lessor in stages over a fixed period of time. Total ownership is eventually transferred to the lessee. The standard ijara contract and the purchase and sale of the equity shares must be clearly separated.

**Ijara Fundamentals**

- The service or asset must be owned by the lessor
- Ownership of an asset is never transferred in a standard ijara. Only the usufruct is transferred to the client. Anything that cannot be used without consumption is not considered as a Shariah-compliant lease assets – for example, food
- The leased asset must be a legal Shariah commodity of value (mal al-mutaqawam)
- All financial liabilities related to the ownership of the leased asset are the responsibility of the lessor and not the lessee
- The risk of the leased item remains with the lessor throughout the leasing tenure.

**Miscellaneous Rulings**

- The ijara asset must be clearly defined
- The legal title of the leased asset may be transferred into the lessee's name to comply with certain financial and government regulations
- Jointly owned properties can be leased out provided that the rental is either shared according to property ownership ratios or mutually agreed ratios
- The subject matter in an ijara must be Shariah compliant.

**Ijara Commencement**

An ijara contract can be set for a future date on condition that the rent is only payable after the leased asset comes into the possession of the lessee. An Islamic contract of sale, on the other hand, cannot be effectuated for a future date. Forward contracts are not Shariah-compliant.

**Ijara Rental Determination**

- The rent or remuneration must be clearly defined before execution of the ijara.
- The rent may be in the form of cash, kind or usufruct.
- Different rentals may be fixed for different leasing phases on condition that the rental for each phase is clearly defined. This is termed 'variable rental'. For example: Zaid leases out his holiday property to Amr for a tenure of seven years. The rental payment schedule for the lease agreement is as follows:

Year One - $5000

Year Two - $7000

Year Three - $8000

Years Four to Seven - $9000

- The lessor cannot unilaterally increase the rental amount
- Advance rental is permissible according to Shariah
- Rentals may be linked to a widely known financial benchmark such as Libor or the consumer price index. These rates should be so well known and defined that there is no cause for future dispute. For example, Zaid leases his car to Bakr for ten months with a rental price linked to the country's inflation rate.
- The lease period only begins once the lessee takes possession of the asset and can benefit from it.

**Ijara Default**

Default in an ijara refers to the lessee's failure to meet ijara payment schedules or to make ijara payments.

The mujir, or lessor, may take legal recourse and reclaim the leased assets in the event of an ijara default as a valid Shariah-compliant alternative. The lessor and lessee may agree on a default clause in the Ijara Master Contract (IMC) stating that the mujir has the legal right to claim his monetary rights.

The mujier can also grant the lessee respite until the lessee's financial condition improves.

Financial penalties for late payment are not Shariah compliant.

**Ijara Renewal**

An ijara may be contracted for short tenures that can be extended upon maturity. An ijara extension or renewal must be effectuated by mutual consent of the lessor and lessee. Both parties have the right to reject the renewal, in which case the lessee is obliged to vacate the leased asset.

**Ijara Maintenance**

The lessee is responsible for the general upkeep and maintenance of the leased asset. The lessee must ensure that the asset is used for its intended purpose and no other.

**Lessor's Duties and Rights**

*Duties*

- The lessor is the owner of the leased asset and therefore bears the full risk of the asset even during the lease tenure.
- The lessor must hand over the leased property in such a condition that the lessee may take benefit from the asset. If the asset is not put at the disposal of the lessee, the lessee is not obliged to pay any rental.
- The lessor must ensure that the leased asset is kept in a sound, proper and usable condition. The lessor is responsible for major maintenance costs and all necessary improvements..
- The lessor is responsible for all costs involved in the delivery of the leased asset to the lessee, unlike in conventional leases. The lessor can, however, integrate these financial costs within the rental amount.

*Rights*

- The lessor may rescind the ijara in the event of improper or unintended use of the leased asset – for example, trading from a residential property.
- The lessor may contract an ijara with two or more lessees.
- The lessor may reclaim the leased asset in the event of an ijara default. Penalty fines cannot be charged for late payment. The lessor can hire the services of a legal expert to provide legal assistance in reclaiming his financial and monetary rights.

**Lessee's Duties and Rights**

*Duties*

- The lessee is obliged to pay rent for the amount of time that the leased asset is at the lessee's disposal.
- The lessee is obliged to pay the fair market value in the event that the ijara becomes 'fasid', or 'voidable.
- The lessee must use the leased asset according to customary practice, or 'urf'. The lessee must ensure the asset is not used for any unintended or unlawful purposes.
- The lessee must return the property undamaged. Normal wear and tear is excused.

*Rights*

- The lessee has the right to fair and intended usage of the leased asset.
- The lessee has the right to rescind the ijara contract at any time within the lease tenure if the lessor fails to ensure that the leased asset provides reasonable intended usage.
- The lessee has the right to agree or disagree on the rental amount, payment schedule and non-essential contract terms and conditions before contract execution.
- The lessee can make useful improvements to the leased asset provided that those improvements do not damage nor hinder the normal usage of the property.

**Ijara Sub-Lease and Assignment**

*Sub-Lease*

The lessee is allowed to sub-lease the leased asset if the lessor expressly and clearly agrees, on condition that the sub-lease rental amount is equal to or less than the original rental amount. If the sub-lease rental amount is more, the surplus must be given in charity.

The surplus amount can be kept by the secondary lessor if:

- The sub-lease rental currency is different from the original rental currency.
- The lessee developed the leased asset by making certain useful improvements.

*Assignment*

- The lessor cannot assign the lease to a third party in exchange for monetary benefit, but may do so without financial gain. For example, Zaid assigns his lease to Amr, who is then entitled to receive monthly rentals from the lease contract.
- The lessor is allowed to sell the leased asset, in which case the lease contract will be established with the new owner, who is bound to fulfil and honour all the terms and conditions of the ijara contract.

**Negligence in Ijara**

The lessee is merely an 'amin', or 'trustee', of the leased assets. According to Shariah law, an amin is not 'dhamin', or 'legally responsible'. Therefore, the lessee will only be held liable for any loss caused to the leased assets as a direct result of the lessee's misuse or negligence. The lessee is not responsible for any loss that occurs to the leased assets due to force majeure or factors beyond his control.

**Modern Application**

Islamic banks, investment firms and private equity companies offer Islamic ijara products.

In these, the Islamic bank may appoint a 'mustajir', or lease holder, as its agent, or 'wakir', under a separate agency contract to purchase the lease asset.

The bank enters into an ijara contract with the client or mustajir after agreeing terms, conditions, lease tenure, payment schedule and rental amounts.

The Islamic bank leases out the asset to the mustajir after concluding the ijara contract.

The fundamental stages of an Islamic Financial Lease are:

*1. Lease Requisition*

The client submits a lease requisition to the Islamic bank. The bank approves the ijara facility on the basis of the client's credit rating and its own due diligence checks.

*2. Signing of the Master Ijara Facility Agreement*

A Master Ijara Facility Agreement, or MIFA, is signed between the Islamic financial institution and the client. The MIFA includes:

- Credit facility approval
- Terms and conditions of the facility
- Dispute resolution clause
- Payment schedule and mechanisms
- Lease asset specifications
- Unilateral promissory agreement

The client signs a separate promissory agreement undertaking to rent the lease assets once acquired. This is a non-legally binding agreement completely separate and independent from the master contract.

*3. Agency Agreement*

The Islamic financial institution appoints a third party or the client as agent to purchase the lease asset on its behalf. The bank does not have to appoint an agent to purchase the asset, however. The agency agreement must be well defined, with no vague clauses that could cause future dispute.

*4. Agent's Possession*

The agent signs the purchase order form after the agency. The bank disburses the money to the agent who pays the supplier for the lease asset on behalf of the bank.

*5. Agent's Transfer of Possession*

The agent transfers the leased asset to the Islamic financial institution.

*6. Offer and Acceptance*

The Islamic financial institution and client make an offer and acceptance to enter into the lease agreement. The ijara is concluded upon acceptance of the contract. Either party can make the offer.

*7. Transfer of Possession*

The Islamic financial institution transfers the lease assets to the mustajir. The mustajir only assumes possession but not ownership. The Islamic Banks bears all the financial risk of the leased assets. Legal title may be transferred to the client for financial regulatory reasons.

*8. Ownership*

The Islamic financial institution may unilaterally gift the leased assets to the mustajir upon maturity or sell the leased assets to the mustajir.

**Ijara Termination**

An ijara contract can be terminated for the following reasons:

- Maturity of the lease agreement / contractual terms
- Bilateral rescission of the lease agreement
- Destruction or loss of the leased asset's usufruct
- Failure by the lessee to meet lease terms and conditions
- The lessee losing his sanity during the ijara tenure
- Death of the lessee

The lessee can terminate the ijara contract if the leased asset has such defects that normal usage of the asset's usufruct is hindered and the lessor refuses to repair the asset.

The Shariah Supervisory Board, or SSB, or the External Shariah Audit Committee, or ESAC, is tasked with determining a reasonable compensation amount.

The SSB and ESAC are tasked with auditing the Shariah compliancy of the ijara products of the Islamic bank. This may be done by conducting qualified sample audits at regular intervals. This will ensure that the Shariah non-compliancy risk of the Islamic bank is kept to a minimum.

## Chapter Eight

## Murabaha (Cost plus Financing)

Murabaha is the most widely used financial instrument by Islamic banks and financial institutions.

A murabaha is a sale in which the seller's cost in acquiring the asset and the profit earned from its sale are expressly disclosed to the client.

A murabaha contract can only be Shariah compliant if the cost of the asset's acquisition can be ascertained. If not, then the asset can only be sold on the basis of a general 'musawama', or bargaining, contract without any reference to cost and profit.

Islamic banks offer murabaha contracts for real asset purchases and not as a liquidity financing tool. Musharaka and mudaraba are the original liquidity financing instruments.

A Murabaha is not an interest-bearing loan. It is rather the sale of a real asset in exchange for profit with reference to the cost price. Murabaha contracts can only be used to finance real asset purchases.

### Murabaha Fundamentals

*Subject of Sale*

- The subject of the murabaha must exist when the contract is executed. For example, a murabaha can be contracted for an existing boat, but a boat yet to be manufactured cannot be used as a murabaha commodity.
- The murabaha commodity must be in the ownership of the seller or bank. Ownership can either be physical or constructive.
- The murabaha commodity must be a commodity of value and be Shariah compliant. A murabaha cannot be executed for currencies or media of exchange such as gold and silver, or commercial papers.
- The subject matter must be well defined. For example, if Zaid wishes to sell ten vehicles to Bakr on the basis of a murabaha, the exact specifications of the vehicles must be clearly specified. This ensures there is no possibility of a future dispute between the two contracting parties.
- The murabaha commodity must be acquired from a third party.

*Price*

- The entire cost of the murabaha asset acquisition must be declared to the client before execution of the contract.
- Cost refers to all expenses incurred in acquiring the asset including freight costs, handling fees, customs charges, etc.
- The contractual parties agree a specific and fixed price .
- The murabaha price may be paid immediately as a lump sum, or deferred and paid as a

lump sum at contract maturity, or paid in instalments to a mutually agreed schedule.
- The murabaha price must be fixed before contract execution.
- The price must not be left vague or in any way uncertain, and should not be dependent on a future contingency.

*Contract*

- The murabaha sale must be instant and absolute. Forward murabaha sales are impermissible and not Shariah compliant.
- The sale must be unconditional unless it is a permitted condition.
- Murabaha buy-back sales are not Shariah compliant.

**Modern Application**

Islamic banks and financial institutions that use murabaha as a financial instrument must adhere to certain Shariah procedures:

*1. Purchase Requisition*

The client makes a purchase requisition to the Islamic bank. The bank approves the facility on the basis of the client's credit rating and its own due diligence checks.

*2. Signing Master Murabaha Facility Agreement*

The Master Murabaha Facility Agreement, or MMFA, is signed by the Islamic financial institution and the client. The MMFA includes:

- Credit facility approval
- Terms and conditions
- Dispute resolution clause
- Payment schedule and mechanisms
- Murabaha asset specifications
- Unilateral promissory agreement

The client signs a separate promissory agreement undertaking to purchase the murabaha asset. This is a non-legally binding agreement completely separate and independent from the MMFA.

*Key Points:*

- The MMFA must undergo rigorous Shariah checks and tests by the SSB before reaching the final approval stage.
- The SSB must approve the MMFA before submission to the ESAC for final approval.
- There must be no element of insurance involved in the MMFA.

*3. Agency Agreement*

The Islamic financial institution appoints a third party or the client as agent to purchase the murabaha asset on its behalf. The Islamic term for agency is 'wakala'.

There are two types of wakala agreement:

- Specific Agency Agreement (wakala al-muqayada): The agent is restricted to purchasing the murabaha asset from a particular dealer or supplier. For example: Zaid, the murabaha client, may only purchase the murabaha asset, a car, from ABC Motors.
- Global Agency Agreement (al-wakala al-mutlaqa): The agent is allowed to purchase the murabaha asset from any dealer or supplier. The bank grants the client various sweeping and general powers.

*Key Points:*

- The agency agreement is not a pre-requisite for the validity of the murabaha. Islamic banks appoint their clients as agents for logistical reasons.
- Islamic banks should only appoint their clients as agents in exceptional and difficult conditions.
- The bank should ideally purchase a murabaha asset itself, or appoint a third-party agent to purchase the asset on its behalf.
- An Islamic bank must ensure the asset is not in the possession of the client at the time the murabaha contract is executed.
- The Islamic bank should limit the time frame of the agency agreement as its risk is extremely high at this stage.
- Islamic banks may develop good working relationships with local and international suppliers to ensure clientele honesty and transparency.
- The banks hold the risk of murabaha assets until stage six.

*4. Agent's Possession*

The agent signs the purchase order form. The bank disburses the money to the agent, who pays the supplier for the murabaha asset on behalf of the bank.

*5. Agent's Transfer of Possession*

The agent transfers the leased asset to the Islamic financial institution.

*6. Offer and Acceptance*

The Islamic financial institution and client make an offer and acceptance to enter into the murabaha agreement. The agreement is concluded upon acceptance of the contract. Either party can make the offer.

*7. Transfer of Possession*

The Islamic financial institution transfers ownership of the murabaha asset to the client. The client assumes all financial risks and rewards associated with the asset.

**Murabaha Capacity**

The Islamic bank and client assume different respective roles during the execution process of the murabaha contract as described above:

- Stages one-three: Promissor and Promisee
- Stages four-five: Principal and Agent
- Stage six: Buyer and Seller
- Stage seven: Creditor and Debtor

**Murabaha Security and Risk Mitigation**

Islamic banks may require clients to provide a security in order to effectively manage risk. An Islamic security is termed as 'rahn'. Islamic securities can only be furnished upon the incurrence of liabilities and debts. Therefore, an Islamic bank may only request a security from the client after stage seven, when the client becomes the debtor and the bank the creditor. The security must be well defined. An Islamic bank may also request the client to provide a third party guarantee. An Islamic guarantee is termed a 'kafala'.

Two of the key risks in a murabaha contract are:

*Transit Period Risk*: The risk posed to the Islamic bank once it purchases and possesses the murabaha assets and before effectuation of the murabaha contract.

*Shariah Non-Compliance Risk*: The risk that arises out of non-compliance with the correct Shariah sequence of a murabaha contract. This is one of the greatest risks that Islamic banks face. Shariah supervisory boards must conduct strict Shariah compliancy tests.

**Murabaha Prohibitions**

A roll-over is the extension of a debt in exchange for an increase in the original payable amount. This is clear and evident riba, or interest, as it is nothing more than the re-scheduling and re-structuring of the payable amount in exchange for the increase.

Re-scheduling is the practice of extending the loan tenure in order to make debt repayment easier for the debtor. Conventional financial institutions generally offer re-scheduling facilities on the basis of additional interest amounts. This is totally impermissible under a murabaha contract. Islamic banks may offer re-scheduling facilities, though without any additional fees or payment charges.

**Murabaha Default**

A client cannot be charged any late payment penalties or charges in the event of a murabaha payment default.

The Islamic bank can either grant the defaulting client respite for a reasonable period of time or institute legal claims. The bank can only reclaim its monetary and financial rights and cannot claim for any further damages.

**Modern Murabaha Applications**

- Import financing
- Export financing
- Vehicle and other asset financing
- Land financing
- Machinery and equipment financing

**Early Rebate**

An Islamic Bank can offer a rebate or discount for early payment to the client provided that this facility is voluntary and not made a pre-condition of early payment.

For example: A client enters into a murabaha contract with an Islamic bank on June 3 and the murabaha is fully executed and effectuated on August 1. The murabaha payment schedule allows for a tenure of 24 monthly instalments of $5000. The client, however, makes complete payment after 20 months. The Islamic bank offers the client a rebate of $6000. This discount is offered on a completely voluntary basis with no strings attached. If the Islamic bank does not offer a discount, then the client has no legal claim against it.

## Chapter Nine

## Salam and Istisna

Salam and istisna are types of sales contract where payment is in advance and the specified goods are delivered at a future date. In the case of istisna, the goods have yet to be manufactured.

## Salam

In a salam, the subject of the sale does not have to be in the possession of the seller at the time of the contract. The price is paid in cash. The 'rabb al-salam', or buyer, concludes the purchase with the 'muslam ilaihi', or seller. The capital is termed the 'ra's al mal', while the subject of the sale is the 'muslam fih'.

Salam contracts were initially used to fund the liquidity requirements of agriculturalists and commercial farmers, who would sell their commodities before actual production.

Islamic banks fund the operations of large agricultural corporations and syndicates on the basis of salam contracts.

Salam contracts facilitate the liquidity requirements of sellers while offering prices lower than market rates to purchasers.

### Salam Preconditions

- The quality of the salam commodity must be fully defined in order to avoid any element of ambiguity which may lead to a future dispute.
- The exact quantity of the salam commodity must be fully determined before salam execution.
- Salam cannot be executed for goods having a specific measure and weight since there will be no recourse for the seller in the event that the goods are unsalable, defective or damaged. For example, Zaid cannot sell two tons of wheat based on his own measurements.
- The location of delivery must be specified and the salam goods must be delivered on a fixed date. Delivery of salam commodities can only take place after three days.
- The salam goods must be easily available in the market on the date of contract maturity, so that if they are in any way defective they can be readily replaced.
- The price must be fixed and defined before contract execution. There should be no ambiguity in the salam price. The price must also be paid for contract execution.

### Salam Fundamentals

*Salam Subject Matter*

- The units of a salam contract must be of a similar nature to each other or capable of

substitution with similar items. For instance, Zaid purchases twenty black sedans from an Islamic bank on the basis of a salam contract. The sedans are sold in units of a similar nature and are thus termed as homogenous or fungible goods.
- The subject of the salam contract can also be goods that are measured by volume and weight, such as agricultural produce.
- The subject matter of the deal must be clearly defined before contract execution. The quality and quantity must be well defined and specified.
- The subject matter must be a commodity of commercial value, or 'mal mutaqawam', and lawful under Islamic law.
- Currencies may be used as the salam subject matter provided they are different and exchanged at the current market rate.
- The salam subject matter can be replaced before contract maturity on the basis on mutual agreement.

*Salam Price*

- Any Shariah-compliant legal tender or value of exchange used in a normal sale can be used as the salam price – i.e. usufruct, goods or cash.
- Goods that serve as the salam price cannot be from the amwal al-ribawiya category – the six commodities mentioned in the hadith (gold, silver, dates, wheat, salt and barley).

The term 'usufruct', or 'manafi', refers to the benefit derived from an asset. The purchaser may offer the usufruct of an asset to the seller in exchange for the salam goods. For example, Zaid concludes a salam with Yusuf to deliver 500 black sedans in exchange for 1,000 working hours of Yusuf's oil tanker.

Modern financial institutions and banks calculate the salam price on the basis of investment tenures, capital funding, etc.

*Salam Tenure*

Salam tenures can be mutually agreed upon by the purchaser, or rab al-salam, and the seller, or muslam ilaihi, before contract execution on condition that a tenure is not less than three days.

Islamic banks and financial institutions offer short-term, medium-term and long-term salam financing.

*Salam Delivery*

- The location of salam commodity delivery should be specified and clearly defined before contract execution.
- The date of delivery must likewise be clearly specified and determined before contract execution.
- Salam contracts should ensure the provision of a commodity delivery clause.
- The delivery location should be mutually agreed upon by both parties before salam execution.
- In the event of a dispute, the contract execution location will become the delivery location.

- The purchaser cannot charge a penalty if the seller is unable to deliver the salam goods upon contract maturity.

*Salam Termination*

- A salam contract cannot be unilaterally revoked or rescinded after contract execution.
- A salam contract may only be revoked by mutual agreement between the contracting parties.
- A bilateral revocation may be complete or partial, by returning either the full or proportionate salam price.

*Salam Security*

The purchaser in a salam contract may request the seller to furnish a security. The purchaser has the right to request a security since the salam goods are due against an advance payment.

In the case of default, the purchaser may make an application for security liquidation to the Shariah Supervisory Board, or SSB, and External Shariah Audit Committee, or ESAC, who will review the application and approve the liquidation accordingly.

If the application is successful, the purchaser may then liquidate the security and regain his financial rights.

The contracting parties may also mutually agree on an automatic liquidation clause before contract execution. In the case of default, the security is automatically liquidated.

It is important to remember that the salam security must be clearly defined, specified and distinguishable in order to ensure Shariah compliance. The salam security must also be free of all financial and legal obligations.

*Unintentional Salam Default*

If a seller is unable to meet the delivery schedule due to unforeseen circumstances:

- The purchaser may grant the seller respite for any amount of time

or

- The parties may agree to terminate the contract and the purchaser may be reimbursed for the full salam price

or

- The parties may agree to replace the original salam subject matter with another.

*Intentional Salam Default*

In the event of a default for which the seller bears responsibility:

- The purchaser may compel the seller to deliver the salam goods.
- The purchaser may liquidate the security according to the security liquidation clause of the salam contract.
- The purchaser may institute legal proceedings against the seller.

*Salam Options*

Khiyar al-aib (Option of Defect) – 'Khiyar' is Arabic for 'option', while 'aib' means 'defect'. Khiyar al-aib is an option to return the subject of sale which the purchaser may exercise if the salam goods are found to be defective or not meeting the agreed specifications. Khiyar al-aib cannot be exercised for perishable goods such as food items.

Khiyar al-ru'yah – 'Ru'yah' is the Arabic for 'to see'. Khiyar al-ru'yah refers to the option to revoke a purchase in the event of non-conformance to specifications on condition that the purchaser did not see the goods before purchase. There is no khiyar al-ru'yah in salam.

*Parallel Salam*

Parallel salam refers to the execution of two contracts simultaneously. An Islamic financial institution is the purchaser in the first contract and the seller in the parallel contract.

For example: Zaid enters into an arrangement to sell 500 oil tankers to the Al-Nakheel Islamic Bank. Zaid is the purchaser while Al-Nakheel is the seller. Al-Nakheel Islamic Bank pays Zaid $1,000,000 before the salam execution.

Al-Nakheel Bank profits from the two contracts by recouping the disbursed amount for the initial Salam from the parallel Salam as well as profiteering from the Salam contract.

*Parallel Salam Essentials*

- The original salam contract and the parallel salam must be completely separate, with entirely separate legal documentation, rights and obligations.
- The original and parallel contracts should not be contingent upon each other. For instance, the delivery of the parallel salam goods cannot be made contingent upon the delivery of the initial salam goods. What if the initial seller could not deliver the Salam goods?
- Parallel salam contracts are only permitted with third parties. A seller cannot become the purchaser in the parallel contract. 'Buyback' contracts are not Shariah-compliant. However, the seller can purchase in a parallel salam provided the total shareholding in the purchasing company is less than 50%. For example: ABC Holdings, a Japanese car manufacturer listed on the Japanese Stock Exchange, sells two million cars to Lever Capital under a salam arrangement. Lever Capital then sells the cars to YMI Holdings, in which ABC has a 25% stake.

### Modern Salam Application

An Islamic bank may purchase a commodity under an initial salam contract and then sell it via a parallel salam. The tenure in the parallel contract is much shorter than for the original salam contract and with a higher mark up. The Islamic bank earns a legitimate and fully Shariah-compliant profit from the price difference between the first and second contracts.

The Islamic bank may execute a promissory agreement to sell the salam commodities with a third party in the event of default.

Alternatively, the bank may execute a unilateral promissory agreement with a third party to purchase the salam commodities upon maturity of the initial contract.

## Istisna

Istisna is a contract executed to procure an asset or commodity manufactured to order. The istisna contract may be executed with the actual manufacturer of the commodity or any other third party.

The 'mustasni', or istisna requestor, orders the mustasna, or manufacturer, to manufacture certain goods or commodities. Both parties must agree on all commodity specifications before contract execution.

An istisna contract is executed by the mutual undertaking of one party to manufacture the goods and the other to pay a specified amount for them. An Istisna contract cannot be executed for an already manufactured item.

### Istisna Fundamentals

*Istisna Subject Matter*

- The subject matter in an istisna contract must be clearly defined before contract execution.
- The parties may mutually agree on changing the specifications of the subject matter.
- The manufacturer, not the istisna requestor, must procure the istisna production materials.
- The subject matter must undergo generally accepted market norms of manufacturing.
- The subject matter must be non-existent at the time of contract execution.
- The subject matter in an istisna does not have to be owned at the time of contract execution.

*Istisna Price*

- All Shariah-compliant counter values may be used as the istisna price – i.e. usufruct, goods and cash.
- The istisna price must be clearly specified and agreed before contract execution.
- The price need not be fully paid before contract execution, as in the case of salam contracts. The istisna price may be settled by a one-off payment or in installments to a fixed schedule.
- The istisna price must not be unclear in any way.
- The price must not depend on future contingencies such as inflation rates or manufacturing

costs.

*Istisna Options*

The istisna requestor has the right to exercise the khiyar al-aib but not the khiyar al-ru'yah.

*Istisna Tenure*

The contracting parties may mutually agree a fixed time period. Istisna tenures can be for any amount of time. In the time is not specified, the general market tenure for the production of the goods may be used to determine the tenure. Alternatively, the parties may agree on a tenure even after contract execution. It is not a necessary element of an istisna contract that the tenure be fixed.

*Prohibition of Buy-Back*

There must be no buyback agreements in an istisna contract. Parties should ensure legal and contractual independency at all times. Islamic banks and financial institutions may deal with subsidiary companies if their shareholding is less than 50%.

*Early Rebate*

The istisna requestor may grant the manufacturer a rebate on the istisna price in the case of early delivery. Rebates may not be stipulated or pre-agreed, however, at contract execution.

*Istisna Deposits*

Islamic banks may request the client to furnish an 'amanah', or 'trust', deposit. In conventional finance this would be a safety deposit.

Alternatively, the bank may make it a contractual requirement for istisna clients to provide initial one-off payments such as, for example, 25% of the total istisna price.

Islamic banks may also request istisna clients to provide guarantees in order to lower the risk profile of the transaction.

*Istisna Default*

A penalty may be imposed on the manufacturer for late delivery of goods. This penalty, or shart al-jaza, established before contract execution, allows for a reduction in the istisna price. This clause is only applicable to Shariah-compliant manufacturing contracts.

*Istisna Termination*

Each contracting party can unilaterally terminate the istisna contract on condition that production of the istisna goods has not yet started. Both parties are legally bound by the istisna contract once manufacturing has begun, after which termination of the contract must be by mutual consent.

*Parallel Istisna*

Parallel istisna contracts are secondary istisna contracts executed alongside the original istisna contract but completely independently of it.

The contracting parties must ensure that the parallel and original istisna arrangements are totally independent and separate legal entities.

The manufacturer in the original contract becomes the istisna requestor in the parallel contract.

For example, Zaid enters into an istisna arrangement with Al-Nakheel Islamic Bank for the manufacture of 1,000 corporate suites. Zaid is the istisna requestor, while Al-Nakheel is regarded as the manufacturer. Al-Nakheel is a bank, however, and must enter into an arrangement with a real estate developer or building contractor to develop the units. Al-Nakheel therefore executes a parallel istisna with Al-Mabroor, a real estate developer.

Upon maturity, Al-Mabroor hands over the suites to Al-Nakheel, who then hand over the units to Zaid under a separate and independent istisna transaction.

Al-Nakheel may appoint Zaid as agent to supervise and monitor the development of the real estate units. This promotes financial transparency and trust between the contracting parties.

**Modern Istisna Application**

*Real Estate Istisna Financing*

Islamic financial institutions offer real estate financing on the basis of istisna financing. Islamic banks conclude an istisna arrangement with the client for the development of a certain number of real estate units after agreeing specifications. The client provides the land while the bank develops the units. The Islamic bank executes a separate and independent parallel istisna with a real estate developer to build the units, while ensuring that the developer adheres to the agreed upon specifications. The bank profits from the difference in prices.

*Infrastructure Development*

Governments may finance infrastructure development using istisna contracts. For example, a government issues tenders to various construction and development companies to develop highways, with the price being the usufruct of the highway over a fixed tenure.

Governments may even execute combined arrangements such as two-tiered istisna and salam arrangements.

*Examples of other contracts:*

- BOT (buy, operate, transfer)
- Construction financing
- Local and export istisna products

## Chapter Ten

## Islamic Private Investment Funds

Islamic Private Investment Funds are joint shareholdings of investors in non-listed companies, limited partnerships and joint ventures to invest in Shariah-compliant commodities.

They allow investors to diversify their asset portfolios while being able to personally supervise their investments. Private funds have a much higher risk profile than public funds but generally enjoy higher returns on investment (ROI). Private investment funds can be closed- or open-ended.

For example, ten investors invest $1,000,000 in a large real estate investment target company on the basis of a closed-end musharaka partnership. Partners agree on profit ratios, management duties, legal vehicles, exit strategy and contract terms before partnership execution. They agree a tenure of five years, after which the musharaka is terminated.

### Investment Types

There are various asset classes which may be covered by Islamic Private Investment Funds:

1. Private Equity Investment Funds
2. Real Estate
3. Mixed Funds
4. Trade Finance

### Investment Scope

Major investment classes:

1. Real Estate Development
2. Healthcare
3. Education
4. Services
5. Telecommunications
6. Technology
7. Research
8. Asset Financing

**Investment Classes**

*Private Equity Investment Funds*

A private equity fund is a joint shareholding in companies not listed on the stock exchange. Investors pool their excess liquidity in joint asset portfolios with the intention of gaining profit from the trading of company shares or sharing dividends according to pre-agreed profit ratios.

Conventional equity funds can co-exist and merge with Islamic private equity investment funds subject to certain conditions.

Investors must agree on matters including management scope, legal vehicles, fund structures, profit ratios, investment strategy, legal issues, and Shariah governance.

*Private Equity Shariah Fundamentals*

- All investors or subscribers must agree on profit ratios before fund initiation.
- Losses are shared according to capital contribution ratios.
- All investors should agree on investment tenures.
- There must be no gambling
- There must be no conventional insurance
- There must be no debt financing, debt restructuring or non-compliant debt rescheduling
- There must be no interest
- The underlying investment assets should be Shariah-compliant. The Shariah Supervisory Board should develop standard financial filters to screen target companies for non-compliancy.
- Management scope should be clearly defined before fund initiation. Investors may appoint separate fund managers to manage the asset portfolios.
- In order to ensure Shariah compliance when trading in private equity stocks, the fund should consist of at least 33% of tangible and illiquid assets.
- There must be no gharar, jahala (ambiguity) or other non-compliant elements.

*Islamic Private Equity Fund Structure*

- Documentation Submission – The fund or company promoter submits the articles of association, governance structure, business plan and all other relevant fund documentation to the Shariah Supervisory Board for approval.
- Investment – After approval from the SSB, the investors pool their monies into the Islamic Private Equity Fund.
- Fund Management – The investors either appoint external fund managers or appoint co-investors to manage the fund.
- Shariah Supervision – The SSB monitors and supervises the compliancy of transactions. The Shariah advisor conducts a Shariah assessment and gives the board of directors the Shariah Assessment Report.
- Investment Management – Asset portfolio managers invest the funds in various target companies.

- Profit Distribution – The investment managers conduct detailed portfolio analysis, risk assessments and the like, and provide these reports to the investors. Profit is either generated on the basis of periodic returns or after a planned exit.

*Islamic Private Equity Challenges*

- Asymmetry of information
- Governance structures
- Government regulations and legal frameworks
- Legal structures and vehicles
- Taxation
- Shariah supervision
- Expropriation and dispute resolution

**Real Estate Private Investment Fund**

In this, investors pool money to invest in real estate. They agree a fixed tenure upfront and then exit the fund with either a buy-out or buy-in clause.

Investors must ensure that all elements of the fund such as profit ratios, management scope and third-party agreements are Shariah-compliant.

**Islamic Real Estate Investment Trust (IREIT)**

IREITs are Shariah-compliant certificates or securities of equal value representing the undivided ownership of real estate assets. IREITs allow investors to invest in various real estate classes under a Shariah-compliant trust fund. They operate under a normal trust fund structure, with trustees, fund managers, unit holders and property managers.

*IREIT Check List*

- Rentals must be derived from Shariah-compliant business activities.
- Conventional insurance is not permitted.
- All cash flows, investment types, deposit and financing instruments must be Shariah-compliant.
- All structures and systems must be pre-determined and pre-agreed.
- All certificates and securities must represent underlying assets.

**Mixed Fund**

Subscribers pool their funds in investment bouquets or diversified portfolios of assets such as equities, commodities and real estate.

Investors must ensure strict Shariah-compliance in accordance with international standards.

**Trade Finance**

Closed-end funds used to invest in non-negotiable murabaha certificates.

Murabaha certificates cannot be negotiable since the murabaha clients of Islamic banks and financial institutions generally purchase the commodities on credit. Accounts receivable cannot be exchanged in lieu of money.

## Chapter Eleven

## Liquidity Management for Islamic Finance

Liquidity management refers to the financial management of an excess or shortage of cash funds.

Islamic banks must meet the demand for cash deposit withdrawals, routine cash flows and other liquidity requirements. Financial institutions must maintain optimum liquidity levels in order to operate efficiently and competitively.

Banks may place their excess liquidity in various profitable investment portfolios and access funds from the interbank and money markets in the event of liquidity shortages.

Islamic banks must adopt a coherent and financially prudent liquidity management strategy. They must have in place a Contingency Funding Plan, or CFP, to deal with heightened liquidity stress.

Liquidity stress testing is an important tool in determining an optimum CFP.

### Measures of Liquidity

*Financing to Deposit Ratio*

The Financing to Deposit Ratio is a measure used by financial institutions and banks to determine liquidity risk, or the possibility of a bank being unable to fund its financing commitments or meet demand for cash withdrawals. The ratio expresses the relationship between a bank's financing requirements and its total deposits. The lower the deposits, the higher the liquidity risk.

*Liquidity Ratio*

The ratio of a bank's liquid assets – being the total amount of cash and cash-equivalent reserves, as well as deposits with other banks – to its liabilities is known as its liquidity ratio. Islamic Banks generally have much higher liquidity ratios than conventional financial institutions.

### Liquidity Management Instruments

*Musharaka Investment Pools*

Islamic banks and financial institutions create diversified investment portfolios to finance equities, murabaha arrangements, musharaka partnerships, lease-based contracts and various other contracts.

An Islamic bank will transfer assets from a general investment portfolio to a specific investment pool based on its liquidity management strategy. The bank runs the specific investment pool for a fixed tenure. The pool is dissolved upon maturity and the assets returned to the general pool.

*Musharaka Investment Pool Fundamentals*

- The pool must consist of a minimum 33% in tangible assets when trading in stocks.
- The Islamic bank manages the funds as a working partner, while the investors serve as silent partners.
- The bank must ensure proper profit calculation and distribution.
- It must also ensure that the assets realize a profit above their actual value.
- The assets must be Shariah-compliant.
- All contracts must be regularly monitored by the Shariah Supervisory Board.
- An Islamic bank may also serve as the fund manager, in which case it would become an employee of the investors. Alternatively, the bank may serve as agent of the investors and receive a fixed agency commission.
- All non-permissible income is filtered into a specific charity fund.

*Asset Pool Management System*

- The Islamic bank executes a Deal Confirmation Agreement with the financial institution.
- The assets are recorded and a transfer voucher is generated.
- Each specific investment pool is assigned a unique pool identification number, or PIN.
- Each transaction is given a unique deal/ticket number.

*Interbank Mudaraba Contract*

Islamic banks can also manage liquidity using an interbank mudaraba facility agreement, which has a maximum period of 180 days. Mudaraba is a partnership between two or more parties where one party provides the investment management expertise and the others the capital investment.

The master mudaraba facility agreement contains the following key elements:

- The Islamic bank and investors agree on a specific and fixed profit ratio before contract execution. The investors bear the full loss of the contract, although the bank can be held responsible for proven negligence. Islamic banks allocate different weightings for different asset and investment classes to calculate profit-sharing ratios.
- The venture must only invest in Shariah-compliant assets.
- The Islamic bank and investors agree a fixed tenure.
- The agreement is submitted to the Islamic bank's Shariah Supervisory Board for approval.
- The bank and investors execute the transaction once approved by the SSB.
- The transaction is reported to the bank's Treasury Department.
- The Treasury Department reviews and approves the transaction, weightages, and contract terms and conditions.
- The Islamic bank manages the portfolio, and declares profits or losses at regular intervals until maturity.
- The mudaraba is terminated and liquidated upon maturity.

**Wakala (Agency)**

An Islamic bank appoints another bank as its agent to invest excess liquidity in various Shariah-compliant portfolios under an interbank wakala agreement. The Islamic bank serves as the muwakil, or principle, while the investing bank serves as the wakil, or agent.

*Interbank Wakala Execution*

- The principle identifies a suitable Shariah-compliant investment portfolio and discloses the investment strategy of the portfolio.
- The principle and agent agree terms such as tenures, agency commission and brokerage charges, and scope of management.
- The principle and agent execute the interbank wakala transaction after receiving approval from the Sharia Supervisory Board.
- The agent receives a fixed commission for each successful transaction.
- The principle receives profits in excess of the agency commission.
- The wakala is terminated and liquidated upon maturity.

*Wakala Negligence*

The principle is entitled to receive compensation for any losses suffered by the business venture as result of the agent's negligence.

**Islamic Real Estate Investment Trusts**

Islamic banks can invest in Islamic Real Estate Investment Trusts or IREITs provided all Shariah compliancy requirements are met.

The banks can use IREITs to fulfil short-term liquidity requirements or to manage excess funds.

**Shariah-Compliant Private Equity**

Islamic banks may invest in private equities to manage an excess of liquidity. All Shariah compliance criteria must be met before investment execution.

**Interbank Wadiah Deposits**

Islamic banks may place excess liquidity with other banks under an interbank wadiah agreement, in which the holding bank serves as custodian of the wadiah portfolio. The wadeah depositor may offer a dividend on a purely voluntary basis. The holding bank may charge an administrative fee.

**Local Currency Commodity Murabaha**

The local currency commodity murabaha instrument can be used for various maturities, even including overnight maturities. They can be used by financial institutions to manage excess liquidity or to receive liquidity injections.

1. The Islamic bank appoints an agent to take possession of the commodities on behalf of the bank. The agent issues a delivery order for the commodities when instructed by the bank.

2. The bank then purchases the commodities from a financial broker for the spot cash price.

3. Another financial broker representing a bank facing liquidity shortages issues a delivery order to the Islamic bank's agent. The agent informs the Islamic bank of the order.

4. The Islamic bank sells the commodity to the bank facing liquidity shortages on a deferred payment basis. The financial institution now owns the commodity. Both banks work out fixed tenures and agree on a common benchmark.

5. The financial institution facing liquidity charges sells the commodity to a third party broker based on the original price. The financial institution receives much needed liquidity to fund its operations.

6. The financial institution pays the initiator bank upon contract maturity.

**Foreign Currency Commodity Murabaha**

The foreign currency commodity murabaha instrument is used for absorbing and investing excess liquidity funds.

1. An Islamic bank with excess liquidity purchases aluminium through a financial broker.

2. The Islamic bank maintains the amount payable to the broker as foreign currency in a separate bank account.

3. The Islamic bank executes a murabaha transaction for the aluminium with another financial institution on a deferred payment basis. The bank pays for the commodities in foreign currency within 90 days. The initiator bank discloses the profit margin, commodity purchase price and all other costs.

4. The financial institution sells the aluminium to a third party broker on the basis of a Murabaha transaction for a foreign currency payment.

5. The third party broker then sells the aluminium to the first broker on a deferred payment basis.

6. The Islamic bank then pays the first broker the foreign currency payment upon contract maturity.

7. The first broker then pays the second broker.

8. The financial institution with a shortage of liquidity receives payment from the second broker.

### Islamic Placement Accounts

Islamic banks deposit excess liquidity in Islamic deposit/placement accounts, or IDA, which the counter bank invests to earn profit. The Islamic bank and financial institution agree on a fixed tenure with fixed profit ratios.

### Shariah-Compliant Foreign Exchange

Shariah-compliant foreign exchange contracts can be executed on the spot or on a mutually agreed date via a promise to purchase. The client and Islamic bank agree a fixed exchange rate and promise to execute the contract on a the agreed date.

### Islamic Liquidity Management Challenges

Islamic banks and financial institutions face various challenges in managing their liquidity portfolios including:

- The absence of a global Islamic capital and interbank money market
- An absence of secondary Islamic markets
- A shortage of financially sound and prudent Shariah-compliant liquidity instruments
- The absence of a Shariah-compliant lender of last resort
- The absence of a global Shariah monetary and regulatory organization

## Chapter Twelve

## Risk Management in Islamic Banking

Risk is defined as the exposure to uncertain future events that could adversely affect the objectives of a financial institution.

Among the common uncertainties an Islamic financial institution faces are the failure of a debtor to meet financial obligations, poor profitability, fraud, exchange rate fluctuations, insolvency, and Shariah non-compliance.

Under a Shariah-compliant contract, the contracting parties are entitled to profits in relation to their risk assumption. This is termed 'essential risk' or 'risk for return'.

Also under a Shariah-compliant contract, the seller bears the full risk of loss until the title of the item sold is transferred to the purchaser, who then assumes all associated risks including risk of defect, damage or depreciation.

### Risk Management

Risk management is the process by which various risk exposures for a financial institution are identified, measured, mitigated, controlled, reported and monitored.

It is not necessarily conducted to minimize risk, but to optimize the relationship between risk and reward.

### Risk Register

An effective risk management plan would include a risk register, which records all the finer details of the financial institution's risk profile including risk grading, risk mitigation, prescribed strategies and risk impact.

A risk register will include:

- A unique risk identification code
- A description of the risks
- Risk gradings (low, medium, high)
- Risk mitigation strategy
- Mitigation costing

The register must be regularly monitored and updated by the chief risk officer at the financial institution.

**Risk Profile**

An Islamic financial institution faces both generic risks such as those faced by conventional companies and the unique risks associated with Islamic finance.

*Generic Risk*

- Credit Risk – The potential for a counterparty to fail to meet its financial obligations under the agreed terms and conditions of a credit contract.
- Market Risk – The potential impact of adverse price changes such as benchmark rates, exchange rates, and equity prices on the economic and financial value of assets.
- Operational Risk – The potential direct or indirect loss resulting from inadequate or failed internal processes, human resources, systems or external events.
- Liquidity Risk – The potential risk of loss arising from the financial institution's inability to meet financial obligations.

*Unique Risk*

- Equity Investment Risk – The risk arising from entering into a partnership to participate in a particular business or financing activity. Musharaka and mudaraba fall under this risk type.
- Rate of Return Risk – The potential impact on returns caused by market volatility. In the context of Islamic finance, rate of return risk refers to the potential impact on a financial institution's income or market value of equity.
- Displaced Commercial Risk – The risk that a bank has to pay returns that exceed the actual return rate. Banking clients may have expectations of higher rates of return, forcing the Islamic bank to match these to retain depositors.
- Liquidity Risk – The risk of loss arising from an Islamic bank's inability to fund its financing commitments and meet demand for cash withdrawals as they cannot lend based on debt but based on equity and assets.
- Shariah Non-Compliance Risk – Risk of loss arising from a failure to adhere to Shariah operational procedures and processes.
- Inventory Risk – Risk arising from holding items in inventory. Non-binding murabahas and ijaras are susceptible to inventory risk.

**Risk Profiles – Shariah-Compliant Contracts**

*Murabaha Risk Profile*

- Market Risk – Exposure to adverse commodity price changes.
- Inventory/Transit Period Risk – The risk associated with the murabaha commodities after the Islamic financial institution has procured them and before they are sold to the client.
- Operational Risk – The client takes possession of the goods from the supplier without informing the Islamic bank.
- Credit Risk – The client does not pay instalments according to agreed payment schedules
- Supplier Risk – The supplier is unknown to the bank, which may result in delays in delivering the goods, non-conformity to commodity specifications, and fraudulent activity.
- Shariah Non-Compliance Risk – The client does not adhere to the strict procedures and processes of a Shariah-compliant murabaha as outlined in the Master Murabaha Facility Agreement.

- Legal/Regulatory Risk – The risk associated with non-compliance to legal frameworks and government regulations, especially tax regimes.

*Ijara Risk Profile*

- Inventory Risk – The risk that the lessee will back out from the lease, forcing the bank to liquidate the asset at a lower-than-market price.
- Asset Risk – The risk that the asset depreciates, or is damaged or stolen.
- Credit Risk – The risk that the client is unable to meet payment schedules.
- Shariah Non-Compliance Risk – The risk that the client does not follow Shariah procedures.
- Liquidity Risk – The risk that a financial institution will be unable to fund major maintenance of ijara assets due to a shortage of liquidity.
- Country/Transfer Risk – The risk associated with transferring ijara assets to foreign lessees.

*Salam Risk Profile*

- Settlement & Delivery Risk – The risk associated with non-conformity to specifications or delayed delivery.
- Market Risk – The risk associated with a depreciation of the market value of commodities due to market volatility.
- Rate of Return Risk – The risk associated with a reduction in value of commodities resulting in lower return rates.
- Risk of Early Termination – The risk associated with the client's early termination of the contract before maturity.
- Credit Risk – The risk that the counterparty does not fulfil financial obligations.
- Transfer Risk – The risk that the client sells the commodity before taking ownership.
- Legal Risk – The risk associated with litigation proceedings against the Islamic bank.

*Musharaka Risk Profile*

- Legal Risk - The risk that a partner institutes legal proceedings against the partnership in the event of a dispute.
- Regulatory Risk – The risk that the partnership does not conform to government regulations.
- Operational Risk – The risk associated with partners not adhering to agreed policies and procedures.
- Shariah Non-Compliance Risk – The risk associated with debt funding, prohibited funding sources, and other forms of non-compliance with Shariah standards.
- Liquidity Risk – The risk that partners fail to meet funding requirements.
- Equity Investment Risk – The risks associated with entering into an equity-based partnership. Such risks include fraudulent behaviour and misrepresentation.

**Risk Mitigation**

*Unique Mitigation Tools*

- Agency Agreements – Islamic financial institutions appoint clients or third-party agencies to procure commodities according to specifications.
- Promise to Purchase – The client signs a unilateral, non-legally binding promissory

agreement to purchase commodities at a specified date.
- Securities – The Islamic bank maintains a security furnished by the client.
- Legal Clause – The client signs an agreement stating that the financial institution may institute legal proceedings in the event of default.
- Guarantees – An Islamic guarantee is taken from the client to fulfil financial obligations.

Islamic financial institutions may adopt strict guidelines for all Shariah products in order to manage operational risks more effectively. Strict reporting and handling guidelines for Shariah non-compliance may also be adopted as part of the risk management plan.

*Options*

- Khiyar al-Sharth – An option in a sale's contract established at the time of signing the agreement giving one of the two parties to the contract a right to cancel the sale within a stipulated time.
- Khiyar al-Aib – The option of return in case of a defective asset.
- Khiyar al-Wasf – The option that the buyer has to rescind the sale in the event the goods do not conform to specifications.
- Khiyar al-Ghaban – Option covering deception with regard to a fundamental element of the sold item.
- Khiyar al-Ru'yah – The option of refusal based on which the buyer may decline from accepting the goods of a sale as a result of non-conformity to specifications.

*Displaced Commercial Risk*

- Smoothing of Returns
- Short-Term Liquidity Financing
- Efficient Fund Management

*Generic Risk Mitigation Tools*

*Credit Risk*

- Credit Recovery Policy
- Consumer Grading
- Due Diligence Standard Protocol

*Operational Risk*

- Management Awareness and Self Assessment (MASA)
- Key Risk Indicators (KRI)
- Customer Complaints Service

**Shariah Risk Governance**

Shariah risk governance refers to the governance of risk management, evaluation and assessment for Islamic financial institutions in accordance with Shariah law.

Shariah risk governance policies and guidelines form the backbone of the risk management plan of an Islamic bank. Operational manuals ensure strict implementation of policies and guidelines.

The risk policies, guidelines and operational manuals must be approved by a financial institution's Risk Board, a special committee set up to deal with risk identification, assessment, mitigation and approvals, in consultation with the various bank sub-committees including the Audit Committee, Risk Committee, Board of Directors, Shariah Supervisory Board and External Shariah Audit Committee.

All risk policies, strategies and guidelines must be reviewed on an annual basis to ensure risk optimization.

**Risk Policy & Guideline Sample**

An operational risk policy is aimed at effectively and efficiently managing operational risk in accordance with the strategy adopted by the Risk Board.

*Operational Risk Policy Guidelines*

- Operation Risk Management Guidelines
- Management Awareness and Self-Assessment (MASA)
- Fraud Handling & Reporting Guidelines
- Key Risk Indicators (KRIs)
- Information Technology (IT) Guidelines
- Customer Complaints Guidelines
- Regular Stress Testing

# Chapter Thirteen

# Hawala and Kafala (Islamic Cession and Surety)

## Hawala

The transfer and cession of a debt obligation to a third party is known as 'hawala'.

Hawala assigns the debt rather than sells it.

The person who transfers the debt – the original debtor – is known as the 'muhil'. The creditor is known as the muhtal', while the person to whom the debt is transferred is the 'muhtal alaihi' refers to the transferee. The subject of the cession or reassignment of debt is the 'muhtal bihi'.

For example: Zaid owes Bakr $10,000. Zaid is the debtor while Bakr is the creditor. Zaid cannot fulfil his financial obligations towards Bakr. However, Yusuf agrees to undertake the fulfilment of the debt. Bakr agrees to this arrangement, and Zaid is no longer obliged to pay Bakr the $10,000. Here, Zaid is the muhil, or assignor, while Bakr is the muhtal, or assignee. Yusuf is the muhtal alaihi, or transferee, and the $10,000 is the muhtal bihi, or cession item.

### Hawala Fundamentals

- A hawala contract is initiated by the mutual acceptance of the muhtal, the muhil and the muhtal alaihi.
- Each party to the contract must be adult and sane.
- Securities cannot be assigned under hawala contracts.
- The muhtal bihi must be clearly specified before hawala execution.
- The hawala must be effectuated immediately and not suspended for future contingencies.
- The transaction should not be conditional on any assignment fees or commission.

### Hawala Types

*Hawala Mutlaqa, or Global Cession*

Global cession refers to the transfer of a debt to a third party with the mutual agreement of the assignor, assignee and transferee.

For example, Mark owes John $5,000. Paul agrees to undertake the fulfilment of the debt on Mark's behalf. Paul, John and Mark are all in agreement for this arrangement. The debt is transferred to Paul and Mark is no longer responsible to fulfil the debt obligation.

*Hawala Muqayyada, or Specific Cession*

A specific cession is the assignment of receivables to the creditor with the mutual agreement of the assignor, assignee and transferee.

For instance, Zaid owes Yusuf $10,000. Yusuf owes Bakr $10,000. Yusuf and Bakr agree to a specific hawala arrangement under which Yusuf assigns the $10,000 debt of Zaid to Bakr. Bakr receives an official letter of endorsement from Yusuf stating that Zaid is obliged to pay the $10,000 to Bakr.

**Hawala Term**

A hawala can be executed for any mutually agreed period of time between the muhil, muhtal alaihi and muhtal. However, the term of the hawala must be determined and specified before hawala execution.

**Hawala Obligations**

- The muhtal cannot claim from the muhil once the hawala has been executed.
- The muhtal alaihi may claim the hawala amount from the muhil upon paying out the debt to the muhtal.
- The muhtal alaihi cannot claim the muhtal bihi from the muhil before fulfilling the debt obligation.
- The muhtal alaihi cannot legally claim from the muhil if the muhil fulfilled the debt after hawala execution.
- The muhtal alaihi cannot claim more than the muhtal bihi amount. Any excess amount given by the muhtal alaihi cannot be claimed from the muhil.
- The muhtal alaihi will not be obliged to fulfil the hawala if the muhtal absolves the muhtal alaihi from the hawala

**Hawala Special Obligations**

The muhtal cannot legally claim from the muhil unless:

- The muhtal alaihi denies the hawala and wins the hawala court case.
- The muhtal alaihi dies and does not leave sufficient funds to fulfil the debt.
- An Islamic judge declares the muhtal alaihi insolvent.

**Hawala Termination**

The hawala is terminated once the muhtal alaihi completes payment of the muhal bihi.

The muhtal alaihi may request an ‘iqala’, or voluntary dissolution, of the hawala.

**Modern Applications**

Islamic bills of exchange are one of the most common hawala instruments. Others include Islamic cheques and travellers cheques.

An Islamic bill of exchange is a mutually agreed order requiring the addressee to pay on demand or at a future date a sum of money to a specified person or bearer of the bill. It facilitates the transfer of financial obligations from one person to another, thereby facilitating credit.

For example, Zaid wishes to purchase a new vehicle from Mark, a car dealer. The price of the vehicle is $5,000. However, Zaid does not have the ready cash to purchase the vehicle. Therefore, Zaid, as the drawer, signs a bill of exchange instructing John to pay Mark the sum of $5,000 on January 21. John is the drawee while Mark is the payee.

## Kafala

Kafala refers to the undertaking of a guarantor to pay a debtor's debt. The liability is shared with the original bearer of the debt.

In a kafala, or Islamic surety, the creditor can claim from both the original debtor and the transferee debtor, while under a hawala, the creditor may only claim from the transferee debtor. Unlike hawala, the original bearer is not absolved of his financial responsibilities in a kafala.

The guarantor who assumes the debt's liability is known as the 'kafil', while the 'asil' is the original bearer of the debt. The creditor is the 'makful lahu', and the subject of the guarantee is the 'makful bihi'.

Guarantees are intended to secure financial obligations and civil rights, and to prevent bad debt. For example, Zaid makes a loan requisition to Bakr for $50,000. Bakr requests Zaid to provide a guarantee to secure payment. Yusuf offers a guarantee to Bakr for the debt obligation.

Here, Zaid is the asil, or original bearer of the debt, while Bakr is the makful lahu, or person seeking the guarantee. Yusuf is the kafil, or guarantor.

In the event of a default, Bakr has a legal right to claim the full payment of the debt from Yusuf and Zaid.

### Kafala Types

*Kafala Bil Nafs*

Kafala bil nafs refers to the assumption of liability for the physical appearance of the debtor under a lawsuit before the court. Kafala bil nafs is termed as a physical or legal guarantee.

For example, John is charged by the Supreme Court with murder. John appeals for bail. The Supreme Court Judge grants John bail on condition that he obtains a physical guarantee. John obtains a physical guarantee from Paul and thus obtains the court bail.

*Kafala Bil Dayn, or Mal*

Kafala bil dayn, or mal, refers to the pledge given by the guarantor that the debtor will pay the debt. Kafala bil dayn is the financial guarantee.

**Kafala Fundamentals**

- The kafala is executed by the mutual offer and acceptance by the kafil and makful lahu.
- The kafala contract is executed by generally accepted expressions denoting kafala.
- The kafil and asil must be both adult and sane to ensure the validity of the contract.
- The makful bihi, or subject of the guarantee, must be something for which the asil can be held legally responsible.
- The makful bihi should be clearly specified well in advance of contract execution in the event of kafala bil nafs, or physical surety.

**Guarantee Order of Demand**

The guarantor is entitled to arrange the guarantee order before contract execution. The creditor will only have the right to claim from the guarantor in the event of the original bearer's default.

**Guarantee Recourse**

Under this, the guarantor has the right to claim from the debtor the full guarantee object in the event of kafala liability discharge. Guarantee recourse is only valid with the prior consent and approval of the creditor.

Under a non-recourse guarantee, which refers to the voluntary guarantee of the guarantor without the prior consent or requisition of the creditor, the guarantor is not entitled to any financial recourse.

**Guarantee Combination**

Kafala bil nafs and kafala bil mal may be contractually combined. For example, a guarantor guarantees that he will present the debtor before the court at a pre-agreed time, failing which the guarantor will be liable for the debt.

**Guarantee Duration**

*Current Guarantee*: The guarantor may claim within the term of the original debt.

*Deferred Guarantee*: The term of the original debt is extended, allowing for the extension of the guarantee.

**Guarantor's Responsibilities**

- The kafil is liable to pay the guarantee item in the event of the original bearer's default.
- The creditor can claim from both the guarantor and original bearer.
- The kafala tenure is extended in the event of a loan extension.
- The kafil's obligation to honor the kafala remains in the event of the asil's death.
- In the event of a kafala termination, the debt obligation remains with the asil.
- If the asil honors the debt or the creditor absolves the debtor from the debt, the kafala obligation is removed from the kafil.

**Kafala Prohibition**

Kafala fees or charges are not Shariah-compliant since kafala is a charitable, voluntary contract. However, volitional payments are permissible.

Modern Applications

- Performance Guarantee
- Tender Guarantee
- Letter of Credit
- Credit Facilities Guarantee

## Chapter Fourteen

## Shariah Governance

Shariah governance refers to the structured organizational policies and processes of an Islamic financial institution to ensure complete Shariah compliance.

It is based on the three fundamental tenets of corporate governance: accountability, transparency and trustworthiness.

Islamic financial institutions must establish a sound and robust Shariah governance framework to ensure that their business operations are Shariah-compliant.

The terms and conditions governing the Shariah Supervisory Board (SSB) should be clearly defined and agreed in advance.

Shariah scholars should meet the right Shariah selection criteria and have access to continuous professional development.

Independency, academic honesty and integrity are the fundamental elements of a Shariah supervisory governance policy.

Reporting structures, codes of conduct and ethics, roles, responsibilities, scope of duties, risk reporting, oversight functions and various other policies and procedures must be clearly determined and documented in an Islamic financial institution's Shariah Governance Framework.

**Fundamentals of Shariah Governance:**

- Oversight & Responsibility
- Independence & Integrity
- Competency
- Confidentiality & Consistency
- Ethics
- Procedures & Processes

*Oversight & Responsibility*

- The Board of Directors, or BOD, of the Islamic financial institution is responsible for the coordination and integration of the Shariah Governance Framework.
- The BOD approves all policies and procedures after consulting with the Shariah Board.
- The BOD may appoint the Chairman of the Shariah Supervisory Board, or SSB, as a board member to enhance coordination and cooperation.
- The SSB is responsible for the general Shariah compliance of the financial institution.
- The management of the institution is responsible for the effective and complete implementation of the rulings and decisions of the SSB.
- Management should ensure effective reporting of non-Shariah compliance operations.
- Management is responsible for developing a sound and robust Shariah governance culture throughout the entire Islamic financial institution.

- Management should ensure that the Shariah governance structures of the financial institution are adequately funded.

*Independence & Integrity*

- The BOD must ensure the complete independence and integrity of the SSB and Shariah governance structures.
- The SSB should have access to accurate information at all times.
- The SSB shall be supreme in matters pertaining to Shariah law.
- The BOD may only dismiss an SSB Member after providing sufficient and reasonable explanation to the Chairman of the SSB and the External Shariah Audit Committee, or ESAC.

*Competency*

- The BOD, audit committee and risk committee members should have adequate knowledge of Islamic finance.
- The BOD should organize continuous professional development programs.
- The BOD should appoint an external Shariah auditor to formally assess the effectiveness, integrity, academic excellence and competence of the Shariah Supervisory Board.

*Confidentiality & Consistency*

- The SSB should have access to all confidential documentation of the financial institution, including minutes of meetings, internal memoranda, official decisions, and product development.
- Each Shariah board member should ensure confidential documentation remains confidential.

*Ethics*

- Shariah board members should always undertake activities that are compatible with their position do not compromise the integrity and independence of the board.
- The Chairman of the SSB may enforce disciplinary sanctions on defaulting board members.
- All members of an Islamic financial institution should follow a general Shariah Code of Ethics.

*Procedures & Processes*

- The Shariah Governance Framework defines a complete reporting structure that covers all departments and sub-departments of the Islamic financial institution.
- The SSB reports directly to the BOD.
- The management reports to the SSB on Shariah matters.
- The Shariah Audit Committee, Research Committee and Secretariat report directly to the SSB.

**Shariah Governance Model**

The following is an example Shariah Governance Model:

- The Shariah Supervisory Board is tasked with overall Shariah compliancy and oversight on Shariah Governance Structures. The SSB reports to the BOD directly.
- The Shariah Risk Management Board is responsible for the effective and optimum management of risk. The SRMB reports directly to the SSB.
- The Shariah Audit Committee is responsible for overall Shariah assurance. It reports to the SSB.
- The Shariah Risk Management Department identifies, measures, monitors and controls Shariah risks. The SRMD reports to the SRMB and coordinates risk management with the bank's management.
- The Shariah Review and Research Departments report to the SSB. The Shariah Research Department conducts in-depth Shariah research and analysis.
- The Shariah Audit Department reports directly to the Shariah Audit Committee.
- The Shariah Secretariat coordinates internal meetings, records minutes of meetings, publish and distributes Shariah decisions and rulings. It serves as the official public liaison body for the SSB.
- The External Shariah Audit Committee, or ESAC, is appointed by the BOD and conducts regular Shariah reviews to ensure strict Shariah compliancy. This promotes financial transparency. The ESAC reports directly to the BOD.

**Shariah Supervisory Board (SSB)**

The Shariah Supervisory Board is responsible for developing Islamic financial products and instruments, and for the general supervision and monitoring of the Shariah compliancy of an Islamic financial institution.

The SSB should have a minimum of three Shariah scholars, including the chairman of the board.

The chairmanship of the SSB should be rotated each financial year. Every Shariah scholar should be assigned specific tasks over and above certain general tasks of the SSB.

*Appointment, Resignation & Dismissal*

- The Board of Directors should appoint a nomination committee, which will recommend the appointment of the Shariah scholars to the SSB.
- Shariah scholars should undergo a rigorous selection process before appointment, and all should fulfill the minimum qualification criteria.
- The Board of Directors may only dismiss a Shariah scholar after providing reasonable and sufficient explanation. Notice periods must be well documented prior to contract execution.
- The BOD and SSB members execute a service contract with the following clauses: appointment tenure; appointment and dismissal authority; notice of dismissal period; duties; remuneration and benefits; special clauses.

*Reporting & Operating Structures*

- The SSB shall report to the BOD on matters pertaining to Shariah law.
- Meetings should be held regularly to ensure that the business of the Islamic financial institution is not adversely affected.
- The chairman of the SSB shall have veto rights in decision making.
- All reported statements and directives must be well recorded and archived for future

reference.
- The SSB should have a Shariah Process Manual documenting the relevant procedures and processes.

*Primary Duties & Responsibilities*

The SSB is primarily responsible and accountable for the general Shariah compliancy of the Islamic financial institution, as well as for:.

- Providing Shariah advice
- Reviewing & endorsing Shariah policies and guidelines
- Endorsing & validating relevant Shariah documentation including Shariah contracts, agreements, forms, and legal documentation used in executing Islamic transactions
- Overseeing the computation and distribution of zakat and purification funds in charitable avenues
- Providing Shariah counsel to relevant parties including legal, compliance, credit and audit bodies
- Providing written Shariah decrees, or fatwa
- Assessing the Shariah Audit, Risk and Research Departments.

*Independence*

The Shariah Supervisory Board should maintain complete independence and integrity at all times to ensure independent and impartial judgment on Shariah matters.

*Powers & Authority*

The SSB may be vested with certain powers and authorities as decided by the BOD.

*Communication*

The BOD & SSB should agree on a special communication strategy and reporting mechanism.

**Shariah Research Department**

The Shariah Research Department conducts in-depth studies on Shariah law, product innovation and development, and high-level consultancy.

Shariah research scholars may seek the assistance of economists, actuaries and legal experts to ensure the comprehensiveness of the Shariah Research.

**Shariah Secretariat**

The Shariah Secretariat coordinates meetings, records Shariah rulings and decisions, records and archives minutes of meetings, documents SSB meeting attendance, and publishes and distributes Shariah decisions and rulings.

**Shariah Audit Department**

The Shariah Audit Department determines the degree of Shariah compliance within the financial institution and communicates its assessments to the appropriate authority.

Islamic financial institutions should conduct periodic Shariah audits. The Shariah Supervisory Board should appoint an independent Shariah lead auditor, who should be assisted by the internal auditor of the financial institution. Shariah auditors should have adequate knowledge of the key management controls, organizational controls and operational controls of the Islamic bank.

The Shariah audit should be a top-down operation targeting the front, middle and back offices. The reporting line of the Shariah Audit Department should be designed to maximize independence and impartiality.

The Shariah auditor should be assisted by an internal IT Auditor to review and evaluate the controls and security of the Shariah operating system and software.

Shariah audit reports should be published in the institution's annual financial statement.

*Scope of the Shariah Audit*

- Financial operations
- Operational and procedural policies
- Product & instrument Shariah compliance
- Shariah governance compliance

**External Shariah Audit Committee**

The Board of Directors should appoint a wholly separate and independent External Shariah Audit Committee, or ESAC, to review, evaluate and monitor the general Shariah compliancy of the financial institution.

The ESAC ensures the SSB does not review itself.

## Chapter Fifteen

## Takaful (Islamic Insurance)

Conventional insurance is impermissible under Shariah law for the following three reasons:

1. Qimar (Gambling)

The insured person pays premiums expecting a much greater return in the event of a loss. However, the insured loses all the premiums paid if there is no such loss.

2. Gharar (Future Uncertainty)

The outcome of the insurance contract is based on an uncertain future.

3. Riba (Interest)

The total premiums paid by the insured party are sometimes worth more than the insurer's payment against a claim.

The Islamic alternative to conventional insurance is known as 'takaful' – an Arabic word meaning 'mutual guarantee'.

Islamic insurance is based on the concept of ta'awun, or mutual cooperation, with each policy holder signing a mutual promissory indemnity form to protect each other against loss. Takaful is offered on the basis of good faith and mutual understanding, allowing the contracting parties to make full disclosures of the insurance fund details.

### Islamic Insurance Financial Structure

- Musharaka: The participants of the joint fund pool monies together to share risk and indemnify each other.
- Wakala: The Islamic insurance company serves as manager on behalf of the policy holders.
- Mudaraba: The fund manager, or operator, invests a percentage of the funds in various Shariah-compliant investment portfolios.

The above three agreements must be wholly independent of each other.

### Islamic Insurance Fundamentals

- The policy holders pool their monies in a joint fund.
- The takaful operator manages the fund for a fixed fee, A percentage of the funds is maintained in the indemnity portfolio while the rest is put into Shariah-compliant investments.
- The insurer cannot guarantee indemnification in the case of loss nor can he guarantee the investment, as he only acts as an agent.
- The Islamic insurance company manager may charge a fixed agency fee for administrative activities but cannot charge a fee based on investment returns.

- The returns from the investment portfolio are distributed between the operator (mudarib) and policy holders (rabb al mal) based on pre-agreed profit ratios.
- In the event of loss to any policyholder, the loss is distributed to each policy holder based on mutual understanding.
- In the case of damages from fraudulent claims and the like, the insurance company may take all necessary legal action to recover the damages.
- Islamic insurance companies should employ Shariah supervisory boards to monitor Shariah compliancy.
- The insured party must provide evidence to support any claim.

## Chapter Sixteen

## Sukuk (Islamic Bonds)

Sukuk are Shariah-compliant certificates or securities of equal value representing undivided shares in the ownership of tangible assets, usufruct and services.

Sukuk is usually translated as 'Islamic bonds' and is the most active Islamic debt market instrument.

Holders of sukuk take direct equity stakes in tangible assets, as opposed to conventional bonds, which are money debt instruments.

Islamic banks invest in sukuk to receive profitable returns on their excess liquidity. Islamic banks may sell sukuk to manage a shortage of liquidity, to expand their investor base, to raise Shariah-compliant funding, to realise Shariah-compliant investment opportunities, or for Shariah balance sheet management and tradability.

Sukuk holders are exposed to asset-level risks and sukuk income is based on asset ownership rather than revenue rights.

### General Shariah Guidelines

- All transactions must conform with Islamic Law (Shariah)
- Prohibition of interest (riba) but trading between parties is acceptable
- Prohibition of speculation (maysir)
- Avoidance of uncertain or excessively risky transactions (gharar)
- Prohibition of investment in unlawful goods and services (e.g. pork, alcohol, or gambling)
- Sharing of risk between parties

### Specific Sukuk Shariah Guidelines

- Funds raised must be used for Shariah-compliant activities
- All funds raised may be used to finance tangible assets. Specificity of assets is important, since sukuk, unlike conventional bonds, cannot be used for the general financial needs of the issuer. Non-tangible assets may be used based on urf and aaadah, or custom and habit, subject to Shariah Board approval.
- Income received by sukuk holders (investors) must be derived from the direct cash flows generated by the underlying assets.
- Sukuk holders have a right to the ownership of the underlying asset and its cash-flows.
- Clear and transparent specification of rights and obligations of all parties to the transaction, in particular the originator (customer) and sukuk holders.
- No fixity in returns and no financial guarantees.
- Generic Shariah-compliant screening.
- All the rules of the original contract on the basis of which sukuk are created should be applied.

- The issuer cannot guarantee the face value of the certificate for the holder except in the case of negligence or misconduct.
- In sukuk based on sale and lease-back, the issuer can unilaterally undertake that he will purchase the asset after one year for a pre-agreed price.
- Different types of reserves (e.g. profit equalization reserve) or takaful pool can be created.
- Only those sukuk can be traded that represent proportionate ownership of tangible assets, usufructs or services.
- In sukuk of musharaka/mudaraba, the issuer can redeem the certificates on the market price. Purchase undertaking is allowed; however the purchase price should be the market value of the underlying assets.

**Sukuk Vs Conventional Debt Instruments**

*Sukuk:*

- Each sukuk unit represents an ownership of the underlying asset
- Maturity of the sukuk corresponds to the term of the underlying project or activity
- The sukuk prospectus contains all the Shariah rules related to the issue
- The underlying asset, project or business has to be Shariah-compliant
- The sukuk manager is required to abide by Shariah rules
- Sukuk holders have the rights to profits but also bear losses

*Conventional Debt Instruments:*

- Bonds represent pure debt obligations due from the issuer
- The core relationship is a loan of money, which implies a contract whose subject is purely earning money on money
- The issue prospectus does not include Shariah constraints
- The underlying asset, project or business can belong to any sector or industry, and can be issued to finance almost any purpose which is legal in its jurisdiction
- Bond holders are not exposed to losses on the asset, although they might bear losses in the event of insolvency by the issuer.

**Sukuk Structures**

*Musharaka Sukuk*

Issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts.

Participation Certificates represent projects or activities managed on the basis of musharaka.

Mudaraba sukuk represent projects or activities managed on the basis of mudaraba.

Investment agency sukuk represent projects or activities managed on the basis of an investment agency by appointing an agent to manage the operation.

*Murabaha Sukuk*

Issued for the purpose of financing the purchase of goods through murabaha so that sukuk holders become the owners of murabaha commodity

*Salam Sukuk*

Issued for the purpose of mobilizing funds so that the goods to be delivered on the basis of salam come to be owned by the sukuk holders

*Istisna Sukuk*

Issued for the purpose of mobilizing funds to be employed for the production of goods so that the goods produced come to be owned by the sukuk holders

*Muzara'a (Sharecropping) / Musaqa (Irrigation) Sukuk*

Issued for the purpose of using the mobilized funds for financing a project so that sukuk holders become entitled to a share in the crop as per the agreement.

*Mugharasa (Agricultural) Sukuk*

Issued for the purpose of mobilizing funds so that sukuk holders become entitled to a share in the land and plantation.

**Sukuk Examples and Shariah Guidelines:**

*Sukuk Musharaka*

- Musharaka financing can be securitized easily, especially in the case of large projects where huge amounts are required.
- A special-purpose vehicle, or SPV, is formed to collect funds from the Islamic investors, acquire assets and serve as partner in the musharaka agreement on behalf of the Islamic investors.
- The obligor serves as musharik and is typically appointed the management agent of the musharaka project.
- Each subscriber is given a musharaka certificate, which represents his proportionate ownership in the assets of the musharakah.
- After the project is started, these certificates can be treated as negotiable instruments. Certificates can be bought and sold in the secondary capital market.
- Securitization of musharaka can be used for construction of projects and factories, expansion projects, or working capital finance.

*Sukuk Musharaka Shariah Guidelines*

- Profit earned by the musharaka is shared according to an agreed ratio.
- Loss is shared on pro rata basis.

- The musharaka portfolio should consist of non-liquid assets valued at more than 33% of its total worth.
- However, if the Hanafi (one of the Islamic schools of jurisprudence) view is adopted, trading will be allowed even if the non-liquid assets are less than 33%, but the size of the non-liquid assets should not be negligible.
- Whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in combination.
- Bilateral undertaking (wa'ad mulzim) is not permissible in Shariah. However, unilateral undertaking (wa'ad ghair mulzim) is permitted.
- Guaranteed fixed returns are not permitted as this constitutes riba.

*Sukuk Ijara*

- Sukuk ijara are title deeds of equal shares in a leasing project giving their holders the right to hold shares, receive rental payments and dispose of their assets or properties. Ijara certificates are tradable on secondary markets.
- The lessor (owner) can sell the leased asset wholly or partly either to one party or to a number of individuals to recover his cost of purchase of the asset with a profit thereon.
- This purchase of a proportion of the asset by each individual may be evidenced by a certificate, which may be called the 'Ijara certificate'.
- The Ijarah certificate represents the holder's proportionate ownership in the leased asset.
- The holder will assume the rights and obligations of the owner/lessor to the extent of his ownership.
- The holder will have the right to enjoy a part of the rent according to his proportion of ownership in the asset.
- In the case of total destruction of the asset, he will suffer the loss to the extent of his ownership.
- The certificates can be negotiated and traded freely in the market and can serve as an instrument easily convertible into cash.

*Sukuk Ijara Shariah Guidelines*

- Rental payments may be structured such that they comprise of profits on the rental and the redemption amount on the principal. Rental payments cannot be guaranteed.
- Sukuk ijara do not represent debts, but undivided proportionate ownership of the leased asset (participatory certificates).
- Because the sukuk ijara are neither debts nor monetary, the issue of the sale of monetary debts with a discount do not arise. Hence sukuk ijara may be traded in the secondary market freely.
- It is essential that the ijara certificates are designed to represent real ownership of the leased assets, and not only a right to receive rental payments.
- The sukuk holders are responsible for major asset maintenance, whereas the obligor (lessee) is responsible for ordinary maintenance.
- All contractual agreements should be separated and individualized. For example, sale and lease agreements should be separated. Conversion should be well defined.

*Sukuk Murabaha*

- Murabaha is broadly understood to refer to a contractual arrangement between a financier (the seller) and a customer (the purchaser) whereby the financier would sell specified assets or commodities to the customer for spot delivery based on a profit and mark-up in exchange for fixed deferred payments.
- Murabaha is a transaction which cannot be securitized for creating a negotiable instrument to be sold and purchased in a secondary market since the murabaha certificates represent entitlements to shares in receivables from the purchaser of the underlying murabaha. Debt cannot be traded in Shariah except on par value.
- Sukuk murabaha certificates may still be negotiable if they form a small part of a larger portfolio consisting mostly of other negotiable instruments such as sukuk ijara, sukuk musharaka, and/or sukuk mudaraba.

*Sukuk Murabaha Shariah Guidelines*

- In murabaha securitization, the pool of assets should consist of ijara assets valued at more than 33% of its total worth.
- However, as described earlier if the Hanafi view is adopted, trading will be allowed even if the non-liquid assets are more than 10% of its total worth.
- Investors will have a mudaraba relationship with the manager of the pool.
- Investors in the pool will have a musharaka relationship and each one will be a proportionate owner of the pool.
- Profit will be shared according to an agreed ratio between the pool and the manager.
- The share of the pool will be further divided among the investors according to the rules of musharaka.
- The SPV should take physical possession of the goods to ensure complete transfer of liability (dhaman) to the purchaser.
- All transactions and documentation should be separated.

*Sukuk Wakala*

- In a wakala agreement, whereby one party entrusts another to act on its behalf, akin to an agency agreement, the investor appoints an agent (wakil) to invest funds into a pool of investments or assets. The wakil lends expertise and manages the investments on behalf of the investor for a particular duration, in order to generate an agreed-upon profit return.

*Sukuk Wakala Shariah Guidelines*

- The scope of the wakala arrangement must be within the boundaries of Shariah; i.e. the principal cannot require the wakil to perform tasks that would not otherwise be Shariah-compliant.
- The wakala agreement must be clear and well defined. The scope of services provided, appointment term, duties, terms and conditions and fees payable should be well defined. Any ambiguity will render the agreement void.
- All portfolio assets should be screened and endorsed by the Shariah Supervisory Board.

**Shariah Compliance Issues**

- The Shariah Supervisory Board should ensure the underlying structure, all financial documentation including prospectus, and implementation of the transaction is Shariah-compliant.
- The prospectus must mention the obligation to comply with all the guidelines and principles of Shariah as advised by the Shariah Supervisory Board.
- All transactions should be separated and individualized. No bilateral agreements are permitted in Shariah.
- An external Shariah oversight committee should be established to ensure optimal Shariah governance.
- Periodical Shariah audits should be conducted by the external oversight committee.

# GLOSSARY: COMMONLY USED TERMINOLOGY

**AAOIFI:** The Accounting and Auditing Organization for Islamic Financial Institutions is based in Bahrain and brings together Islamic finance scholars from around the world. AAOIFI Shariah standards are the de facto Islamic finance standard in over 90% of the world's jurisdictions.

**Advance Against Murabaha:** The amount disbursed by the financial institution for the purchase of goods from the supplier.

**Amwaal e Ribawiya:** Goods which, when exchanged with one another, result in the accrual of interest by either of the contracting parties. Six items have been classified as such by a hadith of the Prophet Muhammad (Allah bless him and give him peace): gold, silver, wheat, barley, salt and dates. These items may only be exchanged for each other in equal measure and at spot.

**Adadiya:** Countables - items which are measured as units and not by weight, length or volume, i.e. eggs sold as units (dozen or half a dozen).

**Adl:** Justice, impartiality, fairness.

**Adil:** Trustee; an honest and trust worthy individual.

**Agency Agreement:** An agreement by means of which a third party whether an individual or a financial institution is established as an agent to carry out an activity such as make an investment, on behalf of the principal.

**Ahadith:** (pl.hadith) Reports of the attributes, words and deeds of the Prophet Muhammad (Allah bless him and give him peace).

**Ajr:** Remuneration or compensation. In a service Ijarah, the ajr is the price paid to the employee by the employer in exchange for services rendered.

**Ajeer:** Employee.

**Ajeer e Aam:** An employee who is not restricted to the employment of a single employer but in fact is free to work for another person or persons as long as he fulfills his duties responsibly towards each of them.

**Ajeer e Khas:** An employee for a specified term, who only serves one beneficiary.

**Akl al Suht:** Illegal acquisition of wealth.

**Al-Ajeer al-Mushtarak:** A worker who may concurrently serve or be contracted by a number of clients, for instance a lawyer.

**Al-Ajr al-Mithl:** The prevalent price; the standard rate for a particular service.

**Al-Akl bi-al-batil:** Wrongful acquisition of wealth.

**Al-Amin al-Amm:** Trustee for property other than that granted for safe-keeping such as the lessee in an Ijarah or the Mudarib in a Mudarabah.

**Al-Amin al-Khas:** Trustee for property granted for safe-keeping as in the Wadi'ah (safe-keeping) contract.

**Al-Ghunm bi-al-Ghurm:** An Arab proverb according to which profit may lawfully be earned provided risk is shared for an economic activity that ultimately contributes to the economy.

**Al-Hisab al-Jari:** Current account.

**Al-Sanadiq:** Marketing investment funds.

**Amanah:** Property in the safe-keeping of another (the ameen) that must be preserved and protected; deposits maintained as trusts on a contractual basis.

**Ameen:** Trustee.

**Amil:** A worker entitled to remuneration, i.e. the Mudarib in a Mudarabah contract or a zakat collector.

**Amoor e Mubaha:** Commodities that are naturally available and may be benefited from by all. For instance, water from a river or the wood from the trees of a forest.

**Amwal:** (pl. maal); goods

**Aqar:** Real estate; immovable property, i.e. land, buildings etc.

**Aqd:** Contract.

**Aqd al-Bai:** A sale contract.

**Arbaab al-Maal:** Partners who contribute capital to the business, plural for Rabb al Maal.

**Arbun:** A non-refundable down payment received from the buyer or the Istisna requestor securing the purchase of manufactured goods.

**Ard:** Land.

**Ariya:** A contract in which one party loans another the use of an item for an indefinite period of time.

**Arif:** An expert who is consulted in matters requiring an informed and just decision.

**Arkan:** (lit. pillars) Fundamentals of a contract.

**Asil:** Assets.

**Average Balance:** A formula for determining the eligibility of profit a partner or Musharakah account holder can receive on his invested amount. Essentially, it is the minimum amount that must remain invested at all times in an account over a period of time for the account holder to be eligible to receive profit.

**Ayn:** Currency or ready money, i.e. gold, silver, coins, notes or any other form of ready cash.

**Bai:** Contract of sale.

**Bai al Dayn bi Dayn:** An exchange of debt, i.e. sale of securities or debt certificates.

**Bai Muajjal:** A deferred sale, where one of the considerations of the contract such as its price or the delivery of its subject matter is delayed to a future date.

**Bai al Muzayadah:** The sale of an asset to the highest bidder in the market.

**Bai' al Salam:** A sale where the price of the subject matter is paid in full at the time of the contract's execution while the delivery of the subject matter is deferred to a future date.

**Batil:** Void, invalid; refers to a transaction, a contract governing a transaction or an element in a contract which is invalid.

**Bai al-Wafa:** A sale where the seller is allowed to repurchase property through a purchase price refund. It is a transaction prohibited by a majority of scholars.

**Bai bi-Thaman 'Ajil:** (syn. bai muajjal) A deferred payment sale, where requested goods are purchased by the bank and sold to the client for a profit. The buyer is usually permitted to complete payments in installments.

**Bai' 'Ajal bi al-'Ajil:** (syn. bai al salam) A type of sale in which the price is paid upon signing the contract and the delivery of goods is delayed to a future date.

**Bai'atan fi Bai:** Two sales in one also referred to as "safaqatan fi safaqah."

**Bai al Inah:** A buy-back transaction that is prohibited in Islam.

**Bai al Istijrar:** A contract where the supplier agrees to provide a particular product to the client on an ongoing basis for an agreed price based on an agreed mode of payment.

**Bai' al-Kali' bi al-Kali':** (kali. syn. debt) Sale of debt for debt, specifically prohibited by the Prophet. In such a transaction, the creditor grants an extension in the repayment period in exchange for an increase on the principal.

**Baytul Maal:** The Muslim community's treasury.

**Benchmark:** A known and acknowledged standard that may already exist or alternatively be identified by means of expert appraisal.

**Benchmarking:** A method by which the rent for the remaining period of an Ijarah is based upon a known and acknowledged standard that may already exist or alternatively be identified by means of expert appraisal.

**Bond:** A certificate of debt based on which the issuer agrees to pay interest if any in addition to the principal, to the bondholder on specified dates.

**B.O.T or Build, Operate and Transfer:** A contract by which the government hires a contracting company to assist it in the development of infra-structure. Usufruct for a fixed period of time is established as the price of the contract after which ownership is transferred to the government free of cost.

**Bringing Forward Future Installments:** Based on this option, in the event a client defaults on his payment, all the installments for the entire term of the contract fall due immediately.

**Buy-Back:** The same as Bai inah, a prohibited type of sale in which one sells an item on credit then buys it back for a lesser price.

**Business Partnership:** A joint venture or project between two or more parties entered into to make a profit.

**Capital Recovery Risk:** The risk of the inability to regain capital from the security maintained by the financial institution in case of a loss.

**Catastrophic Risk:** The risk arising from the possibility of the occurrence of a natural disaster causing loss of or damage to goods.

**Charity Clause:** A stipulation made at the time of contract execution which establishes a certain amount of payment to a designated charity in the event of a default.

**Commodity Murabaha:** A transaction where the Islamic bank purchases a commodity on spot and sells it for a deferred payment for the purpose of managing liquidity.

**Compound Interest:** The accrual of additional interest on existing interest payments due on the principal.

**Commercial Interest:** The excess paid in exchange for a loan taken for the establishment of a commercial enterprise.

**Commutative Contract:** A contract involving an exchange.

**Conditional Agency Agreement:** An agency agreement where the agent is limited by certain conditions and restrictions with respect to the execution of a required task such as the purchase of an asset.

**Constructive Liquidation:** Evaluating the capital value of a business, without actually liquidating or selling it off.

**Constructive Possession:** Any form of documentary evidence that proves rightful ownership of an asset thereby sanctioning the seeking of gain from it; where the one possessing the asset is in a position to use the item for which it is intended.

**Contract:** A commitment to something enjoined by the association of an acceptance with an offer.

**Conventional Insurance:** The conventional form of providing indemnity against loss.

**Credit Risk:** The possibility of a counter party failing to meet its financial obligations in accordance to the terms agreed upon in the contract.

**Credit Stage:** This stage begins once the goods for a Murabaha are received by the financial institution and the documents of offer and acceptance are signed and ends once the Murabaha payment is recovered from the client. It is during this period that the bank has the right to accrue profit. It is also referred to as the financing stage.

**Daftur al-Tawfir:** Savings account.

**Dayn:** A debt created by a contractual obligation or credit transaction.

**Dhaman:** A contract of guarantee whereby a guarantor underwrites any claim or obligation to be fulfilled by the owner of the asset.

**Deal Ticket:** A form of documentation evidencing the acceptance of funds by one bank from another based on a Musharakah contract.

**Default:** A contracting party's failure to make a due payment.

**Dhimmah:** Liability.

**Dhulm:** Refers to all forms of injustice, exploitation or oppression through which a person deprives others of their rights or does not fulfill obligations towards them.

**Diminishing Musharakah:** A temporary partnership where an asset or property is jointly purchased by two partners and one partner eventually acquires ownership of it through a series of property share purchases.

**Dinar:** A gold coin used by early Muslims. Its standard mass was app. 4.25 grams.

**Displaced Commercial Risk:** Islamic financial institutions manage the funds of investment account holders on a profit-and-loss-sharing basis. However, in order to maintain competitiveness with conventional banks which offer fixed returns, IFIs typically surrender part (or all) of their profit share in order to allow their depositors to receive their expected profit allocation. This effectively means that the risk attached to depositors' funds is partially or wholly transferred to the IFI's capital, which increases the overall risk for IFIs and is referred to as DCR.

**Earnest Money:** A sum received from the client as security that serves as compensation in the event the lessee backs out from entering into or continuing an Ijarah. The lessor makes up for the actual loss from it and returns the remainder to the client.

**Equity:** The ownership share in a business.

**Equity Investment Risk:** The risk arising from entering into a partnership in order to finance a particular or general business activity, where the manager of finance also shares the business risk.

**Equity Market:** The equity market is the place where company shares are traded thereby providing viable investment opportunities to individuals, other companies and financial institutions seeking to avail them.

**Faqih:** Muslim jurist.

**Faqir:** A needy person.

**Fasid:** Voidable, usually said of a contract or an element within a contract.

**Faskh:** Cancellation of a contract, usually based on one of the contracting parties exercising an option, i.e. the option of return in case of a defective asset or the option of refusal to purchase an asset.

**Fatwa:** An authoritative legal judgment based on the Shariah.

**FI Pool:** A Musharakah based financial investment pool created by the Islamic financial institution to manage liquidity.

**Financing Stage:** This stage begins once the goods are received by the financial institution and the documents of offer and acceptance are signed and ends once the Murabaha payment is recovered from the client. It is during this period that the bank has the right to accrue profit.

**Fiqh:** Islamic jurisprudence.

**Fiqh al Muamalat:** Islamic jurisprudence governing financial transactions.

**Foreign Currency Commodity Murabaha:** A transaction commonly used for investing excess funds which is available for maturities ranging from overnight to a period of one year. The commodity used in the transaction exists with a foreign asset exchange company.

**Fuduli Transaction:** A transaction with another's property without Shariah consent. For instance, selling property before contracting an agency agreement with its owner is a “fuduli” transaction.

**Fungible Goods:** Goods that are similar to one another and are sold as units, any difference between them is considered negligible.

**Gharar:** Contractual uncertainty that may lead to major dispute between contracting parties which is otherwise preventable or avoidable.

**Ghasb:** The misappropriation of property.

**Global Agency Agreement:** An agreement where the agent may purchase the required asset from any source of his choice. Such an agreement also lists a number of assets which the agent may procure on the bank’s behalf without having to execute a new agency agreement each time.

**Guarantee:** A risk mitigating technique that serves as a form of security in contracts and is provided by a third party. For instance, a guarantee for the supply of specific goods at a specific time or a guarantee for a timely payment.

**Hadith:** A report of the attributes, words and deeds of the Prophet Muhammad (Allah bless him and give him peace).

**Halal:** Permissible in the Shariah

**Haamish Jiddiah:** The Islamic financial term for a sum of earnest money received from the client as security that serves as compensation in the event the lessee backs out from entering into or continuing an Ijarah. The lessor makes up for the actual loss from it and returns the remainder to the client.

**Hand-to-Hand Sale (Mu’ata):** A sale where the seller hands the asset over to the buyer in exchange for a price without any verbal expression of offer or acceptance.

**Haq:** Right.

**Haq Dayn:** Debt rights.

**Haq Mali:** Rights over financial assets.

**Haq Tamalluk:** Ownership rights.

**Haram:** Prohibited in the Shariah.

**Hawala:** A contract by which a debtor transfers his debt to a third party.

**Hawl:** The amount of time that must elapse before a Muslim possessing funds equaling or exceeding the exemption limit/nisab, is required to pay zakat. Typically, one Islamic year/lunar year.

**Hiba:** Gift.

**Holding Risk:** The risk that accompanies the possession of assets by the financial institution before they are delivered to the buyer.

**Homogeneous Commodities:** Commodities that are similar to one another and are sold as units. The difference between them is negligible.

**Huquq:** (Pl. haq) Rights.

**Hybrid Sukuk:** Certificates of ownership representing trust assets for more contracts than one.

**ICD:** Islamic Corporation for the Development of the Private Sector.

**IDB:** Islamic Development Bank.

**IFI:** Islamic financial institution; i.e. bank or financial organization operating commercially within the limits prescribed by Shariah.

**IFSB:** International Financial Standards Board.

**Ihtikar:** Hoarding

**Ijab:** Offer, in a contract.

**Ijarah:** A form of lease seeking to provide the benefits of an asset or a service to the lessee in return for a payment of an agreed upon price or rent.

**Ijarah tul Amaal:** A contract of lease providing services for an agreed upon rental.

**Ijarah tul Ashkhaas:** (syn. ijarah tul amaal) A contract of lease providing services for an agreed upon rental.

**Ijarah tul Manaafay:** A contract of lease executed for the transfer of the benefits of an asset in exchange for an agreed upon price.

**Ijarah Mawsoofah fi Dhimma:** A lease agreed upon and based on a deposit for the future use or delivery of an asset.

**Ijarah Muntahiya bi Tamlik:** An Ijarah based on the lessor's undertaking to transfer the ownership of the leased property to the lessee at the end of the lease or by stages during the term of the contract.

**Ijarah Sukuk:** Certificates representing the ownership of leased assets, the ownership of the usufruct of leased assets or the ownership of the rights to receive benefits from services.

**Ijarah wa Iqtina:** An Ijarah conducted solely for the purpose of transferring the ownership of the leased asset to the lessee at the end of the lease period.

**Ijma':** Juristic consensus on a specific issue. It is recognized as one of the four sources of Shariah.

**Ijtihad:** Juristic reasoning based on the Quran and the Sunnah.

**Illah:** The attribute of an event requiring a specific ruling in all cases possessing that attribute; analogies are drawn based on it to determine the permissibility or prohibition of an act or transaction.

**Inaan:** (A type of Shrikah) A form of partnership in which each partner contributes capital and has a right to work for the business.

**Infisakh:** Contract cancellation without the will of the contracting parties, i.e. as a result of an asset's destruction or the death of a party to the contract.

**Informational Asymmetry:** A situation where important relevant information is known by some parties, but not by all.

**In-kind:** Where instead of cash, payment or capital contribution is made in the form of tangible assets, goods or services.

**Interest:** Any addition or increment involved in an exchange between contracting parties.

**Investment Stage:** This is the stage that begins after the execution of the agency agreement. It is the time period during which the bank has disbursed the money for the purchase of the asset from the supplier but has not yet acquired possession of it in order to sell it.

**Ishara:** A gesture made by a person's head or hand taking the place of speech in expressing the will of two contracting parties.

**Israf:** Immoderateness and wastefulness.

**Istighlal:** Investment.

**Istihlak:** Consumption.

**Istihsan:** Judicial preference for one legal analogy over another in view of general public welfare.

**Istijrar:** A contract where the supplier agrees to provide a client a particular commodity on an ongoing basis for an agreed price based on an agreed mode of payment.

**Istisna:** A transaction used for the purpose of acquiring an asset manufactured on order. It may be executed directly with the supplier or any other party that undertakes to have the asset manufactured.

**Istisna Requestor:** The party placing the manufacturing order.

**Istisna Sukuk:** Certificates representing proportionate ownership of manufactured goods.

**Joa'ala:** A contract involving a reward for a specific service or achievement.

**Jadwala:** Rescheduling.

**Jihalah:** Ignorance; inconclusiveness in a contract leading to gharar.

**Kafalah:** A third party taking responsibility for another's repayment of debt; a pledge given to the creditor that a debtor will repay his debt.

**Kafil:** The party assuming responsibility for repayment of another's debt in a kafalah contract.

**Kali bil Kali:** The exchange of debt for debt.

**Kharaj:** The share of the produce from agricultural lands collected by Muslim rulers and added to the Bayt al-Maal.

**Khayaar:** Option or power to annul or cancel a contract.

**Khayaar e Aib:** The option of return in case of a defective asset.

**Khayar e Majlis:** The option to annul a contract possessed by both contracting parties.

**Khayaar e Rooyat:** The option of refusal based on which the buyer may decline from accepting the goods of a sale as a result of non-conformity to specifications.

**Khayaar e Shart:** An option in a sale's contract established at the time of signing the agreement giving one of the two parties to the contract a right to cancel the sale within a stipulated time.

**Khayaar e Taaeen:** The purchaser's option to return an asset to the seller in case it does not meet specifications as established at the time of contract execution.

**Khilabah:** Fraud in word or deed by a party to the contract to coerce another into entering into a contract.

**Khiyanah:** Deception by withholding information, or breach of an agreement.

**KYC:** (Abb.) Know-Your-Client; the due diligence checks carried out on customers to determine their credit worthiness.

**Legal Risk:** The risk of having to resort to litigation for redemption of claims arising from a contract.

**LIBOR:** London Inter-Bank Offered Rate.

**Lien:** A charge, claim, hypothecation or mortgage, pledging an asset to a creditor.

**Liquidity Management:** The management of an excess or shortage of funds by financial institutions through inter-bank treasury transactions to meet day to day business needs and liquidity reserve requirements.

**Local Currency Commodity Murabaha:** In the absence of an organized asset exchange market, the LCC Murabaha is conducted for the management of funds at financial institutions with the help of local commodities exempt from value added tax.

**Luqta:** An item misplaced by its owner and found by someone else.

**Madhab:** (pl. madhahib) A school of Islamic jurisprudence characterized by differences in the way Shariah sources are understood, forming the basis for differences in Shariah rulings derived from them. The four Sunni schools named after their founders are Hanafi, Maliki, Shafi`i and Hanbali.

**Maisir:** 1) The act of gambling or playing games of chance with the intention of making an easy profit; 2) the element of speculation in a contract; 3) chance or uncertainty with respect to an outcome.

**Major Maintenance:** The fulfillment of all the requirements that ensure that the leased asset provides intended use.

**Maal:** Wealth; anything of value that may be possessed.

**Maal-e-Mutaqawam:** Items that are lawful to use or consume by Shariah; or wealth considered commercially valuable by Shariah.

**Manfa'ah:** Usufruct or benefit derived from an asset.

**Maqasid al-Shariah:** The establishment of goals and objectives by Muslim jurists in a way that assists the investigation of new cases and the organization of prior rulings.

**Market Risk:** The current and future volatility of the market value of specific assets to be purchased and delivered over a specific period of time such as the commodity price of a Salam asset, the market value of a Sukuk, the market value of a Murabaha asset and the fluctuating rates of foreign exchange.

**Minimum Balance:** A formula for determining the eligibility of profit a partner or Musharakah account holder can receive on his invested amount. Essentially, it is the minimum amount that must remain invested at all times in an account over a period of time, for the account holder to be eligible to receive profit.

**Moral Hazard:** Risk of a party acting either in bad faith, or underperforming due to negligence and indifference, brought on by insulation from risk.

**Mu'amalah:** A financial transaction.

**Mubah:** Object that is lawful; an item permissible to use or trade.

**Mudarabah:** A Mudarabah is a business partnership between two or more parties, where, typically, one of the parties supplies the capital for the business, and the other provides the investment management expertise. Also known as Muqaradah or Qirad.

**Mudarib:** Partner responsible for management in a Mudarabah, also defined as an investment manager.

**Mudarabah Sukuk:** Certificates representing the proportionate ownership of capital for specific projects undertaken by an entrepreneur.

**Mufti:** A highly qualified jurist who issues fatawa or legal verdicts.

**Mugharasa:** An agricultural contract similar to muzara`ah in which a land owner agrees to grant the farmer a share of the harvest from the fruit orchard he tends.

**Muwaada/ Mua'hida:** A bilateral promise.

**Mujtahid:** A highly qualified fiqh specialist who engages in independent juristic reasoning.

**Mukhabarah:** An agreement between a landowner and a farmer, similar to a muzara'ah the only difference being that in a muzara`ah the seeds are provided by the landowner whereas in a mukhabarah they are supplied by the farmer.

**Muqassa:** Setting off two debts at an agreed exchange rate.

**Murabaha:** A contract in which the cost of acquiring the asset and the profit to be earned from it are disclosed to the client or the buyer.

**Murabaha Facility Agreement:** An agreement including the approval of the credit facility extended to the client, the terms and the conditions of the contract, the specification of the Murabaha asset and the client's promise to purchase.

**Musawamah:** A general sale in which the price of the commodity to be traded is bargained between the buyer and the seller and where no reference is made to the cost of acquisition of the sale asset or the profit to be earned from it.

**Musaqah/Musaqat:** A partnership whereby the owner of an orchard agrees to share the produce with a farmer as a recompense for the farmer tending the land.

**Musharakah:** A business partnership set up to make profit, where all partners contribute capital and effort to help the business run.

**Musharik:** A partner in a Musharakah.

**Mutual Insurance:** A form of insurance where a group of people exposed to a similar risk, by mutual consent make voluntary contributions to a pool of funds to share that risk and provide one another with indemnity against loss.

**Muwakkil:** The principal in an agency agreement.

**Muzara'ah:** Share-cropping; an agreement where one party agrees to allow a portion of his land to be farmed by another in exchange for a part of its produce.

**Najash:** Deceiving a potential buyer during pre-sale dialogue, through insincere bidding by a third party (a party expressing insincere desire to purchase the commodity at a higher price) or false claims on the seller's part.

**Negligence:** Loss resulting from the violation of the conditions of a contract.

**Nisab:** The exemption limit for paying zakat. A Muslim possessing wealth below the nisab is exempt from zakat whereas a Muslim with wealth at or exceeding the nisab is obligated to pay zakat.

**Numeraire:** A basic standard by which comparative values are measured, or a unit of account.

**Offer and Acceptance:** The actual execution of a sale, where one of the contracting parties makes an offer to sell or purchase an asset and the other accepts it.

**Operational Risk:** The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events as well as non-compliance to Shariah regulations or a neglect of fiduciary responsibilities.

**Parallel Istisna:** Another contract of Istisna executed alongside the original Istisna. The manufacturer in the original contract serves as the Istisna requestor in the parallel contract and profits from a difference in price.

**Periodic Maintenance:** Regular maintenance of the leased asset.

**Permanent Musharakah:** Also referred to as an ongoing Musharakah, a partnership where there is no intention of terminating or concluding the business venture at any point.

**Physical Possession:** The actual or corporal possession of an asset and the ability to benefit from it.

**Pledge:** A form of security that is taken from the client and maintained by the financial institution. It may be in the form of an asset or cash.

**PLS:** Profit and Loss Sharing; used to describe interest-free Islamic finance schemes, typically represented by Musharakah and Mudarabah

**Possession:** The ownership of all the risks and rewards associated with an asset.

**Premium:** The amount of contribution made by the insured to the pool of funds established for the purpose of providing indemnity against loss.

**Price Risk:** The risk arising from the fluctuating price of goods in the market, thereby affecting the value of the goods of the contract.

**Private Equity:** Shares in a business that are not for sale to the general public but are sold exclusively through invitation to certain parties.

**Project Finance:** The financing of large infrastructure and industrial projects based on a comprehensive financial structure for operation.

**Promise:** An undertaking by the client to enter into a contract with the financial institution for the sale or lease of an asset in the future.

**Provisional Profit:** The profit earned by the investor for the period of time his funds remained invested.

**Pure Risk:** The risk that involves the possibility of loss or no loss. For instance damage to property due to a fire that may or may not occur.

**Qabda:** (lit. to seize) Take possession of the exchange commodity in an exchange transaction.

**Qard:** Loan.

**Qard e Hasana:** A goodwill loan against which interest is not charged; where only the principal amount is to be returned in the future.

**Qimar:** An agreement where the acquisition of an asset is contingent upon the occurrence of an uncertain event in the future.

**Qirad:** Alternative name for Mudarabah or Muqaradah.

**Qiyas:** Drawing a comparison; deriving law through analogy from an existing law if the basis for both is the same; also one of the Shariah sources.

**Qubul:** Acceptance, in a contract.

**Ra's al maal:** Capital; the money or capital which an investor (Rabb al Maal) invests in a profit-seeking venture.

**Rabb al Maal:** The investor or the owner of capital in a Mudarabah contract.

**Rahn:** Collateral; a pledge or the transaction which governs such a pledge.

**Rate of Return Risk:** The risk that a financial institution is exposed to as a result of an undetermined or variable amount of return on an investment.

**Receivable:** An asset or cash that a business is due to receive as a result of a prior transaction.

**Restricted Mudarabah:** A Mudarabah in which the Mudarib has to observe certain restrictions regarding how the business may be run. Typically, these restrictions may relate to sector, activity, and/or region in which the business may be operated (various other restrictions also may be included).

**Re-Takaful:** The re-Takaful is a new Takaful arrangement consistent with Takaful principles and guidelines provided by the Shariah board. It is enacted in the event that the funds in the original Takaful are not sufficient to meet the needs of its members.

**Riba:** Any amount that is charged in excess which is not in exchange for a due consideration. Conventionally it is referred to as interest and is prohibited in Islam.

**Riba al Buyu:** The Riba of exchange surplus. Any barter transaction where like commodities are exchanged in unequal measure, or the delivery of one commodity is postponed, is characteristic of Riba al Buyu.

**Riba al Fadl:** The same as Riba al Buyu.

**Riba an Nassiya:** The predetermined excess repayable on the principal extended as a loan.

**Riba al Quran:** The same as Riba an Nassiya.

**Ribawi:** Goods subject to Shariah rulings with respect to Riba in the event of their sale.

**Risk:** An exposure to the likelihood of loss, where this loss takes many forms depending on the kind of risk involved. It is the possibility that the outcome of an action or event could bring an adverse

impact resulting in a direct loss of earning and capital or the imposition of constraints in the bank's abilities to meet its business objectives.

**Risk Management:** The process of evaluating and responding to the exposure facing an organization or an individual. It is a structured and disciplined approach employing people, processes, and technology for managing uncertainties faced by an organization.

**Rishwa:** Bribery.

**Roll-over:** A roll-over is the provision of an extension in return for an increase in the original payable amount.

**Rukn:** (lit. pillar) Fundamental of a contract.

**Sa':** A dry measure in use in Madinah during the time of the Prophet used to weigh dates, barley and other similar items.

**Sadaqah:** Voluntary charitable donations.

**Sahih:** (lit. sound, correct) In reference to: 1) A valid contract, 2) A highly authenticated hadith.

**Sak:** (pl. Sukuk) Certificate of equal value representing an undivided share in the ownership of a tangible asset, usufruct or service.

**Salaf:** A loan that draws no profit for the creditor. Salaf is also referred to as Salam where the price of the subject matter is paid in full at the time of the contract's execution while the delivery of the subject matter is deferred to a future date.

**Salam:** A sale where the price of the subject matter is paid in full at the time of the contract's execution while the delivery of the subject matter is deferred to a future date.

**Sale Contract:** The commitment to trade a commodity in a specific manner for a consideration in cash or kind, evidenced by the exchange of an offer and acceptance.

**Salam Sukuk:** Certificates representing financial claims arising from the purchase of commodities to be delivered in the future based on an advance payment of price.

**Sarf:** Currency exchange.

**Securitization:** The process of issuing certificates of ownership against an asset, an investment good or a business.

**Share:** A form of equity ownership representing claims on earnings and assets.

**Shart:** (pl. shurut) A necessary condition or stipulation, that must exist to ensure the validity of a transaction.

**Shart e Jazai:** The Shart e Jazai is a penalty established at the time of the execution of the Istisna contract which allows for a reduction in the price of the manufactured goods in the event of a delay in their delivery.

**Shariah:** Islamic law.

**Shariah Advisory Board:** A panel of Shariah scholars appointed by Islamic financial institutions to supervise all transactions and ensure their Shariah compliance. Its role also includes conducting regular and annual audits.

**Shariah Non-Compliance Risk:** The risk arising from non-compliance to the standards of Islamic law.

**Sharik:** Partner.

**Sharikah:** The same as Shirkah

**Shirkah:** (lit. sharing) Refers to different kinds of business partnerships based on sharing.

**Shirkah tul Aa'maal:** A partnership based on the pooled provision of services.

**Shirkah tul Wujooh:** A 'partnership of goodwill' where the subject matter is bought on credit from the market on the basis of a relationship of goodwill with the supplier, with the aim of reselling at a profit to be shared.

**Shirkah tul Aqd:** A 'business partnership' established through a deliberate contract.

**Shirkah tul Amwaal:** The commonest type of Shirkah tul Aqd which refers to a partnership between two or more parties for the purpose of earning profit by means of investment in a joint business venture. Also known as Shirkah tul 'Inaan.

**Shirkah tul Inaan:** It is the commonest type of Shirkah tul Aqd and refers to a partnership between two or more parties for the purpose of earning profit by means of investment in a joint business venture.

**Shirkah tul Milk:** Primarily a 'partnership of joint ownership' which may come about deliberately or involuntarily.

**Sigha:** Formulation of the contract, often referred to as 'offer and acceptance.'

**Silent Partner:** A partner in the business who only contributes capital but takes no part in management of the business; also referred to as the sleeping partner.

**Simple Interest:** The excess or increment that is charged over and above the initial investment.

**Sleeping Partner:** A partner in the business who only contributes capital but takes no part in management of the business; also called silent partner.

**Sole Proprietorship:** A business fully owned and managed by one person.

**Specific Agency Agreement:** An agreement based on which the agent is under restriction to purchase a specified asset from a specified supplier only.

**Speculative Risk:** The risk representing potential gain or profit, i.e. the risk involved in a new business venture.

**SPV:** (Abb. Special Purpose Vehicle) An independent entity created based on the Mudarabah contract for the purpose of generating funds by acquiring assets from a company and issuing certificates of proportionate ownership against them.

**Specific Commodities:** Commodities possessing specific attributes that make them different from one other. One may not be replaced by the other, for instance livestock, precious stones.

**Standard Ijarah:** A lease contract executed for the provision of usufruct for a fixed term at the end of which the ownership of the leased asset is not transferred to the lessee.

**Stock Company:** A company in which the capital is partitioned into equal units of tradable shares and each shareholder's liability is limited to his share in the capital; it also represents a form of partnership.

**Sublease:** The lease of an already leased asset to a third party with the primary lessor's consent.

**Sukuk:** Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services.

**Sukuk al Ijarah:** Certificates representing the ownership of leased assets, the ownership of the usufruct of leased assets or the ownership of the rights to receive benefits from services.

**Sukuk al Mudarabah:** Certificates representing the proportionate ownership of capital for specific projects undertaken by an entrepreneur.

**Sukuk al Murabaha:** Certificates representing the investor's shares in receivables from the purchaser of assets based on a deferred sale.

**Sukuk al Musharakah:** Certificates representing proportionate ownership of a Musharakah asset, be it a partnership for new projects or a partnership for the expansion of existing projects.

**Sukuk al Salam:** Certificates representing financial claims arising from the purchase of commodities to be delivered in the future based on an advance payment of price.

**Sunna:** The personal example, comprising words and deeds of the Prophet Muhammad (Allah bless him and give him peace).

**Ta'awun:** Co-operation.

**Tabburro:** Gift or contribution.

**Tadlis al aib:** Refers to the activity of a seller concealing the defects of goods.

**Takaful:** A Shariah-compliant system of insurance based on the principle of mutual co-operation. The company's role is limited to managing operations and investing contributions.

**Takaful Operator:** The manager of Takaful funds.

**Tawarruq:** A mode of financing, similar to a Murabaha transaction, where the commodity sold is not required by the client but is bought on a deferred payment basis and sold to a third party for a lesser price, thereby becoming a means of liquidity generation.

**Thaman:** Price.

**Thaman al bai:** Sale price.

**Tijarah:** Trade.

**Time-Sharing Leasing Contract:** The lease of a single asset to multiple lessees by means of different leasing contracts for different time periods, with none of them overlapping with one another.

**Trade Finance:** The financing of international trade transactions, which involves satisfying the needs of importers and/or exporters.

**Transit Period Risk:** The risk posed to the bank for the time period that ensues after assuming possession of Murabaha goods from the supplier and before selling them to the client.

**Treasury Operations Department:** The section of the financial institution that deals with the maintenance of funds and capital reserves and their movement in and out of the bank.

**Two-Tier Business Model:** Where one set of capital investments enables a stream of follow-on investments in multiple Shariah-compliant ventures.

**Ujrah:** Financial payment for the utilization of services.

**Ulema:** Muslim scholars.

**Ummah:** The Muslim community.

**Unconditional Agency Agreement:** An agency agreement where the principal does not stipulate any conditions or restrictions upon the agent's performance of duties. The agent is allowed to exercise his own discretion with reference to the assigned task, taking into consideration the market norm.

**Unrestricted Mudarabah:** A Mudarabah in which the Mudarib has a free hand regarding where and how to invest the capital of the business.

**Uqud al Mu'wadat:** Exchange contracts.

**Uqud al Ishtirak:** Partnership contracts.

**Uqud al Tabbaruat:** Charitable contracts.

**Urf:** Market norm.

**Ushr:** Islamic tax on agricultural produce.

**Usufruct:** The benefit received from an asset in a contract of lease.

**Usul al Fiqh:** Sources of law.

**Usury:** An exorbitant amount of interest or any rate of interest or the excess paid in exchange for a loan granted for personal use.

**Voluntary Contract:** A contract based on the mutual co-operation of contracting parties for which remuneration is not granted or received.

**Wa'da:** Promise; an undertaking regarding future actions.

**Wadi`a:** Safe-keeping deposit.

**Wadia yad Dhaman:** Goods or deposits granted for safekeeping. As Wadia is a trust, the depository becomes the guarantor for repayment on demand, of all the deposits or any part that remains outstanding in the accounts of depositors. The depositors are not entitled to any of the profits but the depository may grant them a portion of the returns at its own discretion.

**Wakalah:** An agency contract which usually includes in its terms a fee for the agent.

**Wakalah tul Istismaar:** An investment management contract

**Wakalah Muqayyada:** The same as the conditional agency agreement.

**Wakalah Mutluqqa:** The same as the un-conditional agency agreement.

**Wakalah tul Ujrah:** Agency executed for a fee.

**Wakeel:** Agent.

**Wakeel bil Bai:** The agent assigned to sell.

**Wakeel bil Khasooma:** The agent assigned to deal with common disputes.

**Wakeel bil Qabd:** The agent assigned to take possession of debt.

**Wakeel bi Shara:** The agent assigned to purchase.

**Wakeel bi Taqazidain:** The agent assigned to retrieve debt.

**Waqf:** A legal entity that has the potential to own, purchase and sell in addition to grant and receive gifts.

**Wasiya:** Will, bequest.

**Weightages:** Ratios calculated for the appropriate allocation of profit and assigned to investment categories at financial institutions. They are subject to change with changes in market trend; the longer the term of deposit, the greater the weightage assigned to it.

**Working Partner:** A partner who is responsible for running the business.

**Wujuh:** (Lit.face) Interpreted in financial transactions as goodwill or credit for partnership.

**Zakat:** (see also Zakat al Maal) A tax imposed by Islamic law on all persons possessing wealth at or above an exemption limit (nisab). Its objective is to collect a portion of wealth of the affluent members of society and distribute it amongst the underprivileged. It may be collected by the state or distributed by the individual himself.

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

**Zakat al Maal:** The Muslims wealth tax; a Muslim must pay 2.5% of his yearly savings at or above the nisab, to the less fortunate members of the community. Zakat is obligatory for all Muslims who have saved the equivalent of 85g of gold at the time when the annual zakat payment is due.

**Zakat al Maadan:** Zakat on minerals.

**Zakat al Hubub:** Zakat on grain / corn.

**Zakat al Tijarah:** Zakat on profits from trade.

**Zakat al Rikaz:** Zakat on treasure/precious stones.

# THE BEST OF ETHICA'S WEEKLY MAILS

**Every week thousands of people receive an informative email. These are some of our favorites.**

## Recommended Reading

Ethica's career counseling sessions often enter into areas of interest outside Islamic finance, and we are often asked for book recommendations.

Part of being an effective professional is having an informed worldview, and books distill knowledge more effectively than other media. If you want to increase your intelligence and awareness overnight, turn off the smartphone, sell the TV, spurn Youtube and social media, stop browsing the Internet aimlessly, and read a book for half an hour or more in the evening with the intention of following the Prophet's (Allah bless him and give him peace) words, "Be desirous for what benefits you." (Muslim [74], 4.2052:2664. S)

Here is a selection of some of the books that benefited us. For Islamic finance book recommendations, visit https://ethica.institute/articles.aspx.

Disclaimer: Use your judgement. These books are no substitute for reliable information from qualified specialists, and should be treated as such. Moreover, recommendations should not be understood as endorsing all the information in every resource.



FAITH

The Quran
translated by A. J. Arberry

Muhammad: His Life Based on the Earliest Sources
Martin Lings

Sea Without Shore: A Manual of the Sufi Path
Sheikh Nuh Ha Mim Keller

Deliverance from Error: Al Ghazali's Path to Sufism
Abu Hamid Muhammad al Ghazali

The Beginning of Guidance
Abu Hamid Muhammad al Ghazali

Reliance of the Traveller: A Classic Manual of Islamic Sacred Law
Ahmad Naqib al Misri (tr. Sheikh Nuh Ha Mim Keller)

Darqawi Way: Letters of Shaykh Darqawi
Muhammad al-Arabi ibn Ahmed Ad-Darqawi

Discourses of Rumi
Jalal ad-Din Muhammad Rumi (tr. A.J. Arberry)

Screwtape Letters
C.S. Lewis

www.untotheone.com
The Sufi path and traditional Islam

www.masud.co.uk
A leading resource of traditional Islam

FOR THOSE NEW TO ISLAM

Sea Without Shore: A Manual of the Sufi Path
Sheikh Nuh Ha Mim Keller

The Divine for Critical Minds: Inquiry Into God's Existence
Dr. Rehan Zaidi

The Autobiography of Malcolm X
Malcolm X with Alex Haley

Desert Encounter
Knud Holmboe

2. HEALTH AND WELL-BEING

Food Between Curse and Cure: Islam, Health, and the Good Life
Abu Munir and Abdurahman Ashraf
Deep Nutrition: Why Your Genes Need Traditional Food
Dr. Catherine Shanahan
Food Rules: A Doctor's Guide to Healthy Eating
Dr. Catherine Shanahan
The Big Book of Health and Fitness: A Practical Guide to Diet, Exercise, Healthy Aging, Illness Prevention, and Sexual Well-Being
Dr. Phil Maffetone
The Barbell Prescription
Jonathon Sullivan
Spark: The Revolutionary New Science of Exercise and the Brain
Dr. John Ratey

Eight Weeks to Optimum Health: A Proven Program for Taking Full Advantage of Your Body's Natural Healing Power
Dr. Andrew Weil
Nourishing Traditions: The Cookbook that Challenges Politically Correct Nutrition and Diet Dictocrats
Sally Fallon
Healthy at 100
John Robbins
The Vegetarian Myth: Food, Justice, and Sustainability
Lierre Keith
Healing with Whole Foods
Paul Pitchford
Anticancer: A New Way of Life
Dr. David Servan-Schreiber
What's Gotten Into Us: Living in a Toxic World
McKay Jenkins
How to be Free
Tom Hodgkinson
The Complete System of Self-Healing: Internal Exercises
Dr. Stephen T. Chang
The Diet Myth
Tim Spector
The Timeless Way of Building
Christopher Alexander
A Pattern Language: Towns, Buildings, Construction
Christopher Alexander
Fast Food Nation: The Dark Side of the All-American Meal
Eric Schlosser
In Praise of Slowness: Challenging the Cult of Speed
Carl Honore
The Ascent of Humanity: Civilization and the Human Sense of Self
Charles Eisenstein
Dirty Electricity: Electrification and the Diseases of Civilization
Dr. Sam Milham
The Self Sufficient Life and How to Live It: The Complete Back-to-Basics Guide
John Seymour
Beyond Backpacking: Guide to Lightweight Hiking
Ray Jardine

3. PERSONAL RELATIONS
Intiating and Upholding an Islamic Marriage
Hedaya Hartford
Man of Steel and Velvet: What it Takes to be a Man and How to be a Man
Aubrey Andelin
Fascinating Womanhood: How the Ideal Woman Awakens a Man's Deepest Love and Tenderness
Helen Andelin
The Collapse of Parenting: How We Hurt Our Kids When We Treat Them Like Grown-Ups
Leonard Sax
How to Win Friends and Influence People
Dale Carnegie
How to Stop Worrying and Start Living: Time-Tested Methods for Conquering Worry
Dale Carnegie
The Seven Habits of Highly Successful Families
Stephen Covey

4. INSPIRATION
The Autobiography of Malcolm X
Malcolm X with Alex Haley
Desert Encounter
Knud Holmboe
The Road to Mecca
Muhammad Asad
The Warrior Race
Imran Khan
Unbroken: A World War II Story of Survival, Resilience, and Redemption
Laura Hillenbrand
The Long Walk: The True Story Of A Trek To Freedom
Slavomir Rawicz

5. EDUCATION
Wired Child: Reclaiming Childhood in a Digital Age
Richard Freed
Dumbing Us Down: The Hidden Curriculum of Compulsory Schooling
John Taylor Gatto
High Tech Heretic: Why Computers Don't Belong in the Classroom and Other Reflections by a Computer Contrarian
Clifford Stoll
Deschooling Society
Ivan Illich
Endangered Minds: Why Children Don't Think And What We Can Do About It
Jane Healey
The Well Trained Mind: A Guide to Classical Education at Home
Susan Wise Bauer and Jessie Wise

6. PERSONAL PRODUCTIVITY
The Four Hour Workweek: Escape 9-5, Live Anywhere, and Join the New Rich
Timothy Ferriss
Early Retirement Extreme: A Philosophical and Practical Guide to Financial Independence
Jacob Lund Fisker
Getting Things Done: The Art of Stress-Free Productivity
David Allen
Art of the Start 2.0: The Time-Tested, Battle-Hardened Guide for Anyone Starting Anything
Guy Kawasaki
Grit: The Power of Passion and Perseverance
Angela Duckworth
The Magic of Thinking Big
David Schwarz
The Seven Habits of Highly Successful People: Powerful Lessons in Personal Change
Stephen Covey
Influence: The Psychology of Persuasion
Robert Cialdini
The 80/20 Principle: The Secret to Achieving More with Less
Richard Koch
Write to the Point
Bill Stott
Getting Real: The Smarter, Faster, Easier Way to Build a Successful Web Application
37 Signals

7. BUSINESS
See here: https://ethica.institute/articles.aspx

8. SCIENCE
Science Delusion
Rupert Sheldrake
The Seven Mysteries of Life: An Exploration of Science and Philosophy
by Guy Murchie
Evolution: A Theory in Crisis
Michael Denton
The Vanishing Face of Gaia: A Final Warning
James Lovelock
Just Six Numbers: The Deep Forces That Shape The Universe
Martin Rees
A Short History of Nearly Everything
Bill Bryson
Confessions of a Medical Heretic
Robert Mendelsohn
One Straw Revolution: An Introduction to Natural Farming
Manosabu Fukuoka

9. MEDIA AND TECHNOLOGY
Disconnect: The Truth About Cell Phone Radiation, What the Industry Has Done to Hide It, and How to Protect Your Family
Dr. Devra Davis
Ten Arguments for Deleting Your Social Media Accounts Right Now
Jaron Lanier
The Shallows: What the Internet is Doing to our Brains
Nicholas Carr
Four Arguments for the Elimination of Television
Jerry Manders
Alone Together: Why We Expect More from Technology and Less from Each Other
Shelly Turkle
Manufacturing Consent: The Political Economy of the Mass Media
Noam Chomsky
Amusing Ourselves to Death: Public Discourse in the Age of Show Business
Neil Postman
In the Absence of the Sacred: The Failure of Technology and the Survival of the Indian Nations
Jerry Manders
The Case for Working with your Hands, or Why Office Work Is Bad for Us and Fixing Things Feels Good
Matthew Crawford
The Case for Books
Robert Arndt
The Myth of the Machine: Technics and Human Development
Lewis Mumford

10. POLITICS AND POWER
Confessions of an Economic Hit Man
John Perkins
Animal Farm
George Orwell
Brave New World
Aldous Huxley
When Corporations Rule the World
David Korten
The End of Oil: On the Edge of a Perilous New World
Paul Roberts
The Israel Lobby and U.S. Foreign Policy

John Mearsheimer and Stephen Walt
Profit Over People: Neoliberalism & Global Order
Noam Chomsky and Robert W. McChesney
Making Gay Okay: How Rationalizing Homosexual Behavior Is Changing Everything
Robert R. Reilly
When Harry Became Sally: Responding to the Transgender Moment
Ryan T. Anderson
Short Circuit: Strengthening Local Economics for Security in an Unstable World
Richard Douthwaite
Beyond Chutzpah: The Misuse of Antisemitism and the Abuse of History
Norman Finkelstein
Jesus, Interrupted: Revealing the Hidden Contradictions in the Bible
Bart Ehrman
Jewish History, Jewish Religion: The Weight of Three Thousand Years
Israel Shahak
The Creature from Jekyll Island: A Second Look at the Federal Reserve
G. Edward Griffin
Against Our Better Judgment: The Hidden History of How the U.S. was Used to Create Israel
Alison Weir
When Google Met Wikileaks
Julian Assange
Small is Beautiful: Economics as if People Mattered
E.F. Schumacher
The Corporation: The Pathological Pursuit of Profit and Power
Joel Bakan
Ron Unz articles at www.unz.com

Disclaimer: Use your judgement. These books are no substitute for reliable information from qualified specialists, and should be treated as such. Moreover, recommendations should not be understood as endorsing all the information in every resource.

# CONTACT ETHICA

Ethica Institute of Islamic Finance
651 North Broad St.
Middletown, DE 19709
United States

**New inquiries about Ethica's training and certification:**
contact@ethica.institute

**Technical help:**
support@ethica.institute

**Islamic finance questions:**
questions@ethica.institute

# SHARI'AH STANDARDS

**Full Text of Shari'ah Standards for Islamic Financial Institutions As at Safar 1439 A.H. – November 2017 A.D.**

ACCOUNTING AND AUDITING ORGANIZATION
FOR ISLAMIC FINANCIAL INSTITUTIONS

AAOIFI
ACCOUNTING AND AUDITING ORGANIZATION
FOR ISLAMIC FINANCIAL INSTITUTIONS

# SHARI'AH STANDARDS

***King Fahd National Library Cataloging-in-Publication Data***
The Accounting and Auditing Organization for Islamic Financial Institutions
Shari'ah Standards. / The Accounting and Auditing Organization for Islamic Financial Institutions.- Manama, 2015
1262p ; 24×17 cm
ISBN: 6-9616-01-603-978
-1 Finance (Islamic Law) |- Title
275.5 dc 171/1437
**L.D. no. 168/1437**
**ISBN: 6-9616-01-603-978**

**ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS**
P.O. Box 1176, Manama, Kingdom of Bahrain
Telephone: :(17375400 (973+ – Fax: (17250194 (973+
E-mail: info@aaoifi.com
Website: www.aaoifi.com



**Worldwide Distribution: Dar AlMaiman for Publishing & Distributing**
For online shopping, visit our website: www.daralmaiman.com
For more information Email us: info@daralmaiman.com
Connect with us via twitter: @DarAlMaiman
Phone : +966 11 4627336 Fax : +966 11 4612163
Mobile : +966 500004568 Mobile : +966 505455097

# SHARI'AH STANDARDS

**Full Text of Shari'ah Standards for Islamic Financial Institutions as at Safar 1437 A.H. – December 2015 A.D.**

AAOIFI
ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS

# Foreword by AAOIFI Secretary General

Praise be to Allah, Lord of the Worlds, and Allah's blessings and peace be upon the noblest of Messengers, Prophet Muhammad, and upon his household and the companions, and those who follow their example with good conduct until the Day of Judgment.

It is of Allah's Grace that He bestowed on us the great religion of Islam, and made us the best Ummah raised up for mankind, one that is graced with the noblest of Prophets and Heavenly Books and religious codes. This comprehensive religious code encompassed and ordained all things beneficial to humankind in this life and in the Hereafter, and prohibited and banned all evils and vices, as made clear in the Noble Qur`an:

***{"...Today, I have perfected your religion for you, and completed My favour upon you, and have granted Islam as a religion for you..."}.***[1]

One of the basic pillars of Islamic Faith is the belief in, and perseverance towards, the preservation of the well-being of people, and solid establishment of markets, trade, finances, and to distance all of which from prohibitions sanctioned in the Qur`an and the Sunnah; namely, Riba, Gharar, gambling, illegal appropriation of peoples' wealth, etc. This is also embodied in the keenness to observe prohibitions in the area of financial transactions and contracts, especially when it comes to honoring obligations, honesty and straightforwardness, mutual consent of contracting parties, and so on.

Based on this set of norms and values, the Islamic finance industry was established and has attained its current paramount status, as manifested in its growth at a pace greater than that of all other financial sectors. By so doing, it will hopefully be a boon for all peoples and nations of the world.

The cornerstone of the Islamic finance industry is, and will always be, the adherence to, and compliance with, the rules and principles of Shari'ah,

(1) [Al-Ma`idah (The Table): 3]

under the broader collective reasoning by prominent Shari'ah scholars and jurists, and based on evidences found in the Qur`an and the Sunnah, in an attempt to deduce Shari'ah rulings that fit current-day reality and practices.

In this regard, the volume of Shari'ah Standards has become the major compilation of contemporary Fiqh reasoning in the area of *Fiqh al-Mu'amalat* (Jurisprudence of Financial Transactions) around the globe. The standards cover a large array of Islamic financial contracts and products, including those pertaining to banking, Islamic insurance, investment banking, capital markets, financing, and so on.

These standards have acclaimed wide popularity within the global Islamic finance industry, and are deemed the most outstanding Shari'ah reference for this industry and its various stakeholders, including legislative bodies, regulatory authorities, and financial institutions, and other professional entities such as law firms, accounting and consultancy firms, in addition to universities, academic institutions and research centers and Fatwa issuing bodies.

Currently, AAOIFI Standards are officially adopted by a number of central banks and financial authorities on a mandatory basis or as guidance. Hence, these standards are viewed as a major hallmark for the Islamic finance industry and one of its principal accomplishments.

These standards would have not achieved such a prominence and outreach, with Allah's Grace and Guidance first and utmost, had there been no great efforts exerted by the Shari'ah scholars and Fuqaha and a host of experts and professionals, volunteering a great deal of their time towards this great cause.

The success of these standards can be attributed to a set of factors, primarily the thorough scholarly methodology (the due process) that AAOIFI follows in its efforts to develop and issue the standards. The development process is carried out through more than ten stages, commencing with the commissioning of consultants to prepare the exposure drafts. The exposure draft is then submitted to the respective Shari'ah Standards Committee which discusses and reviews it, and then forwards it to the Shari'ah Board to

further discuss and review it, coming up with the draft standard. The draft standard is then presented at a public hearing (one or more) where the Islamic finance institutions can discuss it with Fuqaha, experts and professionals hailing from these institutions in order to make certain the draft standard is meticulous and of high quality, covering all practical aspects and emerging practices faced by the industry practitioners. The remarks and comments presented at the public hearing will be discussed by the Shari'ah Board to introduce the changes it deemed suitable and finally adopt the standard. At this stage, the standard is presented to the drafting committee to edit its text for publication.

One of the major strengths of these standards is reflected in the collective efforts made by the Shari'ah Board which consists of 20 prominent Shari'ah scholars from around the world. This ensures globality and wide geographical outreach of these standards in addition to accounting for various localities, jurisdictions, applications and customary practices, etc. The standards also embody the scholarly background diversification among board members, as all major schools of Islamic Law are duly represented, and various specializations are taken into consideration in its formation (from judiciary to Fatwa issuing, consultancy, research, authorship, law, and economic and financial advisory, etc.).

These standards also pay special attention to noting down classical Fiqh compendiums across ages, in the area of financial transactions, selecting the most practical and convenient out of these references, and giving preponderance to specific rulings in the form of a classified and typified standard. Furthermore, the standards account for modern applications of Islamic financial contracts and products and relevant emerging matters. They also grant special consideration to the use of unified terminology and disambiguation of its different components and aspects: technical, legal, accounting, financial, etc. Moreover, the standards involve the process of deriving Shari'ah rulings to address all pertaining matters and to provide guidance to the process of differentiation between impermissible and permissible transactions and practices all in one neat, summarized compilation.

The Shari'ah Board has made incumbent upon itself, in view of the fast pace of development and change in the Islamic finance industry, to review

existing standards. It formed from amongst its members a special committee for that purpose. The committee reviews all remarks and comments raised by scholars and experts on the form and substance of the standards. The reviews, in a bid to address the industry's requirements as to emerging matters, have resulted in three classes of standards: (I) Standards whose items and paragraphs were updated to remove ambiguity and clarify their meanings and the rulings embedded therein, or to present more precise presentation of content and so on. (II) Standards to which new paragraphs were added or existing paragraphs were merged or omitted, so that the general structure of the standard is maintained. (III) Standards which the board deemed in need of a new preparation and development, in order to account for the sizable emerging matters and changes relating to the topic of the standard such as the Shari'ah Standards on Sukuk, Debit Card, Charge Card and Credit Card, and so on. The development process for such standards has commenced and is under way.

The new version of AAOIFI Shari'ah Standards has included a number of reviewed and revised standards (of types 1 and 2, as mentioned above). These standards are labeled with a "Revised Standard" designation.

We are ever thankful to Allah that issuance of the new version in its elegant layout has been completed both in hardcopy and digital formats. A total of 15 new Shari'ah standards have been translated and added to the English volume. As such, all Shari'ah standards, included in this edition, have been issued both in Arabic and English. New standards are also under preparation and are currently at different stages of the due process.

The newly translated standards that have been added to this edition went through three extensive stages in implementation of proper quality control measures. The first stage constituted institutional efforts made by the International Shari'ah Research Academy for Islamic Finance (ISRA) and the Islamic Development Bank (IDB). The second stage involved revision by a legal expert (lawyer) who examined the translation from the angle of accuracy and faithfulness to the original text and legal vocabulary. Finally, in the third stage, the Translation Committee, consisting of the Honorable Chairman of the Shari'ah Board and four esteemed members, edited and

fine-tuned the translation through ten meetings, some of which spanned 3 successive days. To all of them, we extend our sincere appreciation and best wishes. I would also like to thank my colleague Mr. Mohammad Majd Bakir (Corporate Development Manager, AAOIFI) for his outstanding efforts to accomplish this project.

We warmly welcome your remarks and feedback, including errata, on existing standards and your proposals as to new standards, on our email: sharia@aaoifi.com

With sincere wishes and best regards,

***Dr. Hamed Hassan Merah***

***23 Dhul-Qa'dah, 1436 A.H., 7 September 2015 A.D.***

# Foreword by Shari'ah Board's Chairman

Praise be to Allah, Lord of the Worlds, and peace be upon our master Muhammad, the last-sent Prophet and the leader of Prophets, and on all his household and the companions, and those who follow their example in good conduct till the Day of Judgment.

As to what follows,

Islamic banking does considerably differ from its conventional counterpart in terms of principles, norms, values, and practices. The specialty of Islamic banking and the soundness of its transactions must be clearly reflected in accounting treatments so that no confusion arises, and no mistakes are committed in practice. Conventional accounting cannot serve the purpose, as it is based on a different set of norms and values. Therefore, it was vital that Islamic banks and financial institutions (IFIs) have their own accounting standards, rather than conventional ones. The development of the standards was and is still a gigantic task that draws on the great efforts exerted by Shari'ah scholars and professional experts alike. Since inception in 1411 A.H. (corresponding to 1991 A.D.), AAOIFI has been exerting a lot of efforts in the preparation of accounting standards for Islamic financial institutions and auspiciously the standards have been well received by the industry, especially in the area of Islamic banking where Islamic banks follow them on a mandatory basis or as guidance, based on regulatory enforcement by central banks in many countries around the globe. Subsequently, AAOIFI decided to issue Shari'ah standards in the same way it had issued its accounting standards, in order to provide a reference for Islamic banks and financial institutions to comply with Shari'ah in their transactions and products and to harmonize various Fatwas issued by different Shari'ah Supervisory Boards (SSBs). To that end, AAOIFI formed its Shari'ah Board in 1419 A.H. (corresponding to 1999 A.D.) consisting of Shari'ah scholars versed with *Fiqh al-Mua'amalat* (Islamic commercial and financial jurisprudence), especially in the area

of Islamic banking. The Board, with Allah's Grace, has managed to issue more than 54 standards hitherto, covering a wide array of Shari'ah rules pertaining to financial transactions of Islamic financial institutions (IFIs). These standards have become a reliable reference for the Islamic banking industry, and an essential part of academic curricula in universities, colleges and schools offering education on Islamic banking.

The Board exerts due diligence to develop these standards through the due process which initiatives with commissioning of a consultant/scholar knowledgeable in the area relevant to the topic of the standard. An additional study will be conducted to take into consideration all relevant issues in light of the Noble Qur`an, the Sunnah, and major schools of Islamic Law, setting out Shari'ah basis and newly emerging matters along with contemporary Fiqh views. Then, an exposure draft is prepared for the prospective standard. The study and exposure draft will be submitted to a committee formed from amongst the Board members in addition to a number of external, specialized scholars. For that purpose, the Board formed four committees that convene to review the exposure draft and prepare it for submission to the Shari'ah Board. The Board used to convene every week and other week in Makkah Al-Mukarramah and Al-Madinah Al-Munawwarah, in turns. It currently convenes only four times a year at least, two in the Two Holy Cities, and two elsewhere.

Afterward, the exposure drafts reviewed by the committees are discussed line in line out in the Board's meetings in a deliberate and unhindered manner, until a standard is adopted based on consensus or the opinion of the majority. Thereafter, AAOIFI holds a public hearing to present and discuss the proposed standard with a host of scholars and practitioners who voice their views and opinions, whether in the form of deletions, additions, or amendment. The feedback will be presented to the Board again in its next meeting for discussion. This will represent an opportunity for the Board to discuss the standard for the last time before issuance, where it can add or delete or amend it as deemed appropriate after extensive discussions. At this stage, the due process completes and the standard is officially adopted and issued.

In this regard, two important facts are worth noting:

First, these standards are issued by the Board, not by an individual or an ad-hoc group of individuals. Hence, the rulings and provisions reached at in the standards shall not be attributed to a specific member in his personal capacity. The Board follows a professional methodology as do most similar international bodies. Its decisions are taken by the majority of members, while those members with opposing views or reservations will be referred to along with their views or reservations in the minutes of meetings. The decisions will be issued under the name of the Board and points of incongruity will not be mentioned. Most of the provisions in the standards issued by the Board are typically agreed on by all members. It is not unusual, however, that different points of view often emerge as to rulings developed on the basis of reasoning (*Ijtihad*), especially in relation to new occurrences and issues (*Nawazil*). If incongruity on some issues lingers on after open deliberations, the Board would take its decisions based on the majority of views, and the points of incongruity would be noted down in the minutes as is the usual procedure without referring thereto in the body of the standard.

Second, despite the above-mentioned steps followed by the Board in its keenness to take prudent measures in the process of standards issuance, this all remains a human endeavor that is fallible by nature, where mistakes and oversight are not completely ruled out, and infallibility only belongs to Prophets and Messengers (peace be upon them). Therefore, the Board formed a review committee to look into its existing standards. Should a mistake or oversight be pinpointed, or should there be any suggestion for improvement of the standards, we would be thankful to receive feedback from scholars (please address them to AAOIFI's General Secretariat, which will submit them in turn to the Board through the review committee, Allah's Willing).

Lastly, I would like to extend my appreciation to all Board members for their invaluable efforts and contributions to the realization of this splendid achievement, purely dedicated to Allah, and also for the spirit of understanding they exhibited during constructive scholarly deliberations. I would also like to thank AAOIFI for its remarkable initiative embodied in this

outstanding accomplishment and for its unwavering efforts to support and facilitate the errand of the Board as it saved no means to arrange the Board's meetings, to iron out all obstacles and difficulties, and to follow up on the Board's resolutions and communicate them to all parties concerned. I do supplicate to Allah to amply reward all those who sincerely contributed towards this work, and I pray that Allah accept it and extend its benefits to people everywhere.

And praise be to Allah, first and foremost,

***Muhammad Taqi Usmani***

# Table of Contents

# Introduction

# Introduction

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), formerly known as Financial Accounting Organization for Islamic Banks and Financial Institutions, was established in accordance with the Agreement of Association which was signed by Islamic financial institutions on 1 Safar 1410 A.H., corresponding to 26 February 1990 A.D., in Algiers. AAOIFI was registered on 11 Ramadan 1411 A.H., corresponding to 27 March 1991 A.D., in the Kingdom of Bahrain as an international autonomous non-profit making corporate body.

**Objectives of AAOIFI are:**

1. To develop accounting and auditing thoughts relevant to Islamic financial institutions;
2. To disseminate accounting and auditing thoughts relevant to Islamic financial institutions and their applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research and other means;
3. To prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and
4. To review and amend accounting and auditing standards for Islamic financial institutions.

AAOIFI carries out these objectives in accordance with the precepts of Islamic Shari'ah which represents a comprehensive system for all aspects of life, in conformity with the environment in which Islamic financial institutions have developed. This activity is intended both to enhance the confidence of users of the financial statements of Islamic financial institutions in the information that is produced about these institutions, and to encourage these users to invest or deposit their funds in Islamic financial institutions and to use their services.

Before the establishment of AAOIFI, intensive efforts were made on both administrative and technical levels beginning with the working paper that

was presented by the Islamic Development Bank during the annual meeting of its board of governors in Istanbul in March 1987. Thereafter, a number of committees were formed to examine the appropriate methods of preparing accounting standards for Islamic financial institutions. These committees produced several research studies and reports.(1)

Since its establishment in 1411 A.H., corresponding to 1991 A.D. and until 1415 A.H., corresponding to 1995 A.D., the organizational structure of AAOIFI comprised the Supervisory Committee which consisted of seventeen members, the Financial Accounting Standards Board which consisted of twenty one members, an Executive Committee appointed from within the members of the Standards Board, and a Shari'ah Committee of four members.

After four years of work, the Supervisory Committee decided to form a review committee to look into the statute of AAOIFI and its organizational structure. The amendments that were later introduced in the statute, which were approved by the Supervisory Committee, included the renaming of the Organization and the changing of its organizational structure. The revised structure consisted of a General Assembly, a Board of Trustees (which replaced the supervisory committee), an Accounting and Auditing Standards Board (which replaced the former board that was confined to accounting standards only), an Executive Committee, a Shari'ah Board and a General Secretariat to be headed by a Secretary-General.

The amendment of the statute also included changing the method of financing AAOIFI. In the past, AAOIFI was financed by contributions paid by the founding members (Islamic Development Bank, Dar Al-Maal Al-Islami Group, Al Rajhi Banking & Investment Corporation, Dallah Al Baraka and Kuwait Finance House). The revised statute calls for the establishment of a Waqf (endowment) and charity fund to be financed from membership fee that is paid only once by institutions joining AAOIFI. The proceeds from this fund, the annual subscription fees, grants, donations, bequests and others are the sources from which AAOIFI funds its activities.

(1) These studies and reports are compiled in five volumes and were lodged in the library of the Islamic Research and Training Institute of the Islamic Development Bank in Jeddah - Saudi Arabia under serial no. (332/121021).

The amendment of the statute also included changing the membership of AAOIFI. It consisted of:

- Founding members,
- Non-founding members,
- Observing members.

Attached is an updated list of AAOIFI's members.

In 1419 A.H., corresponding to 1998 A.D., additional amendments were made in AAOIFI's statute. These amendments included, among other things, the broadening of AAOIFI's objectives. Article (4) of the amended statute states that AAOIFI shall:

1. Develop the accounting, auditing and banking practices thought relating to the activities of Islamic financial institutions.
2. Disseminate the accounting and auditing thought relating to the activities of Islamic financial institutions and their applications through training, seminars, publication of periodical newsletters, preparation of research and other means.
3. Prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions in order to harmonize the accounting practices adopted by these institutions in the preparation of their financial statements, as well as to harmonize the auditing procedures adopted in auditing the financial statements prepared by Islamic financial institutions.
4. Review and amend the accounting and auditing standards for Islamic financial institutions to cope with developments in the accounting and auditing thought and practices.
5. Prepare, issue, review and adjust the statements and guidelines on the banking, investment and insurance practices of the Islamic financial institutions.
6. Approach the concerned regulatory bodies, Islamic financial institutions, other financial institutions that offer Islamic financial services, and accounting and auditing firms in order to implement the accounting and auditing standards, as well as the statements and guidelines on the banking, investment and insurance practices of Islamic financial institutions that are published by AAOIFI.

The amendments also included the renaming of non-founding members to be "Associate Members". Article (3) of the amended statute states that associate members shall comprise the following:

1. Islamic financial institutions that comply with Islamic Shari'ah rules and principles in all their transactions.
2. Regulatory and supervisory authorities that supervise Islamic financial institutions. Regulatory and supervisory authorities include central banks, monetary agencies and other similar authorities.
3. Islamic Fiqh academies and authorities that have corporate entity.

The Observing Members shall comprise the following:

1. Organizations and associations responsible for regulating the accounting and auditing profession and/or those responsible for preparing accounting and auditing standards.
2. Practicing certified accounting and auditing firms that have interest in the accounting and auditing practices of Islamic financial institutions.
3. Financial institutions engaged in financial activities of Islamic institutions.
4. Users of financial statements of Islamic financial institutions both individual and corporate.

The conditions of membership specified in Article (8) of the amended statute stipulate that every member should pay the prescribed membership fee and the annual subscription fee. A member should also comply with AAOIFI's statute and bylaws.

The amendment of the statute also included the formation of a Shari'ah Board instead of Shari'ah Committee. Details of the Shari'ah Board are shown below in the organizational structure.

In 1425 A.H., corresponding to 2004 A.D., additional amendments were made in AAOIFI's statute. These amendments included expanding the membership category to include supporting members, which comprise users of financial statements of Islamic financial institutions both individuals and corporate. It also comprises all the local and international financial institutions that already have or intend to have relations with Islamic financial institutions' products.

The changes also include AAOIFI ability to offer a testing and certification programme in the areas of accounting, auditing, financial analysis, and Islamic banking, conducted either by AAOIFI or in cooperation with other parties.

# Organizational Structure

**a) General Secretariat**

The General Secretariat consists of the Secretary-General and the technical and administrative units. The Secretary-General is the executive director of AAOIFI. He coordinates the activities of General Assembly, the Board of Trustees, the Standards Board, Shari'ah Board, the Executive Committee and the subcommittees and acts as their rapporteur. He runs the day-to-day affairs and activities as well as coordinating and supervising the studies related to the preparation of statements, standards and guidelines promulgated by AAOIFI. The responsibilities of the Secretary-General also include strengthening ties between AAOIFI and other organizations and representing AAOIFI at conferences, seminars and scientific meetings.

**b) Board of Trustees**

The Board of Trustees is composed of nineteen part-time members, in addition to the Secretary General, who are appointed by the General Assembly for a five-year term. Members of the Board of Trustees represent the following various categories: regulatory and supervisory bodies, Islamic financial institutions, Shari'ah Supervisory Boards, organizations and associations responsible for regulating the accounting profession and/or responsible for preparing accounting and auditing standards, certified accountants, and users of the financial statements of Islamic financial institutions. The conditions of electing these members are specified in Article (11) of the statute.

The Board of Trustees meets at least once a year. With the exception of the proposals to amend the statute of AAOIFI which requires the vote of three quarters of the members of the Board of Trustees, decisions in all matters before the Board are adopted by the majority of the members voting. In case of a tie, the Chairman shall have the casting vote.

The powers of the Board of Trustees include, among others, the following:

1. Appointment of members of AAOIFI's Boards and termination of their membership, in accordance with the provisions of the statute.
2. Arrangement of sources of finance for AAOIFI and investing those resources.
3. Appointment of two members from amongst the members of the Board of Trustees to the Executive Committee.
4. Appointment of the Secretary-General.

Notwithstanding the provisions of the statute concerning the Board of Trustees' powers and authorities, neither the Board of Trustees nor any of its sub-committees including the Executive Committee, has the right to interfere directly or indirectly in the work of the other Boards of AAOIFI or influence them in any manner whatsoever.

**c) Executive Committee**

The Executive Committee is composed of five members: The Chairman and one member from of the Board of Trustees, the Secretary General, the Chairman of the Accounting and Auditing Standards Board and the Chairman of the Shari'ah Board. The Executive Committee has the power to discuss, among other things, the work plan, the annual budget, financial statements, and the report of the external auditor. The Executive Committee also has the power to approve the employment bylaws and financial regulations of AAOIFI. The Executive Committee meets at least twice at the request of the Secretary–General or as and when required at the request of either its Chairman or the Secretary–General.

**d) General Assembly**

The General Assembly is composed of all founding and associate members, members representing regulatory and supervisory authorities, observer members and supporting members. Observer and supporting members have the right to participate in the meetings of the General Assembly but without a right to vote. The General Assembly is the supreme authority and convenes at least once a year.

**e) Shari'ah Board**

The Shari'ah Board is composed of not more than twenty members to be appointed by the Board of Trustees for a four-year term from among Fiqh scholars who represent Shari'ah Supervisory Boards in the Islamic financial institutions that are members of AAOIFI, and Shari'ah supervisory boards in central banks, in addition to the Secretary General.

The powers of the Shari'ah Board include, among others, the following:

1. Achieving harmonization and convergence in the concepts and application among the Shari'ah Supervisory Boards of Islamic financial institutions to avoid contradiction or inconsistency between the Fatwas and applications by these institutions, thereby providing a pro-active role for the Shari'ah Supervisory Boards of Islamic financial institutions and central banks.
2. Helping in the development of Shari'ah approved instruments, thereby enabling Islamic financial institutions to cope with the developments taking place in instruments and formulas in fields of finance, investment and other banking services.
3. Examining any inquiries referred to the Shari'ah Board from Islamic financial institutions or from their Shari'ah Supervisory Boards, either to give the Shari'ah opinion in matters requiring collective Ijtihad (reasoning), or to settle divergent points of view, or to act as an arbitrator.
4. Reviewing the standards which AAOIFI issues in accounting, auditing and code of ethics and related statements throughout the various stages of the due process, to ensure that these issues are in compliance with the rules and principles of Islamic Shari'ah.

**f) Accounting and Auditing Standards Board**

The Standards Board is composed of twenty part-time members who are appointed by the Board of Trustees for a four-year term, in addition to the Secretary General. Members of the Standards Board represent the following various categories: Regulatory and supervisory bodies, Islamic financial institutions, Shari'ah Supervisory Boards, university professors, organizations and associations responsible for regulating the accounting

profession and/or responsible for preparing accounting and auditing standards, certified accountants, and users of the financial statements of Islamic financial institutions.

The powers of the Standards Board include, among others, the following:

1. To prepare, adopt and interpret accounting and auditing statements, standards and guidelines for Islamic financial institutions.
2. To prepare and adopt code of ethics and educational standards related to the activities of Islamic financial institutions.
3. To review with the aim of making additions, deletions or amendments to any accounting and auditing statements, standards and guidelines.
4. To prepare and adopt the due process for the preparation of standards, as well as regulations and bylaws of the Standards Board.

The Standards Board meets at least twice every year and its resolutions are adopted by the majority of the votes of the members voting. In case of a tie, the Chairman of the Standards Board shall have the casting vote.

# Board of Trustees

| NAME | POSITION | STATUS |
|---|---|---|
| H.E Shaikh Ebrahim Bin Khalifa Al Khalifa | Former Minister of Housing, Kingdom of Bahrain | Chairman |
| H. E. Sheikh Saleh Abdullah Kamel | President, Dallah Al Baraka Group, Kingdom of Saudi Arabia | Deputy Chairman |
| Tan Sri Dr. Munir Majid | Chairman, Bank Muamalat, Malaysia | Member |
| Mr. Ahmed al Gebali | Director, Islamic Development Bank | Member |
| Mr. Shadi Zahran | Group Chief Financial Officer, Kuwait Finance House | Member |
| H. E. Muliaman D Hadad | Chairman, Financial Services Authority of Indonesia | Member |
| Mr. Khalid Hamad | Executive Director, Banking Supervision, Central Bank of Bahrain | Member |
| Mr. Saeed Ahmed | Deputy Governor, State Bank of Pakistan | Member |
| Mr. Abdulmohsen Abdulaziz Al-Fares | Chief Executive Officer, Alinma Bank, Kingdom of Saudi Arabia | Member |
| Mr. Tirad M. Mahmoud | Chief Executive Officer, Abu Dhabi Islamic Bank, United Arab Emirates | Member |
| Mr. Abdulbasit Ahmed A. Al-Shaibei | Chief Executive Officer, Qatar International Islamic Bank, Qatar | Member |
| Mr. Irfan Siddiqui | President & Chief Executive Officer, Meezan Bank, Pakistan | Member |
| Mr. Abdulrazak Mohammed Elkhraijy | Head of Islamic Banking Development Group, National Commercial Bank, Kingdom of Saudi Arabia | Member |

| | | |
|---|---|---|
| Sh. Dr. Sayyed Mohammad Al-Sayyid Abdul Razzaq Al-Tabtaba'e | Shari'ah Scholar, Kuwait | Member |
| Sh. Yousif Khalawi | Shari'ah Scholar, Kingdom of Saudi Arabia | Member |
| Mr. Noor ur Rahman Abid | Former Managing Partner, Auditing and Assurance Business Services, Middle East, EY, Kingdom of Bahrain | Member |
| Mr. Ahmad Fayez Al Shamsi | Chairman, Maayer Consulting and Auditing, United Arab Emirates (and former Chief Financial Officer, Emirates Islamic Bank) | Member |
| Prof. Dr. Necdet Sensoy | Member of the Board, Central Bank of the Republic of Turkey (and former Professor of Accounting in Universities in Malaysia and Turkey) | Member |
| Dr. Hamed Hassan Merah | Secretary General, AAOIFI | Member & Rapporteur |

## Secretary-General

Dr. Hamed Hassan Merah

## Shari'ah Board

| NAME | POSITION | STATUS |
|---|---|---|
| Sheikh Muhammad Taqi Usmani | Vice-President Darul-Uloom Karachi, Pakistan, and Permanent Member, OIC Fiqh Academy, Jeddah, Kingdom of Saudi Arabia | Chairman |
| Sheikh Abdulla Bin Sulaiman Al Manea | Member, Council of Senior Scholars, and Advisor to the Royal Court, Kingdom of Saudi Arabia | Deputy Chairman |
| Sheikh Dr. Abdul Sattar Abu Ghuddah | President and General Secretary of the Unified Shari'ah Board of Al Baraka Banking Group, Kingdom of Saudi Arabia | Member |
| Sheikh Dr. Hussein Hamid Hassan | International Expert and Advisor, Chairman and Member of IFIs' Shari'ah Supervisory Boards, Arab Republic of Egypt | Member |
| Sheikh Abdulla Bin Mohamed Al Mutlaq | Member, Council of Senior Scholars, and Member, Permanent Committee of Ifta', and Advisor to the Royal Court, Kingdom of Saudi Arabia | Member |
| Sheikh Dr. Ahmad Ali Abdulla | Secretary General, The Higher Council of the Shari'ah Supervisory Board, Sudan | Member |
| Sheikh Nizam Yaquby | Chairman and Member, IFIs' Shari'ah Supervisory Boards, Kingdom of Bahrain | Member |
| Sheikh Dr. Mohamed Ali Al Qari | Chairman and Member, IFIs' Shari'ah Supervisory Boards, Saudi Arabia | Member |
| Sheikh Dr. Yousef Abdullah Al-Shubaily | Chairman and Member, IFI's Shari'ah Supervisory Board, Bank Albilad, Kingdom of Saudi Arabia | Member |

| | | |
|---|---|---|
| Sheikh Dr. Ahmed Bin Abdulaziz Al Hadad | Senior Mufti, Supreme Committee of Iftaa, Director, Dar Al Iftaa, Department of Islamic Affairs and Charitable Activities United Arab Emirates | Member |
| Sheikh Dr. Mahmoud Al Sartawi | Chairman, Shari'ah Supervisory Board, Jordan Islamic Bank, Jordan | Member |
| Sheikh Dr. Ayashi Faddad | Shari'ah Advisor, Islamic Development Bank | Member |
| Sheikh Dr. Esam 'Anezi | Chairman, Shari'ah Supervisory Board, Investment Dar, Kuwait. | Member |
| Sheikh Dr. Mohammed Akram Laldin | Executive Director, The International Shari'ah Research Academy for Islamic Finance, | Member |
| Sheikh Waleed Bin Hadi | Head of Shari'ah Compliance, Qatar Islamic Bank, Qatar | Member |
| Sheikh Aflah Alkahalili | Head of Studies and Research, Grand Mufti Office, Sultanate of Oman | Member |
| Mr. Abdulla Bin Humood Al Ezzi | Member, Ulama Society, Yemen | Member |
| Sheikh Mohsen Al Asfoor | Member, Shari'ah Supervisory Board, Ithmaar Bank, Kingdom of Bahrain | Member |
| Dr. Hamed Hassan Merah | Secretary-General, AAOIFI | Member & Rapporteur |

## Former Shari'ah Board Members

| | |
|---|---|
| Sheikh Prof. Dr. Wahbe Mustafa al Zuhaili | Sheikh Prof. Dr. Nazih Hammad |
| Sheikh Abdul Razzaq Naser Mohammed | Sheikh Ghazali Bin Abdul Rahman |
| Sheikh Yousif Mohammed Mahmoud Qasim | Sheikh Dr. Abdul Rahman Bin Saleh Al Atram |
| Sheikh Dato Haji Mohammed Hashim Bin Yehia | Sheikh Prof. Dr. Alsidiq Mohammed Al Dharir |
| Sheikh Yusuf Talal De Lorenzo | Sheikh Prof. Dr. Ali Mohi Eldinne Alqoradaghi |
| Sheikh Dr. Mohammad Daud Bakr | Sheikh Mohammed Ali Taskhiri |
| Sheikh Dr. Mohammed Abdul Rahim Sultan Al Ulama | Sheikh Prof. Dr. Ajeel Jasim Al-Nashmi |
| Sheikh Dr. Saleh Bin Abdulla Lihaidan | |

## Shari'ah Standards Review Committee

| NAME | POSITION | STATUS |
|---|---|---|
| Sheikh Dr. Abdul Sattar Abu Ghuddah | President and General Secretary of the Unified Shari'ah Board of Al Baraka Banking Group, Kingdom of Saudi Arabia | Member |
| Sheikh Dr. Ayashi Faddad | Shari'ah Advisor, Islamic Development Bank, Saudi Arabia | Member |
| Sheikh Waleed Bin Hadi | Head of Shari'ah Compliance, Qatar Islamic Bank, Qatar | Member |
| Sheikh Dr. Yousef Abdullah Al-Shubaily | Member, Shari'ah Supervisory Board, Bank Albilad, Kingdom of Saudi Arabia | Member |
| Sheikh Dr. Esam 'Anezi | Chairman, Shari'ah Supervisory Board, Investment Dar, Kuwait. | Member |
| Dr. Hamed Hassan Merah | Secretary-General, AAOIFI | Member |

## Shari'ah Standards Drafting Committee

| NAME | POSITION | STATUS |
|---|---|---|
| Sheikh Dr. Abdul Sattar Abu Ghuddah | President and General Secretary of the Unified Shari'ah Board of Al Baraka Banking Group, Kingdom of Saudi Arabia | Member |
| Sheikh Dr. Mohamed Ali Al Qari | Chairman and Member of IFIs' Shari'ah Supervisory Boards, Kingdom of Saudi Arabia | Member |
| Sheikh Dr. Yousef Abdullah Al-Shubaily | Member, Shari'ah Supervisory Board, Bank Albilad, Kingdom of Saudi Arabia | Member |

# Shari'ah Standards Translation Committee

| NAME | POSITION | STATUS |
|---|---|---|
| Sheikh Muhammad Taqi Usmani | Vice-President, Darul-Uloom Karachi, Pakistan, and Permanent Member, OIC Fiqh Academy, Kingdom of Saudi Arabia | Chairman |
| Sheikh Nizam Yaquby | Chairman and Member of IFIs' Shari'ah Supervisory Boards, Kingdom of Bahrain | Member |
| Sheikh Dr. Mohamed Ali Al Qari | Chairman and Member of IFIs' Shari'ah Supervisory Boards, Kingdom of Saudi Arabia | Member |
| Sheikh Essam Mohammed Ishaq | Shari'ah Advisor & Board Member, Discover Islam Centre, Kingdom of Bahrain. | Member |
| Sheikh Dr. Mohammed Akram Laldin | Executive Director, The International Shari'ah Research Academy for Islamic Finance, | Member |

# Shari'ah Standards Committee (1)
# Kuwait

| NAME | POSITION | STATUS |
|---|---|---|
| Sheikh Dr. Esam 'Anezi | Chairman, Shari'ah Supervisory Board, Investment Dar, Kuwait. | Chairman |
| Sheikh Dr. Muhammad Anas Al Zarka | Senior Advisor, Shura Shari'ah Consultancy | Member |
| Dr. Mohammed Awd Ali Alfeze'e | Director, Shari'ah Compliance Department, Alimtiaz Investment, Kuwait | Member |
| Dr. Ali Ebrahim Al Rashid | Shari'ah Consultant, Al Raya Consulting and Training, Kuwait | Member |
| Sheikh Abdul Sattar al Qattan | General Manager, Shura Shari'ah Conslutancy, Kuwait | Member |
| Dr. Abdul Aziz Al Qassar | Professor, College of Shari'ah, University of Kuwait, Kuwait | Member |
| Dr. Hamed Hassan Merah | Secretary General, AAOIFI | Member |
| Dr. Abdul Rahman Abdulla Al Saadi | Advisor, AAOIFI | Rapporteur |

# Shari'ah Standards Committee (2)
# Jeddah, Kingdom of Saudi Arabia

| NAME | POSITION | STATUS |
|---|---|---|
| Sheikh Dr. Ayashi Faddad | Shari'ah Advisor, Islamic Development Bank, Kingdom of Saudi Arabia | Chairman |
| Sheikh Dr. Mohamed Ali Al Qari | Chairman and Member of IFIs' Shari'ah Supervisory Boards, Kingdom of Saudi Arabia | Member |
| Sheikh Dr. Yousef Abdullah Al-Shubaily | Member, Shari'ah Supervisory Board, Bank Albilad, Kingdom of Saudi Arabia | Member |
| Dr. Mosa Adam Essa | Head of Shari'ah Compliance, National Commercial Bank, Kingdom of Saudi Arabia | Member |
| Dr. Sami Al-Suwailem | Head, Financial Product Development Centre | Member |
| Dr. Abdulla al Omrani | Faculty Member, College of Shari'ah, Al-Imam Muhammad Ibn Saud Islamic University, Kingdom of Saudi Arabia | Member |
| Dr. Adel Qouteh | King Abdul Aziz University, Jeddah, Kingdom of Saudi Arabia | Member |
| Dr. Hamed Hassan Merah | Secretary General, AAOIFI | Member |
| Dr. Abdul Rahman Abdulla Al Saadi | Advisor, AAOIFI | Rapporteur |

# Shari'ah Standards Committee (3)
# Dubai, United Arab Emirates

| NAME | POSITION | STATUS |
|---|---|---|
| Sheikh Dr. Abdul Sattar Abu Ghuddah | President and General Secretary of the Unified Shari'ah Board of Al Baraka Banking Group, Kingdom of Saudi Arabia | Chairman |
| Dr. Osaid Mohammed Adeeb Kilani | Head of Shari'ah at Abu Dhabi Islamic Bank | Member |
| Dr. M. Imran Usmani | Resident Shari'ah Board Member, Meezan Bank, Pakistan | Member |
| Dr. Abdul Sattar Khuwaylidi | Secretary General, International Islamic Center for Reconciliation and Arbitration, United Arab Emirates | Member |
| Dr. Amin Fatih | General Manager, Minhaj Advisory, United Arab Emirates | Member |
| Sheikh Nizam Yaquby | Chairman and Member of IFIs' Shari'ah Supervisory Boards, Kingdom of Bahrain | Member |
| Sheikh Yusuf Talal De Lorenzo | Chief Shari'ah Officer, Shari'ah Capital, United States | Member |
| Dr. Hamed Hassan Merah | Secretary General, AAOIFI | Member |
| Dr. Abdul Rahman Abdulla Al Saadi | Advisor, AAOIFI | Rapporteur |

# Shari'ah Standards Committee (4)
# Karachi, Pakistan

| NAME | POSITION | STATUS |
|---|---|---|
| Sheikh Muhammad Taqi Usmani | Vice-President, Darul-Uloom Karachi, Pakistan, and Permanent Member, OIC Fiqh Academy, Kingdom of Saudi Arabia | Chairman |
| Dr. M. Imran Usmani | Resident Shari'ah Board Member, Meezan Bank, Pakistan | Member |
| Mufti. M. Hassan Kaleem | Resident Shari'ah Board Member, Dubai Islamic Bank Pakistan Limited, and Shari'ah Advisor, Deloitte | Member |
| Mufti. Irshad Ahmad Aijaz | Chairman, Shari'ah Supervisory Board, Bank Islami Pakistan | Member |
| Dr. Khalil Ahmed Azami | Shari'ah Advisor, Al Falah Bank Limited, Pakistan | Member |
| Dr. Mohammed Zubair Al Usmani | Darul-Uloom Karachi, Member of Shari'ah Board, Habib Bank Limited, Pakistan | Member |
| Mufti. Abdullah Najeeb Ul Haq Siddiqui | Resident Shari'ah Board Member, Al Baraka Bank (Pakistan) Limited, Pakistan | Member |
| Dr. Hamed Hassan Merah | Secretary General, AAOIFI | Member |

# Accounting and Auditing Standards Board

| NAME | POSITION | STATUS |
|---|---|---|
| Mr. Hamad Abdulla Eqab | Senior Vice President, Head of Financial Control, Al Baraka Banking Group, Kingdom of Bahrain. | Chairman of Accounting and Auditing Standards Board |
| Mr. Jalil Al-Aali | Partner, KPMG Fakhro, Kingdom of Bahrain | Chairman of Accounting Standards Committee |
| Mr. Jamil Darras | Head, Central Accounting Section, Finance Department, Islamic Development Bank, Kingdom of Saudi Arabia. | Chairman of Auditing and Governance Standards Committee |
| Sheikh Dr. Abdul Sattar Abu Ghuddah | President and General Secretary of the Unified Shari'ah Board of Al Baraka Banking Group, Kingdom of Saudi Arabia | Member |
| Sheikh Essam Mohammed Ishaq | Shari'ah Advisor & Board Member, Discover Islam Centre, Kingdom of Bahrain. | Member |
| Mr. Firas S Hamdan | Accounting Department, Banque du Liban (Central Bank of Lebanon), Lebanon. | Member |
| Dr. Hussein Said Saifan | Assistant General Manager, Jordan Islamic Bank, Jordan | Member |
| Dr. Nordin Mohammed Zain | Deloitte Kassimchan, Malaysia | Member |
| Mr. Fawad Laique | Partner, EY , Kingdom of Bahrain. | Member |

| | | |
|---|---|---|
| Mr. Oliver Agha | Managing Partner, Agha & Co, United Arab Emirates | Member |
| Mr. Qudeer Latif | Partner, Clifford Chance LLP, Dubai, United Arab Emirates. | Member |
| Mr. Mohamed Said El Saka | General Manager, Financial Control and Planning Department, Kuwait International Bank, Kuwait | Member |
| Dr. Hamed Hassan Merah | Secretary-General, AAOIFI | Member & Rapporteur |

# Accounting Standards Committee

| NAME | POSITION | STATUS |
|---|---|---|
| Mr. Jalil Al-Aali | Partner, KPMG Fakhro, Kingdom of Bahrain | Chairman |
| Mr. Firas S Hamdan | Accounting Department, Banque du Liban (Central Bank of Lebanon), Lebanon. | Member |
| Mr. Fawad Laique | Partner, EY & Young, Kingdom of Bahrain. | Member |
| Mr. Imtiaz Ibrahim | Partner, EY, Qatar | Member |
| Mr. Aly El Azhary | Deloitte & Touch Bakr Albulkhair & Co., Kingdom of Saudi Arabia | Member |
| Mr.Mahesh Balasubramaniam | Partner, KPMG Fakhro, Kingdom of Bahrain | Member |
| Mr. Madhukar Shenoy | Partner, PwC, Kingdom of Bahrain | Member |
| Mr. Irshad Mahmood | Director, PwC, Kingdom of Bahrain | Member |
| Mr. Issam Z Al-Tawari | Vice Chairman & Chief Executive Officer, Rasameel Structured Finance Co., Kuwait. | Member |
| Dr. Hamed Hassan Merah | Secretary-General, AAOIFI | Member |

# Auditing and Governance Standards Committee

| NAME | POSITION | STATUS |
|---|---|---|
| Mr. Jamil Darras | Head, Central Accounting Section, Finance Department, Islamic Development Bank, Kingdom of Saudi Arabia. | Chairman |
| Sheikh Essam Mohammed Ishaq | Shari'ah Advisor & Board Member, Discover Islam Centre, Kingdom of Bahrain. | Member |
| Dr. Hussein Said Saifan | Assistant General Manager, Jordan Islamic Bank, Jordan | Member |
| Mr. Oliver Agha | Managing Partner, Agha & Co, United Arab Emirates | Member |
| Mr. Qudeer Latif | Partner, Clifford Chance LLP, Dubai, United Arab Emirates. | Member |
| Dr. Hatim El-Tahir | Director, Deloitte, Kingdom of Bahrain | Member |
| Dr. Hamed Hassan Merah | Secretary-General, AAOIFI | Member |

## Shari'ah Standard No. (1)

# Trading in Currencies

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to explain the Shari'ah rulings relating to trading in currencies, as well as the conditions and precepts laid down by the Shari'ah as to what is permissible in currency trading and what is not. The standard also explains some of the practices being applied by Islamic financial Institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers issues of both actual and constructive possession of currencies, the use of modern means of communication in currency trading, exchange of currencies in the context of the bilateral settlement of debts owed by the parties to the exchange, dealing in currencies in money markets, bilateral promises to buy and sell currencies, deferment of the delivery of one of two countervalues in currency trading, and some cases practised by the Institutions.

The standard does not cover the following cases: those where there are no trading in currencies; the effect of goldsmithery in selling gold and silver; transfers of debts that do not involve exchanges of currency; and the discounting of bills of exchange.

## 2. Shari'ah Ruling on Trading in Currencies

**2/1 It is permissible to trade in currencies, provided that it is done in compliance with the following Shari'ah rules and precepts:**

2/1/1 Both parties must take possession of the countervalues before dispersing, such possession being either actual or constructive.

2/1/2 The countervalues of the same currency must be of equal amount, even if one of them is in paper money and the other is in coin of the same country, like a note of one pound for a coin of one pound.

2/1/3 The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both countervalues.

2/1/4 The dealing in currencies shall not aim at establishing a monopoly position, nor should it entail any evil consequences to the interest of individuals or societies.

2/1/5 Currency transactions shall not be carried out on the forward or futures market.

2/2 It is prohibited to enter into forward currency contracts. This rule applies whether such contracts are effected through the exchange of deferred transfers of debt or through the execution of a deferred contract in which the concurrent possession of both of the countervalues by both parties does not take place.

2/3 It is also prohibited to deal in the forward currency market even if the purpose is hedging to avoid a loss of profit on a particular transaction effected in a currency whose value is expected to decline.

2/4 It is permissible for the Institution to hedge against the future devaluation of the currency by recourse to the following:

2/4/1 To execute back to back interest free loans using different currencies without receiving or giving any extra benefit, provided these two loans are not contractually connected to each other.

2/4/2 Where the exposure is in respect of an account payable, to sell goods on credit or by Murabahah in the currency of the exposure.

2/5 It is permissible for the Institution and the customer to agree, at the time of settlement of the instalments of a credit transaction (such as a Murabahah), that the payment shall be made in another currency applying the spot exchange rate on the day of payment.

**2/6 Possession in sales of currencies**

2/6/1 When a contract is concluded for the sale of an amount of currency, possession must be taken for the whole amount that is the subject matter of the contract at the closing of the transaction.

2/6/2 Taking possession of one of the countervalues by one party without taking possession of the other is not enough to make a currency dealing transaction permissible. Likewise, taking partial possession is not sufficient. Taking possession of part

of a countervalue is valid only in respect of the part, possession of which is complete, whereas the remaining part of the transaction remains invalid.

2/6/3 Possession may take place either physically or constructively. The form of taking possession of assets differs according to their nature and customary business practices.

2/6/4 Physical possession takes place by means of simultaneous delivery by hand.

2/6/5 Constructive possession of an asset is deemed to have taken place by the seller enabling the other party to take its delivery and dispose of it, even if there is no physical taking of possession. Among other forms of constructive possession that are approved by both Shari'ah and business customary practices are the following:

a) To credit a sum of money to the account of the customer in the following situations:

1. When the Institution deposits to the credit of a customer's account a sum of money directly or through a bank transfer.
2. When the customer enters into a spot contract of currency exchange between himself and the Institution, in the case of the purchase of a currency against another currency already deposited in the account of the customer.
3. When the Institution debits – by the order of the customer – a sum of money to the latter's account and credits it to another account in a different currency, either in the same Institution or another Institution, for the benefit of the customer or any other payee. In following such a procedure, the Institution shall adhere to the principles of Islamic law regarding currency exchange.

A delay in making the transfer is allowed to the Institution, consistent with the practice whereby a payee may obtain actual receipt according to prevailing business practices in currency

markets. However, the payee is not entitled to dispose of the currency during the transfer period, unless and until the effect of the bank transfer has taken effect so that the payee is able to make an actual delivery of the currency to a third party.

b) Receipt of a cheque constitutes constructive possession, provided the balance payable is available in the account of the issuer in the currency of the cheque and the Institution has blocked such a balance for payment.

c) The receipt of a voucher by a merchant, signed by the credit card holder (buyer), is constructive possession of the amount of currency entered as payable on the coupon provided that the card issuing Institution pays the amount without deferment to the merchant accepting the card.

**2/7 Agency in trading in currencies**

2/7/1 It is permissible to appoint an agent to execute a contract of sale of a currency with authorisation to take possession of and deliver the countervalue.

2/7/2 It is permissible to appoint an agent to sell currencies without authorizing him to take possession of the amount sold, provided the principal or another agent takes possession at the closing of the transaction, before the principal parties are dispersed.

2/7/3 It is permissible to authorise taking possession of the countervalues after the execution of a contract of currency exchange, provided such possession is completed by the authorised agents at the closing of the transaction, before the principal parties are dispersed.

**2/8 Use of modern means of communication for currency trading**

2/8/1 Bilateral contracting between two parties at different remote places using modern communication means has the same juristic consequences as execution of the contract in one and ame place.

2/8/2 An offer made for a stated period, which is transmitted by one of the prescribed means of communication, remains binding on the offeror during that period. The contract is not completed until acceptance by the offeree, and taking possession of the countervalues (either actual or constructive) by both parties, has taken place.

**2/9 Bilateral promise to purchase and sell currencies**

2/9/1 A bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even for the purpose of hedging against currency devaluation risk. However, a promise from one party is permissible even if the promise is binding.

2/9/2 Parallel purchase and sale of currencies is not permissible, as it incorporates one of the following invalidating factors:

a) There is no delivery and receipt of the two currencies bought and sold, and thus the contract amounts to a deferred sale of currency.

b) Making a contract of currency exchange conditional on another contract of currency exchange.

c) A bilateral promise that is binding on both parties to the contract of currency exchange, and this is not permissible.

2/9/3 It is not permissible for one of the partners in Musharakah or Mudarabah to be a guarantor for the other partner, to protect the latter from the risks of dealing in currencies. However, it is permissible for a third party to volunteer being a guarantor for that purpose, provided this guarantee is not stated in the contract.

**2/10 Exchange of currencies that are debts owed by the parties**

An exchange of amounts denominated in currencies that are debts established as an obligation on the debtor is permissible, if this results in the settlement of the two debts in place of a bilateral exchange of currencies, and in the fulfilment of the obligations in respect of these debts. This covers the following cases:

2/10/1 Discharge of two debts when one party owes an amount from another party denominated in (say) dinar and the other party owes an amount from the first party denominated in (say) dirham. In this context, both may agree on the rate of exchange between the dinar and the dirham in order to extinguish the debts, wholly or partially. This type of transaction is known as *al-Muqassah* (set-off).

2/10/2 The creditor's making payment of a debt due to him in a currency different from that in which the debt was incurred, provided the settlement is effected as a spot transaction at the spot exchange rate on the day of settlement.

**2/11 Combination of currency exchange and transfer of money**

It is permissible to execute a financial transfer of money (remittances) in a currency different from that presented by the applicant for the transfer. This transaction consists of a currency exchange effected through actual or constructive possession by delivering an amount of currency that is evidenced by a bank draft, followed by the transfer of the amount using currency that is bought by the applicant for the transfer of money. It is permissible for the Institution to charge a fee for the transfer.

**2/12 Forms of dealing in currencies via Institutions**

2/12/1 Among the forms that are not permitted is the customer of an Institution entering into currency trading for an amount of money exceeding the amount of money he owns, using credit facilities granted by the Institution which handles the currency trading, thus enabling the customer to enter into a transaction for an amount in excess of what he would otherwise be able to pay for.

2/12/2 It is not permitted for the Institution to lend the customer a sum of money on the condition that currency dealing must be effected with that Institution and not with any other. If there is no such condition, then there is no Shari'ah prohibition.

## 3. Date of Issuance of the Standard

This Standard was issued on 27 Safar 1421 A.H., corresponding to 31 May 2000 A.D.

# Adoption of the Standard

The Shari'ah Standard on Trading in Currencies was adopted by the Shari'ah Board in its meeting No. (4) held on 25-27 Safar 1420 A.H., corresponding to 29-31 May 2000 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (1) held in Bahrain on Saturday 11 Dhul-Qa'dah 1419 A.H., corresponding to 27 February 1998 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah standard on Trading in Currencies.

On Saturday 11 Dhul-Qa'dah 1419 A.H., corresponding to 27 February 1999 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft.

In its meeting held in Bahrain on 13-16 Rabi' I, 1420 A.H., corresponding to 27-30 June 1999 A.D., the Shari'ah Committee discussed the juristic study and made certain amendments to it. The committee also discussed the exposure draft of the standard in its meeting No. (3) held in Bahrain on 9-11 Rajab 1420 A.H., corresponding to 18-20 October 1999 A.D., and asked the consultant to make some amendments in light of the comments made by the members.

The revised exposure draft of the standard was presented to the Shari'ah Board in its meeting No. (2) held in Mecca on 10-15 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 29–30 Dhul-Hajjah 1421 A.H., corresponding to 4-5 April 2000 A.D. The Public hearing was attended by more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Members of the Shari'ah Studies Committee responded in the

public hearing to the written comments as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Studies Committee held its meeting No. (5) on 22-24 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D, to discuss the comments made about the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of both the discussions that took place in the public hearing and the written comments that were received.

The Shari'ah Board in its meeting No. (4) on 25–27 Safar 1421 A.H., corresponding to 29–31 May 2000 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Studies Committee, and made the necessary amendments, which it deemed necessary. The standard was adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the Shari'ah Board.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Available Evidence Pertaining to the Exchange of Currencies**

In the Hadiths of the Prophet, there are many Hadiths which govern the rules regarding the exchange of currencies. The best known Hadith is the one reported on the authority of Ubadah Ibn Al-Samit (may Allah be pleased with him) that the Prophet (peace be upon him) said: *"Gold for gold, silver for silver – until he said - equal for equal, like for like, hand to hand, if the kinds of assets differ, you may sell them as you wish provided it is hand to hand."*(2) The other Hadith, reported on the authority of Abu Sa'id Al-Khudri, is that the Prophet (peace be upon him) said: *"Do not sell gold for gold except equal for equal and do not sell what is deferred for a spot exchange."*(3) These two Hadiths show clearly enough that gold is of one kind and the silver is of another. A few decisions have been issued by Islamic Fiqh organizations(4) in accordance with the Shari'ah ruling that has been already accepted amongst the jurists, namely that dinars are of a different kind from dirhams. Contemporary Islamic Fiqh scholars have made an analogy between paper and coin money and gold and silver money referred to in the prophetic Hadith. The currency of each

(2) Related by Muslim in his *"Sahih Muslim"*.

(3) Related by Al-Bukhari in his *"Sahih Al-Bukhari"*.

(4) Among other examples is the one issued by the General council of Fatwa in Kuwait as follows: It is permissible to sell currencies that are different from each other because every currency is considered as a kind of money on its own, like that of gold and silver, and therefore it is permissible to sell a particular currency such as dollar, for another currency such as Indian Rupee even for inequality as it is permissible to sell gold for silver for a different weight, provided the bilateral taking possession of the two counter values ( two currencies) must take place in the session of the contract. However, if a certain amount of a particular currency is sold for the same currency such as Indian rupee for Indian rupee, then the inequality is impermissible (*"Majmu'at Al-Fatawa Al-Shar'iyyah"*, Adminsitration of Fatwa of Kuwait 3/160 no. 788).

country is considered as being of a kind that is different from that of other countries as they are 'constructive money' according to the decision of the International Islamic Fiqh Academy.(5) Therefore, these currencies differ in kind according to the authority that considers them as money.

On this basis, it has been a condition, in the exchange of currencies that are of the same kind, that equality in amount as well as taking possession of the two countervalues before the two contracting parties depart the place of the closing of the contract. However, if the kind of the currencies to be exchanged is different, then it is permissible for the amounts to be different, but the condition of taking possession of the countervalues before the two contracting parties leave the place of signature of the contract shall prevail.

**Shari'ah Ruling on Trading in Currencies**

The original ruling on trading in currencies is that it is permissible, as it falls under the general Islamic provisions regarding the permissibility of selling gold, silver and money because this is one means of earning a profit. This ruling is applicable as long as there is no reason for considering the dealing as prohibited or objectionable. The basis of this ruling is the Hadith that are available with regard to exchange of currencies and the general ruling that is derived from these Hadith as decided by the jurists in the chapter on currency exchange. Whenever one of the Shari'ah precepts is not met, then the dealing is not permissible.

**Stipulation of Equality and Taking Possession**

While equality of the countervalues and concurrent taking of possession are required in the exchange of two similar kinds of currencies, only bilateral taking of possession is required in the exchange of two dissimilar kinds, based on the basis stated in (1) above.

**Constructive Possession**

Constructive possession –as in the forms mentioned in the standard– is on an equal footing with actual possession, because the Shari'ah never prescribed a particular method for taking possession. Therefore, reference must be made to the prevailing custom in the business community which

(5) The International Islamic Fiqh Academy Resolution No. 21 (9/3).

results in the ability to dispose of the currency for the intended purpose and transfer of the risk of the currency to the transferee, as in the forms mentioned in the standard.

As for the various forms of constructive possession, there is a decision issued by the International Islamic Fiqh Academy,(6) and the various Fatwa Committees have added to these forms some others, such as the credit card settlement coupon.(7)

The Ninth Seminar of Al Baraka(8) has confirmed the prohibition of giving a guarantee by one of the parties in Mudarabah or Musharakah transactions to the other party, to indemnify him against currency risks.

**Agency in Exchange of Currencies and Issue of Taking Possession**

Agency in exchange of currencies is permissible because agency is permissible with regard to an activity that the principal could undertake personally. As one could undertake the exchange himself, then it is also permissible for him to authorise its undertaking by others on his behalf. However, since taking possession of the countervalues immediately after concluding the contract has been a juristic condition, the juristic requirement in the case of agency would be the taking possession by the parties to the contract of exchange, whether through principal or agent. When the agency is for the purpose of taking possession only, the juristic rule relates to the leaving of the place of execution of the contract by both principals before possession is taken, and not to the agent's doing so.

**Use of Modern Means of Communication for Trading in Currencies**

The International Islamic Fiqh Academy(9) issued a decision on the subject of those means of communication. This is a reinforcement of what has already been approved by the jurists on the permissibility of concluding

(6) International Islamic Fiqh Academy Resolution No. 53 (3/6); *"Majallat Al-Majma'"*, vol. 6 [2: 785].

(7) Fatwa No. (12/6) of Al Baraka Seminar No. (12), stating: A payment slip signed by the cardholder is tantamount to receipt, by means of a cheque. In this respect it is stronger than a cheque, as stated by experts, because it is binding on the trader and it discharges the cardholder of the debt immediately, and he may not protest the collection of the amount thereof.

(8) Al Baraka Seminar No. 9 (9/5).

(9) The International Islamic Fiqh Academy Resolution No. 52 (3/6).

a contract via writing and communications that can be understood. This would cover all contemporary means such as telex, fax, internet, etc.

**Bilateral Promise in Exchange of Currencies**

The prohibition of a binding bilateral promise in an exchange of currencies is supported by the majority of Shari'ah jurists, because binding bilateral promises from two parties are equivalent to a contract, and also for the reason that the bilateral promise is not immediately followed by taking possession of the countervalues, since it is not the wish of the parties to take possession at that time.

Financial Institutions have a customary practice of treating promises as binding, even when formally they are not. A promise from one party only (as opposed to a bilateral promise) is permissible in currency exchange, even if it is binding.

**Exchange of Currencies that Are Owed by the Parties**

The basis of the permissibility of an exchange of amounts denominated in currencies that are debts established as an obligation of the debtor, on the condition that the two obligations are thereby settled, is that this would entail the settlement of the debt by discharging it. This does not involve any prohibited transaction pertaining to debts either with regard to sale or purchase.

As for some of the forms mentioned in the standard, there are texts to support them, inter alia, the Hadith reported on the authority of Ibn Umar (may Allah be pleased with him) who said: "I have met the Prophet (peace be upon him) at the house of Hafsah (may Allah be pleased with her). And I said to him: 'O Prophet of Allah, I would like to ask you; 'I sell a camel in Al-Baqi' for a price quoted in dinar but I take dirham, and I sell for a price quoted in dirham but I take dinars, I take this from this and I give this from this'. The Prophet (peace be upon him) replied: *'There is no objection to your taking the other currency based on the price of the day, provided you do not leave each other with something remaining owed as a debt between you'*."[10] Some of the forms in the standard are a kind of set-off and this is permissible.

(10) Related by Abu Dawud, Al-Tirmidhi, Al-Nassa`i, Ibn Majah and Al-Hakim, who deemed it a sound Hadith, as confirmed by Al-Dhahabi. It was also narrated without a chain of narrators, quoting only Ibn Umar (*"Al-Talkhis Al Habir"* [3: 26]).

**Combination of Currency Exchange and Transfer of Money**

The basis of the permissibility of the combination of currency exchange and transfer of money is the achievement of constructive possession by virtue of a bank draft for the amount that is given in one currency in return for an amount paid in another currency for the purpose of its transfer. In this regard, there is a decision by the International Islamic Academy of Fiqh that reads: "If a transfer of money is to be made in a currency different from the currency of the amount paid by the applicant, then the transaction is based on currency exchange and transfer of money. The currency exchange takes place before the transfer, that is, the customer pays the amount of money to the bank and the bank, after agreeing on the currency exchange rate that is printed on the receipt delivered to the customer, issues a bank draft on the basis of transfer of debt in the sense that has been mentioned."(11)

**Forms of Trading in Currencies**

The following form is not permissible: providing a type of financial facility to a customer who wishes to engage in currency trading which enables him to deal in amounts that he does not own and to sell amounts that he does not own. An alternative and permissible form is that the Institution lends the money to the customer so that the latter would then deal in amounts that he owns. However, this would not be permissible if the Institution made it a condition of the loan that the customer must carry out the currency trading with the Institution, as this would involve a combination of both loan and contract of exchange. This is not permissible because it results in a benefit to the lender. Where no such condition is imposed, there is no prohibition.

(11) International Islamic Fiqh Academy Resolution No. 48 (1/9)

## Shari'ah Standard No. (2)

# Debit Card, Charge Card and Credit Card

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of the standard on debit card, charge card and credit card is to explain their types and characteristics, and to lay down the Shari'ah principles for dealing with the three types of card by both Islamic financial Institutions(1) and their customers who hold their cards and use them. The standard also explains the Shari'ah rulings on the use of the cards in various circumstances.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

The standard covers debit cards, charge cards and credit cards that are issued by Institutions to their customers to enable the latter, by using the cards, either to withdraw cash from their accounts or to obtain credit or to pay for goods or services purchased. These cards include the following types:

- Debit card
- Charge card
- Credit card

## 2. Characteristics of Different Types of Card

While some of the characteristics are common to more than one type of card, some are specific to a particular type of card.

### 2/1 Characteristics of the debit card

2/1/1 The Institution issues the card to a customer with available funds in his account.

2/1/2 The card confers on its holder the right to withdraw cash from his account or to pay for goods or services purchased up to the limit of the available funds (credit balance) on his account. The debit to the customer's account will be immediate, and the card does not provide him with any credit.

2/1/3 The customer will not normally pay any charges for using this card, except when it is used to withdraw cash or to purchase another currency through another Institution different from the Institution that has issued the card.

2/1/4 The issuing Institution may charge a fee for issuing the card, or may make no charge for issuing it.

2/1/5 Some Institutions charge the party accepting payment by means of the card a commission calculated as a percentage of such payments.

**2/2 Characteristics of the charge card**

2/2/1 The card provides a credit facility up to certain ceiling for a specified period of time, as well as providing a means of repayment.

2/2/2 The card is used to pay for goods and services and to obtain cash.

2/2/3 This card does not provide revolving credit facilities to the cardholder, insofar as the cardholder is obliged to make payment for the purchased goods or services by the end of a prescribed credit period following receipt of a statement sent by the Institution issuing the card.

2/2/4 If the cardholder delays payment of the amount due beyond the period of free credit, an interest charge is imposed on the cardholder but none is imposed by the Institutions.

2/2/5 The Institution issuing the card does not charge the cardholder any percentage commission on purchases, but receives a percentage commission from the party accepting the card on purchases made by using the card.

2/2/6 The Institution issuing the card is obliged to pay the party accepting the card for purchases made by the cardholder, within a specified transaction credit limit (or the agreed increase thereon). This obligation on the card issuer to pay for the cardholder's purchases is direct, and is independent of the relationship between the party accepting the card and the cardholder.

2/2/7 The Institution issuing the card has a personal and direct right against the cardholder to be reimbursed for any payments made on his behalf. The issuer's right is absolute and independent of

the relationship between the cardholder and the party accepting the card in accordance with the contract between them.

**2/3 Characteristics of the credit card**

2/3/1 This card provides a revolving credit facility within the credit limit and credit period determined by the issuer of the card. It is also a means of payment.

2/3/2 The holder of a credit card is able to pay for purchases of goods and services and to withdraw cash, within the approved credit limit.

2/3/3 When purchasing goods or services, the cardholder is given a free credit period during which the amount due should be paid and no interest is chargeable. The cardholder is also allowed to defer paying the amount due and is charged interest for the duration of the credit. In the case of a cash withdrawal, there is no free credit period.

2/3/4 The conditions set out in items 2/2 (e), (f) and (g) above are equally applicable to this type of card.

**3. Shari'ah Rulings for Different Types of Card**

**3/1 Debit card**

It is permissible for Institutions to issue debit cards, as long as the cardholder does not exceed the balance available on his account and no interest charge arises out of the transaction.

**3/2 Charge card**

It is permissible for Institutions to issue charge cards on the following conditions:

3/2/1 The cardholder is not obliged to pay interest in the case of delay in paying the amount due.

3/2/2 If the Institution obliges the cardholder to deposit a sum of money as a guarantee and this amount is not available for the use of the card holder, then it must be made clear that the In-

stitution will invest the money for the benefit of the cardholder on the basis of Mudarabah and that any profit accruing on this amount will be shared between the cardholder and the Institution according to a specified percentage.

3/2/3 The Institution must stipulate that the cardholder may not use the card for purposes prohibited by the Shari'ah and that the Institution has the right to withdraw the card in case such a condition is violated.

**3/3 Credit card**

It is not permissible for an Institution to issue credit cards that provide an interest-bearing revolving credit facility, whereby the cardholder pays interest for being allowed to pay off the debt in instalments.

**4. General Provisions**

**4/1 The affiliation of the Institution to membership of international card regulatory organizations**

4/1/1 It is permissible for Institutions to join the membership of international card regulatory organizations, provided the Institutions avoid any infringements of Shari'ah that may be prescribed by those organizations.

4/1/2 It is permissible for the Institutions to pay membership fees, service charges and other fees to international card regulatory organizations, so long as these do not include interest payments, even in an indirect way, such as in the case of increasing the service charge to cater for the granted credit.

**4/2 Commission to the card issuer payable by merchants accepting the card**

It is permissible for the Institution issuing the card to charge a commission to the party accepting the card, at a percentage of the purchase price of the items and services purchased using the card.

**4/3 Fees charged by the Institution to the cardholder**

It is permissible for the Institution issuing the card to charge the cardholder membership fees, renewal fees and replacement fees.

**4/4 Purchasing gold, silver and currency with cards**

It is permissible to purchase gold, silver or currency with a debit card or a charge card, in cases where the issuing Institution is able to settle the amount due to the party accepting the card without any delay.

**4/5 Cash withdrawal using a card**

4/5/1 It is permissible for the cardholder to withdraw an amount of cash within the limit of his available funds, or more with the agreement of the Institution issuing the card, provided no interest is charged.

4/5/2 It is permissible for the Institution issuing the card to charge a flat service fee for cash withdrawal, proportionate to the service offered, but not a fee that varies with the amount withdrawn.

**4/6 Privileges granted by card issuing parties**

4/6/1 It is not permissible for Institutions to grant the cardholder privileges prohibited by the Shari'ah, such as conventional life insurance, entrance to prohibited places or prohibited gifts.

4/6/2 It is permissible to grant privileges to the cardholder that are not prohibited by the Shari'ah, such as a priority right to services or discounts on hotel, airline or restaurant reservations and the like.

**5. Date of Issuance of the Standard**

The Standard was issued on 27 Safar 1421 A.H., corresponding to 31 May 2000 A.D.

# Adoption of the Standard

The Shari'ah Standard on Debit Card, Charge Card and Credit Card was adopted by the Shari'ah Board in its meeting No. (4) held on 25-27 Safar 1421 A.H., corresponding to 29-31 May 2000 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (1) held in Bahrain on Saturday 11 Dhul-Qa'dah 1419 A.H., corresponding to 27 February 1998 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah standard on debit card, charge card and credit card.

On Saturday 11 Dhul-Qa'dah 1419 A.H., corresponding to 27 February 1999 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft.

In its meeting held in Bahrain on 13-16 Rabi' I, 1420 A.H., corresponding to 27-30 June 1999 A.D., the Shari'ah Studies Committee discussed the juristic study and inserted certain amendments to it. The committee also discussed the exposure draft of the standard in its meeting No. (3) held in Bahrain on 9-11 Rajab 1420 A.H., corresponding to 18-20 October 1999 A.D. and, asked the consultant to make the necessary amendments in light of the comments made by the members.

The revised exposure draft of the standard was presented to the Shari'ah Board in its meeting No. (2) held in Mecca on 10-15 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 29–30 Dhul-Hajjah 1421 A.H., corresponding to 4-5 April 2000 A.D. The public hearing was attended by more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Members of the Shari'ah Studies Committee responded in the

public hearing to the written comments as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Studies Committee held its meeting No. (5) on 22-24 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., to discuss the comments made about the exposure draft. The committee made the necessary amendments, which it deemed necessary in light of both the discussions that took place in the public hearing, and the written comments that were received.

The Shari'ah Board in its meeting No. (4) held on 25–27 Safar 1421 A.H., corresponding to 29–31 May 2000 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Studies Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

# Appendix (B)
# The Shari'ah Basis for the Standard

**1. Debit Cards**

It is permissible to issue debit cards subject to the conditions mentioned in the standard, because such issuance does not incur any Shari'ah prohibition.

**2. Charge card**

It is permissible to issue charge cards subject to the conditions mentioned in the standard, because such issuance does not incur Shari'ah prohibition and because the contract involved does not grant credit facilities to the cardholder in exchange for interest. Prohibition might be caused by conditions incorporated in the contract, or by dealings of the cardholder, which contravene the Shari'ah.

**3. Credit card**

It is prohibited to issue credit cards, as mentioned in the standard, where such issuance is based on a contract granting the cardholder the right to a revolving credit on terms that involve interest, because Riba is prohibited in terms of either taking or giving. The prohibition of Riba is established through Quranic Texts, direct and certain Hadiths of the Prophet (peace be upon him) and the consensus of Muslim scholars, rendering its prohibition well known in the Muslim community as self-evident. However, the issuance of credit cards free from Riba, or from any other legal prohibition, is permissible.

4. Institution's affiliation to membership of international card regulatory organizations is permissible because the contracts of the Institutions with those organizations are free from Shari'ah infringements. The fees that the companies pay are the charges for the services rendered by the international organizations, by granting a license, carrying out set-

off in transactions and other services. The transactions do not relate to the advance of loans interest, since the dealings of the Institutions are confined to debit and charge cards that are free from any requirement to pay interest. These dealings do not involve credit cards of the type that are not permissible for the reason given above.

5. It is permissible for Institutions to charge the party accepting a card commission based on the prices of purchases or services made with the card, as this can be considered as partly a brokerage and marketing fee as well as a service charge for the collection of the debt.

6. It is permissible for Institutions to charge the cardholder membership or renewal or replacement fees, because these fees are in exchange for the right given to the customer to carry the card and to benefit from its services.

7. Purchasing with a debit card constitutes constructive possession as endorsed by the Shari'ah. When the purchaser receives gold or silver or currencies which he is buying, uses the card and signs the payment coupon for the account of the party accepting the card, then constructive possession takes place. This ruling is extracted from the decision of the International Islamic Fiqh Academy(2) which states that an accounting entry is considered to be constructive possession. Thus, the legal condition of taking possession is satisfied when using cards to purchase gold or silver or currencies.

8. It is permissible for the cardholder to withdraw cash from his available funds at the bank using the card, because this is to withdraw his own money. Likewise, it is permissible for him to withdraw more than his available funds from the Institution, if the latter has agreed that he may do so and has not stipulated that interest is payable on the such amounts. This is a permissible loan.

9. In the case of the Institution stipulating that the cardholder must deposit a sum of money prior to receiving approval to use the card, then it is not

(2) International Islamic Fiqh Academy Resolution No. 53 (4/6).

permitted for the Institution to prevent the cardholder from investing the amount deposited in his account, as this would be tantamount to a loan that draws extra benefit. For that reason, the appropriate alternative is for amounts so deposited to be invested for the benefit of the cardholder on the basis of profit and loss sharing.

Shari'ah Standard No. (3)

# Procrastinating Debtor

(Revised Standard)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to explain the Shari'ah rulings applicable to the transactions of Islamic financial Institutions[1] relating to solvent debtors and/or guarantors procrastinating in settling their obligations and contractors delaying in fulfilment of their obligations, which invokes penalty stipulated in the contract.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers cases of default on the part of a solvent debtor or a solvent guarantor, and the case of a contractor or concessionaire who is late in completing work and thus becomes a debtor by virtue of a penalty clause.

The standard does not cover debtors who are insolvent or bankrupt, or debtors who delay payment for an established Shari'ah reason.

## 2. Shari'ah Ruling

### 2/1 Default in payment by a debtor

2/1/1 Default in payment by a debtor who is capable of paying the debt is *Haram* (prohibited).

2/1/2 It is not permitted to stipulate any financial compensation, either in cash or in other consideration, as a penalty clause in respect of a delay by a debtor in settling his debt, whether or not the amount of such compensation is pre-determined; this applies both to compensation in respect of loss of income (opportunity loss) and in respect of a loss due to a change in the value of the currency of the debt.

2/1/3 It is not permitted to make a judicial demand on a debtor in default to pay financial compensation, in the form either of cash or of other consideration, for a delay in settling his debt.

2/1/4 The procrastinating debtor is liable for legal and other expenses incurred by the creditor in order to recover his debt.

2/1/5 The creditor is entitled to apply for the sale of any asset mortgaged as collateral for the debt, for the liquidation of the debt. He is equally entitled to stipulate that the debtor must give a mandate

to the creditor to sell the mortgaged asset without recourse to the courts.

2/1/6 Unless failure to pay was caused by force majeure, it is permissible to stipulate that all outstanding instalments become due once the procrastinating debtor fails to pay an instalment. It is preferable that this clause is implemented only after notifying the debtor and after the lapse of a reasonable period of time. [see Shari'ah Standard No. (5) on Guarantees (item 5/1)]

2/1/7 In the case of a Murabahah sale, if the asset that was sold is still available in the condition in which it was sold, and the buyer has defaulted in the settlement of the price and has later become bankrupt, then the seller (the Institution) is entitled to repossess the asset instead of initiating procedures to obtain a bankruptcy order.

2/1/8 It is permissible in contracts involving indebtedness (such as Murabahah) to stipulate an undertaking by the debtor, that in case of procrastinating in payment, the latter will donate an amount or a percentage of the debt to be spent for charitable causes through the Institution.

**2/2 Guarantor**

a) It is permissible for a creditor to demand that a debt be settled by the debtor or the guarantor of the debtor, unless the guarantor stipulated that the settlement must first be sought from the debtor.

b) All rulings applicable to debtors in default are equally applicable to guarantors in default.

**2/3 Contractor**

It is permissible to include penalty clauses in contracts for construction, Istisna'a and supply contracts. In case of a refusal to pay the amount due under a penalty clause, the rulings relating to default by a debtor would be applicable. It is permitted to deduct the amount from outstanding amounts due to the contractor.

**2/4 Non-material punishments for default in payment**

The Institution is entitled to include the name of a debtor in default in a list of undesirable customers (black list) and to send a warning admonition to other companies about the defaulting debtor, either when there is an inquiry from other companies about the debtor or when such 'black lists' are exchanged between companies directly.

**2/5 General rulings**

2/5/1 The Institution is entitled to [monitor and] investigate [the financial status and activities] of a defaulting debtor through all permissible and legitimate means.

2/5/2 The Institution may accept a payment from a debtor who is in default that is in excess of the amount of the debt, provided there is no contractual condition whether written or verbal, or custom or mutual agreement relating to this additional amount.

2/5/3 It is permissible for the Institution to stipulate in a contract dealing with indebtedness that, if the debtor is late in making payment, the Institution is entitled to recoup the amount due from any of the accounts of the customer with the Institution, whether current accounts or investment accounts. This may be done without getting any further consent of the debtor provided the balance in the account is of the same currency as that of the debt. If, however, the currency is different, then the rate of exchange to be used must be the then prevailing rate of exchange.

**2/6 Establishment of default in payment**

Default in payment is established when, following a normal demand for payment, a debtor who has not proved that he is insolvent fails to settle the debt on its due date.

**3. Date of Issuance of the Standard**

The Standard was issued on 27 Safar 1421 A.H., corresponding to 31 May 2000 A.D.

# Adoption of the Standard

The Shari'ah Standard on Procrastinating Debtor was adopted by the Shari'ah Board in its meeting No. (4) held on 25-27 Safar 1421 A.H., corresponding to 29-31 May 2000 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (1) held in Bahrain on Saturday 11 Dhul-Qa'dah 1419 A.H., corresponding to 27 February 1998 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah standard on procrastinating debtor.

On Saturday 11 Dhul-Qa'dah 1419 A.H., corresponding to 27 February 1999 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft.

In its meeting held in Bahrain on 13-16 Rabi' I, 1420 A.H., corresponding to 27-30 June 1999 A.D., the Shari'ah Studies Committee discussed the juristic study and introduced certain amendments to it. The Committee further discussed the exposure draft of the standard in its meeting No. (3) held in Bahrain on 9-11 Rajab 1420 A.H., corresponding to 18-20 October 1999 A.D., and asked the consultant to make additional amendments to reflect the comments made by the members.

The revised exposure draft of the standard was presented to the Shari'ah Board in its meeting No. (2) held in Mecca on 10-15 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard, and decided that the amended exposure draft should be distributed to specialists and interested parties to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 29–30 Dhul-Hajjah 1421 A.H., corresponding to 4-5 April 2000 A.D. The public hearing was attended by more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested

in this field. Members of the Shari'ah Studies Committee responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Studies Committee held its meeting No. (5) on 22-24 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., to discuss the comments made about the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of both the discussions that took place in the public hearing, and the written comments that were received.

The Shari'ah Board in its meeting No. (4) held on 25–27 Safar 1421 A.H., corresponding to 26-28 May 2000 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Studies Committee, and made the necessary amendments, which deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Muharram 1433 A.H., corresponding to November 2011 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (38) held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia on 28 Sha'ban - 1 Ramadan 1435 A.H., corresponding to 26-28 June 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved the necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Default on the Part of a Debtor**

The debtor must settle his debt when it is due. Default in payment by a debtor who is able to settle the debt is prohibited. The Prophet (peace be upon him) says: *"Default in payment on the part of a solvent debtor is unjust."*(2) He (peace be upon him) also says: *"Delay in payment by a solvent debtor would be a legal ground for his being publicly dishonoured and punished."*(3) Moreover, he (peace be upon him) approved the statement of Salman Al-Farisi to Abu Al-Darda` saying: "Give everyone his right."(4) Muslim scholars have agreed on the permissibility of a debtor being punished in such circumstances.(5) However, an insolvent debtor should be granted a grace period.

(2) Related by Al-Bukhari in his *"Sahih"* [2: 999], Dar Al-Qalam edition, Damascus, 1401 A.H./1981 A.D.; Muslim in his *"Sahih"* [10: 288], Al-Maktabah Al-Misriyyah edition with the commentary of Al-Nawawi, Cairo, 1349 A.H./1930 A.D.; and Ahmad in his *"Musnad"* [2: 71 and 345], Al-Maktab Al-Islami edition, Damascus.

(3) Related by Ahmad in his *"Musnad"* [4: 388-399], and all relators of Hadith except Al-Tirmidhi, Al-Bayhaqi, Al-Hakim and Ibn Hibban who deemed it authentic. Al-Bukhari deemed it 'suspended'. In his *"Fath Al-Bari"*, Ibn Hajar has said: "Its chain of transmission is good": *"Nayl Al-Awtar"* [5: 240], Mustafa Al-Babi Al-Halabi edition, Cairo, 1378 A.H./1951 A.D.; and *"Fayd Al-Qadir"* [5: 400], Mustafa Muhammad edition. Cairo, 1371 A.H./1938 A.D.

(4) Related by Al-Tirmidhi from Abu Juhayfah quoting the statement of Salman (may Allah be pleased with him) which the Prophet (peace be upon him) approved when mentioned to him saying: *"Salman has said the truth."* Al-Tirmidhi said: "It is an authentic Hadith": "*Sunan Al-Tirmidhi"* [2: 66], Bulaq Edition.

(5) *"Bada`i' Al-Sana`i'"* [7: 173], Dar Al-Kitab Al-Arabi, Beirut, 1982 A.D.; *"Al-Muhadhdhab"* [3: 245], Dar Al-Qalam edition, Damascus, 1417 A.H./1996 A.D.; *"Al-Mughni"* [4: 501], Maktabat Riyad Al-Hadithah, Riyadh; *"Hashiyat Qalyubi"* [2: 288], Dar Al-Fikr edition, Beirut, no date; *"Mu'jam Al-Mustalahat Al-Iqtisadiyyah"*, (P. 314); The International Institute of Islamic Thought edition, Virginia, USA, 1415 A.H./1995 A.D.; and *"Dalil Al-Mustalahat Al-Fiqhiyyah Al-Iqtisadiyyah"*, (P. 274), Kuwait Finance House edition, Kuwait, 1412 A.H./1992A.D.

**Stipulation of, or Legal Claim for, Compensation for Late Payment of the Debt**

It is not permitted to stipulate as a condition of a contract involving indebtedness that in case of default the debtor should pay compensation, or to have a legal claim for compensation against a defaulting debtor, whether such arrangements are made at the beginning of the contract or on its maturity, since this would constitute Riba and any such stipulation or arrangement is null and void. This is because the Prophet (peace be upon him) says: *"Muslims are bound by their contractual conditions, except those that render impermissible what is permissible or render permissible what is impermissible."*(6) There is also the reason that, during the pre-Islamic period, lenders who charged interest used to say to their debtors: "Do you want to settle now or to pay an additional amount for a further period of credit?". The prohibition of any loan which requires a payment in excess of the amount lent has also been reported on the authority of many companions from the Prophet (peace be upon him). On this basis, a decision was reached by the International Islamic Fiqh Academy which reads as follows: "It is impermissible from the Shari'ah perspective to stipulate a condition of compensation in the case of delay in the settlement of a debt".(7)

No penalty clause may be applied in the case of a delay in settling a debt, as any increase in the amount of the debt is Riba; this is in contrast to the application of a penalty clause to other cases of delay, such as delay in fulfilling construction or Istisna'a contracts. As the judgement on this issue by the court is binding, it is therefore not permitted to stipulate such a condition directly in the contract creating a debt or to enforce it subsequently by recourse to the judiciary.

(6) This Hadith has been narrated by a number of the companions and it was related by Ahmad in his *"Musnad"* [1: 312]; Ibn Majah through a good chain of transmission [2: 783], Mustafa Al-Babi Al-Halabi edition, Cairo, 1372 A.H./1952 A.D.; Al-Hakim in his *"Mustadrak"*, Hyderabad edition, India, 1355 A.H.); Al-Bayhaqi in his *"Sunan"* [6: 70 and 156] and [1: 133], Hyderabad edition, India, 1355 A.H.; and Al-Darqutni in his *"Sunan"* [4: 228] and [3: 77], Dar Al-Mahasin Lil-Tiba'ah edition, Cairo, 1372 A.H./1952 A.D.

(7) International Islamic Fiqh Academy Resolution No. (51); and *"Majallat Majma' Al-Fiqh Al-Islami"*, No. 6 [1: 193]; and No. 6 [2: 9].

**Litigation Expenses**

A defaulting debtor must bear the litigation expenses and other expenses relating to his default in payment as he is the cause of the expenses.(8)

**Disposal of a Mortgaged Asset**

It is permissible for the creditor to demand the selling of a mortgaged asset and other properties belonging to a debtor which are in his possession for the purpose of liquidation and recovery of the debt. Furthermore, it is permissible for the creditor to obtain a mandate from the debtor to sell the mortgaged assets or other properties of the debtor, because such disposal is permissible for the creditor, and such a practice would speed up the procedures for disposing of the charged asset.(9)

**Maturity of Instalments in the Case of Instalment Credit**

It is permissible for the creditor to impose the condition that, if the debtor is late in paying one instalment, all the instalments become due. To this effect, there is a decision by the International Islamic Academy of Fiqh, the text of which reads as follows: "It is permissible for a seller on deferred credit terms sale to impose the condition that instalments become due before their original due date in case of the delay of the debtor in paying some of the instalments, so long as the debtor consented to this condition when the contract was agreed".(10) Such a condition would be valid, as there is no Shari'ah text to the contrary, and it serves a lawful interest of the creditor.(11) Giving prior notice to the debtor before giving effect to such

(8) Some of the jurists have stated this such as Ibn Taymiyyah in *"Al-Ikhtiyarat"* and in "*Mukhtasar Al-Fatawa"* (P. 346), Al-Mawardi in *"Al-Insaf"* and Sheikh Muhammad Ibn Ibrahim Al Al-Shaykh (see: Paper by Sheikh Ibn Mani' in the Fourth Fiqh Conference (pp. 226-227), organized by Kuwait Finance House 1416 A.H./1995 A.D.

(9) *"Al-Rawd Al-Murbi'"*, (P. 74), 2nd edition, Dar Al-Turath, Cairo.

(10) International Islamic Fiqh Academy Resolution No. (51); *"Majallat Majma' Al-Fiqh Al-Islami"* No. 6 [1: 193] and No. 7 [2: 9]. This has been reinforced by the Resolution No. 64 (2/7); see: *"Majallat Jami'at Al-Malik 'Abd Al-'Aziz"*, Al-Iqtisad Al-Islami, (P. 89).

(11) Ibn Abidin says; "If one says, I have invalidated the deferred period and I have abandoned it, the debt becomes due on the spot": *"Hashiyat Ibn Abidin"* [5: 157], Dar Al-Fikr edition, Beirut, 1399 A.H./1979 A.D. The Shari'ah Supervisory Council of the Kuwait Finance House has supported this in its Fatwa No. (542). *"Al-Fatawa Al-Shar'iyyah Fi Al-Masa'il Al-Iqtisadiyyah"*, Kuwait Finance House, [4: 18].

a condition is merely of the nature of a reminder, so as to provide him with reasonable time for payment.

**The Right to Repossess a Sold Asset**

If an asset sold by Murabahah or another sales contract is still available to the seller, and the purchaser has defaulted in the payment of the price, and subsequently has become bankrupt, then the seller is entitled to repossess the sold asset instead of initiating legal proceedings to obtain a bankruptcy order. This judgement is based on the report of Abu Hurayrah (may Allah be pleased with him) that the Prophet (prayers and peace of Allah be upon him) said: If one party has sold an asset and the other party (the purchaser) has become bankrupt, and the former party has managed to retain the asset, then he is more qualified to take possession of the asset in preference to the other creditors.(12)

**A Commitment on the Part of the Debtor to Make a Donation in Case of Default**

The permissibility of stipulating a condition, whereby the debtor in case of default is obliged to donate a sum of money (in addition to the amount of the debt) to be spent by the creditor (the Institution) on charitable causes, is because this has been considered as an instance of the commitment to make a donation, which is well established in the Maliki school of law. This is the opinion of Abu Abdullah Ibn Nafi' and Muhammad Ibn Ibrahim Ibn Dinar, two Maliki jurists.(13)

**Guarantor**

A guarantor is liable for anything for which the debtor whose debt is guaranteed is liable, because standing as a surety adds one obligation to another with respect to the liability. This is in line with the Quranic verse expressing the statement of Prophet Yusuf (peace be upon him) saying: ***{"... and I will be a guarantor to it"}***.(14) Also, the Prophet (peace be upon

(12) This Hadith has been related by Al-Bukhari in his *"Sahih"* [2: 846]; and Muslim in his *"Sahih"* [10: 221]. Also, see: *"Al-Muhadhdhab"* by Al-Shirazi [3: 253], Dar Al-Qalam edition, Damascus 1417 A.H./1996 A.D.

(13) See the book entitled: *"Tahrir Al-Kalam Fi Masa'il Al-Iltizam"* by Al-Hattab and the legal opinions of the Fourth Fiqh Conference organized by the Kuwait Finance House.

(14) [Yusuf (Joseph): 72].

him) affirmed the suretyship of Abu Qatadah in respect of the debt of a deceased person, when Abu Qatadah said; "I take responsibility as surety for both (two dinars), O Messenger of Allah."[15] It is a principle of law that the demand for payment from either the debtor or guarantor is permissible, as this is the very essence of suretyship, so long as there is no stipulation that the demand be in sequence; that is, it must start with the debtor and once he refuses to pay, payment will be demanded from the guarantor, because this sequence is a valid stipulation and believers are bound by their stipulations.

**Contractor or Concessionaire**

It is permissible to impose penalty clauses in contracts for constructions, Istisna'a and supply contracts, as such clauses are included in what may be validly stipulated as part of the contract. This does not render the impermissible permissible, or vice versa, and it complies with the Hadith of the Prophet (peace be upon him): *"Muslims are bound by contractual conditions, except those that render impermissible what is permissible or render permissible what is impermissible."*[16] Also, this is based on the statement of Shurayh (may Allah confer mercy upon him) saying: "Whoever has bound himself by a contractual condition voluntarily without any coercion, is bound by that condition". The International Islamic Fiqh Academy has also issued a decision which states: "It is permissible to include in an Istisna'a contract a penalty clause according to what is agreed upon by the two contracting parties provided that there are no unusual circumstances.[17] In addition, it is a juristic principle in the Hanbali school of law. This is also what has been decided by consensus of the Council of the Eminent Scholars of Saudi Arabia, in the following words: "The council has decided by consensus that a penalty clause that is stipulated in a contract is a valid and enforceable stipulation".[18] It is well known that the stipulation of the penalty clause is permissible only for non-financial obligations.

(15) Related by Al-Bukhari in his *"Sahih"* [2: 800-803]; Ahmad and others.
(16) This Hadith has been previously explained under Note No. (5).
(17) International Islamic Fiqh Academy Resolution No. 56 (3/7); see also the Journal of the Academy vol. 2, issue No. (7), (p. 223).
(18) Research papers by the Eminent Scholars of the Kingdom of Saudi Arabia, vol. 1, the penalty clause, Maktabat Ibn Khuzaymah edition, Riyadh, 1412 A.H.

**Non-Material Penalties Applied to the Debtor in Case of Default**

The grounds for such penalties lie in the jurists' decision which is based on their interpretation of the Hadith of the Prophet (peace be upon him): *"Delay in payment by a solvent debtor would be a legal ground for his being publicly criticised and punished"*.(19) A public complaint about his default in payment is not a prohibited slander; on the contrary, there is an obligation to warn other companies about his character, as this falls under the category of advice which it is a duty to give.

**General Provisions**

a) The monitoring of the affairs of the default debtor, is a kind of pursuing that has been established by the Shari'ah jurists. This pursuit is intended to make recovery from the defaulting debtor out of assets that he may have concealed from the knowledge of the creditor. In the circumstances, such pursuit does not constitute interference in the affairs of others.

b) The debtor may, entirely at his own discretion without any condition or customary practice, pay an additional amount when settling the debt, and this is part of good settlement following the saying of Allah: ***{"...No ground (of complaint) can there be against the Muhsinun (good-doers)..."}.***(20) Also, the prophetic Hadith says: *"Verily the best of you is he who is the best in the settlement of debt."*(21) The Prophet (peace be upon him), occasionally used to pay an additional amount when settling a debt. The permissibility of this practice depends on the discretionary nature of this extra payment and the absence of any stipulation or customary practice of making such a payment, since the existence of such a customary practice would be inconsistent with the condition that the extra payment be entirely discretionary and not stipulated.

c) It is permissible to accept the extra amount paid by the debtor following the proofs mentioned earlier.

(19) This Hadith has been previously explained under Note No. (3).
(20) [Al-Tawbah (Repentance): 91].
(21) Related by Al-Nasa`i on the authority of Al-'Irbad Ibn Sariyah: *"Fayd Al-Qadir"* [3: 497].

d) A stipulation by an Institution that it may recover amounts owing to it by a defaulting debtor by right of set-off from accounts of the debtor that are kept by the Institution is valid, since believers are bound by their stipulations. This right of set-off, even though it does not require the consent of the debtor, should preferably be documented in the contract that establishes the indebtedness, in order to shorten the procedures in case of dispute. This right is based on the amicable right of recovery that is based on Shari'ah evidence including the saying of the Prophet (peace be upon him) to the wife of Abu Sufyan: *"Take (from his property) what would suffice you and your child amicably."*(22)

(22) Related by Al-Bukhari and Muslim: *"Al-Lu`lu` Wa Al-Marjan"*, No. (1115).

# Appendix (C)
# Definitions

**Default in payment**

Delay in the settlement of an obligation or in paying an amount due for payment, without any legitimate reason.

**Procrastinating debtor**

A debtor who is solvent but refuses to pay a debt that is due, without any legitimate reason, after receiving the normal demand for payment.

**Penalty clause**

An agreement between two parties to a contract stipulating a pre-determined amount of compensation that will be due to the obligee, should the obligor delayed carrying it out.

Shari'ah Standard No. (4)

# Settlement of Debts by Set-Off

(Revised Standard)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The aim of this standard is to outline the rules governing the use of set-off in settling debts, the Shari'ah requirements and conditions applicable to set-off, what is permissible or not permissible in this procedure and the most significant practices of Islamic financial Institutions (Institution/ Institutions)(1) in this regard.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers the settlement of debt by way of set-off. The standard shall not apply to discharge of liability by way of transfer, waiving of obligation, composition, acquisition of a right payable or bilateral cancellation of a contract, as they are covered by their respective Standards.

## 2. Definition of Set-Off and Its Various Forms

A set-off is to extinguish a debt receivable by a debt payable. It is divided into two main forms: mandatory set-off and contractual set-off.

### 2/1 Mandatory set-off

A mandatory set-off is a set-off that occurs without the need for bilateral agreement or consent of both indebted parties and, in some cases of mandatory set-off, it is one party that is forced to comply with the request of the other party for set-off. It is divided into compulsory set-off (on both parties)[2] and set-off on demand (of the person with the superior debt whereby the other party is obliged to comply with the demand).

2/1/1 A compulsory set-off is the spontaneous discharge of two debts that is not contingent on the request or consent of both or either party.

2/1/2 The conditions of the permissibility of compulsory set-off are the following:

a) Each party should be a creditor and debtor simultaneously.

b) Both debts should be equal in kind, type, description and maturity. However, if the two debts are not equal in amount, a set-off will take place of an equivalent amount on both

(2) Compulsorily set-off is a set-off that occurs without a need to bilateral agreements or consents of the parties.

sides, and the party that is owed the larger debt will remain a creditor for the remaining balance.

c) Neither of the two debts should be encumbered by an obligation to a third party, such as the right of a mortgagee to one of the debts. The intention of this is to protect rights associated with the amount of the debt and belonging to third parties.

d) The set-off should not be arranged in a manner that results in violation of a rule of Shari'ah, such as Riba (usury) or *Shubhat al-Riba* (a transaction potentially involving Riba).

2/1/3 A set-off on demand is the discharge of two debts at the request of the creditor for the superior debt and his consent to forgo the excess of the amount or privilege he is owed over what he owes. This set-off will take place whether or not the creditor for the smaller debt consents.

2/1/4 The conditions of permissibility of a set-off on demand are the following:

a) Each party should be a creditor and debtor simultaneously.

b) The creditor for the superior debt, in terms of quality and duration, should consent to relinquish his additional right or privilege. An example of superiority in terms of quality is when the debt is secured by a mortgage, or when a third party has given a guarantee to pay the debt, and the owner of the secured debt consents to relinquish this guarantee. Superiority in terms of duration exists if the duration of one of the debts is shorter, or one debt is now due and the other is not yet due. In these cases, the debt which has the shorter duration or which is now due is superior.

c) Both debts should be similar in kind and type, but not necessarily in quality and date of maturity. However, if the two debts are not equal in amount, a set-off will take place of an equivalent amount on both sides, and the party that is owed the larger debt will remain a creditor for the remaining balance.

d) The set-off should not be arranged in a manner that results in violation of a rule of Shari'ah, such as Riba (usury) or a transaction potentially involving Riba.

**2/2 Contractual set-off**

2/2/1 A contractual set-off is the discharge of two debts by the consent of the two parties to extinguish their obligations towards each other.

2/2/2 The conditions of the permissibility of a contractual set-off are the following:

a) Each party should be a creditor and debtor simultaneously.

b) The two parties should mutually consent to the set-off.

c) The set-off should not be arranged in a manner that results in violation of a rule of Shari'ah, such as Riba or a transaction potentially involving Riba.

2/2/3 A contractual set-off is permissible even without the need for two debts to be similar in kind, type, description or maturity. This is because the agreement on contractual set-off means that each party has agreed to relinquish any extra privilege associated with his debt. A contractual set-off is also permissible if the two debts are not equal in terms of amount, in which case a set-off will take place of an equivalent amount on both sides, and the party that is owed the larger debt is entitled to request payment of the remaining balance. [see item 2/10 (a) of the Shari'ah Standards on Trading in Currencies]

**3. Bilateral Exchange of Promises to Conclude a Set-Off in the Future**

It is permissible for the Institution and its customers or other Institutions to exchange bilateral promises that debts that may be created between them in the future will be settled by way of set-off, in which case all the conditions mentioned in the items 2/1 and 2/2 will be applicable at the time of actual set-off. However, if the currencies of the two debts differ, a bilateral exchange of promise of set-off should be concluded on the basis

that a set-off will take place based on the current currency exchange rate at the time of actual set-off; this ruling is to prevent the practices of Riba by roundabout methods or by implied agreement for practicing Riba.

## 4. Application of the Rules of Set-Off to Some Modern Transactions

The followings are some rules of set-off to modern transactions:

4/1 Stipulating set-off between the customer and the Institution in respect of debts to the Institution arising out of sales on deferred payment. The agreement on contractual set-off of future debts, commonly known as set-off and consolidation, is a practice employed by a large number of financial Institutions. This form of set-off may take place either compulsorily or contractually depending on whether the situation that gives rise to this set-off meets the conditions of compulsory set-off or the conditions of contractual set-off. Moreover, by pre-stipulating this type of set-off in the agreement, a fresh agreement may be avoided at the time of set-off when the two currencies are different or when one of the debts is superior to the other.

4/2 A set-off may take place between a financial Institution accepting a cheque and the drawer of the cheque, through the clearing-house. This form of set-off may also take place either compulsorily or contractually depending on whether the state that gives rise to this set-off meets the conditions of compulsory set-off or the conditions of contractual set-off.

4/3 Set-off that is concluded among financial Institutions through international or national networking systems, such as credit card or debit card organisations. This form of set-off may be either compulsory or contractual depending on whether the state that gives rise to this set-off meets the conditions of compulsory set-off or the conditions of contractual set-off.

## 5. Currency Swaps

The currency swaps that are concluded on the basis of Riba are not permissible. This is because in this process it is the interest-based securities that are set-off against interest-based securities.

## 6. Date of Issuance of the Standard

This Standard was issued on 29 Safar 1422 A.H., corresponding to 23 May 2001 A.D.

# Adoption of the Standard

The Shari'ah Standard on Settlement of Debts by Set-off was adopted by the Shari'ah Board in its meeting No. (6) held on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (2) held in Makkah Al-Mukarramah on 10-14 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on settlements of debt by way of set-off.

On Tuesday 27 Ramadan 1420 A.H., corresponding to 4 January 2000 A.D., one Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft.

In its meeting held in Bahrain on 18-19 Rabi' I, 1421 A.H., corresponding to 20-21 June 2000 A.D., the Shari'ah Studies Committee discussed the juristic study and made certain amendments to it. The committee also discussed the exposure draft of the Standard in its meeting No. (6) held in Bahrain on 20-21 Jumada II, 1421 A.H., corresponding to 18-19 September 2000 A.D., and asked the consultant to make some amendments in light of the comments made by the members.

In its meeting No. (7) held in Bahrain on 5-6 Sha'ban 1421 A.H., corresponding to 1-2 November 2000 A.D., the Shari'ah Studies Committee discussed the exposure draft and made some relevant amendments.

The revised exposure draft of the standard was presented to the Shari'ah Board in its meeting No. (5) held in Mecca on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2000 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 4-5 Dhul-Hajjah 1421 A.H., corresponding to 27-28 February 2001 A.D. The public hearing was attended by

more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Members of the Shari'ah Studies Committee responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Studies Committee held its meeting No. (8) on 16-17 Dhul-Hajjah 1421 A.H., corresponding to 11-12 March 2001 A.D., to discuss the comments made about the exposure draft. The Committee made the necessary amendments in light of both the written comments that were received and oral comments that took place in the public hearing.

The Shari'ah Board in its meeting No. (6) held in Al-Madinah Al-Munawwarah on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D., discussed the amendments made by the Shari'ah studies committee, and made necessary amendments. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Muharram 1433 A.H., corresponding to November 2011 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (38) held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia on 28 Sha'ban to 1 Ramadan 1435 A.H., corresponding to 26-28 June 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved the necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

The basis for debt settlements by way of set-off is that it has been practised from time immemorial without any report of disapproval. Moreover, set-off is in line with the objectives of the Shari'ah as it encourages discharging individuals from liability of debt and set-off is one way of discharging debt liabilities without involving futile processes of debt recovery.

In addition, there is no Shari'ah objection to a set-off taking place on demand. The authority for this permissibility is that the person entitled to the superior debt has agreed to forgo the advantage attached to his debt and the Shari'ah will not object to such a gesture.

If set-off is executed contractually, it is then based on the prophetic Hadith stating; *"Muslims are bound by the conditions and agreements they have made, except a condition that has rendered the unlawful lawful or rendered the lawful unlawful."*(3)

(3) The Hadith has been related by Al-Tirmidhi in his *"Sunan Al-Tirmidhi"* [3: 634] edited by Ahmad Muhammad Shakir and others, Beirut: Dar Ihya` Al-Turath Al-'Arabi. Also, it has been related by Al-Bayhaqi in his *"Sunan Al-Bayhaqi"* [7: 248]; and Al-Manawi, *"Fayd Al-Qadir"* [6: 272], Egypt: Al-Maktabah Al-Kubra, 1356 A.H..

# Appendix (C)
# Definitions

**Debt and Loan**

A debt is any liability that is not in terms of a specified or defined item, whatever the cause of its establishment, i.e. whether its origin is in cash or in a commodity, or in a particular described benefit such as the benefit of using particular things or services of persons. For instance, the consideration in deferred sales and loans is described as a debt.

The relationship between a loan and a debt is that the latter is more general than the former, since every loan is described as a debt but the converse is not true. Not all debts originate from a loan. In this sense, a loan is but one cause of the creation of debt.

**Due Debt**

A due debt is a debt that is immediately payable or that is payable on the creditor's demand, whether on its original due date or, if it has been rescheduled and deferred, on its rescheduled due date.

**Deferred Debt**

A deferred debt is a debt the payment thereof is due at a certain time in the future, and it may also be due in periodic instalments over time.

**Description**

A description is a condition that distinguishes particular specimens of the same species from one other. For examples, conditions such as good quality and poor quality, or mortgage of security or personal guarantees, letters of guarantee and the freezing of the amount of cheques for payment which are attached to the debt are considered descriptions.

**Ibra` (discharge)**

An act by a person to discharge another person from a liability (owed by the latter to the former)

**Reconciliation (Sulh)**

An agreement to solve dispute between parties.

**Iqalah (Mutual Rescission of Contract)**

Revocation of a contract and cancellation of its effects with mutual consent of both parties.

## Shari'ah Standard No. (5)

# Guarantees

## (Revised Standard)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The aim of this standard is to outline the Shari'ah rules governing guarantees, and to clarify the forms of guarantees that are permissible or prohibited. It also outlines some significant modern applications of guarantees as employed by Islamic financial Institutions (Institution/ Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers securities (Guarantees) intended to secure obligations and protect debts against procrastination and default. Such securities may take the form of written documents, attestations, personal guarantees, mortgages, cheques and promissory notes. The standard also explains the permissible and prohibited forms of securities. It also intends to distinguish between liabilities and the assets held on trust.

The standard does not cover guarantees against torts.

## 2. General Rulings on Guarantees

### 2/1 Permissibility of guarantees and their relevance to contracts

2/1/1 A contract of guarantee is permissible in contracts of exchange, e.g. a contract of sale, or contract of rights, e.g. right of intellectual property. Such a guarantee contract does not affect the permissibility of the original contract in which it is required. It is, moreover, permissible to stipulate a guarantee into the body of an original at one time, because guarantee is appropriate to, or relevant in, contracts.

2/1/2 There is no objection in Shari'ah to include a number of guarantees in one contract, such as incorporating a personal guarantee together with a mortgage of security in the same contract.

### 2/2 Guarantees in trust (fiduciary) contracts

2/2/1 It is not permissible to stipulate in trust (fiduciary) contracts, e.g. agency contracts or contracts of deposits, that a personal guarantee or mortgage of security be produced, because such a stipulation is against the nature of trust (fiduciary) contracts, unless such a stipulation is intended to cover cases of miscon-

duct, negligence or breach of conditions or stipulations. The prohibition against seeking a guarantee in trust contracts is more stringent in Musharakah and Mudarabah contracts, since it is not permitted to require from a manager in the Mudarabah or the Musharakah contract or an investment agent or one of the partners in these contracts to guarantee the capital, or to promise a guaranteed profit. Moreover, it is not permissible for these contracts to be marketed or operated as a guaranteed investment.

2/2/2 It is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest-based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to Riba). But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his clients independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent.

## 2/3 Guaranteeing existing leased properties

The lessor bears the risk associated with the leased property and the lessee holds it on a trust basis. Hence, it is not permissible for the lessor to stipulate in the lease contract that the lessee provide a guarantee or mortgage of security, etc., so that he may use it to recover the amount of the lease rental if the leased property is damaged, unless such a stipulation is restricted to cases of misconduct, negligence or breach of contract. Therefore, the lessor is liable for the consequences of any damage to the leased property that is not caused

by the misconduct or negligence of the lessee, and is responsible for any related insurance expenses. The lessor also bears the expense of any major maintenance work required to keep the leased property in the condition necessary to provide the contractual benefits under the lease.

**2/4 Written documentation and attestation**

2/4/1 Documentation in writing is recommended by Shari'ah, whether such documentation is in the form of ordinary (private) or official documents. However, customary practice is applicable in the drawing up of such documents and in determining the documents that are relevant as proof (or have evidential value). It is prohibited to forge documents or to conceal their contents or to destroy them so as to bring about the loss of other peoples' rights.

2/4/2 Attestation in financial transactions is recommended by Shari'ah. It is also commendable, and in case of necessity it is obligatory, to give testimony. On the other hand, perjury is prohibited and is one of the major sins.

2/4/3 It is not permitted to scribe or witness acts prohibited by Shari'ah, such as certifying or witnessing borrowing on the basis of interest.

**3. Personal Guarantees**

**3/1 Permissibility and types of personal guarantee**

3/1/1 It is permissible for an Institution to stipulate that a customer should provide one or more guarantors to secure the debts owed by the customer.

3/1/2 Personal guarantees are divided into two types. One type is a guarantee where the guarantor has a right of recourse to the debtor, and this guarantee is offered at the request or with the consent of the debtor. The other type is a non-recourse guarantee, which is offered voluntarily by a third party without the debtor's request or consent (voluntary guarantee).

3/1/3 An Institution is not entitled to guarantee financial commitments without a right of recourse to the debtor, i.e. to be a non-recourse guarantor, unless the Institution is already authorised by its shareholders and investors to make donations or to perform acts of benevolence.

3/1/4 It is permissible to fix the duration of a personal guarantee. It is also permissible to set a ceiling on the amount to be guaranteed and it is permissible that the personal guarantee be restricted by, or be contingent upon, a condition. In addition, it is permissible that such a guarantee be made contingent upon a future event, for example, by fixing a future date at which liability will commence and, in this case, the guarantor may validly withdraw the guarantee, by notifying the creditor, before the prospective obligation to be guaranteed arises.

3/1/5 It is not permissible to take any remuneration whatsoever for providing a personal guarantee per se, or to pay commission for obtaining such a guarantee. The guarantor is, however, entitled to claim any expenses actually incurred during the period of a personal guarantee, and the Institution is not obliged to inquire as to how the guarantee produced has been obtained by the customer. [see item 7/1/1 and 7/1/2)]

**3/2 Guaranteeing unknown (Majhul) and future debts**

A valid guarantee may be given for debts, the exact amount of which is unknown. Similarly, a valid guarantee may be given for a debt that will arise in the future. However, it is permissible for the guarantor to withdraw such a guarantee before a future debt is actually created, after notifying the person having interest in the guarantee. This is called a "market (business) guarantee," or a "guarantee of contractual obligation." An example of this type is a third party's guarantee to refund the price to the buyer if it appears that the sold commodity belongs to a person other than the seller and this guarantee is known as *Daman al-Dark* (dealers/business misrepresentation guarantee).

### 3/3 The effect of a personal guarantee

3/3/1 The creditor is entitled to claim the amount of his debt from either the debtor or the guarantor and he has the choice of claiming his right from either of them. However, the guarantor is entitled to arrange the order of liability, for example, by stipulating (at the conclusion of the contract of guarantee) that the creditor shall first claim payment from the principal debtor and that the creditor is entitled to recourse to the guarantor for payment only if the principal debtor refuses to fulfil his obligation.

3/3/2 If the creditor discharges the debtor from the debt, the guarantor is also discharged automatically from his liability. However, if the creditor discharges the guarantor from liability, the debtor remains in debt. If the guarantor secures a discount that results in paying an amount less than the original debt, the guarantor is entitled to recover only the amount he has actually paid to the creditor; he cannot demand that the debtor pay the debt in full ignoring the discount. This rule is intended to prevent a procedure being used that potentially leads to Riba. However, if the guarantor reaches an agreement with the creditor to settle the debt using as consideration a commodity of a different type from that in which the original debt was designated, the guarantor is entitled to recover the exact amount of the commodity provided as consideration for the debt, or the exact amount of the debt, whichever is less.

3/3/3 It is permissible for a personal guarantee contract to be designated in a separate contract. It can also be concluded together with, or before, or after, the conclusion of the contract of a credit transaction.

3/3/4 If an Institution manages transactions on the basis of Mudarabah or Musharakah or investment agency, it is not permitted for it to guarantee the fluctuations of currency exchange rates so that the investors will recover their investment shares irrespective of the behaviour of the currency market. Such a guarantee is prohibited

because it is tantamount to the Mudarib or partner or investment agent guaranteeing the capital of other partners or investors, which is prohibited by Shari'ah. [see items 2/21 and 2/2/2]

3/3/5 If the contract of a credit transaction stipulates that the debtor shall provide a guarantor and the debtor fails to provide one, the Institution is entitled to initiate legal action to force him to provide a guarantor or to terminate the contract.

## 4. Mortgage (Rahn)

It is to make a financial asset or so tied to a debt so that the asset or its value is used for repayment of the debt in case of default. [see Shari'ah Standard No. (39) on Mortgage]

## 5. Cases of Achieving the Objectives of Securities

### 5/1 Bringing forward future instalments in case of default on payment

It is permissible to include a term in a debt contract to the effect that, if the debtor defaults on the payment of one or more instalments, some or all of the future instalments shall fall due immediately, provided the default was not caused by unforeseeable intervening events or force majeure. However, this term shall not be effective until the debtor has been served with a reminder notice and after a reasonable period of time has elapsed.

### 5/2 Termination of a sale on deferred payment terms in case of failure to pay

The seller is entitled, in a contract of sale on a deferred payment basis, to stipulate that if the buyer fails to pay the price within a certain period of time, the seller is entitled to revoke the contract and repossess the sold asset without recourse to the courts.

## 6. Some Contemporary Applications of Securities

### 6/1 Letters of guarantee

6/1/1 It is not permissible to take remuneration for issuing a letter of guarantee, whether it is with cover or without cover, if the remuneration is intended as consideration for the guarantee

*per se*, since the amount guaranteed and the duration of the guarantee are usually taken into consideration in computing remuneration.

6/1/2 Asking an applicant for a letter of guarantee to bear administrative expenses incurred in issuing a letter of guarantee of either type (i.e. preliminary or final) is permissible in Shari'ah, provided the remuneration for such expenses do not exceed the commission that others would charge for such services. Where full or partial cover is provided, it is permissible, in estimating the expenses for issuing a letter of guarantee, to take into account anything that will reflect the actual service to be rendered in providing a cover for the transaction.

6/1/3 It is not permitted for the Institution to issue a letter of guarantee in favour of an applicant who will use it to acquire an interest-based loan or to conclude a prohibited transaction.

**6/2 Documentary credit**

It is a written undertaking by a bank (known as the issuer) given to the seller (the beneficiary) as per the buyer's (applicant's or orderer's) instruction or is issued by the bank for its own use, undertaking to pay up to a specified amount (in cash or through acceptance or discounting of a bill of exchange), within a certain period of time, provided that the seller present documents for the goods conforming to the instructions.

In brief, a documentary credit is an undertaking by a bank to pay subject to conformity of the documents to the contractual instructions. [see Shari'ah Standard No. (14) on Documentary Credit]

**6/3 Use of cheques or promissory notes**

There is no Shari'ah objection to obtaining cheques or promissory notes from the debtor (unless not allowed by law) as a means to force the debtor to make timely payment of instalments in cash, whereby if the debtor pays on time such cheques or promissory notes shall be returned to him, and in the event of default on payment they

may be produced for recovery. The party providing these cheques or promissory notes as security is entitled to obtain an undertaking from the Institution that they will be used only for timely recovery of its due debts without any addition.

**6/4 Insurance for doubtful or bad debts**

It is permissible to subscribe to an Islamic insurance coverage as security for debt obligations and it is not permissible that debts be insured on a conventional insurance basis.

**6/5 Freezing cash deposits (blocking withdrawals)**

6/5/1 In order to secure the future payment of debts on a single payment or an instalment basis, it is permissible for the Institution to stipulate, that it is entitled to freeze the customer's investment account, or to revoke his right to withdraw money from such an account entirely or to block an amount in the account equivalent to the debt, which is the preferred option. Nevertheless, the customer remains entitled to share profits on the whole balance of the investment account after deducting the Institution's share for acting as a Mudarib.

6/5/2 In a credit transaction, it is not permitted for the Institution to stipulate a right to freeze the customer's current account. However, a stipulation of this kind is allowed where the customer has freely, willingly and absolutely agreed to his current account to be frozen.

**6/6 Third party guarantees (voluntary undertakings to compensate an investment loss)**

It is permissible for a third party, other than the Mudarib or investment agent or one of the partners, to undertake voluntarily that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked in any manner to the Mudarabah financing contract or investment agency contract.

**6/7 Underwriting the subscription of shares issued (subscription guarantee)**

6/7/1 It is permissible for the Institution to undertake that it will underwrite the remaining shares offered for subscription after the expiry of the offer period, provided the shares are underwritten at the offer value without any consideration for the underwriting per se.

6/7/2 The underwriter is entitled to receive consideration for a service it provides other than the guarantee, such as conducting a feasibility study or marketing the shares.

**6/8 Guarantees in tenders, security deposits in Murabahah transactions and 'Arboun (Earnest Money)**

6/8/1 It is permissible to obtain guarantees for tenders and this includes both the amounts paid for participating in the bid (primary cash security for participating in the bid) and the amounts paid when the contract is awarded to the successful bidder (final cash security providing evidence of ability to complete the project). Such amounts shall be considered as being held on trust by the offeror of the bid on behalf of the successful bidder, and are not viewed as 'Arboun (Earnest Money). Hence, such amounts are recoverable if they are intermingled with other amounts of money (i.e. irrespective of any unwanted circumstances). Moreover, it is not permissible to confiscate such amounts of money, except in compensation for an equivalent amount of financial damage actually sustained in the tendering process. Such amounts may be invested in the benefit of the customer with his consent, unless he requests it to be credited to his current account.

6/8/2 It is permissible for the Institution, in the case of a unilateral binding promise, to take a sum of money called *Hamish Jiddiyyah* (security deposit) from the purchase orderer (customer) as security for his promise. This sum of money is held on trust, not as

'Arboun, because no contract has been established. The rules set out in item 6/8/1 apply here. Where the customer fails to honour his binding promise, the Institution is not permitted to retain the security deposit as such. Instead, the Institution's rights are limited to deducting the amount of any damage actually incurred as a result of the breach, namely the difference between the cost of the item to the Institution and its selling price to a third party.

6/8/3 It is permissible to take 'Arboun from a buyer or lessee when a sale or lease contract is concluded, on condition that, if the contract is not terminated within the specified period during which the option to terminate the contract remains valid, such an amount will be considered as part of the consideration for the contract and, if the buyer or lessee fails to perform the contract within this period, the seller or lessor is entitled to retain the amount. It is, however, preferable that the Institution should refund to the customer any balance remaining after deducting from the 'Arboun the amount of any damage actually sustained by it.

## 6/9 Priority right of recovery and the right to follow up

6/9/1 The Institution is entitled to recover first its tangible items that were sold to or manufactured for a customer and have not been paid for and can be identified among the assets of the customer.

6/9/2 The Institution is entitled to protect the integrity of the subject of a guarantee, such as a mortgaged asset, and pursue a legal action against misusing it if it is established that the person holding it is using it in a manner that may lead to losses to be borne by the Institution.

6/9/3 The rights of the parties holding mortgages of security shall be given priority over the rights of the parties who are unsecured. [see Shari'ah Standard No. (39)]

6/9/4 In the event of bankruptcy or liquidation, the parties in charge of the liquidation have a preferential right or priority over other creditors in recovering their rights; i.e. the cost of any services provided in the process of liquidation. [see Shari'ah Standard No. (43) on Insolvency]

## 7. Date of Issuance of the Standard

This Standard was issued on 29 Safar 1422 A.H., corresponding to 23 May 2001 A.D.

# Adoption of the Standard

The Shari'ah Standard on Guarantees was adopted by the Shari'ah Board in its meeting No. (6) held on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (2) held in Mecca on 10-14 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Guarantees.

On Tuesday 27 Ramadan 1420 A.H., corresponding to 4 January 2000 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft.

In its meeting held in Bahrain on 18-19 Rabi' I, 1421 A.H., corresponding to 20-21 June 2000 A.D., the Shari'ah Committee discussed the juristic study and made certain amendments to it. The committee also discussed the exposure draft of the Standard in its meeting No. (6) held in Bahrain on 20-21 Jumada II, 1421 A.H., corresponding to 18-19 September 2000 A.D., and asked the consultant to make some amendments in light of the comments made by the members.

In its meeting No. (7) held in Bahrain on 5-6 Sha'ban 1421 A.H., corresponding to 1-2 November 2000 A.D., the Shari'ah Committee discussed the exposure draft and made some relevant amendments.

The revised exposure draft of the standard was presented to the Shari'ah Board in its meeting No. (5) held in Mecca on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2000 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 4-5 Dhul-Hajjah 1421 A.H., corresponding to 27-28 February 2001 A.D. The public hearing was attended

by more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Members of the Shari'ah studies committee responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Committee held its meeting No. (8) on 16-17 Dhul-Hajjah 1421 A.H., corresponding to 11-12 March 2001 A.D., to discuss the comments made about the exposure draft. The committee made the necessary amendments in light of both the written comments that were received and oral comments that took place in the public hearing.

The Shari'ah Board in its meeting No. (6) held in Al-Madinah Al-Munawwarah on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D., discussed the amendments made by the Shari'ah Committee, and made necessary amendments. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Muharram 1433 A.H., corresponding to November 2011 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (38) held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia on 28 Sha'ban - 1 Ramadan 1435 A.H., corresponding to 26-28 June 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Guarantees and Its Relevance to Contracts**

The basis of the permissibility of stipulating guarantees in contracts is that it protects property, which is one of the objectives of Shari'ah. The other authorities mentioned in the standard in support of each kind of guarantee can be cited as authority for the permissibility of guarantees in contracts.

**Guarantees in Trust Contracts**

Assets held on trust must be returned to their owners in the manner in which they were received and in their original physical state promptly after the owners demand their return. Allah, the Almighty, says: ***{"Allah doth command you to render back your trusts to those to whom they are due"}.***(2) Since such assets are not subject to exchange, they are purposely meant either for custody with permission to use them, such as assets on deposit, or for charitable acts, such as a loan of tangible assets. Therefore, the persons holding such assets are considered by the owners from the beginning as capable of returning them to their owners on demand, making them trustees, and as a principle of Shari'ah, a trustee is not held liable (for loss of, or damage to, an asset held on trust), except in circumstances of misconduct, negligence or violation of the conditions agreed upon, because in other circumstances it is inconsistent with the fundamental principle of trusts for a trustee to be held liable.

**Written Documentation and Attestation**

Written documentation is recommended by Shari'ah. This is the opinion of the majority of Fuqaha, in contrast to Ibn Hazm who argued that written documentation is an obligation (i.e. if one did not put his financial

(2) [Al-Nisa` (Women): 58].

transactions in writing he has committed a sin) relying on the literal meaning of the Qura`nic verse: ***{"O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period time, reduce them to writing"}***[3] and the Quranic Verse: ***{"Disdain not to reduce to writing your contract for a future period, whether it be small or big".***[4] The majority of Fuqaha have also inferred that this verse itself excluded written documentation in the cases of trustworthiness, as the last part of the following verse says: ***{"And if one of you deposits a thing on trust with another, let the trustee (faithfully) discharge his trust and left him fear Allah his Lord."}***

It must be noted that customary practice is the basis in determining the form and evidential value of written documentation, because Shari'ah did not specify a particular manner of writing to be considered. As for the permissibility of attestation as documentation, the authority for that is the following Qura`nic verse: ***{"And get out two witnesses, out of your own men. And if there are not two men, then a man and two women, such as ye choose, for witnesses, so that if one of them errs, the other can remind her"}.***[5]

The evidential value of attestation according to traditional Fuqaha is stronger than that of written documentation. But in modern times, things have changed so that some laws rely on witnesses only in a very limited number of cases and paramount importance is given to written documentary evidence.

## Personal Guarantees

### Permissibility of personal guarantees

Personal guarantees derive their permissibility from the Qura`n, Sunnah, consensus and reasoning. In the Qura`n, Allah, the Almighty, says: ***{"They said: 'We miss the great beaker of the king; for him who produces it, is (the reward of) a camel load; I will be bound by it'"}.***[6] In Sunnah, there is the Hadith narrated by Salamah Ibn Al-Akwa', who said: "We were with the

(3) [Al Baqarah (The Cow): 282].
(4) [Al Baqarah (The Cow): 282].
(5) [Al Baqarah (The Cow): 282].
(6) [Yusuf (Joseph): 72].

Prophet (peace be upon him) when a deceased person was brought. They said, 'O Prophet of Allah, perform prayers on him.' He (peace be upon him) said, *'Has the deceased left anything?'* They said, 'No.' He (peace be upon him) said, *'Is he in debt?'* They said, 'Three dinars.' He said, *'Perform prayers on your companion.'* Abu Qatadah said, 'O Messenger of Allah, perform prayer on him, and I am responsible for his debt.' Then the Prophet (peace be upon him) performed prayers on him."[7] In another text of the Hadith, he (Qatadah) said: "I guarantee (to pay) his debt."[8]

The Fuqaha are unanimous on the permissibility of personal guarantees. Moreover, the need of people for personal guarantees to facilitate dealings with each other had also made them legitimate, particularly in the case of customers who lack a good credit record. In addition, personal guarantees encourage performance and prevent the contract from being breached and this security also justifies their permissibility.

The objection to taking consideration for personal guarantees is that giving a guarantee is one of the charitable acts that should be offered without consideration, and this ruling has generated consensus among the Fuqaha. Moreover, a personal guarantee indicates a readiness to give away the amount of a loan, which means that the guarantor will pay the loan (if the principal debtor fails to pay) and have recourse to the guaranteed person for fulfilment. Hence, it is not permissible to take consideration for a guarantee, because it is not permissible to take consideration for giving away the amount of the loan itself, since such consideration is considered to be Riba.

**Guaranteeing unknown and future debts**

The Shari'ah basis for the permissibility of guaranteeing the unknown is the general meaning of the Hadith: *"The guarantor is liable."*[9] because

(7) Related by Al-Bukhari in his *"Sahih"* [2: 800], Dar Ibn Kathir and Yamamah.

(8) *"Sunan Al-Nasa`i"* [7: 317]; *"Sunan Ibn Majah"*, [2: 804]; and Al-Bayhaqi in *"Al-Sunan Al-Kubra"* [4: 95].

(9) The Hadith has been related by Ahmad, Abu Dawud, and Al-Tirmidhi: *"Al-Darari Al-Mudiyyah"* [1: 399], Dar Al-Jil; Ibn Majah in his *"Sunan Ibn Majah"* [2: 804], Dar Al-Fikr; and Al-Bayhaqi in *"Al-Sunan Al-Kubra"* [6: 72], Maktabat Dar Al-Baz.

this Hadith makes no distinction between guaranteeing the known and the unknown since there is no harm or element of dispute arising due to uncertainty here, because the unknown transaction guaranteed will become certain and known, and the guarantor will know, after the debt is incurred, the actual obligation he undertakes. Another authority for the permissibility of guaranteeing what is not known is the Quranic verse: ***{"...for him who produces it, is (the reward of) a camel load and I will be bound by it".***[10] Here, the guarantor guaranteed a camel load although it was not yet a debt.

The evidence for the creditor's right to demand payment from either the debtor or the guarantor is that the debt is established as liability of both of them, hence the right to demand payment from either of them. The permissibility for stipulating that the creditor has first to ask for payment from the principal debtor and that he may ask the guarantor for payment only if the debtor fails to pay, is based on an opinion in the Maliki school of law[11] and it is also an opinion of the Hanafis.[12] These opinions argued that if the debtor is solvent then demanding payment from the guarantor is pointless, unless the debtor refuses to pay. So, the requirement that payment be first sought from the debtor has a Shari'ah basis as well as being a case of adherence to a principle of natural justice.

**Bringing Forward Future Instalments in Case of Default in Payment**

The basis for this condition is the Hadith of the Prophet (peace be upon him): *"Muslims are bound by the conditions they made,"*[13] and because payment on a deferred basis is the right of the debtor, and the debtor may choose to pay before time and relinquish the deferral of the date of payment entirely. If this is the case, the date of payment may also be based on default so as to strengthen the collectibility of the debt and secure payment on time. The basis of the rule enabling the creditor to demand payment of all instalments in the event of default, instead of waiting until each instalment

(10) [Yusuf (Joseph): 72]. ***"I will be bound by it"*** means being a guarantor.

(11) Ibn Rushd, *"Al-Bayan Wa Al-Tahsil"* [11: 291].

(12) *"Bada`i' Al-Sana`i'"* [7: 2423].

(13) Related by Al-Bayhaqi in *"Al-Sunan Al-Kubra"* [6: 79], Maktabat Dar Al-Baz; Al-Daraqutni in his *"Sunan Al-Daraqutni"* [10: 27], Dar Al-Ma'rifah; Ibn Abu Shaybah in his *"Musannaf"* [4: 450], Maktabat Al-Rushd; and Al-Tahawi in *"Sharh Ma'ani Al-Athar"* [4: 90], Dar Al-Kutub Al-'Ilmiyyah.

is due, is the possibility that during the period of delay in payment the debtor may find a means to conceal his assets and claim insolvency. The permissibility of this condition is confirmed by the Resolution No. (51) issued by the International Islamic Fiqh Academy.

**Termination of a Sale on Deferred Payment Terms in Case of Failure to Pa**

The basis for this is that the seller has consented to deferred payment only if it will not lead to a loss of what is due to him. This is the opinion of the majority of Fuqaha, as opposed to the Hanafis who have confined the creditor's right to litigation, unless he has stipulated the right to terminate the contract and "Muslims are bound by conditions they made."

**Guarantees and Their Modern Applications**

**Letters of Guarantee**

The basis of the rule that no remuneration may be taken for a guarantee per se is that it is a surety, and as such it is one of the contracts of charity since it involves a readiness to give away the amount of a loan for no consideration. The majority of Fuqaha agree that it is prohibited to take consideration for guarantee. However, issuing the letter of guarantee is a service that justifies charging fees.

The prohibition of issuing a letter of guarantee for unlawful acts is analogous to the prohibition of giving assistance in committing a sin. The Hadith: *"Allah curses the one who gives Riba and the one who takes it and the one who writes its contract and the two witnesses involved"*(14) also supports this ruling, because the personal guarantor has a stronger role in establishing and recovering a debt than the writer of the contract and the witness mentioned in the Hadith.

**Documentary credits**

The basis for the permissibility of charging fees for a documentary credit is that issuing a documentary credit is a service performed in the interest of the applicant for the documentary credit, for which the Bank has the right to charge fees.

(14) Related by Muslim in his *"Sahih"* [3: 1219], Dar Ihya` Al-Turath Al-'Arabi; and the five compilers of Hadith, and see: Al-Shawkani *"Nayl Al-Awtar"* [5: 296], Dar Al-Jil.

**Use of cheques or promissory notes**

The Shari'ah basis for obtaining cheques or promissory notes from the debtor as a guarantee is the general sources on the permissibility of guarantees in general.

**Insurance for debts**

Islamic insurance is based on the principle of donation, and Gharar is tolerable in such conditions. In Islamic insurance, the instalments that are paid are provided within a framework of donations organised for the mutual benefit of the contributors to the insurance fund. The permissibility of Islamic insurance is confirmed by the resolutions issued by the Islamic Fiqh Academy of the World Muslim League [(15)] and the International Islamic Fiqh Academy of the Organisation of Islamic Conference.[(16)] Although this form of insurance falls within the meaning of a guarantee, the guarantee here is not provided in return for conditional consideration as such, hence the permissibility of subscribing to an Islamic insurance coverage as security for doubtful or bad debts.

**Freezing cash deposits**

The basis for the permissibility of stipulating a right to freeze acustomer's investment account is the permissibility of pledging funds, in addition to the fact that the purpose behind such freezing is to be able to agree on a set-off if it appears that the pledgor of the balance is in debt to the bank. It is a form of mortgage to secure a possible future debt. The basis for the prohibition of stipulating a right to freeze a customer's current account is that such a right would be tantamount to a combination of a sale on deferred payment terms and a loan transaction; i.e., it amounts to a deferred sale with a condition to provide a loan, which is prohibited by Shari'ah.

**Third party guarantees**

The basis for third party guarantees is that they are a promise to volunteer to remedy a loss of capital under an investment contract with a party other

(15) The First Session, Resolution No. (5).
(16) Resolution No. 9 (9/2).

than the volunteer. This is a permissible act as a volunteer, as is evidenced in the Holy Qura`n: ***{"No ground (of complaint) can there be against such as do right,"}.***[17] A resolution passed by the International Islamic Fiqh Academy states as follows:

> "There is no Shari'ah objection to mention in the prospectus of the issue or in the documents of Muqaradah (Mudarabah) bonds the promise of a third party, who is independent personally and in terms of financial liability from the two parties to the contract, to volunteer an amount of money for no consideration to be allocated to make good a loss on a particular project. However, this is circumscribed with a condition that such a promise should be an obligation independent from the Mudarabah contract. In other words, the third party's performance of his obligation should not be a condition for the enforcement of the contract and the conditions and liabilities of the parties to the contract. As such, holders of the bonds or the manager of the Mudarabah are not entitled to claim that they may fail to honour their obligations relating to their contracts because the volunteer failed to fulfil his promise because the performance of their obligations takes into consideration the promise to volunteer."[18]

**Underwriting the subscription of shares issued**

If such underwriting is offered without consideration, it is considered as a personal guarantee for no consideration, and this is permissible in Shari'ah. However, if it is for consideration, the basis for its prohibition is what we have mentioned in respect to taking a commission for a guarantee. [see item 4/1]

**Guarantees in tenders, security deposits in Murabahah transactions and 'Arboun (Earnest Money)**

The basis for the permissibility of guarantees in tenders and earnest money is the afore-mentioned authority for guarantees in general. Both guarantees in tenders and security deposits are permissible because they facilitate obtaining compensation for actual damages in case of breach of contract. The basis for obtaining the earnest money to secure performance

(17) [Al-Tawbah (Repentance): 91].
(18) Resolution No. 30 (5/4)

is the practice of Umar Ibn Al-Khattab (may Allah be pleased with him) in the presence of some companions of the Prophet (peace be upon him), which has been permitted by Imam Ahmad. A resolution has been issued in connection with the permissibility of 'Arboun (Earnest Money) by the International Islamic Fiqh Academy.(19)

**Priority right of recovery and the right to follow up**

The basis for the permissibility of the priority of certain rights, such as those of liquidators, is that these rights are considerations that are determined by the judiciary on the basis of public interest. The basis for giving priority to a person whose assets per se have contributed to the increase of the bankrupt's assets, and have been located and identified, is the Hadith of the Prophet (peace be upon him): *"If one sells a commodity, and the owner thereof becomes bankrupt, and then he finds it without being altered, he has more right over it than the other creditors."*(20) A resolution in connection with the permissibility of preference was issued by the Second Fiqh Seminar hosted by Kuwait Finance House, based on a number of Fiqh rulings determining certain preferences that include priority in the recovery of debts. The right of following up the subject of a mortgage is based on the fact that the aim of the mortgage is to facilitate recovery of the amount of the debt and leaving the debtor without a right of follow-up will defeat this objective.

(19) Resolution No. 72 (3/8) in respect of 'Arboun (Earnest Money).

(20) Related by Al-Bukhari and Muslim with different texts as follows: *"If one finds his property without being altered in the possession of a bankrupt, he has more right over it than the other creditors"*: *"Sahih Al-Bukhari"* (H: 2402); and *"Sahih Muslim"* (H: 1559).

# Appendix (C)
# Definitions

**Payables:**

Debts that are absolutely payable and liabilities held on trust basis, either because of being contractually created, or because unjust enrichment has given rise to a liability for restitution.

**Liabilities:**

Liabilities held on trust basis, i.e., obligations that are not subject to compensation for any loss suffered except in circumstances of misconduct, negligence or violation of the conditions agreed upon.

Shari'ah Standard No. (6)

# Conversion of a Conventional Bank to an Islamic Bank

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The aim of this standard is to explain procedures, mechanisms and treatments that are required for converting a conventional bank to an Islamic bank (bank/banks)[1] that observes the rules and principles of Shari'ah in its operations and financial relationships, and, at the same time, embraces the objectives and functions of Islamic banking services. The standard also includes an outline of significant Islamic banking activities that constitute alternatives to conventional banking practices that are in place prior to conversion.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers fundamental mechanisms for converting a conventional bank to a bank that complies with Shari'ah rules and principles right after the decision to undertake immediate comprehensive conversion within a particular designated period that is announced, whether such a decision comes from within the bank or from outside the bank to be converted by outside parties interested in converting it. The standard covers the time frame required for the conversion, the effect of conversion on the methods used to solicit and receive deposits, and the method to be used to invest such deposits. The standard provides guidance on how to treat the receivables and liabilities realized by the bank prior to the conversion, whether or not such receivables and liabilities are received or paid. The standard includes a treatment of the prohibited assets that are in the possession of the bank before conversion and the appropriate ways of disposing of them.

The standard does not cover activities of the converting bank that are naturally permissible or the profit made by permissible means, as these are not the subject matter of the conversion. This is because there is no Shari'ah objection to the bank continuing such activities or employing them for its own benefit. The standard also does not cover activities of Islamic windows or departments or units in conventional banks.

## 2. Time Frame for the Conversion

2/1 It is necessary that all Shari'ah requirements be executed in the process of converting a conventional bank to a potential Islamic bank. It is also necessary that the Shari'ah rules and principles be observed in respect of all new transactions after conversion. In principle, the transactions that are concluded before the decision to convert must be ceased or disposed of immediately. It is not permissible to delay clearing out non-permissible transactions

unless such delay becomes a necessity or a pressing need. Thus, the circumstances surrounding the conversion must be taken into consideration in order to avoid the risk of failure or a breakdown of the bank's operations, taking into account that the provisions of this standard will be applied to accommodate the situation.

2/2 If the bank did not decide on an immediate and comprehensive conversion as per item 2/1 and decided to adopt a gradual or partial conversion, then it is not regarded as a converted bank and may not be granted a licence as an Islamic bank unless the conversion process is completed. The shareholders are required to accelerate the process of conversion in order to free themselves from the sin of impermissible activities. This standard may be used as a guideline for identifying the steps of conversion.

2/3 The impermissible profits realised and transactions concluded during the period of conversion can be treated as per the explanation in items 8-11.

**3. Necessary Measures for Conversion**

3/1 For the success of the process of conversion, it is necessary that the bank set up all necessary procedures, create the required tools, explore alternatives to non-permissible financial practices, and train and promote the personnel required for proper implementation of the procedures of conversion.

3/2 The appropriate administrative arrangements must be in place, including changing the bank's operating license if required by the supervisory authorities, and amending the bank's by-laws (memorandum and articles of association) through the required procedures so that they include objectives and operational measures that are appropriate to Islamic banking. The by-laws must be cleansed from anything that contradicts the nature of Islamic banking.

3/3 Restructuring the organizational structure of the bank and its employment procedures, conditions and employee statutes to fit the situation of conversion.

3/4 Formation of a Shari'ah supervisory board and an internal Shari'ah compliance department in accordance with the Governance Standards issued by Accounting and Auditing Organization for Islamic Financial Institutions.

3/5 Reformatting or designing standard contracts or specimens or exemplars of documents that comply with Shari'ah rules and principles.

3/6 Opening accounts with local or international Islamic banks and revamping of the accounts that are maintained with local or corresponding conventional banks [see, item 4 (b)]. Any dealings with conventional banks must be limited to the magnitude of the need to do so.

3/7 Preparing a special programme for preparing personnel and training them to deal with the application of Islamic banking practices.

3/8 Taking necessary measures for the implementation of accounting, auditing, governance, and ethics standards issued by Accounting and Auditing Organization for Islamic Financial Institutions.

**4. Dealings with Banks**

4/1 Exerting all possible efforts to adapt the ways of dealing with central banks regarding deposits, liquidity needs or otherwise in a way that does not conflict with the rules of Shari'ah, especially rules that govern Riba transactions. The possible alternatives to the reserve amount required by law include, among others, depositing receivables represented by commercial paper to be paid later by customers instead of accepting the freezing of the cash account. The bank can also finance government projects using Islamic instruments. Among the possible alternatives for the purpose of set-off is for the bank to maintain current accounts that accrue no interest or disposing of the interest earned, if that is impossible, and adapting the ways of dealing with the central bank for acquiring liquidity, for example, by the opening of investment accounts for the central bank.

4/2 Revamping the transactions with conventional banks on the basis of Riba free transactions and the application of instruments acceptable by Shari'ah.

4/3 Intensifying transactions with Islamic financial Institutions through bilateral exchange of current or investment accounts and considerable cooperation in the areas of remittances, documentary credits and syndicated financing.

## 5. Providing Banking Services in Permissible Ways

In providing banking services, it is not permissible for the bank to receive interest as compensation for services rendered. It is a requirement that an Islamic alternative be worked out, such as treatment of uncovered documentary credits through Murabahah, Musharakah or Mudarabah in accordance with the rules of Shari'ah. It is not permissible to take a commission for providing a mere facility. However, the commission may be linked to expenses incurred for the execution of the credit facility accordingly.

## 6. Effect of Conversion on the Interest Based Receivables and Their Shari'ah Alternatives

6/1 All traces of conventional transactions whereby the bank originated monetary assets and is liable to pay interest for them must be liquidated. This is the rule whether such transactions involve individuals, banks or central banks. This liquidation includes, among others, the conditions relating to the deposits, preference shares, investment bonds and interest-based certificates that were issued by the bank before the decision for conversion. [see item 9]

6/2 The bank must confine itself to permissible operations for acquiring the necessary funds to operate or to meet its liabilities. Examples of such operations are:

6/2/1 The shareholders may increase their share capital in order to increase the bank's capital and provide a basis for attracting investment accounts and current accounts.

6/2/2 Issuance of Islamic certificates such as Mudarabah, Musharakah or Ijarah certificates within the parameters of Shari'ah.

6/2/3 Concluding Salam contracts whereby the bank acts in the capacity of a supplier, or Istisna'a contracts whereby the bank

acts in the capacity of a manufacturer or builder with the condition that the contract price of the Istisna'a is paid to the bank in advance, although the deferment of payment of the price in Istisna'a is allowed by Shari'ah.

6/2/4 Concluding a sale-and leaseback deal by selling some of the assets of the bank for liquidity and leasing them back by means of an Ijarah contract. This transaction must take into account the Shari'ah Standards on Ijarah and Ijarah Muntahia Bittamleek whereby the contract of sale must be independent from the contract of lease, i.e. the two contracts must remain separate from each other.

6/2/5 Concluding Tawarruq deals in line with Shari'ah principles by buying a commodity on a deferred payment basis and selling it to a third party, other than the previous seller, for immediate payment.

6/3 If the capital of the bank has increased due to non-permissible transactions or the accumulation of reserves based on non-permissible transactions, then its treatment must be in accordance with the treatment of non-permissible receivables or other non-permissible assets in the possession of the bank as discussed below. [see items 8 and 10]

**7. Effect of Conversion on Investments**

7/1 All interest-based investment instruments must cease to be used and must be replaced by permissible investment instruments such as Mudarabah, all Shari'ah-nominate partnerships, diminishing Musharakah, sharecropping partnerships (agricultural, planting or irrigation partnership) or financing by way of deferred sales, Murabahah, Salam, Istisna'a, operating Ijarah, Ijarah Muntahia Bittamleek or other permissible financing and investment instruments.

7/2 All possible efforts must be exerted to terminate all interest-based loans that the bank has made before the decision to convert, whether such loans are medium-term or long-term facilities, followed by converting

the principal amounts to financing instruments in accordance with the rules and principles of Shari'ah. If the bank is unable to terminate some of these loans, then the bank must dispose of the interest earned in the manner explained in item 10/2.

## 8. Treatment of the Bank's Non-Permissible Existing Receivables before the Decision to Convert

8/1 Non-permissible assets of the bank originated or acquired before the decision to convert

Starting from the financial period in which the bank decides to convert, the following must be done:

8/1/1 If a conventional bank is acquired with the intention to convert it to an Islamic bank, the new owners are not obliged to dispose of interest and impermissible earnings that have been earned before such acquisition.

8/1/2 If a conventional bank is converted by its existing shareholders into an Islamic bank, then the process of disposing of interest and impermissible earnings should be considered as commencing at the beginning of the financial period in which the conversion starts to take effect. However, for any impermissible earnings that have been distributed prior to conversion, it is necessary, on ethical grounds, for the shareholders and depositors to whom these earnings have been distributed to dispose of them personally. The bank is not bound to do so.

8/1/3 Revenues not yet received that are of doubtful permissibility are not subject to compulsory disposal, whether they were earned before or during the financial period in which the bank decides to convert. The same rule applies to revenues of doubtful permissibility that have been already received because of a belief that they are permissible on the basis of (I) an interpretation of a person who is qualified to perform *Ijtihad* on issues that are subject to personal juristic interpretation, (II) juristic position of an authoritative school of Shari'ah or (III) the opinion of some eminent and knowledgeable scholars.

8/1/4 If the bank has rights to prohibited non-monetary assets, it may receive them with the intent to destroy them. If the bank is entitled to receive consideration for supplying non-permissible assets or services, the bank may receive the consideration with the intent to donate it to charity. The same rule applies to any income that has been acquired from non-permissible assets during the period in which the bank decides to convert. In both cases, the customer should not be allowed to avoid paying the amount receivable or the consideration, otherwise such a customer would end up being entitled to two counter-values of the same transaction: the good or service supplied and the price payable for it.

8/1/5 If the bank is converted and it has, among its tangible assets, impermissible commodities, the bank is obliged to destroy them. If the bank has sold some of these commodities and is yet to receive the price thereof, the price must be received and be donated to charity.

8/1/6 If the property assets of the bank are locations designated for non-permissible activities, they should be changed to locations designated for permissible operations and services.

## 9. Treatment of Non-Permissible Liabilities before the Decision to Convert, Whether the Conversion Is Internal or External

### 9/1 Internal conversion

9/1/1 If the liabilities are in the form of payment of interest, the bank should employ all lawful means to avoid paying such interest. This rule does not apply to the principal amounts of debts or loans. The bank should not pay interest except on the basis of dire need.

9/1/2 If the liabilities are in the form of obligations to provide non-permissible services, then the bank is obliged to make every effort to terminate such liabilities, by refunding the consideration, even if it has to pay compensation for non-fulfilment of such obligations.

**9/2 External conversion through acquisition of the bank by parties interested in converting it.**

If the purchaser is capable of negotiating a deal that could exclude all non-permissible receivables (e.g. interest and non-permissible assets) from the acquisition deal in a way that will make the seller solely liable for non-permissible liabilities, then the Shari'ah requires that the purchaser do so. However, if the acquisition cannot be concluded unless all assets of the bank including the non-permissible assets and receivables are acquired, then the purchaser is required by Shari'ah to act as quickly as possible to dispose of non-permissible liabilities even if the purchaser has to suggest to the creditors of the bank an earlier repayment for a discount.

**9/3 Treatments for impermissible mortgages**

The shareholders must accelerate the redemption of all impermissible mortgages attached to the assets of the bank. In the case of external conversion, the buyer must stipulate that the seller replaces impermissible mortgages with permissible ones.

**10. Disposal of Impermissible Earnings**

10/1 All impermissible earnings acquired by the bank before conversion that need to be disposed of as per the rules in this standard must without delay be paid to charity, unless it is difficult to do so, for example, where complete disposal promptly will lead to the collapse of the bank or bankruptcy. In this case, the implementation of conversion can reasonably take place gradually.

10/2 Any interest and other non-permissible earnings should be channelled to charity and general public utilities. It is not permissible for the bank to use this money, directly or indirectly, for its own benefit. Examples of charitable channels include, among others, training people other than the staff of the bank, funding research, providing relief equipment, financial and technical assistance for Islamic countries or Islamic scientific, academic Institutions, schools, anything to do with spreading Islamic knowledge, and

similar channels. The charity money must go to these channels in accordance with the resolutions of the Shari'ah Supervisory Board of the bank.

## 11. Zakah Obligation on the Bank before the Decision to Convert

When the conversion is initiated by outsiders who acquired the conventional bank for the purpose of converting it, then they are not obliged to make Zakah payment for the past financial periods because the Zakah for previous periods is the liability of the previous owners. The Zakah liability will start to exist for the new owners from the date of the decision to convert. For the purpose of discharging the responsibility to pay Zakah, the owners may apply the Shari'ah Standard No. (35) on Zakah. However, if the decision to convert was made by the shareholders and the Zakah was not paid for the previous financial periods, the shareholders are obliged to pay Zakah for these periods. They must take into account that they are obliged to pay Zakah even if the revenues and the money earned are impermissible because the shareholders are obliged in the first place to dispose of all accrued interest and impermissible earnings. So, the payment of Zakah is part of the obligation to dispose of impermissible earnings and interest.

## 12. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1424 A.H., corresponding to 16 May 2002 A.D.

# Adoption of the Standard

The Shari'ah Standard on Conversion of a Conventional to an Islamic bank was adopted by the Shari'ah Board in its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2000 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Conversion of a Conventional bank to an Islamic Bank.

On Monday 29 Ramadan 1421 A.H., corresponding to 25 December 2000 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft.

In its meeting held in Bahrain on 15-16 Safar 1422 A.H., corresponding to 9-10 May 2001 A.D., the Shari'ah Studies Committee discussed the juristic study and made certain amendments to it. The committee also discussed the exposure draft of the Standard in its meeting No. (10) held in Bahrain on 14 Rabi' I, 1422 A.H., corresponding to 6 June 2001 A.D., and asked the consultant to make some amendments in light of the comments made by the members.

In its meeting No. (11) held in Jordan on 17 Jumada II, 1422 A.H., corresponding to 5 September 2001 A.D., the Shari'ah Studies Committee discussed the exposure draft and made some relevant amendments.

The revised exposure draft of the standard was presented to the Shari'ah Board in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments and discuss them in a public hearing.

A public hearing was held in Bahrain on 29 –20 Dhul-Hajjah 1422 A.H., corresponding to 2-3 February 2002 A.D.. The public hearing was attended by more than 30 participants representing central Institutions, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. The members responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee in its meeting held on 21-22 Dhul-Hajjah1422 A.H., corresponding to 6-7 March 2002 A.D., in the Kingdom of Bahrain discussed the comments made about the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of both the discussions that took place in the public hearing, and the written comments that were received.

The Shari'ah Board in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D, in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Standards Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

# Appendix (B)
# The Shari'ah Basis for the Standard

### Gradual Clearance of Non-Permissible Previous Transactions

The basis for the permissibility of gradual clearance of non-permissible previous transactions due to necessity or need and in accordance with the rules of Shari'ah is because it is not feasible for the converting bank to clear all non-permissible transactions immediately. Therefore, the bank must dispose of the effects of impermissible transactions because this is feasible.

### Necessary Procedures and Mechanisms for Conversion

Since the realisation of the conversion is dependent on the procedures and mechanisms mentioned in this standard, these procedures and mechanisms thus become permissible or in certain circumstances their use becomes obligatory when the conversion will not be realised without applying these procedures and mechanisms. This is because conversion is obligatory, and if an obligation can be realised only by means of a particular way or tool, then the use of such a tool also becomes an obligation.

### Providing Banking Services

The basis for the permissibility of providing banking services that are not related to giving loans on an interest-bearing basis is that such an operation is a practical application of Ijarah and an agency contract with remuneration. If providing these services involves Riba then the operation becomes impermissible as it is a Riba-based transaction that is prohibited by Shari'ah.

### Attracting Investments

The conversion necessitates doing away with the conventional methods of attracting investment funds such as interest-bearing deposits, which should be replaced by the application of Mudarabah and Musharakah contracts or acting as an investment agent. The basis for the impermissibility of using conventional methods of attracting investments is the Saying of Allah,

the Exalted: ***{"But Allah has permitted trade and forbidden usury"}.***[2] The basis for terminating all previous impermissible transactions is the Saying of Allah, the Exalted: ***{"Give up what remains of your demand for usury"}.***[3] Also, a number of Shari'ah boards have issued resolutions for the treatment of pre-conversion liabilities that involve payment of interest by using Shari'ah acceptable instruments and the conversion of interest-based bonds to Islamic certificates and shares.[4] The Fiqh Academy under the auspices of the Muslim World League has issued a resolution confirming the permissibility of Tawarruq (which is one of the instruments that can be used to acquire liquidity).[5]

**Investment of Funds**

- The basis for the rule that the bank must cease investing through making loans and receiving interest is that this is Riba and paying or receiving Riba is prohibited.
- The basis for the alternatives to interest-based transactions provided in this standard is the authorities that are mentioned for each investment instrument in details in the Fiqh books[6] and the Shari'ah Standards.

**Treatment of Impermissible Rights of the Bank before the Decision to Convert**

- The basis for not obliging the bank to dispose of impermissible intangible assets from the previous financial period, i.e. before the year of conversion, is because the management of the bank cannot change rights originating in the previous financial period, as the responsibility and authority for doing so ends at the end of the previous financial period. As for the shareholders (the owners), they are obliged person-

(2) [Al-Baqarah (The Cow): 275].
(3) [Al-Baqarah (The Cow): 278].
(4) *"Qararat Al-Hay`ah Al-Shar'iyyah Li Sharikat Al Rajhi"*: Fatwa No. (106 and 200); *"Fatawa Nadwat Al Baraka"* [11: 6]; *"Fatwa Hay`at Al-Fatwa Wa Al-Raqabah Al-Shar'iyyah li Bayt Al-Tamwil Al-Kuwayti"* No. (415).
(5) *"Qararat Majma' Al-Fiqh Al-Islami Al-Tabi' Li Rabitat Al-'Alam Al-Islami"*, the session held in 1419 A.H.
(6) See: Chapters on Mudarabah, partnerships, agency contract, sales, Ijarah, etc. in different Fiqh books and also the Shari'ah rules for investment and financing instrument issued by Accounting and Auditing Organisation for Islamic Financial Institutions.

ally to dispose of any dividends from non-permissible earnings that were distributed to them, because the responsibility of shareholders remains even after termination of the responsibility of the management at the end of the financial period, i.e. the end of financial period does exonerate shareholders from responsibility.

- The basis for allowing the bank to keep impermissible earnings and income of doubtful permissibility earned on the basis of an interpretation of a person who is qualified to perform *Ijtihad* on issues that are subject to personal juristic interpretation and the juristic position of an authoritative School of Shari'ah, etc., is that the Shari'ah validates actions that occur on the basis of an interpretation that one believes to be valid until such an interpretation is proved incorrect. The scholars are unanimous that in times of social unrest due to the actions of insurgents who believe in their cause by interpretation or *Ijtihad* to the effect that they have a right to do so, the insurgents are entitled to items of property they acquire during this time, even if they realise later that they were wrong and end their act of insurgence.(7)
- The basis for destroying the bank's non-permissible tangible assets in the possession of others before the year of conversion is that these assets are worthless by Shari'ah Standards since they are impermissible. This is because disposing of a prohibited thing is an obligation as in the case when the verse that prohibited liquor was revealed people discharged the wine that was in their possession.

**Treatment of Non-Permissible Liabilities of the Bank before the Decision to Convert**

- The basis for the rule that the bank should refrain from paying interest after the conversion is because such interest is not, by the Shari'ah Standard, a valid debt that should be honoured. Again, repentance through conversion necessitates refraining from prohibited acts including payment of interest. The principle of necessity is the basis for allowing payment of interest if the bank could not refrain from doing

(7) See Ibn Qudamah, *"Al-Mughni"* [12: 250-251], Hajr publication, 2nd edition 1413 A.H., edited by Abdullah Al-Turki and Abdul-Fattah Al-Hulw.

so because of lack of legal protection and the possibility that the bank may be subject to punishment that may prevent the avoidance of paying interest. The payment of interest due to necessity is supported by saying of Allah, the Exalted: ***{"Whoever disbelieved in Allah after his belief, except him who is forced thereto and whose heart is at rest with Faith..."}***(8) and the saying of the Prophet (peace be upon him): *"Verily, Allah, the Exalted, Has forgiven my ummah those act done by mistake, forgetfulness and compulsion".*(9)

- The basis for making a distinction between the principal loan and interest is because the loan contracts per se are valid. It is the interest associated with the loan that is forbidden. This is the view of the Hanafi jurists who say that the loan contract itself is valid and the condition to pay interest is void.(10) Again, the basis for this ruling is the legal maxim that says acts of Muslims must be deemed valid as far as possible even if their acts are based on a non-preferable juristic view.(11)
- The basis for the requirement that the outside buyer interested in converting the conventional bank should exert all possible effort to exclude impermissible rights is that the payment of interest is the responsibility of the seller. Such interest would have no bearing on the buyer of the bank as the seller's right to receive such interest can be taken into account in computing the price to be paid for the bank. If the buyer is unable to convince the seller in this respect, the principle of necessity becomes applicable with regard to payment of interest. The basis for extinguishing Riba-based loans as soon as possible even if such an act will impose on the buyer the need to suggest to the creditor/s early payment of these loans for a discount is the principle of *Da' Wa Ta'jjal* (discount for acceleration of payment) that was endorsed by the resolution of International Islamic Fiqh Academy provided the discount was not agreed upon earlier.(12)

(8) [Al-Nahl (The Bees): 106].
(9) The Hadith is related by Ibn Majah, *"Sunan Ibn Majah"* [1: 695].
(10) See Al-Sarakhsi, *"Al-Mabsut"* [12: 25-26], Dar Al-Ma'rifah.
(11) See Ibn Al-Humam, *"Fath Al-Qadir"* [9: 114], Dar Al-Fikr; Al-Sarakhsi, *"Al-Mabsut"* [7: 86]; Al-Kasani, *"Bada`i' Al-Sana`i'"*, [3: 79], [4: 5], [7: 149 and 177], (Dar Al-Kutub Al-'Ilmiyyah).
(12) International Islamic Fiqh Academy Resolution No. 64 (2/7).

- The basis for requiring that the purchaser accelerate the redemption of all impermissible mortgages attached to the assets of the bank is because Riba is prohibited; hence, securing payment of Riba by personal guarantees or mortgages is also prohibited. It must be noted that the graveness of securing Riba by personal guarantee is greater than graveness of securing Riba by writing and attestation, which were mentioned in the saying of the Prophet (peace be upon him): *"Allah curses the one who take (earn) Riba, the one who gives it, the one who scribe it and the two witnesses"*.(13)

**Treatment of Impermissible Tangible Assets Acquired by the Bank Before the Decision to Convert**

- The basis for destroying the existing tangible assets of the bank after conversion has already been explained. The basis for donating to charity receivables earned from trading in such assets has also been explained earlier. The basis for transforming the locations that were used for impermissible services to locations for permissible services is that the prohibition does not concern the location itself, rather the prohibition relates to the use of the location.

**Disposal of Impermissible Rights**

- The basis for the requirement that impermissible earnings be donated to charity is that these revenues are not permissible for the person who earns them. This is evidenced by the order of the Prophet (peace be upon him) that the usurped goat be given to war prisoners.(14)
- The basis for indicating charity as a way of disposing of impermissible earnings is that by transferring the ownership of these earnings, the characterisation of prohibition in respect to these earnings is changed and they become permissible for the beneficiary. Again, a thing which is prohibited for one person is not necessarily prohibited for another person, i.e. when it is prohibited for one, it may be permissible for other.

(13) The Hadith has been related by Muslim in his *"Sahih"* [3: 1219], verified by Muhammad Fu`ad Abdul-Baqi, Dar Ihya Al-Turath Al-'Arabi.

(14) The Hadith has been related by Al-Daraqutni, *"Sunan Al-Daraqutni"* [4: 285]; and *"Nayl Al-Awtar"* [9: 18].

The International Islamic Fiqh Academy has issued a resolution in support of this ruling.(15)

- The basis for allowing delay in disposal of non-permissible earnings if such disposal will lead a total breakdown of the activities of the bank or its bankruptcy is that the Fuqaha were of the view that a repentant may use impermissible earnings to cover his unavoidable needs. However, the Institution is not entitled to benefit whatsoever, i.e. directly or indirectly, from the earnings that must be disposed of. This is because such benefit adds value to the asset of the Institution.
- The channels for disposing of impermissible earnings include, as well as those mentioned in this standard, all other channels of disposal that the Shari'ah Supervisory Board of each Institution will regard as appropriate channels for disposal of impermissible earnings.

(15) International Islamic Fiqh Academy Resolution No. 13 (1/3).

## Shari'ah Standard No. (7)

# Hawalah

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The aim of this standard is to explain the rulings, types, requirements and limitations of transfers (transfer of debts and transfer of rights), what is permissible or prohibited in this regard, and the applications of transfers in Islamic financial Institutions (Institution/Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers Hawalah transactions that involve a change of debtor, i.e. transfer of debt. The scope of this standard does not cover banking remittances except the remittances that take the form of Hawalah (transfer of debt).

## 2. Definition of Hawalah

Hawalah of debt is the transfer of debt from the transferor (*Muheel*) to the payer (*Muhal Alaihi*). The transfer of right, on the other hand, is a replacement of a creditor with another creditor. The transfer of debt differ from transfer of right in that in transfer of debt a debtor is replaced by another debtor, whereas in a transfer of right a creditor is replaced by another creditor.

## 3. Permissibility of Hawalah

3/1 Hawalah is a legitimate and an independent contract made out of courtesy and is not a contract of sale. It is permitted in order to facilitate payments and recovery.

3/2 The acceptance of Hawalah is recommended for the transferee if the potential payer is known to be solvent and a person who honours payments. This is because Hawalah benefits the creditor and gives relief to the debtor. If the financial status and creditworthiness of the potential payer are unknown, then Hawalah becomes *Mubah* (permissible).

## 4. Form of a Hawalah Contract

4/1 A contract of Hawalah can be concluded by an offer from the transferor and acceptance from the transferee (*Muhal*) and the payer in a manner that clearly indicates the intention of the parties to conclude a Hawalah contract and the transfer of the liability or obligation in respect of

a debt from one party to another party. It is not necessary that the word transfer be used.

4/2 Hawalah is a binding contract. Therefore, it is not subject to unilateral termination.

4/3 It is a requirement that a transfer of debt take effect immediately, not to be suspended for a period of time and not to be concluded on a temporary basis or contingent on future events. However, it is permissible to defer payment of the transferred debt until a future specified date.

## 5. Types of Hawalah and the Applicable Rulings

5/1 Hawalah is divided into restricted and unrestricted Hawalah.

5/1/1 Restricted Hawalah is permissible. It is a transaction where the payer is restricted to settling the amount of the transferred debt from the amount of a financial or tangible asset that belongs to the transferor and is in the possession of the payer.

5/1/2 Unrestricted Hawalah is permissible. It is a kind of transfer of debt in which the transferor is not a creditor to the payer and the payer undertakes to pay the amount of the debt owed by the transferor from his own funds and to have recourse afterwards to the transferor for settlement, provided that the transfer for payment was made on the order of the transferor.

5/1/3 It is permitted to conclude a Hawalah on a spot payment basis. This is a Hawalah in which the debt transferred to the payer becomes payable on the spot, whether the debt has already fallen due and the obligation is then transferred to the payer for immediate settlement, or the transferred debt is yet to fall due and the transferee has required, as a condition for accepting the transfer, that it be paid immediately by virtue of transfer.

5/1/4 It is permissible to conclude a Hawalah contract on a deferred payment basis. This is a Hawalah in which the debt transferred to the payer is to be paid in the future, whether the payment of the debt is not yet due and was transferred as such to the payer,

or the payment of such debt is due but the payer required that it should be transferred for future payment at an agreed date. In the latter case, the payer cannot be asked for payment before the agreed date.

## 6. Conditions of Hawalah

6/1 The permissibility of Hawalah requires the consent of all parties, namely the transferor, the transferee and the payer.

6/2 The permissibility of a Hawalah requires that the transferor be a debtor to the transferee. A transaction in which a non-debtor transfers another is an agency contract for collection of the debt and not a transfer of debt.

6/3 It is not a condition in a Hawalah that the payer be a debtor to the transferor. If the payer is not a debtor to the transferor, the Hawalah will be an unrestricted Hawalah. [see item 5/1/2]

6/4 It is a condition that all Hawalah parties be legally competent to act independently.

6/5 It is a condition in Hawalah that both the transferred debt and the debt to be used for settlement be known and transferable.

6/6 It is a condition for concluding restricted Hawalah that the transferred debt or the transferred portion of the debt be equal to the debt owed to the transferee in terms of kind, type, quality and amount. However, the transferor may transfer a lesser amount of a debt owed to the transferee to be settled from a larger amount owed by the transferor on condition that the transferee be entitled only to the equivalent amount of his debt.

## 7. Effect of Hawalah on the Relationship between the Transferor and the Transferee

7/1 A valid Hawalah discharges the transferor from both the debt liability and any claims in respect of it. In other words, the transferee will have no right of recourse against the transferor for payment. However, if

the acceptance of the transfer was based on the condition that the payer must be solvent, then the transferee will have a right of recourse if the payer is not solvent.

7/2 The transferee is entitled to have a right of recourse against the transferor in situations of (I) death of the payer in bankruptcy, (II) liquidation of an Institution that is the payer in the case of bankruptcy before payment of the debt, (III) the payer is declared bankrupt in his lifetime, or he denies concluding the Hawalah contract and has taken a judicial oath to this effect and there is no evidence to prove otherwise and (IV) the Institution that is the payer is declared bankrupt by a court order.

**8. Effect of Hawalah on the Relationship between the Transferor and the Payer**

After the conclusion of a restricted Hawalah, the transferor is no longer entitled to reclaim from the payer an amount transferred to the payer in respect of the debt to be settled, because the right to receive this amount has now passed to the transferee.

**9. Effect of Hawalah on the Relationship between the Transferee and the Payer**

9/1 The transferee is entitled to claim the amount of the debt assigned to him through Hawalah from the payer in accordance with conditions of Hawalah contract. The payer, on the other hand, is obliged to pay him and has no right to refuse payment.

9/2 The payer takes the place of the transferor in respect to all rights, legal protections and obligations. The transferee in restricted Hawalah takes the place of the transferor in respect to all rights, legal protections and obligations against the payer.

**10. Effect of Death and Bankruptcy on a Hawalah Transaction**

10/1 A Hawalah shall not be annulled by the death of the transferor or liquidation of a transferor Institution. The transferee is the sole owner of the amount of the debt payable by the payer and, after

a Hawalah transaction, such a debt cannot be included in the assets of the transferor that are available to be distributed, after death or liquidation, among creditors on a pro rata basis.

10/2 A Hawalah transaction shall not be annulled due to the death of the payer or the liquidation of the Institution acting as payer. In these cases, the transferee will have the right of recourse against the estate of the payer for recovery, a personal guarantor, if any, or pre-distribution assets of the liquidation. However, if the payer dies in the state of bankruptcy, then the transferee shall be entitled to have recourse to the transferor. [see item 7/2]

10/3 A Hawalah transaction shall not be annulled due to the death of the transferee and the heirs shall replace the transferee. The Hawalah will also not be void in case of liquidation of a transferee Institution in which case the liquidator takes the place of the Institution for settlement.

## 11. Termination of a Hawalah Liability

A Hawalah liability will come to an end by settlement of the debt or by a mutual agreement to terminate it or by the debt being written-off by the transferee.

## 12. Modern Applications of Hawalah Rules

### 12/1 Withdrawals from a current account

An issuance of a cheque against a current account is a form of Hawalah if the beneficiary is a creditor of the issuer or the account holder for the amount of the cheque, in which case the issuer, the bank and the beneficiary are the transferor, the payer and the transferee respectively. If the beneficiary is not a creditor to the issuer of the cheque, then this is not a Hawalah transaction because there can be no Hawalah transaction without an existing debt. In the absence of a debt, the transaction becomes an agency contract for recovery of the amount of the debt on behalf of the transferor, which is permissible by Shari'ah.

**12/2 Overdrawing from an account or overdraft**

If the beneficiary of the amount of a cheque is a creditor to the issuer, then issuing a cheque against the account of the issuer without a balance is unrestricted transfer of debt if the bank accepts the overdraft. If the bank rejects the overdraft, then this is not considered a transfer of debt, in which case the potential beneficiary may have recourse to the issuer.

**12/3 Travellers' cheques**

The holder of a travellers' cheque, the value of which has been paid by him to the issuing Institution, is a creditor to such an Institution. If the holder of the travellers' cheque endorses the cheque in favour of his creditor, it becomes a transfer of debt in favour of a third party against the issuing Institution that is a debtor to the holder of the traveller's cheque. This is a restricted transfer of debt and the amount of the debt is the value of the cheque for which the Institution received payment.

**12/4 Bills of exchange**

12/4/1 A bill of exchange is a form of Hawalah if the beneficiary is a creditor to the drawer. The drawer is, in this case, the transferor who gives orders for the paying bank to pay a certain sum of money at a specified date to the defined beneficiary. The party executing payment of such amount of money is the payer whereas the beneficiary, i.e. the holder of the bill, is the transferee. If the beneficiary is not a creditor of the drawer, then the issuance of the bill of exchange becomes an agency contract to recover or collect the amount of the bill of exchange on behalf of the drawer.

12/4/2 In the absence of a debt obligation between the drawer and the paying bank, the issuance of a bill of exchange becomes an unrestricted Hawalah.

**12/5 Endorsement of a negotiable instrument**

12/5/1 An endorsement of a negotiable instrument in a manner that transfers title to its value to the beneficiary is a form of Hawalah if the beneficiary is a creditor to the endorser. If the beneficiary is not a creditor to the endorser, the endorsement becomes one of agency contract for collection of the amount of the debt.

12/5/2 An endorsement of a bill of exchange on behalf of a client who requires the Institution to transfer, after collection, the amount of the instrument into his account is not a Hawalah. This is a contract of agency that is permissible with or without consideration.

12/5/3 Subject to item 12/5/1, it is permissible for the first beneficiary from a bill of exchange to endorse it in favour of any other party. The second beneficiary may also endorse such a bill of exchange in favour of a third party and so on, in which case the revolving of endorsements is a form of successive Hawalah which is not objectionable in Shari'ah.

12/5/4 It is not permissible to discount bills of exchange by transferring the ownership of their value, before their due date, to an Institution or others for a discounted immediate payment. This is because the transaction in this manner is a form of Riba.

**12/6 Transfer of money (remittances)**

The request of a customer for the Institution to transfer a certain amount of money in the same currency from his current account to a particular beneficiary is a transfer of debt if the applicant is a debtor to such a beneficiary. The fee that the Institution gains from this transaction is consideration for the delivery of the money and it is not an additional amount gained by the Institution over the amount transferred. However, if a remittance is to take place in a currency different from that presented by the applicant

for the transfer, then the transaction consists of a combination of currency exchange and a transfer of money that is permissible. [see item 2/11 of the Shari'ah Standard on Trading in Currencies]

## 13. Date of Issuance of the Standard

This standard was issued on Rabi' I, 1423 A.H., corresponding to 16 May 2002 A.D.

# Adoption of the Standard

The Shari'ah Standard on Hawalah was adopted by the Shari'ah Board in its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2000 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Hawalah.

On 29 Ramadan 1421 A.H., corresponding to 25 December 2000 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft.

In its meeting held in Bahrain on 15-16 Safar 1422 A.H., corresponding to 9-10 May 2001 A.D., the Shari'ah Studies Committee discussed the juristic study and made certain amendments to it. The committee also discussed the exposure draft of the Standard in its meeting No. (10) held in Bahrain on 14 Rabi' I, 1422 A.H., corresponding to 6 June 2001 A.D., and asked the consultant to make some amendments in light of the comments made by the members.

In its meeting No. (11) held in Jordan on 17 Jumada II, 1422 A.H., corresponding to 5 September 2001 A.D., the Shari'ah Studies Committee discussed the exposure draft and made some relevant amendments.

The revised exposure draft of the standard was presented to the Shari'ah Board in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 29–20 Dhul-Hajjah 1422 A.H., corresponding to 2-3 February 2002. The public hearing was attended by

more than 30 participants representing central Institutions, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. The members responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee in its meeting held on 21-22 Dhul-Hajjah 1422 A.H., corresponding to 6-7 March 2002 A.D., in the Kingdom of Bahrain discussed the comments made about the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of both the discussions that took place in the public hearing, and the written comments that were received.

The Shari'ah Board in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Standards Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Hawalah**

The contract of Hawalah derives its permissibility from the Qur`an, the Sunnah, Ijma' (consensus of Fuqaha) and reasoning. Abu Hurayrah (may Allah be pleased with him) narrated that the Prophet (peace be upon him) said: *"Default on payment by a solvent debtor is unjust, and if anyone of you is transferred to a solvent person, he must accept the transfer."*(2) In another text of the Hadith, related by Ahmad and Al-Bayhaqi, the Prophet (peace be upon him) said: *"If one is referred to a solvent person for the recovery of his right, such a person must accept the transfer"*. The Prophet's order that the creditor must accept the transfer means transfer of debt is legal, otherwise he would not give that order.

The permissibility of Hawalah has enjoyed unanimity in Muslim societies and communities from time immemorial and there is no report that anyone has disapproved of it.(3)

The acceptance of a Hawalah contract is recommended for the transferee if the potential payer is known to be solvent and keeps his promises in respect to payments because it benefits the creditor and gives relief to the debtor from liability by the transfer.

The basis that a Hawalah transaction is also *Mubah* (permissible) for the transferee if the financial status and creditworthiness of the potential payer are unknown is that the order in the above-mentioned Hadith does not make it a condition that the payer be solvent for the permissibility of Hawalah. If

(2) *"Sahih Al-Bukhari"* [3: 123]; and *"Sahih Muslim"* [3: 119].

(3) Ibn Qudamah, *"Al-Mughni"* [4: 336]; Al-Buhuti, *"Kashshaf Al-Qina'"* [3: 382]; Al-Buhuti, *"Sharh Muntaha Al-Iradat"* [2: 134]; Ibn Nujaym, *"Al-Bahr Al-ra`iq"* [6: 269]; and Al-Zayla'i, *"Tabyin Al-Haqa`iq"* [4: 171].

the payer is not solvent then the acceptance of the Hawalah by the transferee remains permissible.

**A Hawalah Contract is Binding**

If all its conditions are met, a Hawalah contract becomes binding without any difference of opinion among the scholars.

**Form of a Hawalah Contract**

The contract of Hawalah cannot be concluded on a deferred basis or subject to the happening of a particular event, as it has the character of a contract of (immediate) exchange. This is because by virtue of the Hawalah contract both the transferee (the payee) and the payer have immediately entered into a new contractual relationship. Also, a Hawalah cannot be concluded on a temporary basis nor can it be contingent on future events, because this conflicts with the nature of Hawalah which is the immediate transfer of the debt to the payer.(4)

**Types and Rulings of a Hawalah Contract**

- The scholars have unanimously endorsed the permissibility of restricted Hawalah, whether it is restricted to a debt owed to the transferor by the payer or it is restricted to the value of a tangible good belonging to the transferor in the possession of the payer. The unrestricted Hawalah is permitted by the Hanafis only. They based this permissibility on the Prophet's order that a Hawalah deal must be accepted, without indicating that the payer must be a debtor to the transferor or not. This shows the permissibility of both the unrestricted and restricted Hawalah.(5)
- The basis for the permissibility of a deferred Hawalah contract is that the payer is liable to make payment to the payee (transferee) by virtue of Hawalah. This permissibility is analogous to the permissibility of a deferred guarantee contract. As a matter of principle, a right that is due by virtue of Hawalah is similar to a right that is due by virtue of a guarantee

(4) Ibn Abidin, *"Radd Al-Muhtar"* [5: 349]; *"Durar Al-Hukkam Fi Sharh Majallat Al-Ahkam"* [2: 52]; and *"Al-Mawsu'ah Al-Fiqhiyyah Al-Kuwaytiyyah"* [18: 191-192].

(5) Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 16]; Al-'Ibadi, *"Al-Jawharah Al-Nayyirah"* [1: 316]; Al-Zayla'i, *"Tabyin Al-Haqa`iq"* [4: 174]; and *"Majallat Al-Ahkam Al-'Adliyyah"*, article (686).

contract. Since the latter can be concluded on a deferred basis, so a Hawalah transaction.[6]

- The basis for the permissibility of *Hawalat al-Haqq* (transfer of a right) as advocated by the Hanafis is that its essence is similar to suretyship which is permitted by all four schools of Islamic law, regardless of the name of the contract in this regard.[7] Again, *Hawalat al-Haqq* does not significantly differ from restricted transfer of debt. If one looks at the change of creditor, then the transaction is one of transfer of rights, and if one looks at the change of debtor, it is a restricted transfer of debt. The differences between transfer of debt and transfer of right are evident in some forms, such as when the creditor makes a gift of the amount of his debt claim against the payer to a person who is not a debtor to the transferor. Here, there are not two debts, hence there is a transfer of right and not a restricted Hawalah because of the lack of two debtors, as the transferor here is not a creditor of the beneficiary from the gift.

**Conditions of Hawalah**

- The basis for the necessity of the consent of all the three parties in a Hawalah contract is as follows:
  a) The transferor is required to consent because he might not want a third party to pay the debt on his behalf. Therefore, his consent is necessary for the permissibility of the Hawalah contract.
  b) The transferee must also consent to the Hawalah contract because the Hawalah contract necessitates a transfer of his right to payment from the transferor as debtor to another person (the payer), and people differ in various aspects when it comes to payment of debts.
  c) The payer must also consent in the unrestricted Hawalah because the effect of the Hawalah contract is to make the payer liable for payment and, as a principle; there is no liability without there first being an acceptance of such liability.[8]

(6) Al-Sarakhsi, *"Al-Mabsut"* [20: 71-72]; Ibn Nujaym, *"Al-Bahr Al-Ra`iq"* [6: 270]; *"Durar Al-Hukkam"* [2: 52]; and Al-Balkhi, *"Al-Fatawa Al-Hindiyyah"* [3: 298].
(7) Wahabah Al-Zuhayli, *"Al-Fiqh Al-Islami Wa Adillatuhu"* [5: 171].
(8) Ibn Abidin, *"Radd Al-Muhtar"* [5: 341]; and Mullah Khasru, *"Durar Al-Hukkam"* [2: 308].

- The basis for the requirement that the transferred debt or the transferred part of a debt be equal to the payable debt in kind, type, quality or amount is to avoid Riba. However, this condition does not mean that the liability of the transferor must be similar in quantity to the liability of the payer towards the transferor in order to make a Hawalah contract valid. In other words, a Hawalah contract is permissible even if the amount of one of the two liabilities is either greater or lesser than the other liability provided that the transferee will be paid only an amount equivalent to his debt. For example, one can transfer the right to his creditor to collect 10 dinars, the equivalent amount of his debt, out of the 20 dinars he is owed. The transferor may also direct the transferee to collect five dinars being his right against the payer out of the ten the transferor owes the transferee. Therefore, the similarity in amount that is required here is that the transferee must not take more than the actual amount of his debt. The intention of this is to avoid Riba.(9)

**Effect of Hawalah on the Relationship Between the Transferor and the Transferee**

- The reason for saying that the transferor is discharged from liability after the conclusion of a Hawalah transaction is because this is the legal effect of Hawalah. Hawalah means that the other party (the transferee) is deemed to have received his right to payment by the payer outright, which connotes its obligatory nature. Therefore, the transaction cannot be reversed for the simple reason that if something is transferred then it cannot be argued that it remains in the same place. This means the transferee is not entitled to ask the transferor for payment and the payer, on the other hand, becomes liable for payment.(10)
- The right of the transferee to have recourse, in the event of non-performance by the payer, to the transferor as advocated by the Hanafis is based on a Hadith. It is reported that Uthman Ibn Affan was asked about a situation in which a transfer of debt is concluded and the transferee

(9) Al-Ruhaybani, *"Matalib Uli Al-Nuha"* [3: 325]; Al-Buhuti, *"Kashshaf Al-Qina'"* [3: 308]; *"Hashiyat Al-Dusuqi 'Ala Al-Sharh Al-Kabir"* [3: 327]; and Al-Sawi, *"Hashiyat Al-Sawi 'Ala Al-Sharh Al-Saghir"* [3: 426].

(10) Ibn Qudamah, *"Al-Mughni"* [4: 338].

found the payer had died in a state of bankruptcy. The answer was that the transferee is entitled to return to the transferor for payment, as the right of a Muslim cannot go unfulfilled.(11) This report reveals that the transferor has a right of recourse to the original debtor if the payment is not attained due to bankruptcy or death of the payer.

- The Hadith that says, Muslims are bound by the conditions they made(12) is the basis for the view of the majority of jurists that the transferee has a right of recourse to the transferor if he had stipulated that he accepts the transfer on the basis that the payer is solvent and is capable of paying the amount of the debt. Moreover, this stipulation serves the purpose of the contract; hence, termination of the contract takes place if such a condition is not met.(13)

**The Effect of Hawalah on the Relationship Between the Transferor and the Payer**

The basis for the rule that the transferor loses his claim over the amount of the debt against the payer after the Hawalah transaction is that the right to this claim has shifted to the transferee by virtue of the contract of Hawalah.

**The Effect of Hawalah on the Relationship Between the Transferee and the Payer**

The basis for the rule that the transferee no longer has a financial claim against the transferor is that the contract of Hawalah transfers the liability to pay to the payer.(14)

The right of the payer to be entitled to all rights associated with the securities that were available to the debtor (the transferor) is based on the fact that these securities are associated with the debt of the transfer or, which are the subject matter of the Hawalah contract. These rights are

(11) Ibn Qudamah, *"Al-Mughni"* [4: 339].

(12) This Hadith has been related by Al-Bayhaqi in *"Al-Sunan Al-Kubra"* [6: 79] and [7: 249], Maktabat Dar Al-Baz; and Al-Daraqutni in his *"Sunan Al-Daraqutni"* [10: 27], Dar Al-Ma'rifah.

(13) Ibn Qudamah, *"Al-Mughni"* [4: 339]; Al-Buhuti, *"Kashshaf Al-Qina'"* [3: 387]; and Al-Buhuti, *"Sharh Muntaha Al-Iradat"* [2: 136].

(14) Al-Balkhi, *"Al-Fatawa Al-Hindiyyah"* [3: 297], *"Durar Al-Hukkam Fi Sharh Majallat Al-Ahkam"* [2: 36]; and Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 18].

therefore transferable with the transfer of the debt liability. Hence, the payer is entitled to all these rights as well.(15)

**Effect of Death and Bankruptcy on a Hawalah Contract**

The basis that the death of the transferor will not affect the Hawalah contract is that the transferor, after the Hawalah contract, is not entitled to the transferred debt.(16) In addition, the reason why the death of the payer will not affect the Hawalah contract is that the heirs or the guarantor of the payer, if any, will be liable for payment.(17)

The practices of overdrafts, negotiable instruments and endorsing cheques and bills of exchange are valid because they are practical applications of the concept of Hawalah.

**Transfer of Money (Remittances)**

The International Islamic Fiqh Academy has issued a resolution in respect to the permissible solutions for the combination of transfer of money (banking remittances) and currency exchange.(18)

(15) *"Al-Mawsuah Al-Fiqhiyyah Al-Kuwaytiyyah"* [18: 225]; *"Qanun Al-Mu'amalat Al-Sudani"*, article (510); and Jordanian Civil code, Article (1005).

(16) Al-Babarti, *"Al-'Inayah Sharh Al-Hidayah"* [7: 249]; Al-Zaylai, *"Tabyin Al-Haqa`iq"* [4: 174]; Ibn Abidin, *"Tanqih Al-Fatawa Al-Hamidiyyah"* [1: 293]; Malik, *"Al-Mudawwanah"* [4: 126-127]; Ibn Nujaym, *"Al-Bahr Al-Ra`iq"*, [6: 274]; and Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 17].

(17) *"Durar Al-Hukkam Fi Sharh Majallat Al-Ahkam"* [2: 36]; and *"Al-Mabsut"* [20: 72].

(18) International Islamic Fiqh Academy Resolution No. 8 (1/9).

# Appendix (C)
# Definitions

**Hawalah**

Hawalah is the transfer of a debt liability from the transferor to the payer (i.e. it is a process of changing debtors and creditors)

**Muheel (the transferor)**

The transferor is the principal debtor and who usually refers his creditor to a third party for the collection of the debt. In some forms of Hawalah, he may be a creditor.

**Muhal**

Muhal or the transferee is the creditor or the party who accepts the offer to collect his due from the transferor's debtor. He is also known as Muhal Lahu or Muhtal Lahu.

**Muhal Alaihi**

Muhal Alaihi is the party accepting the debt liability that will be collected from him by the transferee. He is also called Muhtal Alaihi.

**Hawalat al-Haqq**

The transfer of a right from one creditor to another

## Shari'ah Standard No. (8)

# Murabahah*

## (Revised Standard)

* This standard was previously issued by the title "Shari'ah Rules for Investment and Financing Instruments No. (1) Murabahah to the Purchase Orderer. It is reissued as a Shari'ah standard based on the resolution of the Shari'ah Board to reformat all Shari'ah Rules in the form of Shari'ah Standards.

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to explain the Shari'ah basis and rules for a Murabahah transaction, the stages of this transaction beginning from the promise to transferring ownership of the goods to the customer, and the Shari'ah requirements that need to be observed by Islamic financial Institutions.(2)

(2) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers the Murabahah transaction and its various stages, the issues relating to guarantees before concluding a Murabahah deal such as promise, *Hamish Jiddiyyah* (security deposit) and issues relating to guarantees for recovery of the debt created by the Murabahah transaction.

This standard does not cover deferred payment sales that take place on a basis other than that of Murabahah. It also does not cover other trust and bargaining sales.

## 2. Procedures Prior to the Contract of Murabahah

### 2/1 The customer's expression of his wish to acquire an item through the Institution

2/1/1 The Institution may purchase the item only in response to its customer's wish and application, as long as this practice is compatible with the Shari'ah precepts for the contract of sale.

2/1/2 With due consideration to item 2/2/3, it is permissible for the customer to request the Institution to purchase the item from a particular source of supply. However, the Institution is entitled to decline to carry out the transaction if the customer refuses offers from other sources of supply that are more suitable for the Institution.

2/1/3 The customer's wish to acquire the item does not constitute a promise or commitment except when it has been expressed in due form. It is permissible to prepare a single set of documentation to be signed by the customer and to include both the customer's stated wish that the Institution should buy the item from the supplier and a promise to buy the item from the Institution. It is permissible for the customer to prepare such

a document, or it may be a standard application form prepared by the Institution to be signed by the customer.

2/1/4 The customer may obtain statement of prices from the supplier whether they are addressed to the customer by name [specific offer], or with no reference to any named customer [general offer]. In the latter case, the statement is considered as an invitation to negotiate, and not as an offer of sale. It is preferable that the invoice should be addressed to the Institution so as to include an offer of sale from the supplier effective up to the end of a specified period. The contract of sale is deemed concluded once acceptance comes from the Institution.

**2/2 The position of the Institution in respect to the application of the customer for Murabahah**

2/2/1 When there is acceptance by the customer of an offer from the supplier that is either addressed to him personally, or that has no addressee, then the sale is concluded with the customer and so it is not permissible for the Institution to carry out Murabahah on the same item.

2/2/2 It is essential to exclude any prior contractual relationship between the customer who is the purchase orderer and the original supplier of the item ordered, if any, regarding the supply of the item. It is a requirement of Murabahah that the transaction between the two parties must genuinely, not fictitiously, exclude any prior contractual relationship.

It is not permissible to assign a contract that has been executed between the customer and the supplier of the ordered item to the Institution.

2/2/3 The Institution must ensure that the party from whom the item is bought is a third party other than customer or his agent. For example, it is not permitted for a customer to sell an ordered item to the Institution and then repurchase it through a Murabahah transaction. Nor may the party that is supplying the item be wholly, or by way of majority [more than 50%],

owned by the customer. If a sale transaction takes place and later on it is discovered that it was carried out through such practices, this would render the transaction void as it is tantamount to 'Inah.

2/2/4 If the supplier (owner) of the item has a blood relationship or marital relationship with the customer, then the Institution shall verify, before entering into Murabahah, that the sale is not fictitious and not a stratagem for the sale of 'Inah.

2/2/5 It is not permissible for the Institution and the customer to agree to form a Musharakah in a project or a specified deal together with a promise from one of them to buy the other's share in Musharakah by means of Murabahah on either spot or deferred payment terms. However, it is permissible for one partner to promise to purchase the other's share in Musharakah at market price or at a price to be agreed upon at the time of sale provided a new contract is drawn up. This sale may be on spot or on deferred payment terms.

2/2/6 It is not permitted to carry out a Murabahah on deferred payment terms where the asset involved is gold, silver or currencies.

2/2/7 It is also impermissible to issue negotiable Sukuk where the underlying asset consists of Murabahah receivables or other receivables only.

2/2/8 Likewise, it is not permitted to renew a Murabahah contract on the same commodity that was the subject matter of a previous Murabahah contract with the same customer, i.e. to refinance the transaction.

**2/3 The promise from the customer**

2/3/1 It is not permissible that the document of promise to purchase (signed by the customer) should include a bilateral promise which is binding on both parties (the Institution and the customer).

2/3/2 The customer's promise to purchase, and the related contractual framework, are not integral to a Murabahah transaction, but are intended to provide assurance that the customer will complete the transaction after the item has been acquired by the Institution. If the Institution has other opportunities to sell the item, then it may not need such a promise or contractual framework.

2/3/3 A bilateral promise between the customer and the Institution is permissible only if there is an option to cancel the promise which may be exercised either by both promisors or by either one of them.

2/3/4 It is permissible for the Institution and the customer, after the latter has given a promise but before the execution of the Murabahah, to agree to revise the terms of the promise whether with respect to the deferment of payment, the mark-up or other terms. The terms of the promise cannot be revised except by mutual consent by both parties.

2/3/5 It is permissible for the Institution to purchase the item from a supplier on a "sale or return" basis, i.e., with the option to return it within a specified period. If the customer then does not purchase the item, the Institution is able to return it to the supplier within the specified period on the basis of the conditional option that is established in Shari'ah. The option between the Institution and the supplier does not expire by the mere presentation of the item to the customer, but it expires by virtue of the actual sale to the customer. It is advisable to stipulate in a stipulated option to revoke (*khiyar al-Shart*) that the mere offer by the purchaser for the sale of the item to a third party does not invalidate the option.

**2/4 Commissions and expenses**

2/4/1 It is not permissible for the Institution to receive a commitment fee from the customer.

2/4/2 It is not permissible for the Institution to receive a fee for providing a credit facility.

2/4/3 The expenses of preparing the documents of the contract between the Institutions and the customer are to be borne evenly by the two parties (the Institution and the customer), provided they do not agree that the expenses are to be borne wholly by one party, and provided those expenses are proportional to the actual amount of work involved, so that they do not implicitly include a commitment fee or a facility fee.

2/4/4 If the Murabahah is carried out by means of syndicated financing, the Institution which acts as the arranger of the syndicate is entitled to an arrangement fee to be paid by the participants in the syndicate.

2/4/5 It is permissible for the Institution to receive a fee for a feasibility study that it undertakes in case such study is requested by the customer and for the benefit thereof and the customer agrees to pay the fee thereof. The customer is entitled to a copy of the study if he so requires.

**2/5 Guarantees related to the commencement of the transaction**

2/5/1 It is permissible for the Institution to obtain from the customer (the purchase orderer) a guarantee (performance deed) regarding the good performance by the supplier of his contractual obligations towards the Institution in his personal capacity and not in his capacity as purchase orderer or in his capacity as an agent of the Institution. Hence, if the Murabahah contract is not executed, his guarantee would still be valid. This guarantee is required only in cases where the customer has suggested a particular source of supply for the item that is the subject matter of the Murabahah contract.

As a consequence of this guarantee, the customer shall make good any damage suffered by the Institution due to failure of the supplier to provide good performance of his contractual obligations. These obligations concern meeting the specification

of the item to be supplied and the exercise of diligence in executing the contract, non-observance of which may result in the loss of the Institution's time and efforts or property, or in a legal dispute and damage claims.

2/5/2 It is not permitted to impose on a customer who is the purchase orderer a guarantee regarding hazards that may affect the item such as damage and destruction during a period of shipment or storage.

2/5/3 It is permissible for the Institution, in the case of a binding promise by the customer, to take a sum of money as *Hamish Jiddiyyah* (security deposit). This is to be paid by the customer at the request of the Institution, both as an indication of the financial capacity of the customer and to ensure the compensation of any damage to the Institution arising from a breach by the customer of his binding promise. Having taken this *Hamish Jiddiyyah*, the Institution need not to demand compensation for damage as this may be charged against the *Hamish Jiddiyyah*. The *Hamish Jiddiyyah* is not considered as 'Arboun (Earnest Money). The amount of money deposited by the customer as security for his commitment can be either held, if the customer permits the Institution to invest it, as an investment trust on the basis of Mudarabah between the customer and the Institution, or held in a current account at the discretion of the customer.

2/5/4 In the case of the customer's breach of his binding promise, the Institution is not permitted to retain *Hamish Jiddiyyah* as such. Instead, the Institution's rights are limited to deducting the amount of the actual damage incurred as a result of the breach, namely the difference between the cost of the item borne the Institution and the price at which the item is sold to a third party. The actual damage to the Institution may not include the loss of its mark-up in the Murabahah transaction, that is, its opportunity loss.

2/5/5 When the customer has fulfilled his promise and executed the contract of Murabahah, the Institution must refund *Hamish Jiddiyyah* to the customer. The Institution is not entitled to receive any amount out of *Hamish Jiddiyyah* except in the case of breach of promise as laid down in item 2/5/3. It is permissible for the Institution to agree with the customer that the amount of *Hamish Jiddiyyah* will be deducted from the price payable by the customer pursuant to the contract of Murabahah.

2/5/6 It is permissible for the Institution to take 'Arboun (Earnest Money) upon conclusion of the Murabahah sale with the customer. This may not be done during the contractual stage at which the customer has given his promise to purchase. In the event that the customer revokes the contract in an 'Arboun-based transaction, it is preferable that the Institution, after deducting the actual damage it incurs, refunds the remaining amount of 'Arboun to the customer. The damage in this context means the difference between the cost of the item borne the Institution and the price at which the item is sold to a third party.

## 3. Acquisition of Title to, and Possession of, the Asset by the Institution or Its Agent

### 3/1 The acquisition of the asset or good by the Institution prior to its sale by means of Murabahah

3/1/1 The Institution shall not sell any item in a Murabahah transaction before it acquires such item. Hence, it is not valid for the Institution to conclude a Murabahah sale with the customer before the Institution concludes a urchase contract with the supplier of the item the subject matter of the Murabahah and before it acquires actual or constructive possession of such items, which can be achieved when the supplier gives the Institution control over the item or the documents that represent possession thereof [see items 3/2/1-3/2/4]. Likewise, the Murabahah is considered void in case the contract with the supplier is void, because

in this case the Institution would fail to acquire complete title to the item.

3/1/2 It is permitted that the contract between the Institution and the supplier be completed by means of a meeting of the two parties to discuss the details, at which point the contract may be executed. Likewise, it is permitted that the contract be completed through exchanging of the notices of offer and acceptance, either in writing or by any form of modern communication customarily practiced according to known principles.

3/1/3 The original principle is that the Institution itself purchases the item directly from the supplier. However, it is permissible for the Institution to carry out the purchase by authorizing an agent, other than the purchase orderer, to execute the purchase; and the customer (the purchase orderer) should not be appointed to act as an agent except in case of a dire need. Furthermore, the agent must not sell the item to himself. Rather, the Institution must first acquire title of the item and then sell it to the agent. In such a case, the provisions of item 3/1/5 should be observed.

3/1/4 In cases when the customer is authorized to purchase the item as the Institution's agent, it is obligatory to adopt procedures which would ensure that certain conditions are observed. These conditions include:

a) the Institution itself must pay the supplier, and not pay the price of the item into the account of the customer as agent, whenever possible.

b) the Institution should obtain from the supplier the documents that confirm that a sale has taken place.

3/1/5 It is obligatory to separate the two liabilities of risk attaching to the purchased item, namely the liability of the Institution and the liability of the customer as agent of the Institution. This is achieved by having an interval in time between the

performance of the agency contract and the execution of the contract of Murabahah, as indicated in the customer's notice of performance of the agency contract to acquire the item and offer to purchase the item by means of Murabahah [see Appendix (a)], followed by the institution's notice of its acceptance of the customer's offer to purchase and the execution of the Murabahah sale contract [see Appendix (b)].

3/1/6 The original principle is that all documents and contracts concerned with the execution of the sale of the item must be in the name of the Institution and not in that of the customer, unless the latter acts as the Institution's agent in acquiring the item.

3/1/7 It is permissible, at the time when the Institution appoints someone as its agent for the acquisition of the item, that the two parties agree to authorize the agent to carry out the acquisition of the item as agent, without disclosing the existence of the agency agreement. In this case, the agent will act as principal in dealing with other parties, and will undertake the purchase directly in his name but on behalf of the Institution as principal. However, it is preferable that the agent's role be disclosed.

**3/2 The Institution's taking possession of the asset or good, prior to its sale by Murabahah**

3/2/1 It is obligatory that the Institution's actual or constructive possession of the item be ascertained before its sale to the customer on the basis of Murabahah.

3/2/2 The condition that possession of the item must be taken by the Institution (before its onward sale to the customer) has a specific purpose: that the Institution must assume the risk of the item it intends to sell. This means that the item must move from the responsibility of the supplier to the responsibility of the Institution. Similarly, it is obligatory that the point when the risk of the item is passed on by the Institution to the customer

be clearly identified, with reference to the stages in which the item is transferred from one party to another.

3/2/3 The forms of taking delivery or possession of items differ according to their nature and different trade customs. Taking possession may be actual in the case of the physical delivery or transportation to the acquirer or its agent, but may also take place constructively by placing of the item at the acquirer's disposal so as to enable him to deal with it at his will, even though no physical delivery has taken place. Taking possession of an item of real property may also take place by means of the property being vacated and its being placed at the acquirer's disposal; if the latter is not able to have disposal of the purchased item, then the vacation of the property is not considered as conveying possession. In the case of moveable assets, possession will take place in accordance with the nature of the asset.

3/2/4 The receipt of a bill of lading by the Institution or its agent, when purchasing goods on the international market, is considered as constructive possession. The same would apply to the Institution's receipt of certificates of storage issued by warehouses following appropriate and reliable formalities.

3/2/5 The original principle is that the Institution itself must receive the item from the premises of the supplier or from a location that is specified in the delivery conditions. The responsibility for the risk attached to the item is transferred to the Institution upon its taking possession of the item. However, it is permissible for the Institution to authorize another party to take delivery of the item on its behalf.

3/2/6 As the Institution is the owner of the subject matter of Murabahah its insurance lies with the Institution before selling it to the customer. Any amount recovered from insurance at this stage will belong to the Institution exclusively and the customer has no claim to it even if the recovered amount exceeds the purchase price. The Institution is entitled to include

the expenses of insurance in the Murabahah cost price to be subsequently added to the price of Murabahah. Insurance must be on the basis of Takaful whenever possible.

3/2/7 Agency in carrying out the procedures of obtaining insurance cover for the item at the stage of the Institution's acquisition of ownership of the asset is permitted. However, it is obligatory that the Institution should bear the cost of insurance.

**4. Conclusion of a Murabahah Contract**

4/1 It is not permitted for the Institution to consider that the contract of Murabahah is automatically concluded by its mere taking possession of the asset. Likewise, the Institution may not force a customer who is the purchase orderer to take delivery of the asset and pay the Murabahah selling price, if the customer refuses to conclude the Murabahah transaction.

4/2 The Institution is entitled to receive compensation for any actual damage it has incurred as a result of the customer's breach of a binding promise. The compensation consists of the customer reimbursing the Institution for any loss due to a difference between the price received by the Institution in selling the asset to a third party and the original cost price paid by the Institution to the supplier.

4/3 When the Institution has purchased an asset for a deferred price, with the intention that it will be sold on a Murabahah basis, then the Institution is obliged to disclose to the customer that the asset is purchased by the Institution on deferred payment basis. The Institution has the obligation to disclose to the customer, when concluding the contract of sale, the details of any expenses that it would include in determining the cost. The Institution is also entitled to include any expenses relating to the item if this is acceptable to the customer. However, if the Institution failed to disclose any expenses, it is not entitled to include them unless they are customarily considered as normal expenses, such as transportation expenses, storage expenses, fees for letters of credit and insurance premiums.

4/4 The Institution is not entitled to include in the base cost of the item, for the purpose of calculating the Murabahah price, any amounts other than the direct expenses that are paid to a third party. It is not permissible, for example, for the Institution to add to the cost of the item payments made to its own staff for their work, and the like.

4/5 If the Institution has, even after the drawing up of the Murabahah contract, received a discount for the same item that was sold on Murabahah basis from the supplier of the item, then the customer should benefit from that discount by a reduction of the total Murabahah selling price in proportion to the discount.

4/6 It is an obligation that both the price of the item and the Institution's profit on the Murabahah transaction be fixed and known to both parties on the signature of the contract of sale. It is not permitted under any circumstances to subject the determination of the price or the profit to unknown variations or variations that are determinable in the future, such as by concluding the sale and making the profit dependent on the rate of LIBOR that will prevail in the future. There is no objection to referring to any other known indicators during the promise stage as a comfort indicator to determine the rate of profit, provided that the determination of the Institution's profit at the time of concluding the Murabahah is based on a certain percentage of the cost and is not tied up with LIBOR or a time factor.

4/7 The Institution's profit mark-up in Murabahah must be known, and the mere mention of the total selling price is not sufficient. It is permissible that the profit be determined based on a lump sum amount or a certain percentage of the cost price only or of the cost price plus the expenses. This determination is completed by the agreement and mutual consent of the two parties.

4/8 It is permissible to agree on the payment of the price of the item under Murabahah either by short or long term instalments, and the selling price of the asset becomes a debt that the customer is obligated to pay at the time agreed upon. It is not permitted subsequently to demand any extra payment either in consideration of extra time

given for payment or for delay in payment that may be for a reason or no reason.

4/9 It is permissible for the Institution to stipulate in the contract of Murabahah a condition that the Institution is free from responsibility for all or some of the defects of the asset, but not from destruction caused before the possession of the customer or diminution of quantity sold; this is known as *Bay' al-Bara`ah* (sale on 'as is' basis). In the case of stipulating such a condition, it is preferable that the Institution should assign to the customer the right of recourse to the supplier to obtain compensation for any defects that are established, which would otherwise be recoverable by the Institution from the supplier.

4/10 The Institution shall be responsible for pre-existing hidden defects which appear after the conclusion of the contract, unless it stipulates otherwise according to item 10/4. However, it shall not be responsible for any new defects (recent defects) that arise after the conclusion of the contract and taking delivery by the customer.

4/11 The Institution is entitled to include, as a condition of the contract, that in case of the customer's refusal, after the execution of the Murabahah contract, to take delivery of the asset at the prescribed time, the Institution could revoke the contract or sell the asset to a third party on behalf of the customer and for his account. The Institution could then recover from the selling price the amount due to it from the customer under the contract, and would have recourse to the customer for the balance if that price were not sufficient to cover the amount due to the customer.

**5. Guarantees and Treatment of Murabahah Receivables**

5/1 It is permissible for the Institution to stipulate to the customer that instalments may become due before their originally agreed due dates in case of the customer's refusal or delay in paying any instalment without any valid reason after the lapse of the time specified in the notice to be sent by the Institution to the customer within a reasonable period of time following the due date.

5/2 The Institution should ask the customer to provide permissible security in the contract of Murabahah. Among other things, the Institution may receive a third party guarantee or the mortgagee of the investment account of the customer or the mortgagee of any item of real or moveable property, or the mortgagee of the subject matter of the Murabahah contract as a fiduciary mortgagee (or a registered charge), either without taking possession of the mortgageed asset, or by taking possession of the mortgageed asset and then releasing the mortgagee progressively according to the percentage of the total payment received.

5/3 It is permissible for the Institution to require the customer to provide cheques or promissory notes before the execution of the contract of Murabahah, as a guarantee of the indebtedness that will be created after the execution of the contract. This is possible on the written condition that the Institution is not entitled to use these cheques or documents except on their due dates. The requirement to provide cheques as security is not permissible in countries where they could be presented for payment before their due date.

5/4 It is not permissible to stipulate that the ownership of the item will not be transferred to the customer until the full payment of the selling price. However, it is permissible to postpone the registration of the asset in the customer's name as a guarantee of the full payment of the selling price. The Institution may receive authority from the customer to sell the asset in case the customer delays payment of the selling price, in which case the Institution should issue a counter-deed to the customer to establish the latter's right to ownership. If the Institution sells the asset as a result of the customer's failure to make a payment of the selling price on its due date, it must confine itself to recovering the amount due to it and must return the balance to the customer.

5/5 In the case of the Institution receiving a mortgagee from the customer, the Institution is entitled to stipulate that the customer should make an assignment to the Institution to enable it to sell the mortgageed

asset for the purpose of recovering the amount due from the customer without recourse to the judiciary.

5/6 It is permissible that the contract of Murabahah consists of an undertaking from the customer to pay an amount of money or a percentage of the debt, on the basis of undertaking to donate it in the event of a delay on his part in paying instalments on their due date. The Shari'ah Supervisory Board of the Institution must have full knowledge that any such amount is indeed spent on charitable causes, and not for the benefit of the Institution itself.

5/7 It is not permissible to extend the date of payment of the debt in exchange for an additional payment in case of rescheduling, irrespectively of whether the debtor is solvent or insolvent.

5/8 When there is default in payment by the customer with regard to instalments of the selling price that are due, the amount due is just the amount of the unpaid selling price. It is not permissible for the Institution to impose any additional payment on the customer for the Institution's benefit. This provision is, however, subject to item 5/6 .

5/9 It is permissible for the Institution to give up part of the selling price if the customer pays early, provided this was not part of the contractual agreement.

5/10 If the customer wishes to pay in a currency different from Murabahah currency, it is permissible, with the agreement of the Institution at the time of payment on condition that the payable debt is paid in full or the amount agreed to be paid in different currency is paid in full and no part of the currency exchange amount remains due. This currency exchange may not be stipulated in the contract of Murabahah.

## 6. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1423 A.H., corresponding to 16 May 2002 A.D.

# Adoption of the Standard

The Shari'ah standard for Murabahah was adopted by the Shari'ah Board in its meeting No. (4) held on 25-27 Safar 1421 A.H., corresponding to 29-31 May 2000 A.D.

In its meeting No. (8) held in Mecca on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board readopted a resolution to reformat the Shari'ah rules for Murabahah in the form of a Shari'ah standard.

# Appendix (A)
# Notice from Institution's Customer of Its Performance of Purchasing Asset or Good As Agent for Institution, and of Its Offer to Purchase Item from Institution According to Contract of Murabahah

**Notice from the institution's customer of its performance of the purchase of the asset or good as agent for the institution:**

**From:** (The Institution's customer as agent) .....

**To:** (The Institution).....

In the performance of my contract of agency with you, I hereby inform you that I have purchased the item described below on your behalf and for your benefit. This item is in my possession on your behalf.

In accordance with my promise to you, I hereby agree to purchase this item from you for a total price of ….., namely the cost price of ….. plus the mark-up of …...

The payment of this price will be in accordance with the following schedule of instalments:

- ……..

- …….

- ……..

**Please send the acceptance in accordance with this offer.**

# Appendix (B)
# Notice of Acceptance by Institution of Customer's Offer to Purchase Asset or Good to Be Acquired, and of selling item by Institution to Customer

**Notice of the acceptance by the Institution of the customer's offer to purchase the asset or good to be acquired:**

**From:** (The Institution).....

**To:** (The customer as the Institution's agent).....

In response to your notice dated ….., containing your offer to purchase the item described below which is owned by us, we hereby confirm to you our sale of the item to you at a total price of ….. comprising the cost price of ….. plus the mark-up of ….., in accordance with the conditions explained in the general agreement to a contract of Murabahah.

**Please send the acceptance in accordance with this offer.**

# Appendix (C)
# Brief History of the Preparation of the Standard

In its meeting No. (1) held on 11 Dhul-Hajjah 1419 A.H., corresponding to 27 February 1999 A.D., the Shari'ah Board decided to give priority to the preparation of a Standard setting out the Shari'ah rules for Murabahah.

On Tuesday 13 Dhul-Hajjah 1419 A.H., corresponding to 30 March 1999 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft of the Shari'ah Rules for Murabahah.

In its meeting held on 13-14 Rajab 1420 A.H., corresponding to 22-23 October 1999 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Murabahah, and asked the consultant to make the amendments in light of the comments made by the members.

The revised exposure draft of the Shari'ah Rules was presented to the Shari'ah Board in its meeting No. (2) held in Mecca on 10-15 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D. The Shari'ah Board made further amendments to the exposure draft of the Shari'ah Rules and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 29–30 Dhul-Hajjah 1421 A.H., corresponding to 4-5 April 2000 A.D. The public hearing was attended by more than 30 participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. The members responded to the written comments that were

sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Studies Committee and the Fatwa and Arbitration Committee held a joint meeting on 21-23 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., to discuss the comments made about the exposure draft of the Shari'ah Rules. The joint meeting made the necessary amendments, which it deemed necessary in light of the discussions that took place in the public hearing.

The Shari'ah Board in its meeting No. (4) held on 25–27 Safar 1421 A.H., corresponding to 29–31 May 2000 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Studies Committee and the Fatwa and Arbitration Committee, and made the necessary amendments, which it deemed necessary. The standard was adopted with the name of "Shari'ah Rules for the Murabahah". Some paragraphs were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Board decided in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding 24-28 November 2001 A.D., to pass a resolution to reformat all Shari'ah rules in a form of standards and a committee was formed for this purpose.

In its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board adopted the reformatting of the Shari'ah Rules for Investment and Financing No. (1) on Murabahah with the name of Shari'ah Standard No. (8) on Murabahah.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved the necessary amendments, and the standard was adopted in its current amended version.

# Appendix (D)
# The Shari'ah Basis for the Standard

## Preface on the Permissibility of Murabahah

### Definition of Murabahah

Murabahah is selling a commodity as per the purchasing price with a defined and agreed profit mark-up. This mark-up may be a percentage of the selling price or a lump sum. This transaction may be concluded either without a prior promise to buy, in which case it is called an ordinary Murabahah, or with a prior promise to buy submitted by a person interested in acquiring goods through the Institution, in which case it is called a "banking Murabahah" i.e. Murabahah to the purchase orderer. This transaction is one of the trust-based contracts that depends on transparency as to the actual purchasing price or cost price in addition to common expenses.

### Permissibility of Murabahah

The authorities for the permissibility of Murabahah are authorities on the permissibility of sale. Among them is the saying of Allah, the exalted: ***{"...Allah has permitted trade..."}***.(3) Some scholars has also cited to support the permissibility of Murabahah the saying of Allah, the Exalted: ***{"It is no crime for you to seek the bounty of your Lord,"}***(4) arguing that the bounty mentioned here means profit. The Murabahah is also analogous to a form of sale called *Tawliyyah* (which means to sell as per the purchasing price without making profit). This is because the Prophet (peace be upon him) purchased a she-camel from Abu Bakr to use it as a transportation to immigrate to Medina. Abu Bakr wanted to give it to the Prophet (peace be upon him) free of charge, but the Prophet refused

(3) [Al-Baqarah (The Cow): 275].
(4) [Al-Baqarah (The Cow): 198].

saying: *"I will preferably take it at the acquisition price"*. The majority of scholars agreed, in principle, on the permissibility of Murabahah.

**Promise from the Purchase Orderer**

- The basis for the permissibility of responding to the application of the customer that the Institution buys the commodity from a particular supplier is because such a demand will not affect the acquisition of the commodity by the Institution, especially in view of the fact that this demand is not binding. The Institution is entitled to acquire the commodity from another supplier provided the commodity complies with the desired specification. The customer may be forced to fulfil his obligation on the basis of general sources of the Qur`an and Sunnah that require fulfilment of obligation and undertaking. The International Fiqh Academy has issued a resolution endorsing a unilateral binding promise.(5) The same was adopted in a fatwa for Kuwait Finance House,(6) Qatar Islamic Bank,(7) and others.
- The basis for allowing price quotations be submitted in the name of customer is because such an act has no contractual effect if there is no acceptance by the customer. The basis why it is preferred that the quotation be submitted in the name of the Institution, is to avoid confusion and this is what was endorsed by the Fatwas of Qatar Islamic Bank,(8) and Kuwait Finance House.(9)
- The basis for not allowing a Murabahah deal when the customer accepts the deal directly from the supplier is because, by this, a sale contract has taken place between the customer and the supplier in which case the commodity enters into ownership of the customer. This ruling will not be affected whether or not the customer has paid the price. This is because payment is not a condition for the permissibility and conclusion of a contract as payment of the price is but a consequence of a contract and is not principal requirement or a condition for regarding a contract valid.

(5) International Fiqh Academy Resolution No. 40-41 (2/5 and 3/5).
(6) Fatwa No. (49).
(7) Fatwa No. (8).
(8) Fatwa No. (35).
(9) Fatwa No. (87).

- The basis for the requirement that there must not be any contractual commitment between the customer and the supplier is to safeguard against the contract being a mere interest-based financing. Therefore, the lack of any commitment between the customer and the supplier is a basic condition for the permissibility of executing a Murabahah by the Institution.
- The basis for the requirement that the customer must not have any (business) connection with the supplier is to avoid involving in a 'Inah (sell and buy back) transaction that is prohibited by Shari'ah.
- The basis for the permissibility that the supplier may be a relative of the customer or a husband or wife to the customer is because both parties have independent legal liability unless it has come to be that they are involved in a 'Inah transaction, in which case the transaction is prohibited. This is to defeat a potential intentional arrangement to evade formalities of the transaction. The Fatwa of Kuwait Finance House supports this.(10)
- The basis for not allowing a partner to promise to buy the shares of another partner on a Murabahah basis is because this will lead to the buyer guaranteeing the share of other partner, which is Riba.
- The basis for not allowing dealings in gold, silver and currencies on deferred Murabahah basis is the saying of the Prophet, peace be upon him, in respect to exchange of gold with silver that such exchange take place *"hand to hand"*;(11) i.e., without delay in delivery, and the rules of currencies are subsumed under the ruling for gold and silver. This ruling is endorsed by the resolution of the International Fiqh Academy.(12)
- The basis for the prohibition of Murabahah tradable securities or refinancing of a Murabahah transaction is because these fall under the heading of sale of debt that is prohibited by Shari'ah.
- The basis for not allowing a bilateral binding promise is because it amounts to a contract prior to acquisition of the item to be sold. The International Fiqh Academy has issued a resolution in this respect.(13)
- The basis for the permissibility of the agreement to amend the terms of the promise is because a promise is not a contract and as such the amendment

(10) Fatwa No. (55).
(11) The Hadith has been related by Muslim in his *"Sahih"*.
(12) International Fiqh Academy Resolution No. 63 (1/7).
(13) International Fiqh Academy Resolution No. 41(3/5).

of the profit margin and the duration will not amount to rescheduling of debt which is prohibited by Shari'ah.

- The basis for using options when buying on Murabahah is the case of Hiban Ibn Munqidh when the Prophet (peace be upon him), said to him: *"If you buy, a condition that there is no cheating and that you have a three day period for any of the goods bought. If you are satisfied, then keep it and if you are not satisfied, return it to the buyer."*(14) The ruling on the application of option in Murabahah is endorsed by a resolution issued during the second Fiqh Forum organised by Kuwait Finance House.
- The basis for the impermissibility of a commitment fee is because such a fee is in exchange for the right to contract, which is a mere intention and wish that is not a subject of exchange.
- The basis for the impermissibility of a facility commission is because it is not allowed to receive commission in the event of giving out a loan facility itself. It is therefore a logical conclusion to disallow commission for a mere readiness to finance the customer on a deferred payment basis.
- The basis for allowing that the expenses of preparing the document of contracts between the Institution and the customer be borne by the two parties is because both parties will equally benefit from this, and moreover there is no any impermissible act involved. The basis for the permissibility that these expenses may be borne by one of the parties is because this is a form of condition that is permissible.
- The basis for the permissibility of the customer guaranteeing the good performance of the supplier is because this guarantee secures rights and does not adversely affect any rules of the Murabahah transaction.
- The basis for not allowing that the customer guarantee the risk of transportation of the goods is because the safety of the goods is the responsibility of the owner and the customer is not the owner. Hence, the owner must bear the risk since the right to profit is associated with bearing risk.
- The basis for the permissibility of *Hamish Jiddiyyah* (security deposit) is because it is a form of guarantee for any financial damage that may occur.
- The basis for the permissibility of obtaining the earnest money to secure performance is the practice of Umar Ibn Al-Khattab (may Allah be pleased

(14) The Hadith has been related by Ibn Majah, *"Sunan Ibn Majah"* [2: 789].

with him) in the presence of some companions of the Prophet, peace be upon him,[15] which has been permitted by Imam Ahmad. A resolution has been issued in connection with the permissibility of 'Arboun (Earnest Money) by the International Islamic Fiqh Academy.[16]

**Acquisition of Title to, and Possession of, the Asset by the Institution or its Agent**

- The basis for the prohibition of selling a commodity before taking possession is the saying of the Prophet (peace be upon him): *"Do not sell what you own not"*[17] and the Hadith in which the Prophet (peace be upon him) prohibits a person from selling what he does not own.[18] The basis for preferring that the Institution appoint an agent other than the purchase orderer in case of the need to do so is to avoid a fictitious transaction that shows on paper that the acquisition is made on behalf of the Institution. This is necessary in order that the Institution appear as the real purchaser and in order to demarcate the liabilities of the parties, the liability of the Institution and the liability of the purchase orderer after the sale contract.
- The basis for the requirement that the Institution must pay the supplier directly is to avoid the risk of the contract degenerating into mere interest-based financing.
- The basis for the requirement that the liabilities of the parties -in case the Institution acquires the goods through agency- is to demarcate the two liabilities.
- The basis for the requirement that documents must be directed to the Institution is because the purchase is taking place on behalf of the institution.
- The basis for the requirement that the agent must explain to the supplier his agency status is to control the transaction and to determine the party to be referred to for the execution of the contract.

(15) The source of the Hadith has been stated earlier.
(16) Resolution No. 72 (3/8) in respect of 'Arboun (Earnest Money).
(17) The Hadith has been related by Al-Tirmidhi *"Sunan al-Tirmidhi"* [3: 534].
(18) The Hadith has been related by Al-Tabrani in *"Al-Mu'jam Al-Awsat"* [5: 66], Dar Al-Haramayn, Cairo, 1415 A.H.

- The basis for the requirement of possession before a sale contract is to ensure that the Institution becomes liable for the risk of destruction of the commodity before it is entitled to sell it.
- The basis for separating an agency contract from a Murabahah transaction is to be sure that there is no any intentional arrangement to connect the two contracts.
- The basis for the rule that constructive possession is sufficient to meet the requirement of possession and that possession is according to the nature of the items is because the Shari'ah did not state a particular form for possession. Rather this is left to the customary practices. Again, the purpose of possession is to enable one to have control over something. Therefore, any procedure that serves this objective would be regarded as possession.
- The basis for the requirement that the contract of agency be separate from the contract of sale on a Murabahah basis is because of the risk that the contracts may be connected to each other.
- The basis for the rule that the Institution bear the expenses of insurance is because these expenses follow ownership of the goods.

**Conclusion of a Murabahah Contract**

- The basis for the rule that the Institution is entitled to compensation in case of breach of a binding promise by the customer to buy the goods is because of the damage that may be inflicted on the Institution due to the act of the customer. This is because the customer has caused the Institution to enter into a deal that it would not have concluded in the absence of the promise. The International Islamic Fiqh Academy has issued a resolution in this respect.(19)
- The basis for the rule that the Institution's rights are limited, in case of breach of promise, to the difference between the cost of the item to the Institution and its selling price to a third party is because the lawful right in a guarantee is limited to the amount that compensates for the damage suffered and because the Institution's right to recover loss of its mark-up is irrational since there is no mark-up unless there is actually a Murabahah transaction and in this case there is no such transaction.

(19) International Islamic Fiqh Academy's resolution No. 40-41 (2/5 and 3/5).

- The basis for the requirement of transparency as to the cost price is because Murabahah is a trust related contract that requires disclosure of the amount and the currency of the cost price because a price in a deferred payment sale is higher.
- The basis for allowing normal expenses to be included in computing the selling price of the commodity is because these expenses are paid to a third party.
- The basis for entitlement of the buyer to benefit from the discount acquired by the Institution is because Murabahah is a mark-up sale. Therefore, if the previous purchasing price decreases then the cost price is the amount that remains after the discount and this price is the cost price for the purpose of the Murabahah.
- The basis for the requirement that the price and the profit in Murabahah must be determined is to avoid uncertainty and lack of knowledge.
- The basis for the requirement that the profit must be separately disclosed from the cost price and that it is not allowed to be calculated as a single amount for the customer is because Murabahah is a sale with a profit margin. Therefore, it is necessary this profit be disclosed separately to ensure that the customer will agree to it.
- The basis for the permissibility of instalment payment is because Murabahah is one of the sale contracts that are subject to spot payment, deferred payment or instalment payment. The basis for the impermissibility of requesting an additional sum of money for delay in payment is because this is the prohibited Riba.
- The basis for the permissibility of stipulating a defect exclusion item is because a buyer is entitled to require guaranteeing hidden defects which are related to the sold commodity by the seller. However, the buyer may relinquish this right by agreeing to a defect exclusion item, as stated by a number of scholars.(20)
- The basis for the permissibility of stipulating that the contract would be terminated for default in payment is because the original princi-

(20) See Al-Kasani, *"Bada`i' Al-Sana`i'"* [5: 276]; Al-Mawwaq, *"Al-Taj Wa Al-Iklil"* [4: 439]; Al-Shirazi, *"Al-Muhadhdhab"* [1: 284]; Ibn Qudamah, *"Al-Mughni"* [4: 129]; and Al-Buhuti, *"Kashshaf Al-Qina'"* [3: 228].

ple in respect to stipulations is validity and permissibility. In addition, this item does not render permissible an impermissible act or prohibit a permissible act. Hence, this item falls under the Hadith that says: *"Muslims are bound by the conditions they made, except a condition that renders permissible an impermissible act or prohibits a permissible act.*(21)

**Guarantees in Murabahah and Treatment of Murabahah Receivables**

- The basis for the condition that all instalments will become due if there is delay in payment is the Hadith of the Prophet, peace be upon him: Muslims are bound by the conditions they made, and because payment on a deferred basis is the right of the buyer, and the buyer may choose to pay before time and relinquish the deferral of the date of payment entirely or make payment of all instalments contingent on default on payment of one instalment.
- The basis for demanding collateral to secure payment is because such a requirement does not affect the contract; rather, it consolidates performance and such guarantees are relevant to contracts involving credit.
- The basis for not allowing a stipulation that delays transfer of ownership is because such a stipulation is against the effect of a sale contract, which is immediate transfer of ownership. The basis for allowing the Institution to hold up registering the commodity in the name of the customer until payment is realised is that such an action does not affect the transfer of ownership to the buyer.
- The basis for the permissibility of stipulating a condition, whereby the debtor in case of default is obliged to donate a sum of money in addition to the amount of the debt to be spent by the Institution on charitable causes, is because this has been considered as an instance of the commitment to make a donation, which is well established in the Maliki school of law. This

(21) This Hadith has been reported by number of the companions. It has been related by Ahmad in his *"Musnad"* [1: 312]. Ibn Majah through a good chain of transmission in his *"Sunan"* [2: 783], Mustafa Al-Babi Al-Halabi edition, Cairo, 1372 A.H./1952 A.D.; Al-Hakim in his *"Mustadrak"*, Hyderabad edition, India, 1355 A.H.; Al-Bayhaqi in his *"Sunan"* [6: 70 and 156] and [1: 133], Hyderabad edition, India, 1355 A.H.; and Al-Daraqutni in his *"Sunan"* [4: 228] and [3: 77], Dar Al-Mahasin Lil-Tiba'ah edition, Cairo, 1372 A.H./1952 A.D.

is the opinion of Abu Abdullah Ibn Nafi' and Muhammad Ibn Ibrahim Ibn Dinar, among the Maliki jurists.[22]

- The basis for the prohibition of additional payment over the principal debt in consideration for extension of time is because such action is a pre-Islamic form of Riba.
- The basis for the permissibility of discount or rebate for earlier payment is because discount for early payment is a form of settlement between the creditor and the debtor to pay less than the amount of the debt. This is among the settlement that are endorsed by Shari'ah as stated in the case of Ubay Ibn Ka'b (may Allah be pleased with him) and his debtor where the Prophet (peace be upon him) suggested to him in words: *"write off a portion of your debt."*[23] The International Islamic Fiqh Academy has issued a resolution in support of this rule.[24]
- The basis of the permissibility of payment of debt in another currency is that this would entail the settlement of the debt by discharging it. This does not involve any prohibited transaction pertaining to debts either with regard to sale or purchase.

As for some of the forms mentioned in the standard, there are texts to support them, inter alia, the Hadith reported on the authority of Ibn Umar (may Allah be pleased with him) who said: "I have met the Prophet (peace be upon him) at the house of Hafsah (may Allah be pleased with her), and I said to him: 'O Prophet of Allah, I would like to ask you: 'I sell a camel in Al-Baqi' for a price quoted in dinar but I take dirham, and I sell for a price quoted in dirham but I take dinars, I take this from this and I give this from this.' The Prophet (peace be upon him) replied: *'There is no objection to your taking the other currency based on the price of the day, provided you do not leave each other with something remaining owed as a debt between you'."*[25] Some of the forms in the standard are a kind of set-off and this is permissible.

(22) See the book entitled: *"Tahrir Al-Kalam Fi Masa`il Al-Iltizam"* by Al-Hattab. This rule has been endorsed by the resolutions and recommendations of the Fourth Fiqh Forum organized by the Kuwait Finance House.

(23) The Hadith has been related by Al-Bukhari: *"Sahih Al-Bukhari"* [1: 179] and [2: 965].

(24) The International Islamic Fiqh Academy Resolution No. 64 (7/2).

(25) Related by Abu Dawud, Al-Tirmidhi, Al-Nassa`i, Ibn Majah and Al-Hakim, who deemed it a sound Hadith. Al-Dhahabi agreed with Al-Hakim. It was also narrated without a chain of narrators, quoting only Ibn Umar: *"Al-Talkhis Al-Habir"* [3: 26].

# Appendix (E)
# Definitions

**Murabahah**

It is the sale of a commodity by an institution to its customer (the purchase orderer) as per the purchasing price/cost with a defined and agreed profit mark-up (as set out in the promise/*Wa'd*), in which case it is called a banking Murabahah. The banking Murabahah involves deferred payment terms, but such deferred payment is not one of the essential conditions of such transaction, as there is also a Murabahah arranged with no deferral of payment. In this case, the seller only receives a mark-up that only includes the profit for a spot sale and not the extra charge it would, otherwise, receive for deferral of payment.

**Commitment Fee**

A commitment fee is the percentage or amount which the Institution takes from the customer to start processing the transaction even though a sale contract may not be concluded).

**'Arboun**

The term 'Arboun means an amount of money that the customer as purchase orderer pays to the Institution after concluding the Murabahah sale, with the provision that if the sale is completed during a prescribed period, the amount will be counted as part of the price. If the customer fails to execute the Murabahah sale, then the Institution may retain the whole amount.

**Syndicated Financing**

A syndicated financing is a partnership relationship for financing a particular project which two or more parties has interest to finance. They will distribute the profit or revenue as per agreement. In other words, syndicated financing is the acceptance of a number of companies (financial Institutions) to enter into a joint investment transaction through one of the permissible investment instruments with an understanding that one of the

parties assumes leadership of the deal. During the period of the transaction, the transaction would enjoy an independent liability separated from their companies.

**Credit Facility**

A credit facility is an upper limit for a customer's Murabahah transactions. This credit facility may be restricted to a specified type of item, or to a specified period of time.

## Shari'ah Standard No. (9)

# Ijarah and Ijarah Muntahia Bittamleek*

## (Revised Standard)

* This standard was previously issued by the title "Shari'ah Rules for Investment and Financing Instruments No. (2) Ijarah and Ijarah Muntahia Bittamleek. It was reissued as a Shari'ah standard based on the resolution of the Shari'ah Board to reformat all Shari'ah Rules in the form of Shari'ah Standards.

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This standard outlines the basis of the Shari'ah rulings on Ijarah and Ijarah Muntahia Bittamleek, beginning with the rules relating to the promise to lease, if any, and concluding with the rules of repossession of the leased property in an operating Ijarah by the lessor or transferring its ownership in case of Ijarah Muntahia Bittamleek, within or by the end of the lease term. The Standard also aims to outline the Shari'ah requirements that must be observed by Islamic financial Institutions (Institution/Institutions)[(2)] with respect to Ijarah transactions.

(2) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers operating leases of properties or Ijarah Muntahia Bittamleek, whether the Institution is the lessor or the lessee.

This standard does not cover *Sukuk al-Ijarah*, as they are covered by Shari'ah Standard on Investment Sukuk, nor the employment of persons (labour contract), as it is covered by a separate standard.

## 2. Promise to Lease (an Asset)

2/1 In principle, an Ijarah contract is executed for an asset owned by the lessor or an usufruct owned by the sub-lessor. However, it is for a customer to request an Institution to acquire the asset or to acquire the usufruct of an existing asset which the customer wishes to take on lease.

2/2 In principle, Ijarah may be effected directly on the asset without any requirement of a preceding master agreement. However, it is permissible to have a master agreement drawn up coveringa number of Ijarah transactions between the Institution and the customer, setting out the general terms and conditions of agreement between the two parties. In this case, there may either be a separate lease contract for each transaction, in a specific written document signed by the two parties, or alternatively the two parties may exchange notices of offer and acceptance by referring to the terms and conditions contained in the master agreement.

2/3 It is permissible for the Institution to require the customer who has promised to lease to pay a sum of money to the Institution to ensure the customer's seriousness in accepting a lease on the asset and the subsequent obligations, provided no amount is to be deducted from

this sum except in proportion to the actual damage suffered by the Institution in case the customer does not fulfil his promise. Thus, if the customer, in case of Ijarah associated with a promise to transfer ownership, breaches his promise, the promisor shall be charged either the difference between the cost of the asset intended to be leased and the total lease rentals for the asset which is leased on the basis of Ijarah Muntahia Bittamleek to a third party, or, in case of operating Ijarah, the promisor breaching his promise shall be charged the difference between the cost of acquisition and the total selling price if sold to a third party by the Institution (promisee). Otherwise; i.e., in case it is not sold, the promisee shall not be entitled to receive any compensation.

2/4 The amount of money deposited by the customer as security for his commitment can be either held on trust in the custody of the Institution in which case the latter cannot invest it, or it may be held on an investment trust basis in which case the customer permits the Institution to invest it on the basis of Mudarabah between the customer and the Institution. It is permissible to agree with the customer, upon the execution of the contract of lease, that this amount shall be treated as an advance payment of the instalments of the lease rental.

**3. Acquisition of the Asset to Be Leased, or Its Usufruct, by the Institution**

3/1 For the permissibility of an Ijarah contract concerning a specified asset, the lease contract should be preceded by acquisition of either the asset to be leased or the usufruct of that asset.

3/1/1 If the asset or the usufruct thereof is owned by the Institution, which should in principle be the case, an Ijarah contract may be executed as soon as agreement is reached by the two parties.

3/1/2 However, if the asset is to be acquired by the customer [see item 3/2 below], or by a third party, the Ijarah contract shall not be executed unless and until the Institution has acquired that asset.

Ownership is possible under a sale contract, even if the title is not registered in the purchaser's name (the Institution), and the purchaser has the right to obtain a counter-deed to establish the actual transfer of his ownership of the asset. [see item 3/5 below]

3/2 An asset may be acquired by a party and then leased to that party. In this case, the Ijarah transaction should not be stipulated as a condition of the purchase contract by which the Institution acquires the asset.

3/3 A lessee of an asset may enter into a sub-lease contract with a party other than the owner for a rental that is either the same, lower or higher, payable either currently or on a deferred basis, unless the owner stipulates that the lessee should not assign or sublet the property to third parties, or should not do so without his approval.

3/4 The lessee may lease the asset back to its owner in the first lease period for a rental that is lower, same or higher than what he is paying, if the two rentals are paid on a spot basis. However, this is not permissible if it should lead to contract of 'Inah, by varying the rent or the duration. For example, it is not permissible, if the first rental is one hundred dinars payable on a spot basis, for the lessee to sublet it to the lessor for one hundred and ten dinars payable on a deferred basis, or if the first rental is one hundred and ten dinars payable on a deferred basis, for the second to be for one hundred dinars payable instantly, or if the two rentals are of the same amount, but the payment of the first rental is deferred for one month and the second rental is deferred for two months.

3/5 An Ijarah contract may be executed for an asset undertaken by the lessor to be delivered to the lessee according to accurate specifications, even if the asset so described is not owned by the lessor. In this case, an agreement is reached to make the described asset available during the duration of the contract, giving the lessor the opportunity to acquire or to produce it. It is not a requirement of this lease that the rental should be paid in advance as long as the lease is not executed according to the contract of Salam (or Salaf). Should the lessee receive

an asset that does not conform to the description, then he is entitled to reject it and demand an asset that conforms to the description.

3/6 An Institution's customer may jointly acquire an asset that he wishes to lease with the Institution, and then lease the Institution's share of the asset from the Institution. In this case, the rental specified as receivable by the Institution should only be in proportion to its share in the ownership of the asset, since the lessee is a co-owner of the asset and therefore has to pay rent only on the share that he does not own.

3/7 An Institution may appoint one of its customers to act as its agent in acquiring on its behalf an asset that is desired by that customer such as equipment, machinery, etc., whose description and price are fixed with a view to the Institution's leasing such asset or assets to the customer after it has acquired their ownership through either actual or constructive possession. Although this type of agency (for the purchase of the assets) is permissible, it is always preferred that the agent is someone other than the customer (prospective lessee) as far as possible.

## 4. Concluding an Ijarah Contract and the Forms of Ijarah

### 4/1 Signature of the contract and the consequences thereof

4/1/1 The lease contract is a binding contract which neither party may terminate or alter without the other's consent [see items 5/2/2, 7/2/1, and 7/2/2]. However, an Ijarah contract may be terminated in accordance with item 7/2/1.

4/1/2 The duration of an Ijarah contract must be specified in the contract. The period of Ijarah should commence on the date of execution of the contract, unless the two parties agree on a specified future commencement date, resulting in a future Ijarah, that is, an Ijarah contract to be executed at a future date.

4/1/3 If the lessor fails to deliver the asset to the lessee on the date specified in the Ijarah contract, no rental is due for the period

between the date specified in the contract and the date of actual delivery, and the rental should be reduced accordingly, unless it is agreed that the lease be extended by an equivalent period after its original expiry date.

4/1/4 'Arboun (Earnest Money) may be taken in respect of lease at the execution of the contract of lease, with the lessee having the right to terminate the contract during a specified period of time, and 'Arboun is treated as an advance payment of the rental. If the Ijarah contract is not executed for a reason attributable to the lessee, the lessor may retain the 'Arboun. However, it is preferable for the Institution to forgo any amount in excess of the actual damage it has suffered. [see para. 3/2]

**4/2 Forms of the Ijarah contract**

4/2/1 Ijarah contracts may be executed in respect of the same asset for different periods for several lessees, provided that two contracts are not executed in respect of the same asset for the same period. Such an arrangement is called "successive leases", because each Ijarah is considered as being successive to the previous one and not concurrent with it on the basis of its being a future Ijarah. [see item 4/1/2 above]

4/2/2 If the lessor signs an Ijarah contract for a particular asset for a specified period of time, he cannot sign another Ijarah contract with another lessee for the duration of the existing Ijarah period or for any remaining period thereof. [see item 7/1/2 below]

4/2/3 An Ijarah contract may be signed with several lessees being entitled to the same specified usufruct of a particular asset and duration of rent, without specifying a particular period of time for a particular person. In this case, each lessee may benefit from the property during the time assigned to him in accordance with specified rules. This case is one form of Muhaya`ah (time-sharing) in benefiting from the usufruct.

4/2/4 A lessee may invite others to share with him in the usufruct he owns. In this case, they become co-owners in the usufruct of the leased property. This can only be done before entering into a sub-lease. If the property is sub-leased after the co-owners having owned the usufruct each co-owner is entitled to a share in the sub-lease rental pro rata to his share in the usufruct.

## 5. Subject Matter of Ijarah

### 5/1 Rules governing benefit and leased property

5/1/1 The leased asset must be capable of being used while preserving the asset, and the benefit from an Ijarah must be permissible by Shari'ah. For example, a house or a chattel may not be leased for the purpose of an impermissible act by the lessee, such as leasing premises to be used as headquarters by an Institution dealing in interest or to a shopkeeper for selling or storing prohibited goods, or leasing a vehicle to transport prohibited merchandise.

5/1/2 The subject matter of Ijarah may be a share in an undivided asset held in common with the lessee, whether the lessee is a partner with the lessor or not. In this case the lessee may benefit from the leased share in the same way in which the lessor used to benefit from it, i.e., by usufruct division based on Muhāya'ah i.e. by identifying a particular time (time-sharing) or a particular part of the property, used alternately by the co-owners, or any other means with consent of the other partner.

5/1/3 An Ijarah contract may be executed for a house or a chattel, even with a non-Muslim, if the use to be made of it is permissible, such as a house for residential purposes, a car for transport, or a computer to store data, unless the lessor knows in advance, or has reason to presume, that the use of the asset to be leased will be for an impermissible purpose.

5/1/4 The lessee must use the leased asset in a suitable manner or in conformity with common practice, and comply with conditions which are acceptable in Shari'ah. He must also avoid causing

damage to the leased asset by misuse through misconduct or negligence.

5/1/5 The lessor must accept responsibility for any defects of the leased asset which impair the intended use of the asset, and may not exclude his liability for any impairment that the leased asset may sustain, either by his own doing or as a result of events outside his control, which affect the benefits intended to be available under the Ijarah contract.

5/1/6 If the benefit from the leased asset is impaired wholly or partially as a result of the lessee's misconduct, while the property remains under lease, the lessee is obliged to restore or repair the usufruct, and rent for the time during which the benefit is lost is not to be waived.

5/1/7 The lessor may not stipulate that the lessee will undertake the major maintenance of the asset that is required to keep it in the condition necessary to provide the contractual benefits under the lease. The lessor may delegate to the lessee the task of carrying out such maintenance at the lessor's cost. The lessee should carry out operating or periodical (ordinary) maintenance.

5/1/8 The leased asset is the responsibility of the lessor throughout the duration of the Ijarah, unless the lessee commits misconduct or negligence. The lessor may take out permissible insurance on it whenever possible, and such insurance expenses must be borne by the lessor. The lessor may take this into account implicitly when the lease rental is to be fixed. However, he may not, after the contract is signed, charge the lessee any cost in excess of the cost anticipated at the time of fixing the rent. The lessor may also delegate to the lessee the task of taking out insurance at the lessor's expense.

**5/2 Rules governing lease rentals**

5/2/1 The lease rental may be in cash or in kind (goods) or benefit (service). The rental must be specified, either as a lump sum

covering the duration of the Ijarah contract, or by instalments for parts of the duration. It may also be for a fixed or variable amount, according to whatever designated method the two parties agree upon. [see item 5/2/3 below]

5/2/2 The rental is made obligatory by the contract and the lessor's entitlement to the rental runs from the time when the lessee starts to benefit from the asset or once the lessor makes the usufruct of the asset available to the lessee, and the entitlement to the rental does not necessarily commence on the date of signing the Ijarah contract. The rental may be paid entirely in advance or in instalments during a period equivalent, or more or less, to the duration of the Ijarah. However, if the asset is made available only after a period longer than what customary practices deem proper, then no payment shall be obligatory.

5/2/3 In case the rental is subject to changes (floating rental), it is necessary that the amount of the rental of the first period of the Ijarah contract be specified in lump sum. It is then permissible that the rentals for subsequent periods be determined according to a certain benchmark. Such benchmark must be based on a clear formula which is not subject to dispute, because it becomes the determining factor for the rentals of the remaining periods. This benchmark should be subject to a ceiling, on both maximum and minimum levels.

5/2/4 It may be agreed that the rental should consist of two specified parts: one to be paid or transferred to the lessor and the other to be held by the lessee to cover any expenses or costs approved by the lessor, such as the cost of major maintenance, insurance, etc. The excess of the second part of the rental shall be treated as an advance to the lessor on account, while the lessor shall bear any shortage.

5/2/5 The amendment of future rentals is permissible by the agreement of both parties, i.e. the periods for which the lessee has not yet received any benefit. The rentals of any previous periods which

have not yet been paid become a debt owed to the lessor by the lessee, and therefore cannot be increased.

## 6. Guarantees and Treatment of Ijarah Receivables

6/1 Permissible security, of all kinds, may be taken to secure the rental payments or as a security against misuse or negligence on the part of the lessee, such as a charge over assets, guarantees or an assignment of rights over assets of the lessee held by third parties, even if such rights are a permissible life or property insurance indemnity in favour of the lessee.

6/2 The two parties may agree that the rental be paid fully in advance. It is also permissible to make the rent payable in instalments, in which case the lessor may stipulate that the lessee should immediately pay the remaining instalments if he, after receiving a specified period of due notice, delays, without a valid reason, payment of one instalment or more, provided that the asset shall be made available for the lessee to use for the remaining period of time. Any stipulated upfront rental or accelerated -because of delay of payment- rental is subject to settlement at the end of the Ijarah period or, if the Ijarah contract is terminated earlier, at the time of such termination. Any extension of time by the lessor after the stipulated time for prompt payment is considered as a consent to deferral of payment throughout the extension period and not a right of the lessee, subject always to item 5/2/2 above.

6/3 No increase in the rental due may be stipulated by the lessor in case of delay in payment by the lessee.

6/4 It may be provided in the contract of Ijarah or Ijarah Muntahia Bittamleek that a lessee who delays payment for no good reason undertakes to donate a certain amount or percentage of the rental due in case of late payment. Such donation should be paid to charitable causes under the co-ordination of the Institution's Shari'ah Supervisory Board.

6/5 In case of foreclosure of the security provided by the lessee, the lessor may deduct from such amounts only what is due in respect

of rental for previous periods, and not all rental instalments, including instalments which have not yet fallen due and in respect of periods for which the lessee has not had the benefit of the leased asset. The lessor may also deduct from the security all legitimate compensations necessitated by the lessee's breach of contract.

## 7. Changes to the Ijarah Contract

### 7/1 Selling of or damage to the leased asset

7/1/1 If the lessor sells the leased asset to the lessee, the Ijarah contract is terminated due to the transfer of the ownership of the leased asset and ownership of usufruct to the lessee.

7/1/2 The lessor may sell the leased asset to a third party other than the lessee, and the title to the asset together with the rights and obligations of the lessor under the Ijarah contract is thereby transferred to the new owner, because the asset and the rights and obligations attached to it become the right of the third party. The lessee's consent is not necessary when the lessor decides to sell the asset to a third party. If the purchaser does not know about the Ijarah contract, he may terminate the sale contract, but if he knows about it and consents to it, he takes the place of the previous owner in his entitlement to the rental for the remaining period.

7/1/3 In case of total destruction of the leased asset, the Ijarah contract is terminated if it is concluded on an identified asset. In such a case, it may not be stipulated that the rest of the instalments should be paid.

7/1/4 The leased asset in the possession of the lessee is held by the lessee in a fiduciary capacity on behalf of the lessor. The lessee will not be held liable for any damage or destruction of the leased asset unless such damage or destruction is a result of misconduct or negligence on the part of the lessee. In this case, he is obliged to replace the asset if it is replaceable; otherwise, he is liable for the amount of the damage to be determined by valuation.

7/1/5 In case of the partial destruction of the leased asset in a manner that impairs the benefits expected from the leased asset, the lessee may terminate the Ijarah contract. Both he and the lessor may also agree to amend the rental in case of partial destruction of the leased property, if the lessee waives his right to termination. The lessor in this case is not entitled to rent for the period during which the lessee was not able to benefit from the asset unless the lessor makes it up (by agreement with the lessee) with a like benefit after the expiry of the period specified in the contract. [see para. 5/1/6]

7/1/6 In an *Ijarah Mawsufah fi al-Dhimmah* (contract for an unidentified asset undertaken by the lessor to be delivered according to the agreed specifications), the owner in cases of total and partial destruction must offer an alternative asset having a specification similar to that of the destroyed asset, unless otherwise agreed at the time. The Ijarah shall continue for the remaining time of the contract. If it is not possible to provide a substitute asset, the contract will be terminated. [see item 3/5]

7/1/7 If the lessee stops using the leased asset or returns it to the owner without the owner's consent, the rental will continue to be due in respect of the remaining period of the Ijarah, and the lessor may not lease the property to another lessee for this period, but must keep it at the disposal of the current lessee unless the lessee relinquishes to the lessor the remaining period of time, in which case the lease expires. [see item 7/2/1 below]

**7/2 Termination, expiry and renewal of the Ijarah contract**

7/2/1 It is permissible to terminate the lease contract by mutual consent but it is not permissible for one party to terminate it except in case of force majeure or there is a defect in the leased asset that materially impairs its use. Termination is also possible when one party secures an option to terminate the contract in which case the party who holds the option may exercise it during the specified period.

7/2/2 The lessor may stipulate that the Ijarah contract be terminated if the lessee does not pay the rent or fails to pay it on time.

7/2/3 An Ijarah contract does not terminate with the death of either party thereto. However, the heirs of the lessee may terminate the Ijarah contract if they can prove that the contract has become, as a result of the death of their legator, too onerous for their resources and in excess of their needs.

7/2/4 An Ijarah contract expires with the total destruction of the leased asset in the case of leasing a specific asset or with the inability to enjoy the usufruct owing to the loss of the benefit that the asset was intended to provide.

7/2/5 The two parties may terminate the Ijarah contract before it begins to run.

7/2/6 The lease expires upon the expiry of its term, but it may remain operative for a good cause, such as the late arrival to the place intended in the lease of transportation vehicles, and in the case of a late harvesting period for land leased for crop cultivation. The lease then continues with the rental based on the prevailing market value. An Ijarah may be renewed for another term, and such renewal may be made before the expiry of the original term or automatically by adding a provision in the new contract for such renewal when the new term starts, unless either party serves a notice on the other of its desire not to renew the contract.

## 8. Transfer of the Ownership in the Leased Property in Ijarah Muntahia Bittamleek

8/1 In Ijarah Muntahia Bittamleek, the method of transferring the title in the leased asset to the lessee must be evidenced in a document separate from the Ijarah contract document, using one of the following methods:

a) By means of a promise to sell for a token or other consideration, or by accelerating the payment of the remaining amount of rental, or by paying the market value of the leased property.

b) A promise to give it as a gift (for no consideration).

c) A promise to give it as a gift, contingent upon the payment of the remaining instalments.

In all these cases, the separate document evidencing a promise of gift, promise of sale or a promise of gift contingent on a particular event, should be independent of the contract of Ijarah Muntahia Bittamleek and cannot be taken as an integral part of the contract of Ijarah.

8/2 A promise to transfer the ownership by way of one of the methods specified in item 8/1 above is a binding promise by the lessor. However, a binding promise is binding on one party only, while the other party must have the option not to proceed. This is to avoid a bilateral promise by the two parties which is Shari'ah impermissible because it resembles a concluded contract.

8/3 In all cases of transfer of ownership by way of gift or sale, it is necessary, when the promise is fulfilled, that a new contract be drawn up, since the ownership to the property is not automatically transferred by virtue of the original promise document that was drawn up earlier.

8/4 In case the Ijarah contract is combined, through a separate document, with a gift contingent upon the condition that the remaining rent instalments be paid, the ownership to the leased property is transferred to the lessee if the condition is fulfilled, without the need for any other procedure to be adopted or a document to be signed. However, if the lessee's payment is short of even one instalment, the ownership to the property is not transferred to him, since the condition has not been fulfilled.

8/5 If the leased asset was purchased from the lessee before it was leased back to the lessee on the basis of Ijarah Muntahia Bittamleek, a (reasonable) period of time, between the lease contract and the time of the sale of the asset to the lessee, must have expired, to avoid the contract of 'Inah. This period must be long enough so that the leased property or its value could have changed. This shall

also apply to the case of early ownership of the asset where a sale contract is concluded during the Ijarah. [see para. 7/1]

8/6 Subject to item 8/8 below, the rules governing Ijarah must apply to the Ijarah Muntahia Bittamleek, i.e. when a promise is made by the lessor to transfer the ownership in the leased asset to the lessee. None of these rules should be breached under the pretext that the leased asset was bought by the lessor on the basis of a promise by the lessee that he would acquire it or that ownership of it would devolve upon him, or that he would pay rentals in excess of those payable in respect of a similar property which are similar in amount to the instalments of an instalment sale, or that local laws and conventional banking practices consider such a transaction as an instalment sale with a deferred transfer of the ownership.

8/7 Transfer of the ownership in the leased property cannot be made by executing, along with the Ijarah, a sale contract that will become effective on a future date.

8/8 If the leased asset is destroyed or if the continuity of the lease contract becomes impossible up to the expiry period without the cause being attributable to the lessee in either case, then the rental is adjusted based on the prevailing market value. That is, the difference between the prevailing rate of rental and the rental specified in the contract must be refunded to the lessee if the latter rental is higher than the former. This is to avoid loss to the lessee, who agreed to a higher rental payment compared to the prevailing rate of rental in consideration of the lessor's promise to pass the title to him upon the expiry of the lease term.

## 9. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1423 A.H., corresponding to 16 May 2002 A.D.

# Adoption of the Standard

The Shari'ah standard for Ijarah and Ijarah Muntahia Bittamleek was adopted by the Shari'ah Board in its meeting No. (4) held on 25-27 Safar 1421 A.H., corresponding to 29-31 May 2000 A.D.

In its meeting No. (8) held in Mecca on 28 Safar - 4 Rabi' I, 1423 A.H. corresponding to 11-16 May 2002 A.D., the Shari'ah Board readopted a resolution to reformat the Shari'ah rules for Ijarah and Ijarah Muntahia Bittamleek in the form of a Shari'ah standard.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (1) held on 11 Dhul-Hajjah 1419 A.H., corresponding to 27 February 1999 A.D., the Shari'ah Board decided to give priority to the preparation of the Shari'ah rules for Ijarah and Ijarah Muntahia Bittamleek.

On Tuesday 13 Dhul-Hajjah 1419 A.H., corresponding to 30 March 1999 A.D., the Fatwa and Arbitration Committee decided to commission a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Rules for Ijarah and Ijarah Muntahia Bittamleek.

In its meeting held on 13-14 Rajab 1420 A.H., corresponding to 22-23 October 1999 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Ijarah and Ijarah Muntahia Bitamleek, and asked the consultant to make the amendments in light of the comments made by the members.

The revised exposure draft of the Shari'ah Rules was presented to the Shari'ah Board in its meeting No. (3) held in Mecca on 10-15 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D. The Shari'ah Board made further amendments to the exposure draft of the Shari'ah Rules and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 29–30 Dhul-Hajjah 1421 A.H., corresponding to 4-5 April 2000 A.D. The public hearing was attended by more than 30 participants representing central Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. The members responded to the written comments that were sent prior

to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee and the Fatwa and Arbitration Committee held a joint meeting on 21-23 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., to discuss the comments made about the Shari'ah Rules. The committee made the amendments which it considered necessary in light of the discussions that took place in the public hearing.

The Shari'ah Board in its meeting No. (4) held on 25–27 Safar 1421 A.H. corresponding to 29–31 May 2000 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Studies Committee and the Fatwa and Arbitration Committee, and made the amendments which it considered necessary. Some paragraphs of the standard were adopted in the name of Shari'ah Rules for Ijarah and Ijarah Muntahia Bittamleek by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

In its meeting No. (7) held on 9-13 Ramadan 1422 A.H. corresponding to 24-28 November 2001 A.D., in Makkah Al-Mukarramah, the Shari'ah Board decided to convert all Shari'ah rules for Investments and Financing to Standards and a committee was formed for this purpose.

In its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H. corresponding to 11-16 May 2002 A.D., the Shari'ah Board adopted the reformatting of Shari'ah Rules for Ijarah and Ijarah Muntahia Bittamleek in the name of Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek. The committee did not make any changes to the substance.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II, 1433 A.H. corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Ijarah and Ijarah Muntahia Bittamleek**

- Ijarah derives permissibility from the Qur`an, the Sunnah, consensus of Fuqaha and Ijtihad (reasoning).
- On the level of the Qur`an, Allah, the Almighty, says: ***{"said one of them 'O my father engage him on wages"}***,(3) and ***{"if you had wished, surely you could have exacted some recompense for it"}***.(4)
- The authority for the permissibility of Ijarah in the Sunnah is the saying of the Prophet (peace be upon him): *"Whoever hired a worker must inform him of his wages"*,(5) and his saying: *"Give a worker his wages before his sweat (body odour) is dried"*.(6)
- The permissibility of Ijarah also generated consensus among the legal community. The Ijarah is also acceptable by reasoning because it is a convenient means for people to acquire right to use assets that they do not own since not all people may be able to own tangible assets.
- The Ijarah Muntahia Bittamleek, on the other hand, is not different in its rules from an ordinary Ijarah, except that it is associated with a promise by the lessor to transfer ownership at the end of the Ijarah term. The permissibility of this form of Ijarah is confirmed by the resolution of International Islamic Fiqh Academy which explained the impermissible and the permissible forms of Ijarah Muntahia Bittamleek.(7)
- It must be noted that the permissible Ijarah Muntahia Bittamleek is different from hire-purchase as commonly practised by the conventional

(3) [Al-Qasas (The Narrative): 26].
(4) [Al-Kahf (The Cave): 77].
(5) This Hadith has been related by Ibn Majah in his *"Sunan"* [2: 817]; and Al-Haythami in *"Majam' Al-Zawa'id"* [4: 98].
(6) This Hadith has been reported by Ibn Majah in his *"Sunan"* [2: 817]; and Al-Tabrani in *"Al-Mu'jam Al-awsat"*; and Al-Haithami in *"Majam' Al-Zawa'id"* [4: 98].
(7) Resolution of the International Islamic Fiqh Academy No. 110 (4/12).

banks in the following respects. In hire-purchase, the terms and provisions of sale and leasing are applied to the subject matter at the same time, and subsequently the ownership of the subject matter is transferred to the lessee (buyer), once he pays the last instalment without the need for a separate contract for the transfer of ownership. In the permissible Ijarah Muntahia Bittamleek, on the other hand, the provisions governing Ijarah are applied to the leased asset until the end of the Ijarah term, after which the lessee obtains ownership of the asset in the manner explained in this Standard.

- It must be noted also that the Ijarah contract intended in this Standard is the lease of tangible assets (chattels or property), which is a contract giving a legal title to legitimate and identified usufruct for a defined period of time in exchange for a legitimate and determined consideration.

**Promise to Lease an Asset**

The basis for allowing the Institution to demand payment of money by a party who has promised to take the property as lessee is the need to confirm the commitment of the promissor. This is because a binding promise has financial implications if the promissor retracts the promise. The request for payment of a commitment fee is to cater for financial damage that the Institution may have incurred as a result of the promissor taking back the promise or defaulting in payment. The unified Shari'ah Supervisory Board of Al Baraka issued a Fatwa in respect to *Hamish Jiddiyyah* (security deposit) in Murabahah.[8] This ruling is also applicable to Ijarah.

**Acquisition of the Asset to be Leased, or Its Usufruct, by the Institution**

- The basis for not allowing the leasing of an asset that is not owned by the lessor is the Hadith that prohibits one from selling what he does not own,[9] and Ijarah proper is a sale of usufruct. The basis for allowing the leasing back of an asset to the person from whom the asset was acquired is because such a transaction does not involve any 'Inah sale.
- The basis for not allowing a simultaneous combination of Ijarah and sale is because making purchase contracts contingent upon leasing contracts is impermissible by an explicit text in the view of a number

(8) International Islamic Fiqh Academy Resolution No. 110 (4/12).
(9) Fatwa of Unified Shari'ah Board of Al Baraka No. (9/10).

of jurists. This is prohibited by a well-known Hadith which prohibits two sales in one sale.(10)

- The basis for the permissibility of sub-leasing when the lessor has allowed it is because the lessee has ownership of the usufruct by virtue of the Ijarah contract, in which case he is entitled to transfer such usufruct for consideration as he deems fit. The basis for impermissibility of sub-leasing when the lessor has not allowed it is because the ownership of usufruct by the lessee is limited in which case the lessee is obliged to consider any limitations on this ownership.
- The basis for the permissibility of leasing a property on the basis of specifications even if the lessor does not own it is that this will not lead to dispute, in which case it is similar to a Salam contract. However, in this case the lessor should not request advance payment of the rentals according to one of the views of the Shafi'is and Hanbalis.
- The basis for preferring that the agent who purchases on behalf of the Institution be someone other than the customer (lessee) is to avoid fictitious transactions and to demonstrate the genuine role of the Institution in making the usufruct of the asset available to the lessee.

**Contract of Ijarah**

- The basis for the binding nature of an Ijarah contract is because Ijarah is one of the contracts for transferring ownership that depends on an exchange of counter-values. The Shari'ah principle is that these contracts are binding because of the Saying of Allah, the Almighty: ***{"... Fulfil (your) obligations..."}***.(11) The basis for allowing cancellation of an Ijarah contract due to contingencies is because without the right to cancel the Ijarah contract the lessee would waste money by paying rent for unneeded usufruct due to an event of which he did not contribute to the occurrence.
- The basis for requiring a designated term for the lease is because without such a designated term there would be an uncertainty that might lead to dispute. The basis for allowing an Ijarah contract take effect based on

(10) The Hadith has been related by Abu Dawud in his *"Sunan"* [3: 283].

(11) The Hadith has been related by Ahmad, Al-Nasa'i and Al-Tirmidhi. Al-Tirmidhi autheticated the Hadith: see, *"Nayl Al-Awtar"* [5: 248].

future events is because Ijarah is, unlike a sale contract, a contract that involves time and for this it is relevant that it be contingent on future events.

- The basis for the permissibility of obtaining 'Arboun (Earnest Money) to secure performance is the practice of Umar Ibn Al-Khattab (may Allah be pleased with him) in the presence of some companions of the Prophet (peace be upon him). This practice is also permitted by Imam Ahmad. A resolution has been issued in connection with the permissibility of 'Arboun (Earnest Money) by the International Islamic Fiqh Academy.(12)
- The basis for the impermissibility of re-leasing after the lease of the asset is that under the first contract, the usufruct of the asset no longer belongs to the owner, and a new contract may not be signed with another lessee before the contract with the first lessee is terminated. Hence, this form of Ijarah is not suitable as an investment instrument, because it constitutes an impermissible sale of the rent receivable pursuant to providing new lessees with an asset already leased out to the existing lessee. The form just described is different from the transfer, by the owner, of the ownership of the leased assets to an investor, so that the latter takes his place, wholly or partially, with regard to the ownership of all or some parts of the assets, as well as in the ownership of the usufruct of, and entitlement to his share of the rent from, those assets. Al Baraka Forum has issued a resolution disallowing multiple leases of the same asset after the first Ijarah contract.(13)
- The basis for allowing successive leases on the same specified usufruct of a particular asset without specifying a particular period for a particular person is because the usufruct -in line with the term assigned to each party- can accommodate the parties. The justification for not allowing a specific term for each person is that each party will know the term to which he is entitled in his turn and because their applications are considered in order. This rule was supported by a resolution of Al Baraka Forum.(14)

(12) [Al-Ma`idah (The Table): 1].
(13) Resolution No. 72 (3/8) in respect of 'Arboun (Earnest Money).
(14) Resolution No. (13/4).

- The basis for the requirement that incorporating co-lessees must take place before any sub-lease contract is signed is because sub-leasing the property means the sub-lessor no longer owns the usufruct, and thus he would be leasing out a benefit of the usufruct that he does not own, which is not permissible in Shari'ah as stated earlier. The jurists have considered a bankrupt lessor -a person who leases things he does not own- among those who must be restricted in using their property.

**Subject Matter of Ijarah**

- The basis for the requirement that the leased asset must be capable of being used while preserving the asset is that the subject of a lease is usufruct and not the asset, as leasing is not possible for things that perish by use. The basis for the requirement that benefit from Ijarah must be permissible is that leasing an asset that will be used in impermissible way makes the lessor an accomplice in doing evil and this is prohibited as per the saying of Allah, the Almighty: ***{"Help you one another in Al-Birr and At-Taqwa (virtue, righteousness and piety)"}***.(15)
- The basis for the impermissibility of stipulating a defect exclusion clause in respect to the leased asset is that such a condition defeats the purpose of the contract, which is exchange of usufruct for rentals. If the usufruct is partially or wholly impaired, the receipt of the rentals by the lessor becomes a form of unjust enrichment. The resolution of the International Islamic Fiqh Academy has declared that the lessor must accept responsibility for any destruction or impairment of the leased asset insofar as these events are not sustained as a result of misconduct or negligence on the part of the lessee.(16) The Fatwa of the unified Shari'ah Supervisory Board of Al Baraka states that the lessor is not entitled to exclude his liability in respect of defects in the leased asset.(17)
- The reason why the lessor may not stipulate that the lessee will undertake the major maintenance of the leased asset is that this condition defeats the purpose of an Ijarah contract. Again, it is the duty of the lessor to ensure that the usufruct is intact, and this is not possible unless the asset is maintained and kept safe so that the lessor may be entitled

(15) Resolution No. (10/1).
(16) [Al-Ma`idah (The Table): 2].
(17) International Islamic Fiqh Academy Resolution No. 13 (1/3).

to the rentals in consideration for the usufruct. The unified Shari'ah Supervisory Board of Al Baraka issued a fatwa supporting this.(18)

- The reason why insurance expenses must be borne by the lessor is that the owner of the asset is responsible for insuring it, and the lessor is the owner. This is supported by the resolution issued by the International Islamic Fiqh Academy.(19)
- The basis for the permissibility of using a certain benchmark or price index to determine rentals of subsequent periods after the expiration of the first period of an Ijarah contract is that the rentals will subsequently be known. This is similar to the principle of *Ujrat al-Mithl* (prevailing market rate of rental) and does not lead to dispute. Again, using a benchmark to determine the rentals is to the benefit of all parties since there is possibility of rental fluctuation that may be in favour of either the lessee or the lessor in view of the fact that the contract remains binding on both parties throughout its term. This rule is supported by a Fatwa issued during Al Baraka's 11th Forum.
- The basis for the permissibility of restructuring the rentals for the future periods is that such an act is deemed to create a new contract for a new term for which the rentals are not yet due. Hence, the rentals are not regarded as a debt, in which case the prohibition of rescheduling rentals in return for higher payment is not applicable to this. However, increasing previously agreed rentals in exchange for a deferred period of payment is a form of Riba.

**Guarantees and Treatment of Ijarah Receivables**

- The basis for the permissibility of obtaining guarantees for payment is that this is not contrary to the purpose of an Ijarah contract. Rather guarantees are relevant to credit transactions because they secure performance.
- The basis for the permissibility of a payment acceleration clause is the saying of the Prophet (peace be upon him): *"Muslims are bound by the conditions they made"*, and because payment on a deferred basis is the right of the lessee (the debtor as to rentals), and the lessee may, based

(18) Fatwa of the Unified Shari'ah Board of Al Baraka No. (1/97).
(19) Fatwa of the Unified Shari'ah Board of Al Baraka No (9/9).

on agreement, choose to pay before time and relinquish the deferral of the date of payment entirely. The lessee may also agree to a stipulation that bases acceleration of payment on the event of default in payment.

- The basis of the prohibition of increasing the amount of lease receivables in exchange for a deferral of payment is because this is a form of Riba.
- The basis for the permissibility of stipulating that a solvent debtor should undertake to make a payment to charity in case of default is that this is similar to an undertaking to make a donation that is approved by the Maliki scholars, notably Abdullah Ibn Nafi' and Muhammad Ibn Ibrahim Ibn Dinar.[20]

**Changes to the Ijarah Contract**

- The basis for allowing the lessor to sell the leased asset to a third party without the consent of the lessee is that the lessor owns the asset and is acting within the limits of his ownership without affecting the right of the lessee that is materialised in the usufruct. If the Ijarah expires, enabling the buyer to take possession of the asset is sufficient to discharge the seller from any responsibility as to delivery in which case the buyer will own the asset excluding the right of the lessee to the usufruct which is attached to the asset even if the ownership is transferred. The Shari'ah Supervisory Board of Al Rajhi Banking and Investment Corp.,[21] and the Shari'ah Supervisory Board of the Jordan Islamic Bank[22] have issued a resolution in support of this ruling.
- The basis for the termination of the lease contract due to a total destruction of the leased asset is that the rent is in consideration of the benefit of the leased asset and if the latter is destroyed, there is no justification for the payment of the rental.
- The basis for the entitlement of the lessor to the rentals even though the lessee returns the leased asset to the owner or stops using it is that Ijarah is a binding contract that cannot be terminated unilaterally by the lessee.

(20) International Islamic Fiqh Academy Resolution No. 13 (1/3).

(21) See: Al-Hattab, *"Tahrir Al-Kalam Fi Masa`il Al-Iltizam"* (pp. 170). This view appeared in the Fatwas of Kuwait Finance House.

(22) Resolution of the Shari'ah Board of Al Rajhi Banking and Investment Corp. No. (11).

- The basis for the permissibility of terminating the lease contract in case of intervening contingencies or force majeure is that there is a pressing need which calls for this. This is because if the contract were to be binding in spite of such contingencies, then a person with a valid excuse may incur loss that was not a result of a contract. The Shari'ah Supervisory Board of the Kuwait Finance House[23] and the unified Shari'ah Supervisory Board of Al Baraka[24] have issued a supporting Fatwa in this regard.
- The basis for the permissibility that the lessor may stipulate that an Ijarah contract be terminated due to non-payment of rental by the lessee is that contractual stipulations are primarily valid and enforceable. This stipulation does not legalise impermissible acts or invalidate permissible acts. Therefore, the permissibility of this stipulation comes under the prophetic Hadith stating: *"Muslims are bound by the conditions they made except a condition that legalises impermissible act or invalidates permissible act"*.[25]
- The basis of the rule that Ijarah does not terminate with the death of either party thereto is that the subject-matter of the contract is the asset and as long as the asset is available the Ijarah contract remains unaffected. The basis for the right of the lessee's heirs to terminate the Ijarah if they can prove that the contract has become too onerous for their resources is to avoid inflicting damage on the heirs. This exceptional ruling is taken from the Maliki School of law since it serves the interests of the lessee. The heirs of the lessor may not terminate the Ijarah in the event of the death of the lessor because there is no potential damage to them, as they will receive the rentals for the remainder of the term of the contract.

**Transfer of the Ownership in the Leased Asset in Ijarah Muntahia Bittamleek**

- The basis of the rule that the documents of the lessor's promise to sell and the methods of transfer of ownership be separated from the Ijarah contract is to ensure that the obligations and liabilities are not

(23) Fatwas of the Shari'ah Board of Jordan Islamic Bank No. (18).
(24) Fatwa No. (233) and (253).
(25) Fatwa No. (9/9) of the Unified Shari'ah Board.

linked to each other. The International Islamic Fiqh Academy has issued a resolution in this regard.(26)

- The basis for the rule that the promise of a client to take an asset acquired by the Institution on lease is binding is that the Institution has acquired the asset in order to lease it to the client due to the promise. Therefore, the rule that the promise to take the asset on lease is binding will protect the promisee.
- The basis for not allowing bilateral promises is that the resemblance of these promises to a contract, i.e. a contract is effected before taking ownership of the subject matter of the contract. The International Islamic Fiqh Academy has issued a resolution in this regard.(27)
- The basis for the permissibility of a gift contingent upon the expiry of the Ijarah term is that a conditional gift is valid. The Prophet (peace be upon him) sent a gift to Negus (the former emperor of Ethiopia) on condition that he was alive at the time of the arrival of the messenger.(28) The basis for the permissibility of leasing an asset to the person from whom it is purchased by way of Ijarah Muntahia Bittamleek on condition that the parties observe the lapse of a period of time is that this prevents the contract from becoming a 'Inah transaction. This is because the physical changes to the asset or changes in the value of the asset during this period give it the economic characteristics of a different asset.
- The basis for the requirement that all the rules prescribed for an ordinary lease are applicable to Ijarah Muntahia Bittamleek is that a mere promise to transfer ownership does exclude the contract from becoming an Ijarah contract or from the applicable rules. This requirement is necessary in order to prevent a linking of contracts (the sale contract and lease

(26) This Hadith has been related by a number of companions. It was also related by Ahmad in his *"Sunan"* [1: 312]; Ibn Majah in his *"Sunan"* through a good chain of transmission [2: 783], Mustafa Al-Babi Al-Halabi edition, Cairo, 1372 A.H./1952 A.D.; Al-Hakim in *"Mustarak"*, Edition of Hyderabad, India, 1355 A.H.; Al-Bayhaqi in his *"Sunan"* [6: 70 and 156] and [1: 133], Edition of Hyderabad, India, 1355H; and Al-Daraqutni in his *"Sunan"* [4: 228] and [3: 77], Dar Al-Mahasin Lil-Tiba'ah edition, Cairo, 1372 A.H./1952 A.D.

(27) Intenatioanl Islamic fiqh Academy Resolution No. 13 (1/3).

(28) The Hadith has been related by Ibn Hibban: *"Sahih Ibn Hibban"* [11: 516]; and Ahmad in his *"Musnad"* [6: 404].

contract). The International Islamic Fiqh Academy has issued a resolution in support of this ruling.[29]

- The basis for the rule that ownership cannot be made in contingent on a future date is that a sale contract cannot be dependent on a future date, as the term 'sale' means that its effect (transfer of ownership) immediately takes place.
- The basis for allowing recourse to the prevailing market rate of rental when the transfer of ownership becomes impossible without any cause attributable to the lessee is to protect the lessee against any loss as the lessee has paid more than the prevailing rate of rental in order to acquire title to the asset. If this acquisition of title becomes impossible, then the rental must be adjusted retrospectively to the prevailing market rate. This ruling is analogous to the principle that the price must be discounted when a sold crop has suffered damages due natural calamities.

(29) See Note (25).

# Appendix (C)
# Definitions

**Ijarah**

The term Ijarah as used in this standard means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.

**Ijarah Muntahia Bittamleek**

One of the forms of Ijarah used by Islamic financial Institutions is Ijarah Muntahia Bittamleek. This is a form of leasing contract which includes a promise by the lessor to transfer the ownership in the leased property to the lessee, either at the end of the term of the Ijarah period or by stages during the term of the contract, such transfer of the ownership being executed through one of the means specified in the Standard.

Shari'ah Standard No. (10)

# Salam and Parallel Salam

(Revised Standard)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The aim of the standard is to explain the rules for and limitations of Salam and Parallel Salam in respect to concluding a Salam contract, the subject matter of Salam and changes to the contract, whether in the event of ability to deliver or otherwise. The standard also explains rulings in respect to issuing Salam Sukuk.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers Salam and Parallel Salam transactions, whether the Institution is the buyer or the seller, and issuing Salam Sukuk. This standard does not cover Istisna'a (manufacturing or supplier contract) because the latter is covered by a separate standard.

## 2. Contract of Salam

### 2/1 General framework for Salam contracts

2/1/1 It is permissible to initiate through negotiations several Salam contracts (with different parties). Each operation will end at its due date. It is also permissible to draw up a general framework or a master agreement that consists of an understanding to conclude successive Salam contracts, each of which will take place at an appropriate time. In this latter case, the transaction involved shall be concluded on the basis of a memorandum of understanding in which the contracting parties determine the framework of the contract and the intention of the parties to buy and sell. The parties shall also determine the quantity and specifications of the goods, the manner of their delivery, the basis for determining the price, and the manner of payment. The types of guarantees and other prospective arrangements shall also be specified in the memorandum. The execution of each Salam contract may then take place separately at the appropriate date.

2/1/2 If the Salam contract is concluded on the basis of what was initially agreed in the memorandum of understanding, the contents of the memorandum become part and parcel of the contract. This will hold true unless the parties agreed when the

contract was concluded to exempt themselves from some of the obligations referred to in the memorandum of understanding.

### 2/2 Form of a Salam contract

A contract of Salam may be concluded using the word Salam, or Salaf, or sale, or any term that indicates sale of a prescribed commodity for deferred delivery in exchange for immediate payment of the price.

## 3. Subject Matter of Salam

### 3/1 Capital of Salam contract and its conditions

3/1/1 It is permissible for the capital of Salam to be in the form of fungible goods (such as wheat and other cereals) in which case the parties must make sure that they do not fall into Riba. The capital may also be items of material value (such as livestock). It is also permissible for it to be in the form of the general usufruct of a particular asset, such as living in a house or having the use of an aircraft or a ship for a certain period. In such a case, when a party is granted access to the usufruct through delivery of the asset, this is regarded as immediate receipt (possession) of the Salam capital.

3/1/2 The capital of Salam should be made known to the two parties in a manner that removes all uncertainty and eliminates the possibility of dispute. In principle, the capital of Salam should be in the form of cash. In this case, the currency of payment, the amount and the manner of payment shall be clearly defined. If the capital of Salam is in the form of fungibles,[1] then the kind, type, specifications and quantity of these shall be clearly defined.

3/1/3 The capital in a Salam contract must be paid immediately at the place where the contract is concluded. However, as an exception to this ruling, payment may be delayed for two or three days at

(1) Fungibles are goods that share common features such that they do not differ significantly. Any fungibles can be replaced by any other in the event of destruction, without need to assess the value of the item destroyed or the one replacing it.

most. Even if such a short delay has been stipulated earlier, this will not affect the Salam contract provided that the period of delay is not equal to or greater than the delivery period for al-Muslam Fihi.

3/1/4 It is not permitted that a debt be recognised as the capital of Salam, such as using as the capital of Salam loans or debts owed by the seller to the Institution as a result of previous transactions.

**3/2 Al-Muslam Fihi and its conditions**

3/2/1 Salam contracts are permitted for fungible goods, like those that may be weighed, measured or counted, the articles of which do not differ in any significant manner, provided that no Riba ensues.

3/2/2 Among the items for which variations in numbers make no difference are the products of companies that manufacture goods in approximate units that are identified by trademarks, standardised specifications and are regularly and commonly available at any time. However, this rule must be read together with item 3/2/8.

3/2/3 Salam is not permitted for anything specific like "this car". Nor is it permitted for anything for which the seller may not be held responsible, like land, buildings or trees; or for articles whose values change according to subjective assessment, like jewellery and antiques. Also, it is not permissible to stipulate that al-Muslam Fihi must be from a specific piece of land. However, on the delivery date the seller may present the buyer with whatever items are available (and meet the contract specifications), irrespective of whether such items are from his own fields or factories or elsewhere.

3/2/4 It is not permissible for al-Muslam Fihi to be an amount of currency, gold or silver, if the capital of the Salam contract was paid in the form of currency, gold or silver.

3/2/5 Al-Muslam Fihi must be the kind of article for which a specification may be drawn up so that the seller may be held responsible for its conformity to the specification. It will be sufficient if the specification is explained in a manner that removes uncertainty, except for minor discrepancies that are customarily ignored, considered acceptable, and not usually regarded as grounds for dispute.

3/2/6 It is a requirement that al-Muslam Fihi be clearly known to the contracting parties in a manner that eliminates any possibility of uncertainty or ambiguity. The reference for determining descriptions that are used to specify and identify al-Muslam Fihi is customary practice and the experience of experts.

3/2/7 It is a requirement that the parties know the quantity of al-Muslam Fihi. The quantity of each item is determined according to its condition and nature with regard to weight, measurement, volume and number.

3/2/8 It is a requirement that al-Muslam Fihi be commonly available under normal circumstances at the place where it should be on the delivery date, so that the commodity will be accessible to the seller in order to discharge his obligation by delivering it to the buyer.

3/2/9 It is a requirement that the date of delivery for al-Muslam Fihi be known in a manner that eliminates any uncertainty or ambiguity which may lead to a dispute. There is no Shari'ah objection to the contracting parties setting various dates on which the delivery of al-Muslam Fihi may take place, in instalments, provided the capital of Salam was paid at the time the contract was originally concluded.

3/2/10 In principle, the parties may designate the place at which al-Muslam Fihi is to be delivered. If the parties to the contract do not determine the place of delivery, then the place at which the contract was concluded will be regarded as the place of delivery unless it turns out to be impossible to make delivery

to such a place. In that case, the place of delivery should be determined according to customary practice.

**3/3 Security for al-Muslam Fihi**

Al-Muslam Fihi may be secured by a mortgagee or a guarantee or any other permissible means of securing payment.

**4. Changes to al-Muslam Fihi**

**4/1 Selling al-Muslam Fihi before taking possession**

It is not permitted for the buyer to sell al-Muslam Fihi before taking possession of it.

**4/2 Replacement of al-Muslam Fihi**

It is permissible for the buyer to exchange al-Muslam Fihi for other goods, except currency, after the delivery date falls due, as long as such a substitution was not stipulated in the contract. This rule applies whether or not the substitute is similar in kind to al-Muslam Fihi. This is provided that the substitute is suitable for being exchanged as al-Muslam Fihi for the capital of the Salam contract, and that the market value of the substitute should not be greater than the market value of al-Muslam Fihi at the time of delivery.

**4/3 Cancellation (Iqalah) of a Salam contract**

It is permissible, when both parties agree, to cancel the entire Salam contract in return for repayment in full of the amount of the capital of Salam. Partial cancellation, that is, cancellation of the delivery of part of al-Muslam Fihi, in return for repayment of a corresponding part of the capital of Salam, is also permissible.

**5. Delivery of al-Muslam Fihi**

5/1 The seller is under an obligation to deliver al-Muslam Fihi to the buyer on the due date in accordance with the terms of the contract, such as agreed specifications and quantity. The buyer, on the other hand, must accept the goods if they meet the specifications explained in the contract. If the buyer refuses to accept al-Muslam Fihi, he shall be compelled to do so.

5/2 If the seller offers delivered goods of a quality that is superior to that required by the contractual specifications, the buyer must accept the goods, provided that the seller shall not seek a higher price for the better quality. This may be considered one of the ways in which a contract is ethically fulfilled. However, this will apply only if the (inferior) description specified in the contract is not itself deemed vital.

5/3 If the quality of the delivered goods is inferior to that required by the contractual specifications, the buyer is entitled either to reject or to accept the goods in that condition. If he accepts the goods, his action is considered as ethical acceptance. It is also permissible for the two parties to agree to a settlement on terms for acceptance of the goods even at a discounted price.

5/4 It is not permitted for a seller to deliver al-Muslam Fihi in the form of a commodity different from the one agreed upon if the commodity is considered to belong to the same genus as al-Muslam Fihi (e.g., al-Muslam Fihi is corn and the commodity that the seller wants to deliver is wheat). However, the delivery of al-Muslam Fihi in the form of a different type of commodity from that agreed upon may take place only on the basis of the conditions for the replacement of al-Muslam Fihi by other goods. [see item 4/2]

5/5 Delivery of al-Muslam Fihi may take place before the due date, on condition that the goods conform to the agreed specifications and quantities. If the buyer has a valid reason for rejecting the goods, then he will not be compelled to accept them. Otherwise, the buyer will be forced to accept the goods.

5/6 If the seller fails to perform his obligation, owing to insolvency, he should be granted an extension of time for delivery.

5/7 It is not permitted to stipulate a penalty clause in respect of delay in the delivery of al-Muslam Fihi.

5/8 In case all or part of al-Muslam Fihi is not available to the seller on the due date, the buyer shall have the following options:

5/8/1 To wait until al-Muslam Fihi is available.

5/8/2 To cancel the contract and recover the paid capital.

It is also permissible for the parties to agree to replacement of al-Muslam Fihi by other goods. [see item 4/2]

**6. Parallel Salam**

6/1 It is permissible for the seller to enter into a separate, independent Salam contract with a third party in order to acquire goods of a similar specification to those specified in the first Salam contract, so that the first Salam obligation will be discharged by delivering these goods. Hence, the seller in the first Salam contract becomes the buyer in the second Salam contract.

6/2 It is permissible for the buyer to conclude a separate parallel Salam with a third party for the purpose of selling, on the basis of Salam, a commodity whose description corresponds to the description of the commodity to be acquired through the first Salam contract. In this situation, the buyer in the first Salam contract becomes the seller in the second Salam contract.

6/3 In both the two situations mentioned in items 6/1 and 6/2, it is not permissible for the parties to link the obligations under the two Salam contracts together so that the execution of the obligations of one contract is contingent on the outcome of the other. Hence, it is necessary that both the obligations and the rights under the two contracts stand alone in all respects. Therefore, if one party breaches his obligation under the first Salam contract, the other party (the injured party) has no right to relate this damage or loss to the party with whom he concluded a Parallel Salam. Consequently, he has no right on the basis of his loss or damage under the first Salam contract to terminate the second Salam contract or to delay in performing it.

6/4 All the rules of Salam as explained in items 1-5 above are applicable to Parallel Salam as well.

## 7. Salam Sukuk Issues

It is not permitted to issue tradable Sukuk based on the debt from a Salam contract. [see item (4/1)]

## 8. Date of Issuance of the Standard

This Shari'ah Standard was issued on 29 Safar 1422 A.H., corresponding to 23 May 2001 A.D.

# Adoption of the Standard

The Shari'ah Standard on Salam and Parallel Salam was adopted by the Shari'ah Board in its meeting No. (6) held on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D.

In its meeting No. (8) held in Mecca on 28 Safar - 4 Rabi' I 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board readopted a resolution to reformat the Shari'ah Rules for Salam and Parallel Salam in the form of a Shari'ah Standard.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2001 A.D., the Shari'ah Board decided to give priority to the preparation of the a Shari'ah rules for Salam and Parallel Salam.

On Monday 11 Shawwal 1420 A.H., corresponding to 17 January 2000 A.D., the Fatwa and Arbitration Committee decided to commission a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Rules for Salam and Parallel Salam.

In its meeting held in Bahrain on 21-23 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah rules for Salam and Parallel Salam and asked the consultant to make the amendments in light of the comments made by the members.

In its meeting No. (4) held in Abu Dhabi, United Arab Emirates, on 14 Sha'ban 1421 A.H., corresponding to 10 November 2000 A.D., the Fatwa and Arbitration Committee discussed the exposure draft and made some relevant amendments.

The revised exposure draft of the Shari'ah rules was presented to the Shari'ah Board in its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2000 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments to discuss them in a public hearing.

A public hearing was held in Bahrain on 4-5 Dhul-Hajjah 1421 A.H., corresponding to 27-28 February 2001 A.D. The public hearing was attended by more than 30 participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in this field. Members of the Shari'ah Studies Committee responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Fatwa and Arbitration Committee held its meeting No. (5) in Bahrain on 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., to discuss the comments made about the exposure draft. The committee made the necessary amendments in light of both the written comments that were received and oral comments that took place in the public hearing.

The Shari'ah Board in its meeting No. (6) held in Al-Madinah Al-Munawwarah on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D., discussed the amendments made by the Fatwa and Arbitration Committee, and made the necessary amendments. The standard was adopted in the name of Shari'ah rules for Salam and Parallel Salam. Some paragraphs were adopted by the unanimous vote of the members of the Shari'ah Board while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Board decided in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding 24-28 November 2001 A.D., to reformat all Shari'ah rules in a form of standards and a committee was formed for this purpose.

In its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board adopted the reformatted version of the Shari'ah rules for Investment and Financing No. (3) on Salam and Parallel Salam with the title of Shari'ah Standard No. (9) on Salam and Parallel Salam, without any substantial changes in the content.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II, 1433 A.H., corresponding to March 2012 A.D.,

in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Salam**

A contract of Salam derives its permissibility from the Qur`an, the Sunnah and Ijma' (consensus of Fuqaha). On the level of the Qur`an, Allah, the Almighty, says: ***{"O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period time, reduce them to writing"}***.(2) Ibn Abbas said: "I declare that a Salaf (Salam) contract in which the commodity is guaranteed for future delivery has been permitted by Allah" and then he read: ***{"O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period time, reduce them to writing"}***. It is reported that Ibn Abbas said: "This verse is a revelation for the particular purpose of making Salam permissible."(3)

On the level of Sunnah, Ibn Abbas is reported to have said: *"The Prophet (peace be upon him) has came to Medina and found that people were selling dates for deferred delivery after a duration of one or two years on a Salam basis. The Prophet (peace be upon him) said: 'Whoever pays for dates on a deferred delivery basis (Salam) should do so on the basis of a specified scale and weight'"*. In another text of the Hadith the Prophet (peace be upon him) said: *"Whoever pays on a deferred delivery basis should do so on the basis of a specified scale, weight and date of delivery"*.(4)

The scholars are unanimous on the permissibility of a Salam contract. Ibn Mundhir said that the scholars agreed that a Salam contract -i.e, a contract

(2) [Al-Baqarah (The Cow): 282].

(3) See: Ibn Al-Jawzi, *"Zad Al-Masir Fi 'Ilm Al-Tafsir"* [1: 336]; and Ibn Kathir, *"Tafsir Al-Qur`an Al-'Azim"* [1: 496].

(4) The Hadith has been related by Al-Bukhari, Muslim and others. See: *"Sahih Al-Bukhari"* [2: 781], Damascus: Dar Al-Qalam edition; and *"Sahih Muslim"* [3: 1226], Beirut: Dar Al-Fikr edition.

in which a person sells to his fellow man a specific and determined thing by weight or measure for a future defined date of delivery—is permissible.(5)

**Wisdom of Making Salam Permissible**

The wisdom of making Salam permissible lies in the fact that Salam facilitates a type of financing for people in need of it. In particular, farmers, market gardeners and merchants, among others, need working capital for their businesses and for their living expenses in order to operate. Hence, Salam is made permissible so that these businesses may benefit from it. The buyer may benefit from its permissibility as well, by acquiring the commodity at a price below the market price.

Similarly, a contract of Salam responds to the needs of a large number of business enterprises at different levels, ranging from small and medium-sized enterprises to conglomerates that are involved in agricultural and industrial production or trade and the like. In order for these businesses to be productive, they need working capital in the form of either cash or assets. Hence, Salam has provided an investment opportunity in the form of financing of the working capital for trade. It also covers the demands of those in need of liquidity, as long as they are able to fulfill the orders they receive in return at the due date.

Although the contract of Salam is commonly used by agricultural businesses, its permissibility is not, however, confined to these fields. It can also be used in other investment opportunities, such as industry or trade.

The contract of Salam also meets immediate needs for liquidity. This is because it gives the seller flexibility in using the sale proceeds (before the commodity is delivered), and the opportunity to arrange for the counter-value (al-Muslam Fihi) and its delivery to the buyer at the date of delivery.

**Subject Matter of a Salam Contract**

- The basis for the permissibility of presenting usufruct as capital in a Salam contract is the view of the Maliki scholars. This is regarded as immediate receipt of the capital based on the Shari'ah maxim that says:

(5) Ibn Al-Mundhir, *"Al-Ijma"* (P. 54); and Ibn Qudamah; *"Al-Mughni"* [6: 385], Cairo: Matba'at Hajar edition.

"Taking possession of part of a thing is like taking possession of the whole thing".(6) Hence, this is not a sale of debt (because the buyer has received control over the usufruct).(7)

- The basis for the requirement that the capital of Salam must be known to the two parties is that a Salam contract is one of the exchange contracts in which the consideration need to be known so as to remove any uncertainty.(8)
- The basis for the requirement that the capital must be paid at the conclusion of a Salam contract is the saying of the Prophet (peace be upon him): *"Whoever pays on a deferred delivery basis should do so on the basis of specifying the scale"*.(9) The *Taslif* or *Islaf* means payment in advance. Salam was so named because the capital must be paid in advance. If payment is delayed, the transaction is not called Salam.(10) Again, any delay in payment of the capital and dispersal of the parties renders the transaction a sale of debt for debt(11) which is prohibited, and the scholars agreed on its prohibition. Ibn Rushd said: "As for sale of debt for debt, Muslim scholars are unanimous regarding its prohibition".(12)
- The basis for it not being permitted that a debt be capital in Salam is because this would render the transaction a form of sale of debt and this is prohibited by the Shari'ah.
- The basis for the impermissibility of Salam where the subject matter is a specific and identified thing is the Hadith stating that *"A man came*

(6) Al-Dardir, *"Al-Sharh Al-Saghir"* [4: 347].
(7) Al-Buhuti, *"Sharh Muntaha Al-Iradat"* [2: 37].
(8) Al-Qadi Abdul-Wahhab, *"Al-Ma'unah"* [2: 987]; Ibn Juzay, *"Al-Qawanin Al-Fiqhiyyah"* (P. 202); Al-Kasani, *"Bada`i' Al-Sana`i'"* [5: 301]; Ibn Qudamah, *"Al-Mughni"* [6: 411]; and Al-Shirazi, *"Al-Muhadhdhab"* [1: 300].
(9) The Hadith has been related by Al-Bukhari, Muslim and others: *"Sahih Al-Bukhari"* [2: 781], Damascus: Dar Al-Qalam edition; and *"Sahih Muslim"* [3: 1226], Beirut: Dar Al-Fikr edition.
(10) Ibn Qudamah, *"Al-Mughni"*, [6: 408]
(11) See: Al-Kasani, *"Bada`i' Al-Sana`i'"* [5: 202]; Ibn Rushd (the grandson) *"Bidayat Al-Mujtahid Wa Nihayat Al-Muqtasid"* [2: 205], Beirut, Dar Al-Qalam edition; Al-Qadi Abdul-Wahhab, *"Al-Ma'unah"* [2: 988]; and Al-Zayla'i, *"Tabyin Al-Haqa'iq Sharh Kanz Al-Daqa'iq"* [4: 117].
(12) Ibn Rushd, *"Bidayat Al-Mujtahid"* [2: 150].

*to the Prophet (peace be upon him) and said; 'The kin of so and so from the Jews had embraced Islam. However, they are hungry and I am afraid they may become apostates'. The Prophet (peace be upon him) asked the people around him; 'Who has something (money)?' One Jew said; 'I have so and so (he mentioned a sum of money), may be he said; 'I have three hundred dinars and I will pay such and such price for the products of the farm of the kin of so and so'. The Prophet (peace be upon him) said: '(buy) With such and such price to be delivered after such and such period, but not for the products of the kin of so and so'".*(13) Again, if a Salam contract is concluded for providing products from a specific farm, there might not be products from this farm at the time of delivery, and this leads to Gharar (uncertainty).

- The basis for the requirement that the subject-matter of Salam be commonly available under normal circumstances where it is required is to remove uncertainty and to ensure that the seller will be able to deliver it at the date of delivery.

**Changes to a Salam Contract**

- The basis for the impermissibility of selling the subject-matter of Salam before taking possession of it is because such an action is a form of sale of debts which is not permissible.
- The basis for the impermissibility of substituting the subject-matter of Salam with a commodity, the price of which is higher than the prevalent market value of the subject-matter of Salam at the date of delivery is to deter the buyer from making a compound profit on one deal.
- The basis for the permissibility of the termination of a Salam by agreement (Iqalah) is because the Prophet (peace be upon him) has encouraged Iqalah in general and Salam is not an exception from this concession. Salam is also a form of sale and since sale contracts admit Iqalah, so too does a Salam contract. Again, Iqalah is actually

(13) The Hadith has been related by Ibn Majah and Abu Dawud. See: *"Sunan Ibn Majah"* [2: 765-766]; and *"Sunan Abu Dawud"* [3: 744]. Al-Shawkani said: "There is an unknown narrator in the chain of transmission of this Hadith. This is because Abu Dawud narrated it through Muhammad Ibn Kathir from Sufyan from Abu Ishaq from a Najrani man from Ibn Umar. Therefore, the Hadith is not of a strong authority. See: *"Nayl Al-Awtar"* [5: 345-346].

permitted for the sale of tangible goods in consideration of the need of contracting parties to be able to deal with regret and a desire to withdraw from the contract. In the case of Salam, the possibility that the parties may regret concluding the transactions is greater than in the sale of tangible goods because Salam is a low cost form of sale for which permissibility of Iqalah is easily applicable in Salam.(14)

**Delivery of al-Muslam Fihi**

The basis for not allowing penalty clauses in Salam is because al-Muslam Fihi is considered to be a debt; and it is not permitted to stipulate payment in excess of the principal amount of debts.

**Parallel Salam**

- The basis for the permissibility of Parallel Salam is that it represents two Salam deals that are separable from each other despite the fact that the descriptions of the subject-matter in the two contracts are similar. However, the contract does not lead to two sales in one, which is impermissible.
- The basis for the impermissibility of tradeable Salam Sukuk is because trading with such Sukuk is a form of sale of debt which is prohibited.

(14) See: Al-Kasani, *"Bada`i' Al-Sana`i'"* [5: 214].

# Appendix (C)
# Definitions

**Salam**

A Salam transaction is the purchase of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam capital, is paid at the time of contracting while the delivery of the item to be sold, known as al-Muslam Fihi (the subject-matter of a Salam contract), is deferred. The seller and the buyer are known as al-Muslam Ilaihi and al-Muslam or Rab al-Salam respectively. Salam is also known as Salaf (literally; borrowing).

**Parallel Salam**

If the seller enters into another separate Salam contract with a third party to acquire goods, the specification of which corresponds to that of the commodity specified in the first Salam contract, so that he (the seller) can fulfil his obligation under that contract, then this second contract is called, in contemporary custom, Parallel Salam or *Salam Muwazi*. The following is an example of such a contract. An Institution on one hand buys a specified quantity of cotton from farmers on a Salam basis and, in turn, the buyer in the first Salam contract enters into a new separate Salam contract with textile mills so as to provide them, by means of that new Salam contract, with cotton, the specifications of which are similar to the specifications of the cotton to be acquired under the first Salam contract, without making the execution of the second Salam contract contingent on the execution of the first Salam contract.

**Iqalah**

Iqalah or cancellation of a contract is a bilateral agreement of the contracting parties to abate and remove the legal effect of a contract.

**Mithlis (Fungibles)**

Items that are mutually interchangeable, i.e., items whose units are identical (in specifications), and if destructed, are guaranteed by other identical units without consideration to their value.

Shari'ah Standard No. (11)

# Istisna'a and Parallel Istisna'a

(Revised Standard)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The objective of this standard is to explain the Shari'ah rulings and limitations applicable to Istisna'a and parallel Istisna'a transactions in respect to concluding an Istisna'a contract, the subject-matter of Istisna'a and changes to the contract. The standard also explains issues relating to the execution of the contract and the supervision of its execution.

# Statement of the Standard

## 1. Scope of the Standard

The standard covers Istisna'a and parallel Istisna'a transactions whether the Institution is acting as an ultimate purchaser or is acting as a manufacturer or as a builder for construction.(1)

## 2. Istisna'a Contract

### 2/1 Conclusion of an Istisna'a contract at the time of contracting or after the bilateral promise

2/1/1 It is permissible that the Institution and a customer conclude an Istisna'a contract before the Institution assumes title to the subject-matter to be sold to the customer or to the materials from which the subject-matter will be produced (manufactured or constructed).

2/1/2 It is permissible for the Institution to benefit from any price offers or quotations that the customer has obtained from other dealers or suppliers to assist it in the evaluation of expenses and the computation of prospective profit.

2/1/3 It is not permissible that the Institution's role in the Istisna'a be that of a financial intermediary between a buyer and a third party, especially if the buyer has become unable to meet his obligations toward such a third party, and this prohibition applies whether such a role would take place before or after the commencement of the work. [see item 4/2/2]

(1) The Arabic term "Istisna'a" applies to both manufacturing and construction, and there is no convenient term in English that covers both manufacturers and builders. Therefore, the term "manufacturer" will be used in this standard to designate a party acting as manufacturer or contractor in an Istisna'a contract, and the term 'subject-matter' will be used to designate the goods or buildings that are the subject-matter of the contract.

## 2/2 Form and conditions of an Istisna'a contract

2/2/1 A contract of Istisna'a is binding on the contracting parties provided that certain conditions are fulfilled, which include specification of the type, kind, quality and quantity of the subject-matter to be produced. Moreover, the price of the subject-matter must be known and, if necessary, the delivery date must be determined. If the subject-matter does not conform to the specification agreed upon, the customer has the option to accept or to refuse the subject-matter.

2/2/2 Since a contract of Istisna'a is binding, the parties to the contract are inevitably bound by all obligations and consequences flowing from their agreement. In other words, the contracting parties need not to renew an exchange of offer and acceptance after the subject-matter is completed. This is different from the promise in a contract of Murabahah, which requires the signature of a sale contract through a new offer and acceptance by the parties when possession of the items to be sold is taken by the Institution.

2/2/3 It is not permitted for the manufacturer to stipulate in the contract of Istisna'a that he is not liable for defects.

2/2/4 It is not permissible to conclude Istisna'a contracts or processes of Istisna'a in a manner that makes it a legal device for a mere interest-based financing. Examples are a transaction in which the Institution buys items from the contractor on a cash payment basis and sells them back to the manufacturer on a deferred payment basis at a higher price; or where the party ordering the subject-matter to be produced is the manufacturer himself; or where one third or more of the facility in which the subject-matter will be produced belongs to the customer. All the circumstances mentioned above would make the deal an interest-based financing deal in which the subject-matter never genuinely changes hands, even if the deal is won through competitive bidding. This rule is intended to avoid sale and buy back transactions (*Bay' al-'Inah*).

## 3. Subject-Matter of, and Guarantees in, Istisna'a

### 3/1 The rulings concerning al-Masnoo'

3/1/1 An Istisna'a contract is permissible only for raw materials that can be transformed from their natural state by a manufacturing or construction process involving labour. Therefore, Istisna'a is valid only in so far as the supplier has agreed to provide a subject-matter that is manufactured or constructed.

3/1/2 It is permissible that a contract of Istisna'a be concluded for the production of a subject-matter having unique descriptions according to the requirement of the ultimate purchaser even if such a subject-matter has no substitutes in the market, provided the subject-matter is subject to specification. Similarly, it is permissible that the subject-matter of a contract of Istisna'a be items that have perfect substitutes in the market, and can be substituted for one another in fulfilling an obligation, because they share common characteristics by virtue of the process of manufacture or construction. This rule applies whether the items to be produced are intended for consumption or for use with their substance kept intact.

3/1/3 It is not permissible that the subject-matter of an Istisna'a contract be an existing and identified capital asset. For example, it is invalid for the Institution to conclude a contract to sell a particular designated car or factory on the basis of Istisna'a. This is because Istisna'a is a sale contract applicable to items that are identified by specification, not by designation. Unless the items are completely or partially delivered, the ultimate purchaser has no prior right (in the event that the supplier is declared bankrupt or insolvent) over a third party to the items that are the subject-matter of the contract while they are still in the process of being produced and have not yet been delivered to him. In addition, the ultimate purchaser cannot be regarded as the owner of the materials in the possession of the manufacturer for the purpose of producing the subject-

matter of the contract, unless the manufacturer has previously undertaken, as a guarantee for the completion of the work, that such materials will only be used for the order of the ultimate purchaser.

3/1/4 The contract of Istisna'a may be concluded with a condition that the production shall be carried out by the Institution using its own resources, in which case it has to abide by this condition and has no right to assign the process of production to another entity.

3/1/5 It is permissible for the manufacturer to fulfil his obligation in an Istisna'a contract by using items produced by his own resources or items produced by other parties that existed before the contract was concluded. The latter option is, however, only valid if the ultimate purchaser did not stipulate that the manufacturer should use his own resources. However, this rule should not be used as a device for deferment of consideration (the price and the commodity) of a sale of a subject-matter that is to be delivered in the future based on its specification as given by the seller, but which are not intended to be produced.

3/1/6 The manufacturer is under an obligation to produce the subject-matter according to specification and within the period agreed upon or within such reasonable time as the nature of the work may permit, in accordance with accepted practice that is recognised by experts.

3/1/7 The parties may agree on a period during which the manufacturer will be liable for any defects or the maintenance of the subject-matter. They may also leave the determination of liability relating to defects and maintenance to customary practice.

3/1/8 It is permissible to draw up an Istisna'a contract for real estate developments on designated land owned either by the ultimate purchaser or the contractor, or on land in which either of them

owns the usufruct. This is permissible because the contract involves the construction of specified buildings that will be built and sold according to specification and the contract of Istisna'a in this case does not concern a particular identified place (i.e. the land).

**3/2 Price and guarantees of Istisna'a contract**

3/2/1 It is a requirement that the price for an Istisna'a contract be known at the conclusion of the contract, in which case it can be in the form of cash or tangible goods or the usufruct of an asset for a particular duration, whether such usufruct is related to an asset other than the subject-matter or to the subject-matter itself. The use of usufruct of the subject-matter itself as consideration for an Istisna'a contract is relevant to situations when a government offers a preferential contract giving usufruct to the builder or manufacturer for a particular duration, commonly known as Build Operate Transfer (BOT).

3/2/2 The price of an Istisna'a contract may be deferred or paid in instalments within a certain period of time, or if delivery of the subject-matter is to be made in stages a portion of the price may be paid immediately while the balance is paid by instalments according to the stages of delivery. It is also permissible to connect payment with the stage of completion of the work, (such that a payment is made at the end of each stage), provided the stages of this type of work are by custom subject to specification and their identification will not lead to dispute.

3/2/3 If the process of manufacture or construction is divided into phases, or payment is designed according to the stage of completion of the work, then the manufacturer or contractor is entitled to request that the ultimate buyer make payment accordingly for each stage that has been carried out according to specification.

3/2/4 It is permissible that the price of Istisna'a transactions vary in accordance with variations in delivery date. There is also no objection to a number of offers being subject to negotiation, provided that eventually only one offer will be chosen for concluding the Istisna'a contract. This is to avoid uncertainty and lack of knowledge that may lead to dispute.

3/2/5 A contract of Istisna'a cannot be drawn up on the basis of a Murabahah sale, for example, by determining the price of Istisna'a on a cost- plus basis.

3/2/6 If the actual costs incurred by the Institution to bring the subject-matter to completion are substantially less than the estimated costs or the Institution secures a discount from the party with whom it contracted on a Parallel Istisna'a basis to acquire the subject-matter in order to fulfil its contractual obligation, the Institution is not obliged to give a discount to the ultimate purchaser and the latter is not entitled to the amount or part thereof the Institution has gained over the estimated costs. The same rule applies conversely when the actual costs of production are substantially greater than the estimated costs.

**3/3 Guarantees**

3/3/1 It is permissible for the Institution, acting either in the capacity of the manufacturer or of the ultimate purchaser, to give or demand accordingly 'Arboun as a guarantee, which will either be part of the price, if the contract is fulfilled, or forfeited, if the contract is rescinded. However, it is preferable that the amount forfeited be limited to an amount equivalent to the actual damage suffered.

3/3/2 In an Istisna'a contract, it is permissible for the Institution, whether acting in the capacity of manufacturer or in the capacity of the ultimate purchaser, to demand guarantees that it considers sufficient to secure fulfilment of its rights against

an ultimate purchaser or a manufacturer. It is also permissible for the institution, when acting in the capacity of an ultimate purchaser, to give guarantees requested by the manufacturer, which can be in a form of a mortgage, personal guarantee, assignment of rights, a current account, or an investment account or consent to blocking withdrawal from an account.

## 4. Changes to Istisna'a Contract

### 4/1 Amendments, changes and introduction of new conditions

4/1/1 It is permissible, after the conclusion of an Istisna'a contract, for the manufacturer and the ultimate purchaser to agree on amending the manufacturing or construction specifications previously agreed upon or introducing additional specification requirements on condition that the price is adjusted accordingly and a reasonable period for the execution of the new requirements is granted. It is also permissible to state in the contract that the consideration for amendments or introduction of additional requirements shall be determined and added to the original price as per the expert opinion, custom or an identified price index which preclude any uncertainty that may potentially lead to dispute.

4/1/2 The ultimate purchaser cannot oblige the manufacturer to introduce modifications and changes to the subject matter of an Istisna'a contract without the consent of the manufacturer.

4/1/3 It is not permissible for amendments and changes to the contract to be agreed on the basis that an additional sum will be paid in consideration for an extension of the period of payment. However, a rebate for pre-payment is permissible provided it is not stipulated at the conclusion of the contract.

### 4/2 Intervening contingencies (force majeure)

4/2/1 It is permissible, by way of agreement of the contracting parties or arbitration or judicial procedure, to amend the contract price

of an Istisna'a contract upwards or downwards, as a result of intervening contingencies (force majeure). This rule must be read together with item 4/1/3 above.

4/2/2 It is permissible for the Institution to replace a contractor and enter into an Istisna'a contract with a customer to complete a project which had been started by the previous contractor of such a customer. In this case, an assessment of the project should be undertaken on the basis of the existing status of the project. The cost of this assessment is chargeable to the account of the customer, in which case all outstanding debts, if any, that arise from the incomplete Istisna'a contract shall be the personal responsibility of the customer. The parties may after this conclude a new Istisna'a contract for the remaining work. The Institution is not bound to deal with the previous contractor. Rather, the Institution has the right to stipulate that the work needed to complete the project will be carried out by any means it deems fit.

4/2/3 In the case of constructing buildings or public utilities on land owned by the ultimate purchaser, it is permissible to stipulate that the ultimate purchaser has the right to perform the contract of Istisna'a at the expense of the manufacturer if the latter fails to perform the contract or to complete the work within a particular period of time, and that this performance will be effected from the date the manufacturer halted the work.

4/2/4 If the contractor is unable to continue to discharge his obligation, the ultimate purchaser (the owner of the land) is not entitled to acquire ownership of the incomplete building structures or utilities that are already in place without giving consideration to the contractor. However, this rule depends on the cause of the failure to continue the work. If the failure to perform is due to the misconduct of the contractor, the ultimate purchaser is liable only for the value of the building structure and the builder is liable to compensate the ultimate purchaser for any actual

damage or loss he suffered. If the failure to perform is due to the misconduct of the ultimate purchaser, the contractor is entitled to the value of the work he has completed and compensation for any damage or loss. However, if the failure to perform has not been caused by either of them, the ultimate purchaser is liable only for the value of the building structure that is already in place and neither of them has any responsibility to pay compensation for the loss or damage the other party had suffered. [see item 4/2/3]

4/2/5 It is permissible that a contract of Istisna'a includes a clause to the effect that if any additional conditions are inserted into the contract at a later date as a result of directives of the relevant authorities, and these additional conditions lead to extra expenses that cannot, by virtue of the terms of the contract, be borne by the manufacturer because they were not in the original contract as signed or there is no law making such payment compulsory, the extra expenses will be borne by the ultimate purchaser.

## 5. Supervision of the Execution of an Istisna'a Contract

5/1 It is permissible for the seller and purchaser to appoint technically experienced consulting firm to represent it in determining whether the subject-matter conforms to the contractual specification, and to advise the Institution as to whether payment for the subject-matter, or delivery or acceptance of it, under the terms of the contract, should take place, and they should adhere to its resolutions

5/2 It is permissible for the Institution, when acting as the manufacturer, to draw-up an independent and separate contract of agency appointing the ultimate purchaser as an agent of the Institution to supervise the manufacturing or construction process so as to ensure that the items produced conform to contractual specification.

5/3 It is permissible for the manufacturer and the ultimate purchaser to agree on the party who will bear the additional costs of supervision of an Istisna'a contract.

## 6. Delivery and Disposal of the Subject-Matter

6/1 The manufacturer is discharged from liability if the subject-matter is delivered to either the ultimate purchaser or to a person appointed by him or if the ultimate purchaser is enabled to exercise full control over the subject-matter.

6/1/1 If the condition of the subject-matter does not conform to the contractual specifications at the date of delivery, the ultimate purchaser has the right to reject the subject-matter or to accept it in its present condition, in which case the acceptance constitutes satisfactory performance of the contract. It is also permissible for the contracting parties to agree on acceptance of a subject-matter that fails to conform to the specification even if such an arrangement involves a price discount.

6/1/2 If the seller offers to deliver a better quality, then the purchaser shall accept his conditions, provided that the seller shall not charge any additional amounts for the better quality, which may be considered one of the ways in which a contract is ethically fulfilled, unless the quality specified in the contract is particularly pursued by the purchaser.

6/2 It is permissible that delivery of the subject-matter takes place before the due date, on condition that the subject-matter meets the specifications agreed upon, in which case the ultimate purchaser is obliged to accept the subject-matter. If the ultimate purchaser is unwilling to take delivery of the subject-matter, the rule on this point depends on whether or not there is justification for this refusal. If there is a good reason for the rejection of the subject-matter, the ultimate purchaser shall not be obliged to accept it. If there is not a good reason for rejecting it, then the ultimate purchaser will be obliged to accept the subject-matter.

6/3 The delivery of the subject-matter may take place through constructive possession, by enabling the ultimate purchaser to take control over the subject-matter after the production process is completed. At this

point, the liability of the manufacturer in respect of the subject-matter comes to an end and the liability of the ultimate purchaser begins. If after enabling the ultimate purchaser to take control over the subject-matter any loss or damage subsequently occurs to the subject-matter without any proof of negligence or misconduct on the part of the manufacturer, then the ultimate purchaser is liable. This is therefore the demarcation line between the liabilities of the two parties: the liability of the manufacturer and the liability of the ultimate purchaser.

6/4 If the ultimate purchaser refuses to accept the subject-matter without a good reason after he is enabled to take possession, the subject-matter will remain in the possession of the manufacturer on a trust basis, in which case the manufacturer will not be liable for loss or damage that occurs to it, unless such loss or damage is a result of negligence or misconduct on the part of the manufacturer. The ultimate purchaser bears the expenses for the safe keeping of the subject-matter.

6/5 It is permissible to state in a contract of Istisna'a that the manufacturer will act as the agent of the ultimate purchaser to sell the subject-matter if there is a delay on the part of the purchaser in taking delivery of the subject-matter within a particular period of time. In this case, the manufacturer will sell the subject-matter on behalf of the ultimate purchaser and, after deducting the agreed contract price, the balance, if any, will be returned to the purchaser. If the price obtained is less than the contract price, the manufacturer shall have a right of recourse to the ultimate purchaser for the recovery of the remaining balance. In addition, the ultimate purchaser will bear the expenses incurred in selling the subject-matter.

6/6 It is permissible for the contract of Istisna'a to include a fair penalty clause stipulating an agreed amount of money for compensating the ultimate purchaser adequately if the manufacturer is late in delivering the subject-matter. Such compensation is permissible only if the delay is not caused by intervening contingencies (force majeure). However, it is not permitted to stipulate a penalty clause against the ultimate purchaser for default on payment. [see item 2/1/2 of the Shari'ah Standard No. (3) on Procrastinating Debtor]

6/7 It is not permissible to sell the subject-matter prior to taking either actual or constructive possession of it [see item 6/4]. However, it is permissible to conclude an Istisna'a contract to sell an item on the basis of description or specification that is similar to an item to be acquired from a manufacturer, and this is called *Istisna'a Muwazi*: Parallel Istisna'a [see item 7].

6/8 It is permissible for the Institution acting in the capacity of ultimate purchaser to appoint, after taking possession of the subject-matter, the manufacturer as an agent to sell the subject-matter to latter's customers on behalf of the Institution. This agency is permissible whether it is carried out free of charge, or for consideration either in the form of a fixed fee or a particular percentage of the sale price, on condition that the contract of agency and the contract of Istisna'a were not entered into in connection with each other.

**7. Parallel Istisna'a**

7/1 It is permissible for the Institution to buy items on the basis of a clear and unambiguous specification and to pay, with the aim of providing liquidity to the manufacturer, the price in cash when the contract is concluded. Subsequently, the Institution may enter into a contract with another party in order to sell, in the capacity of manufacturer or supplier, items whose specification conforms to the wishes of that other party, on the basis of parallel Istisna'a, and fulfil its contractual obligation accordingly. This is permissible on condition that the delivery date stipulated in the parallel (sale) contract must not precede that stipulated in the original purchase contract, and, moreover, the two contracts should remain separate from each other. [see item 3/1/4]

7/2 It is permissible for the Institution, acting in the capacity of the producer or supplier, to conclude an Istisna'a contract with the aim of selling such items to the customer on a deferred payment basis, and to enter into a Parallel Istisna'a contract on an immediate payment basis with a manufacturer or builder to acquire such items as per the specifications in the first contract and sell them to the customer. This

is permissible on condition that the two contracts should remain separate and, moreover, be subject to the matters set out in item 3/1/4.

7/3 As a result of concluding an Istisna'a contract in the capacity of a producer or supplier, the Institution must assume liability for ownership risk and maintenance and insurance expenses prior to delivering the subject-matter to the ultimate purchaser (the customer). Moreover, the Institution is not permitted, in the Parallel Istisna'a contract concluded with the manufacturer, to transfer to the latter the risk arising from its obligations towards the customer.

7/4 It is not permissible to make any contractual link between the obligations under two contracts (the contract of Istisna'a and the contract of Parallel Istisna'a) when they are concluded. Therefore, it is also not permissible for a party to an ordinary Istisna'a contract (I) to withdraw his contractual obligations or delay delivering the subject-matter of the contract because the obligation under Parallel Istisna'a did not take place or (II) to increase the price of the goods to be delivered because of an increase in the cost of goods in the Parallel Istisna'a. However, there is no restriction on the right of the Institution to stipulate conditions and requirements when concluding a Parallel Istisna'a contract as a purchaser, including a penalty clause similar to, or different from, that which the customer has stipulated in the first Istisna'a contract in which the Institution is the supplier.

## 8. Date of Issuance of the Standard

This Standard was issued on 29 Safar 1422 A.H., corresponding to 23 May 2001 A.D.

# Adoption of the Standard

The Shari'ah Standard on Istisna'a and Parallel Istisna'a was adopted by the Shari'ah Board in its meeting No. (6) held on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D.

In its meeting No. (8) held in Makkah Al-Mukarramah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board readopted a resolution to reformat the Shari'ah rules for Istisna'a and Parallel Istisna'a in the form of a Shari'ah standard.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H. corresponding to 4-8 December, 2000 A.D., the Shari'ah Board decided to give priority to the preparation of the a Shari'ah rules for Istisna'a and Parallel Istisna'a.

On Monday 11 Shawwal 1420 A.H. corresponding to 17 January 2000 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Rules for Istisna'a and Parallel Istisna'a.

In its meeting held in Bahrain on 21-23 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Istisna'a and Parallel Istisna'a and asked the consultant to make amendments in light of the comments made by the members.

In its meeting No. (4) held in Abu Dhabi, United Arab Emirates on 14 Sha'ban 1421 A.H. corresponding to 10 November 2000 A.D., the Fatwa and Arbitration Committee discussed the exposure draft and made some relevant amendments.

The revised exposure draft of the Shari'ah Rules was presented to the Shari'ah Board in its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H. corresponding to 4-8 December 2000 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 4-5 Dhul-Hajjah 1421 A.H., corresponding to 27-28 February 2001 A.D. The public hearing was attended by more than thirty participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Members of the Shari'ah Studies Committee responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Fatwa and Arbitration Committee held its meeting No. (5) in Bahrain on 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., to discuss the comments made about the exposure draft. The committee made the necessary amendments in light of both the written comments that were received and oral comments that took place in the public hearing.

The Shari'ah Board in its meeting No. (6) held in Al-Madinah Al-Munawwarah on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D., discussed the amendments made by the Fatwa and Arbitration Committee, and made necessary amendments. The standard was adopted in the name of Shari'ah Rules for Istisna'a and Parallel Istisna'a. Some paragraphs were adopted by the unanimous vote of the members of the Shari'ah Board while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Board decided in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H. corresponding 24-28 November 2001 A.D. to reformat all Shari'ah rules in the form of standards and a committee was formed for this purpose.

In its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I 1423 A.H. corresponding to 11-16 May 2002 A.D., the Shari'ah Board adopted the reformatting of the Shari'ah Rules for investment and Financing No. (4) on Istisna'a and Parallel Istisna'a in the name of Shari'ah Standard No. (11) on Istisna'a and Parallel Istisna'a without any substantial changes in the content.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II 1433 A.H. corresponding to March 2012 A.D.

in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (4) held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia on 27-29 Sha'ban 1436 A.H. corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

## Legitimacy of Istisna'a Contract

The legitimacy of Istisna'a is based on the request of the Prophet (peace be upon him) that a pulpit (a platform) for preaching and a finger ring be manufactured for him.(2) An Istisna'a contract is also permissible on the basis of the principle of Istihsan (Shari'ah approbation), the general principles of contracts and transactions and the objectives of Shari'ah. The Istisna'a is a binding contract and not a mere promise. The International Islamic Fiqh Academy has issued a resolution in support of the legitimacy of Istisna'a.(3)

## Istisna'a Contract

- The basis for it not being permissible that the role of the Institution remain as a mere financier for a deal concluded between the supplier and the ultimate purchaser is that this would lead to involvement in a Riba transaction which makes the Istisna'a contract a mere cover-up and not a real Istisna'a.
- The basis for stating that an Istisna'a contract is binding is the view of Imam Abu Yusuf, as stated in the *"Majjalat Al-Ahkam Al-'Adliyyah"*, (known in English by the name the Mejelle), that the manufacturer has spent money in order to manufacture and to deliver according to specification. If the ultimate purchaser has a right to refuse the manufactured goods, then the manufacturer will incur losses.

(2) The Hadith in which the Prophet (peace be upon him) requested the manufacture of finger ring has been related by Al-Bukahri and Muslim: *"Sahih Al-Bukhari"* [5: 220]; and *"Sahih Muslim"* [3: 1655]). The Hadith in which the Prophet (peace be upon him) requested the manufacture of a pulpit for preaching has been related by Al-Bukhari in his *"Sahih"* [2: 908].

(3) International Islamic Fiqh Academy Resolution No. 65 (3/7).

- The basis for the impermissibility of the manufacturer including a defect exclusion clause in an Istisna'a contract is that a valid Istisna'a is a sale of specified goods to be delivered in the future and exclusion of liability as to defects is valid only in the sale of particular identified goods. This prohibition of excluding liability as to defects in Istisna'a is one feature that makes it different from an ordinary sale.
- The basis for the impermissibility of drawing up Istisna'a contracts or procedures in a way that appears to be a mere interest-based financing is the need to avoid involvement in a Riba transaction, a potential Riba or 'Inah sales.

**Subject Matter of, and Guarantees in, an Istisna'a Contract**

- The basis for the impermissibility of concluding an Istisna'a contract for items that are not manufactured or constructed is that items that are not the subject of transformation by manufacture or construction by man, that is natural things such as animals, fruits and vegetables, are not by definition covered by the term Istisna'a which means a sale of materials on condition that they be subjected to transformation by a manufacturing or construction process.
- The basis for the permissibility of concluding an Istisna'a for manufactured items that either have or do not have equivalents in the market is because it is normal for people to deal in these kinds of item. As a principle, rules that are based on customary practice will change whenever such customary practice is changed. Therefore, any customary transaction that is subject to specifications may be a subject-matter of Istisna'a, regardless of whether it is for use or consumption.
- The basis for not allowing the subject-matter of Istisna'a to be a specific identified item is that an Istisna'a contract involves a sale for future delivery based on a specification. Therefore, if the items to be sold are specific identified items, the transaction involves selling identified items that the seller does not own, which is prohibited by the saying of the Prophet (peace be upon him): *"Do not sell what you own not"*.(4)

(4) The Hadith has been related by Al-Tirmidhi in his *"Sunan "* [3: 534], edited by Ahmad Shakir; and Al-Albani, *"Irwa' Al-Ghalil"* [5: 132].

Again, items to be manufactured or constructed do not yet exist and thus cannot be specific and identified. The non-existent item is to be produced and delivered later and this constitutes a non-monetary obligation of the supplier.(5)

- The basis for the permissibility of a stipulation by the ultimate purchaser that the manufacture be carried out by the Institution itself is because this stipulation does affect the purpose of the contract. Rather, this condition is relevant in this contract because the ultimate purchaser may be interested in the items that are produced by a particular supplier due to this supplier's distinguished competence in manufacturing or construction and the quality of the items manufactured or constructed by this supplier.
- The basis for the permissibility of the manufacturer presenting to the ultimate purchaser either what he has produced or what other parties have produced, if the ultimate purchaser did not stipulate to the contrary, is because this satisfies the purpose of the contract. This is the case because the items are being delivered according to the specifications that are laid down in the contract.
- The basis for the permissibility of stipulating a time-period during which manufacturer remains liable for any manufacturing or construction defects is that such a stipulation serves the purpose of the contract. This is because the ultimate purchaser wants to use the subject-matter and this is not possible unless the subject-matter is free from defects.
- The basis for the requirement that the price be known is to remove any lack of knowledge and uncertainty that may lead to dispute.
- The basis for the permissibility in Istisna'a of payment on deferred terms or on an instalment basis is that labour (i.e. transformation and added value) is an important part of the items to be sold and this makes the transaction similar to a leasing contract in which it is permissible for the rentals to be paid on a deferred or instalment basis without this being considered as a sale of debt for debt which is prohibited. The same ruling applies to Istisna'a.

(5) See: *"Majallat Al-Ahkam Al-'Adliyyah"*, article (158).

- The basis for the permissibility of offering a difference in the price for an Istisna'a contract relating to a difference in the date of delivery is that Istisna'a is analogous to an Ijarah contract. The fuqaha have stated that it is permissible to give a labourer in Ijarah an option regarding wages depending on whether the worker finishes the work in one day or in two days. The hirer may say two dinars if the worker finishes in one day or one dinar if he finishes in two days. Istisna'a is similar to this. There is a resolution issued during the Al Baraka Annual Forum supporting this ruling.(6)
- The basis for not allowing a contract of Istisna'a to be drawn up on the basis of a Murabahah sale, for example, by determining the price of Istisna'a on a cost- plus basis, is because the subject-matter of Murabahah should be something already in existence, the cost of which is known and which is owned prior to the conclusion of a Murabahah sale. An Istisna'a contract, on the other hand, is concluded prior to ownership of the subject-matter, because (I) it is a sale based on a specification giving rise to a future obligation, and (II) the actual cost will be known only after the completion of the work, and, (III) the price in a contract of Istisna'a should be known when the contract is concluded.
- The basis for deciding that the Institution is not obliged to give a discount when the actual costs of the manufacture are substantially greater than the estimated costs or when it secures a discount from the manufacturer is because the Istisna'a contract and Parallel Istisna'a contract are independent in terms of obligation and effects. The Shari'ah Supervisory Board of the Kuwait Finance House has issued a Fatwa in this respect.(7)
- The basis for the permissibility of the Institution acquiring all necessary guarantees is that these guarantees secure its rights and this request does affect the purpose of a contract.

**Changes to an Istisna'a Contract**

- The basis for the impermissibility of extending the date of payment in return for consideration is because that is Riba.

(6) See: Resolution No. (13/7).
(7) *"Al-Fatawa Al-Shar'iyyah Fi Al-Masa'il Al-Iqtisadiyyah"*, Fatwa No. (447).

- The basis for the permissibility of discounting for unconditional earlier payment is the saying of the Prophet (peace be upon him) in the case of Ubay Ibn Ka'b (may Allah be pleased with him) and his debtor: *"Write off a portion of your debt"*.(8) The International Islamic Fiqh Academy has issued a resolution in support of this rule.(9)
- The ultimate purchaser (the owner of the land) is not entitled to acquire ownership of incomplete building structures or utilities that are already in place without giving consideration to the builder if the builder is unable to continue to discharge his obligation. The basis for this is that the construction was initiated by the builder at the request of the ultimate purchaser and such a request is stronger than a mere permission to build on the latter's land.
- The basis for the permissibility of a contract of Istisna'a including a clause that the manufacturer is not liable for extra expenses that result from additional conditions inserted into the contract at a later date as a result of directives of the relevant authorities, is because this condition is agreed upon by the parties and does not affect the purpose of Istisna'a contract. The Shari'ah Supervisory Board of Kuwait Finance House has issued a Fatwa in respect to this ruling.(10)
- The basis for the permissibility of a penalty clause in an Istisna'a contract is that such a clause is in the interest of the contract and because it is laid down in respect to an obligation regarding items that must be produced and delivered in the future and not in respect to monetary debt.

**Supervision of the Execution of an Istisna'a Contract**

The basis for the permissibility for the Institution, when acting as the ultimate purchaser, to appoint a technically experienced consulting firm and the permissibility for the Institution, when acting as the manufacturer, to appoint the ultimate purchaser as an agent is because agency is permissible and there is nothing against it in an Istisna'a contract provided it is done with the agreement of the parties.

(8) The Hadith has been related by Al-Bukhari in his *"Sahih"* [1: 179] and [2: 965].
(9) International Islamic Fiqh Academy Resolution No. 64 (7/2).
(10) See: Fatwa No. (251).

**Delivery and Disposal of the Subject-Matter**

The basis for the impermissibility of selling the items to be produced prior to taking either actual or constructive possession of them is that such an action is considered as selling a non-existent item. It is also considered as selling what one does not own because it is not available for the seller at the time of conclusion of the contract.

**Parallel Istisna'a**

The basis for the permissibility of the Institution entering into a contract with another party in order to sell, in the capacity of manufacturer, builder or supplier, items whose specification conforms to the wishes of that other party, on the basis of Parallel Istisna'a, is that in such a case there are two separate deals of Istisna'a. There is no link between the two contracts; hence, this is not an instance of two sales in one deal, which is impermissible. The separation of the two contracts also has the effect of making the transaction a type of non-Riba-based financing.

# Appendix (C)
# Definitions

**Istisna'a Contract**

Istisna'a is a contract of sale of specified items to be manufactured or constructed, with an obligation on the part of the manufacturer or builder (contractor) to deliver them to the customer upon completion.

**Parallel Istaisna'a**

Another form of Istisna'a, known in modern custom as Parallel Istisna'a *"al-Istisna'a al-Muwazi"*, takes effect through two separate contracts. In the first contract, the Islamic Financial Institution acts in the capacity of a manufacturer, builder or supplier and concludes a contract with the customer. In the second contract, the Institution acts in the capacity of a purchaser and concludes another contract with a manufacturer, builder or supplier in order to fulfil its contractual obligations towards the customer in the first contract. By this process, a profit is realised through the difference in price between the two contracts and, in most cases, one of the two contracts is concluded immediately, (i.e. the Istisna'a contract entered into with the manufacturer, builder or supplier), while the second contract (i.e. the contract entered into with the customer) is concluded later.

**Difference Between Istisna'a and Ijarah**

The contract of Istisna'a differs from the contract of Ijarah in the sense that the latter is a contract of services without any commitment to supply materials whereas the former requires that the manufacturer or builder provide both services for the transformation or construction process and ultimately to supply the materials in the form of the finished items.

**Difference Between Istisna'a and a Standard Construction Contract**

The contract of Istisna'a also differs from a standard construction contract in that the latter is regarded as an Ijarah contract if it is confined to providing

services only, with the materials to be provided by the customer (the person who engaged the Institution to carry out the construction work). But if a construction contract requires the builder to provide both the services and the materials needed to fulfil the contract, then it is an Istisna'a contract.

**Difference Between Istisna'a and Salam**

The Istisna'a contract also differs from a Salam contract in the sense that the former is a contract that involves a sale of specified items that have by nature to be manufactured or constructed. In other words, an Istisna'a contract is applicable to materials that require transformation by a manufacturing or construction process. The Salam, on the other hand, is a contract of sale of specified goods, the permissibility of which is not attached to a condition that the goods must be manufactured or constructed.

Shari'ah Standard No. (12)

# Sharikah (Musharakah) and Modern Corporations

(Revised Standard)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The objective of this standard is to explain the basis and general rulings for Sharikat al-'Aqd, (contractual partnership) which is known today as Musharakah, including the rulings for joint partnership, reputation (creditworthiness) partnership, vocation partnership, diminishing partnership and modern corporations. The explanation of these partnerships includes definitions, rulings applicable to each partnership and the Shari'ah limitations that must be taken into account by Islamic financial Institutions (Institution/Institutions).[1]

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers all forms of traditional Fiqh-nominate partnerships that operate on the basis of Sharikat al-'Aqd (contractual partnership), except the partnerships that are explicitly excluded by this standard as indicated below. The standard also applies to all modern forms of partnerships including diminishing Musharakah. The standard does not cover ownership partnership where the parties jointly own an asset. It does not include rules for Sharikat al-Mufawadah because the practical application of this form of partnership is rare and, if need be, reference should be made to Fiqh books. The standard does not cover Mudarabah, because this form of partnership has a separate standard. In the same vein, it does not cover sharecropping partnerships, such as irrigation and agricultural partnerships. The standard also does not cover, as far as modern partnerships are concerned, regulatory policies and procedures necessary for operations in the market.

## 2. Definition, Classifications and Types of Sharikat al-'Aqd

### 2/1 Definition of Sharikat al-'Aqd

Sharikat al-'Aqd (contractual partnership) means an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making profits.

### 2/2 Classifications of Sharikat al-'Aqd

Sharikat al-'Aqd is classified into two main categories:

**First Category:** Traditional Fiqh-Nominate Partnerships.

**Second Category:** Modern Corporations.

2/2/1 The traditional Fiqh-nominate partnerships are as follows:

a) Sharikat al-'Inan (contractual partnership)

b) Sharikat al-Wujuh or Al-Dhimam, i.e. partnership of credit-worthiness or reputation (liability partnership)

c) Sharikat al-A'mal (vocational partnerships and partnerships for undertaking difficult work or accepting jobs)

2/2/2 Modern corporations and their well-known forms are as follows:

a) Stock company

b) Joint-liability company

c) Partnership in commendum

d) Company limited by shares

e) Allotment (Muhassah) partnership

f) Diminishing partnership (this partnership has originated from Sharikat al-'Inan)

## 3. First Category: Traditional Fiqh-Nominate Partnerships

### 3/1 General rulings for Sharikah, especially Sharikat al-'Inan

Sharikat al-'Inan is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that the profit is distributed according to the partnership agreement and that the losses are borne in accordance with the contribution of each partner to the capital.

3/1/1 Conclusion of a Sharikah contract

3/1/1/1 A Sharikah contract can be concluded by agreement between the parties concerned on the basis of offer and acceptance. The contract of partnership should, if necessary, be documented and registered officially. The objectives of the partnership must be clearly spelt out in the document of partnership or in the articles of association of the company.

3/1/1/2 It is permissible for the Institution to enter into a partnership contract with non-Muslims or conventional banks to carry out operations acceptable by Shari'ah

unless it has become evident that the funds or items presented by these entities for the purpose of the partnership are from non-permissible sources. In operating a partnership with non-Muslims or conventional banks, arrangements must be made to obtain all necessary assurances and guarantees that rules and principles of the Shari'ah are observed during operations of the partnership. Among such guarantees is one to the effect that the operations of the company be either managed or supervised by an entity that observes the Shari'ah rules.

3/1/1/3 It is permissible for the Institutions to include conventional banks as partners in a syndicated financing which operates on the basis of Shari'ah, provided that the Institution secures the right to manage the partnership's operations and that such operations are subject to the Shari'ah supervision. [see Shari'ah Standard No. (24) on Syndicated Financing]

3/1/1/4 It is permissible for the partners to amend at any point of time the terms of a partnership contract. They may make changes to the ratio of profit-sharing, taking into account that any losses are shared according to the share of each partner in the partnership capital.

3/1/2 The capital of Sharikah

3/1/2/1 In principle, the capital of Sharikah should be contributed in the form of monetary assets on which one can rely in order to determine the amount of the capital and to recognise profit or loss. Nevertheless, it is permissible, with the agreement of all partners, to provide tangible assets (commodities) as the capital of Sharikah after the monetary values of these assets are determined and expressed in currency in order to know the share contributed by each partner.

3/1/2/2 If partners have contributed their partnership capital in different currencies, these currencies must be translated into the currency of the Sharikah at current exchange rates so as to determine the shares and liabilities of each partner.

3/1/2/3 The share of each partner in the capital should be determined, whether it is contributed in the form of one lump sum or by more than one payment over time; i.e., when there is a need for additional funds to increase the capital.

3/1/2/4 It is not permitted that debts (receivables) alone be used as a contribution to the Sharikah capital. However, debts may form part of the contribution to the capital where they become inseparable from other assets that can be presented as a contribution to the capital in Sharikah, such as when a manufacturing firm use its net assets as a contribution to the capital. [see Shari'ah Standard No. (21) on Financial Paper]

3/1/2/5 The funds of current accounts, although they are juristically classified as loans to the Institutions, can be presented as a contribution to the capital in a Sharikah either with the Institution itself or with a third party.

3/1/3 Managing a Sharikah venture

3/1/3/1 In principle, each partner is entitled to act in the interest of the partnership in the following transactions: spot or deferred sales; taking possession or custody of the partnership receivables; making payments or deposits and providing or receiving a mortgage on behalf of the partnership; asking for payment of debts, admission of liabilities, taking up legal actions, cancellation of contracts, rejecting defective goods, renting the assets of the partnership, processing transfers of rights and

debts; requesting credit facilities in the interest of partnership; and doing what is customary in the interest of trading. A partner is not entitled to act against the interest of the partnership or to perform actions that will damage the partnership, such as giving out grants or loans, unless all the partners have consented to such an action. However, the partner may give out short-term minor loans that will not, according to customary practice, affect the operation of partnership.

3/1/3/2 It is permissible for the partners to agree that the management of the partnership will be restricted to certain partners or to a single partner. In this case, the other partners are bound to abide by their consent not to act on behalf of the partnership.

3/1/3/3 It is permissible for the partners to appoint a manager other than one of the partners and pay him a fixed remuneration that will be included in the expenses of the Sharikah. It is also permissible that the partners set aside a portion of the investment profit plus a fixed remuneration as a form of incentive for the manager. However, if the management is carried out from the outset for a percentage share in the profit earned, this action classifies the manager as a Mudarib and he is only entitled to a share in the profit, if any, and deserves no further remuneration for management services.

3/1/3/4 It is not permitted, in a Sharikah contract, to specify a fixed remuneration for a partner who contributes in managing the Sharikah funds or provides some form of other services, such as accounting. However, it is permissible to give him a greater share of profit than he would receive solely on the basis of his share in the partnership capital.

3/1/3/5 It is permissible that one of the partners be appointed to provide services that are mentioned in item 3/1/3/4 provided that the appointment is based on an independent contract from the Sharikah contract so that he may be dismissed as a manager at any point of time without the need to amend or to terminate the Sharikah contract. In this case, the appointed partner may earn a specific remuneration.

3/1/4 Guarantees in a Sharikah contract

3/1/4/1 All partners in a Sharikah contract maintain the assets of the Sharikah on a trust basis. Therefore, no one is liable except in cases of misconduct, negligence or breach of contract. It is not permitted to stipulate that a partner in a Sharikah contract guarantees the capital of another partner.

3/1/4/2 It is permissible for a partner in a Sharikah contract to stipulate that another partner provides a personal guarantee or a mortgage to cover cases of misconduct, negligence or breach of contract.

3/1/4/3 A third party may provide a guarantee to make up a loss of capital of some or all partners. This guarantee is circumscribed with the conditions that (I) the legal capacity and financial liability of such a third party as a guarantor are independent from the Sharikah contract, (II) the guarantee should neither be provided for consideration nor linked in any manner to the Sharikah contract; (III) the third party guarantor should not own more than a half of the capital in the entity to be guaranteed, and (IV) the guaranteed entity should not own more than a half of the capital in the entity that undertakes to provide a guarantee. In case of a third party's undertaking to guarantee, the partner benefiting from such

an undertaking is not, however, entitled either to claim that the Sharikah contract becomes null and void or to refuse to meet his obligations under the contract if the guarantor fails to meet his voluntary promise to cover the loss of his capital, on the grounds that he (the beneficiary) entered into the Sharikah contract taking into account the state of such a third party's undertaking to guarantee the loss of his capital.

3/1/5 The outcome of Sharikah investments (profit and loss)

3/1/5/1 The Sharikah contract should incorporate a provision specifying the manner of sharing profits between the parties. The allocation of profits must be made in a manner that gives each partner an undivided percentage of profit, not a sum of money or a percentage of the capital. [see item 3/1/5/9]

3/1/5/2 It is not permitted to defer the determination of the profit percentages due to each partner until the realisation of profit. The profit percentage for each partner must be determined at the conclusion of Sharikah contract. The parties may bilaterally agree to amend the percentages of profit-sharing on the date of distribution. Also, a partner may relinquish, on the date of distribution, a part of the profit that is due to him in favour of another party.

3/1/5/3 In principle, the shares of profit may be in proportion to the percentage of each partner's contribution to the Sharikah capital. Nevertheless, the partners may agree to make profit-sharing not proportionate to their contributions to capital, provided the additional percentage of profit over the percentage of contribution to the capital is not in favour of a sleeping partner. If a partner did not stipulate a condition that he be

a sleeping partner, then he is entitled to stipulate an additional profit share over his percentage of contribution to the capital even if he did not work.

3/1/5/4 It is a requirement that the proportions of losses borne by partners be commensurate with the proportions of their contributions to the Sharikah capital. It is not permitted, therefore, to agree on holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership in the partnership. It is, however, valid that one partner takes, without any prior condition, the responsibility of bearing the loss at the time of the loss.

3/1/5/5 It is permissible for the partners to agree on the adoption of any method of allocation of profit, either permanent or variable, for example, by agreeing that the percentages of profit shares in the first period are one set of percentages and in the second period are another set of percentages, depending on the disparity of the two periods or the magnitude of the realised profit. This is allowed provided that using such a method does not lead to the likelihood of a partner being precluded from participation in profit.

3/1/5/6 It is not permitted to start the allocation of profit between the partners unless the operating costs, expenses and taxes are deducted in calculating the profit and the capital of the Sharikah is maintained intact.

3/1/5/7 It is not permitted that the conditions or modes of profit allocation in a Sharikah contract include any clause or condition that may result in the probable violation of the principle of sharing profit. For example, if a predetermined amount of profit or a specific percentage of capital is assigned to one of the partners, this assignment will be rendered void. If the assignment

is amended before profit comes forth, profit shall be divided in accordance with what partners agreed on as to amendment. Otherwise, profit shall be divided based on each partner's respective share in capital.

3/1/5/8 Taking into account the provisions of item 3/1/5/3, it is permissible to agree that if the profit realised is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner. The parties may also agree that if the profit is not over the ceiling or is below the ceiling, the distribution will be in accordance with their agreement.

3/1/5/9 The profit may be finally distributed on the basis of the proceeds of selling all the existing assets, known as actual valuation, or on the basis of constructive valuation of assets which means valuation of the assets of the Sharikah at fair value. The receivables must be valued at the cash value that is expected to be realised, i.e. after deduction of an allowance for doubtful debts. In valuing receivables, it is not permitted to take account of the time value of money (interest) or the notion of discount on the basis of current value, i.e. a discount of the amount of the debt as consideration for earlier payment, and cash amounts shall be recognized as is.

3/1/5/10 It is not permitted that the final allocation of profit take place based on expected profit, i.e. it is necessary that the allocation of profit take place on the basis of actual profit earned through actual or constructive valuation of the sold assets.

3/1/5/11 It is permissible to allocate some funds to any of the partners on account, i.e. before actual or constructive valuation, on condition that the final actual settlement will take place at a later stage. In this case, the parties

should undertake to reimburse to the Sharikah any amount that they have received in excess of their share of profit after actual or constructive valuation.

3/1/5/12 If the subject matter of Sharikah is assets acquired for leasing that bring in income or the subject matter is services that bring in revenue, then the amount distributed to the partners annually is on account, and it is subject to settlement and reimbursement at the end of the Sharikah.

3/1/5/13 It is permissible, based on the articles of association or a decision of the partners, not to distribute the profits of the company. It is also permissible to set aside periodically a certain ratio of profit as a solvency reserve or as a reserve for meeting losses of capital (investment risk reserve) or as a profit equalisation reserve.

3/1/5/14 It is permissible to agree on setting aside a proportion of profit for non-partners as a charitable donation.

3/1/6 Maturity of Sharikah

3/1/6/1 Each partner is entitled to terminate the Sharikah (i.e. to withdraw from the partnership) after giving his partner/s due notice to this effect, in which case he shall be entitled to his share in the partnership, and this withdrawal would not necessitate the termination of the partnership of the remaining partners. It is permissible for the partners to enter into a binding promise for the continuity of the partnership for a period of time. In this case, it is permissible for the parties to agree to terminate the partnership before such a fixed period. In all these cases, the obligations and actions that took place before termination will remain unaffected and they will continue to exist.

3/1/6/2 It is permissible for a partner to issue a binding promise to buy, either within the period of operation or at the time of liquidation, all the assets of the Sharikah as per their market value or as per agreement at the date of buying. It is not permissible, however, to promise to buy the assets of the Sharikah on the basis of face value.

3/1/6/3 A Sharikah venture comes to an end at the expiry date or before the expiry date if the partners agree to terminate it prematurely, or, in the case of partnership in a particular business, by actual liquidation of the assets that constitute the subject matter of the partnership. The termination of a Sharikah can take place on the basis of constructive liquidation. In this case, the Sharikah will be regarded as if it has been ended and the parties have commenced a new partnership whereby the assets that were not sold through actual liquidation, but have been valued on the basis of constructive liquidation, will be considered as the capital of the new partnership. If the liquidation is based on the expiry date, then all the existing assets shall be sold according to current market values and the proceeds will be used as follows:

a) Payment of liquidation expenses.

b) Payment of financial liabilities from the net assets of the partnership.

c) Distribution of the remaining assets among the partners in accordance with their percentage of contribution to the capital. If the assets fall short and the partners do not recover all of their contributed capital, the distribution shall take place on a pro rata basis to the shares of capital.

**3/2 Partnership in creditworthiness or reputation (liability partnership)**

3/2/1 A partnership in creditworthiness (partnership of liability) is a bilateral agreement between two or more parties to conclude a partnership to buy assets on credit on the basis of their reputation for the purpose of making profit, whereby they undertake to fulfil their obligations according to the percentages determined by the parties. In addition, the parties should determine for each partner the percentage of profit sharing and of liability sharing, which latter may, by agreement, differ, downwards or upwards, from the percentage of profit sharing.

3/2/2 The partnership in creditworthiness has no monetary capital. This is because the subject matter of the partnership is an obligation or a liability that is contingent on creditworthiness (outstanding reputation). This is the obligation of the partners to pay the amount of debts created through purchases on credit, which form the liability of the partners. Therefore, the parties should agree on the ratio of liability for which each partner is responsible when paying such debts.

3/2/3 The profit shall be distributed according to the agreement. However, the loss will be borne by each partner according to the ratio that each partner had undertaken to bear in proportion to overall assets that are purchased on credit. It is not permitted that the contract of partnership incorporates a provision that specifies a lump sum from the profit for a particular partner.

**3/3 Service partnerships (professional or vocational partnerships and partnerships in skilled trades)**

3/3/1 A service partnership is an agreement between two or more parties to provide services pertaining to a profession, vocation or skilled trade or to render some services or professional advice or to manufacture goods, and to share profit according to an agreed upon ratio.

3/3/2 The service partnership has no monetary capital. This is because the subject matter of the partnership is rendering services. There is no Shari'ah implication regarding any disproportion in the services the partners or their representatives may have rendered. The partners may also distribute different types of services among themselves and may assign some or all partners a set of services or a particular service in a way that will achieve the integration and purpose of the overall service to be rendered.

3/3/3 The profit shall be distributed among the partners according to the agreed ratio, but the contract should not specify that a lump sum be paid from the profit to a particular partner.

3/3/4 If the service partnership requires capital goods (e.g., equipment or tools), then it is permissible for each party to provide the necessary goods that his services require, in which case each partner owns the goods he has provided. The partners may contribute funds to acquire the goods on the basis of a partnership in ownership. It is also permissible for a party to a Sharikah contract to provide the capital goods required by the partnership in consideration for fees that will be charged against the Sharikah operation as expenses.

## 4. Second Category: Modern Corporations

### 4/1 Stock company

4/1/1 Definition of a stock company

4/1/1/1 A stock company is a company of which the capital is partitioned into equal units of tradable shares and each shareholder's (co-owner's) liability is limited to his share in the capital. It is a form of financing partnership. The rules of Sharikat al-'Inan apply to this company except on the issue of the limited liability of the shareholders and the fact that this type of company cannot be unilaterally terminated by one party or a minority of its shareholders. [see items 4/1/2/1 and 4/1/2/9]

4/1/1/2 The stock company has a juristic personality through its incorporation by law in such a way that it cannot avoid its obligations to people dealing with it. This separates the liability of the company from the liability of its shareholders (the co-owners) and also establishes for it a separate legal capacity as required for necessary legal arrangements, irrespective of the legal capacity of the shareholders. By definition, a stock company is entitled to initiate legal claims through its representative. It is subject to the jurisdiction of the place of its incorporation.

4/1/2 Shari'ah Rulings relating to a stock company

4/1/2/1 The contract forming a stock company is binding during the duration designated by the articles of association for the continuity of the company on the basis of the undertaking of the parties not to dissolve the company unless the majority of the partners have consented to do so. Therefore, no one is entitled to dissolve (to terminate) the company in respect to his shares. However, a shareholder is entitled to sell his shares or to relinquish title to them in favour of another person.

4/1/2/2 It is permissible for the issuer of shares to add a certain percentage to the actual value of the shares on the subscription date in order to recover issuing expenses, provided that such percentage is appropriately estimated to reflect the actual expenses incurred.

4/1/2/3 It is permissible to issue new shares in order to increase the capital provided the new shares are issued at the fair value of the old shares. This should be done in accordance with the opinion of experts in valuation of the company's assets. In other words, the new issues can be issued at a premium or at a discount to their nominal value, or issued at a market value.

4/1/2/4 It is permissible that a shareholder underwrite an issue of shares without any consideration. In such a case, there is an agreement between a person and the company on the date of incorporation of the company, or of a share issue, to the effect that such a person is undertaking to buy all or part of the shares issued. In other words, it means an undertaking to subscribe all the remaining shares that are not subscribed at its nominal value. However, it is permissible for a shareholder to ask for consideration for services provided other than the underwriting, such as conducting feasibility studies or marketing the shares.

4/1/2/5 It is permissible that a part of payment for subscription of shares be made in an instalment and that the other instalments be deferred. In this case, the paid instalment is a contribution to the Sharikah capital, and the deferral of some instalments constitutes an undertaking to increase his share of capital in the company subsequently. This is permissible provided the instalments cover all the shares and that the company's liability is confined to the value of the subscribed shares.

4/1/2/6 It is not permitted to purchase shares using interest-based loans, provided by either a broker or any other person, in consideration for mortgaging the shares as a security for payment.

4/1/2/7 It is not permitted for someone to sell shares that he does not own and the promise of a broker to lend the shares to him at the date of delivery does not constitute ownership or possession of the shares. This is not allowed especially if the broker stipulates that the seller must pay the price of the shares so that he can deposit it and earn interest in return for such a loan.

4/1/2/8 In the legitimate public interest, it is permissible for the relevant authorities to organise trading in shares in such a way that trading will not take place except through specific licensed stockbrokers.

4/1/2/9 It is permissible to restrict the liability of a company to its paid up capital if this is made public, in order to make the customers of the company aware of the financial position of the company without any uncertainty or lack of transparency.

4/1/2/10 It is permissible to sell shares in the company subject to rules and regulations of the company that do not conflict with Shari'ah, such as pre-emptive rights of the existing shareholders to purchase the shares.

4/1/2/11 It is permissible to mortgage the company's shares. However, this is subject to the rules and regulations of the company vis-à-vis the right of the shareholders to mortgage their ownership rights to undivided shares in the company.

4/1/2/12 It is permissible to issue shares "to the order of" (nominative shares).

4/1/2/13 It is permissible to issue "bearer shares". This is executed by handing over to the investor a certificate that represents a right to shares in the company and receiving their value in cash or acquiring a counter deed recognising a debt against the shareholder. In this case, the common ownership of shares represented by the certificate is vested in the holder of the certificate of shares at any time.

4/1/2/14 It is not permitted to issue preference shares, i.e. shares that have special financial characteristics that give them a priority at the date of liquidation of the company or at the date of distribution of profit. However, it is

permissible to grant certain shares, in addition to being entitled to rights attached to common shares, certain procedural and administrative privileges, such as a right of vote.

4/1/2/15 It is not permitted to issue *Tamattu'* (enjoyment) shares: shares that entitles the holder a participation in the net profit, but not to vote and which are gradually redeemed before the termination of the company through distribution of profits.

**4/2 Joint-liability company**

4/2/1 Definition of Joint-liability Company

4/2/1/1 A joint-liability company is a form of personal partnership. It is a necessary requirement that this partnership is publicly declared as a registered company assigned a unique title (trademark).

4/2/1/2 A joint-liability company has a juristic personality and independent financial liability unrelated to the liability of the partners. Nevertheless, all the partners are personally responsible for the obligations and liabilities of the company if the existing assets cannot meet the liabilities of the company.

4/2/1/3 In addition to maintaining documents of the joint-liability company, the partners are also obliged to maintain commercial documents relating to external trade activities.

4/2/2 Shari'ah Rulings relating to Joint-liability Companies

4/2/2/1 A creditor of a joint-liability company is entitled to demand fulfilment of all or part of his rights from any of the partners in any way the creditor deems fit. Therefore, the creditor is not obliged to claim such fulfilment from the company first.

4/2/2/2 The contract of a joint-liability partnership is not binding; hence, a partner is entitled to withdraw from the partnership on the following conditions:

a) If the partners did not set a duration for the company. If they agreed on a duration, then such duration must be observed.

b) The partner should notify the other partners of the intention to withdraw.

c) If the unilateral withdrawal from the partnership would not cause damage to other partners.

4/2/2/3 It is not permissible for the partner to bring in a substitute for himself without the agreement of the other partners.

## 4/3 Partnership in commendum

### 4/3/1 Definition of partnership in commendum

4/3/1/1 Partnership in commendum is a form of financing partnership. This is because the personality of the operating partner is important for the sleeping partner and because there is a difference in terms of determination of the ownership of the partners, whereby the ownership is calculated based on disproportionate lots and not on the basis of proportionate shares that are equal in number.

4/3/1/2 This form of company consists of managing partners and sleeping partners. The managing partners in this partnership are jointly liable for the obligations of the company from their personal wealth on the basis of joint-liability. The liability of each sleeping partner is limited to the number of lots he owns and his liability does not extend to his personal assets. It is permissible to limit the liability of some investors

without any consideration for limiting their liability, in which case the company consists of joint-liability partners and partners with limited liability. [see item 4/1/2/9]

4/3/1/3 It is not permissible for the sleeping partners to interfere in the operations of the company. The law does not even allow that their names be mentioned on the date of the registration of the company. Only the funds collected from the sleeping partners are mentioned.

4/3/1/4 The management of the company may be delegated either to one of the joint liability partners or to a third party. The sleeping partners are not entitled to manage the company.

4/3/2 Shari'ah Rulings relating to the partnership in commendum

4/3/2/1 Profit must be distributed according to the ratio of lots or agreement. Losses are borne by managing and sleeping shareholders partners, according to the ratio of their shares in the capital.

4/3/2/2 It is not permissible to stipulate that a sleeping partner has a right to an amount of profit according to a particular percentage of the capital or a lump sum. [see item 3/1/5/8]

**4/4 Company limited by shares**

4/4/1 Definition of a company limited by shares

The company limited by shares is a form of personal partnership. The subscription in this company is in accordance with equal numbers of shares and it comprises of managing partners and sleeping partners.

4/4/2 Shari'ah Rulings relating to the company limited by shares

4/4/2/1 The managing partners in this company are liable for the obligations of the company from their personal

assets on the basis of joint liability. They are in the position of a person who works as a Mudarib and simultaneously participates in a partnership. The sleeping partners' liability is limited to the number of the shares each partner owns and does not extend to his own assets. In this case, the liability of sleeping partners is equivalent to that of the capital providers in a Mudarabah contract. It is permissible to limit the liability of some investors without any consideration for limiting their liability, in which case the company consists of joint liability partners and partners with limited liability. [see item 4/1/2/9]

4/4/2/2 It is not permissible for the sleeping partners to interfere in the operations of the company. The law does not even allow that their names are mentioned on the date of the registration of the company. Only the funds collected from the sleeping partners are mentioned.

4/4/2/3 The management of the company may be delegated either to one of the managing partners or to a third party. The sleeping partners are not entitled to manage the company.

4/4/2/4 Profit must be distributed according to the ratio of participation or agreement. Losses are borne by the managing shareholding partners and sleeping shareholding partners according to their shares in the capital. And any excess losses shall be borne by managing partners.

4/4/2/5 It is not permissible to stipulate that a sleeping partner has a right to an amount of profit according to a particular percentage of the capital or a lump sum.

## 4/5 Allotment/particular (Muhassah) partnership

### 4/5/1 Definition of allotment partnership

4/5/1/1 The definition of Sharikat al-'Inan is applicable to an allotment partnership [see item 3/1]. This type of partner-

ship belongs to the personal (private) form of company. The reason for this is that the partners take into account before concluding a partnership each ones financial strength and ability to meet financial obligations from his personal assets.

4/5/1/2 Sharikat al-Muhassah has no juristic personality because people other than the partners do not know about it. This partnership does not have any separate financial liability as an entity.

4/5/2 Shari'ah rulings relating to Muhassah Company

4/5/2/1 The rulings for and basis of a Muhassah company do not differ from those for an 'Inan partnership. [see item 3/1]

4/5/2/2 The liability of partners is personal and, as such, they are liable for the liabilities of the company from their personal assets. The rules for and classification of an allotment partnership do not differ from 'Inan partnership.

4/5/2/3 The contract of a Muhassah partnership is not binding. However, if the parties agree to make it binding for a particular period of time, then they shall be bound by such an agreement. [see 4/3/2/2]

4/5/2/4 A partner in Sharikat al-Muhassah is entitled to terminate his partnership on condition that (I) he notifies other partners of his intention to withdraw and (II) the unilateral withdrawal from partnership would not cause damage to other partners or clients of the company. The partnership can be liquidated by way of actual or constructive liquidation of the company's assets.

**5. Diminishing Musharakah**

5/1 Diminishing Musharakah is a form of partnership in which one of the partners promises to buy the equity share of the other partner

gradually until the title to the equity is completely transferred to him. It is necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition for concluding the other.

5/2 The general rules for partnerships must be applied to a diminishing partnership, especially the rules for Sharikat al-'Inan. Therefore, it is not permitted that the contract of diminishing partnership include any clause that gives any of the parties a right to withdraw his share in the capital.

5/3 It is not permitted to stipulate that one partner should bear all the cost of insurance or maintenance on the ground that he will eventually own the subject matter of the partnership.

5/4 Each partner should contribute part of the capital. The contribution may be in the form of cash or tangible assets that can be translated into a monetary value, for example, a land for building or equipment required for the operation of partnership. The loss, if any, shall be borne periodically by the parties in accordance with the participation ratio of each partner as the equity stake of one partner decreases and the stake of the other partner increases.

5/5 The ratio of profit or income of the partnership that each partner (the Institution and customer) is entitled to should be clearly determined. However, it is permissible for the partners to agree on a ratio of profit sharing that is disproportionate to the ratio of equity ownership. It is also permissible for the partners either to maintain the ratio of profit already determined even if the ratio of equity shares has changed, or to agree on amending the ratio of profit sharing due to the change in the ratio of equity shares. In doing so, they must ensure that the principle of allocation of losses in accordance with the ratio of equity share of ownership is maintained.

5/6 It is not permitted to stipulate that one partner has a right to receive a lump sum out of the profits. [see item 3/1/5/8]

5/7 It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the Institution) by the other partner, which is prohibited by Shari'ah.

5/8 The partners may arrange for the acquisition of the equity share of the Institution in a manner that serves the interests of both parties. This includes, for example, a promise by the Institution's client to set aside a portion of the profit or the return he may earn from the partnership for the acquisition of a percentage of the equity of the Institution. The subject matter of the partnership may be divided into shares, in which case the Institution's partner can purchase a particular number of these shares at certain intervals until the partner becomes the owner of the entire shares and consequently becomes the sole owner of the subject matter of the partnership.

5/9 It is permissible for either of the partners to rent or to lease the share of the other partner for a specified amount and for whatever duration, in which case each partner will remain responsible for the periodical maintenance of his share on a timely basis.

## 6. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1423 A.H., corresponding to 16 May 2002 A.D.

# Adoption of the Standard

The Shari'ah Standard on Sharikah (Musharakah) and Modern Corporations was adopted by the Shari'ah Board in its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., Corresponding to 4-8 December 2000 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Sharikah (Musharakah) and Modern Corporations.

On Saturday 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Rules for Sharikah (Musharakah) and Modern Corporations.

In its meeting held on 18 Muharram 1422 A.H., corresponding to 12 April 2001 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Sharikah (Musharakah) and Modern Corporations and asked the consultant to make amendments in light of the comments made by the members. The Committee also held a meeting on 20 Jumada II 1422 A.H., corresponding to 8 September 2001 A.D. and made some amendments in light of the comments made by the members.

The revised exposure draft of the Standard was presented to the Shari'ah Board in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments and discuss them in a public hearing.

A public hearing was held in Bahrain on 29–20 Dhul-Hajjah 1422 A.H., corresponding to 2-3 February 2002 A.D. The public hearing was attended by more than thirty participants representing central banks, institutions,

accounting firms, Shari'ah scholars, academics and others who are interested in this field. Some of the members of the Shari'ah Board responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee in its meeting held on 21-22 Dhul-Hajjah 1422 A.H., corresponding to 6-7 March 2002 A.D., in the Kingdom of Bahrain discuss the comments made about the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of both the discussions that took place in the public hearing, and the written comments that were received.

The Shari'ah Board in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Al-Madinah Al Munawwarah discussed the amendments made by the Shari'ah Standards Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II 1433 A.H., corresponding to March 2012 A.D. in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (41) held in Al-Madinah Al Munawwarah, Kingdom of Saudi Arabia on 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Partnership**

The Fuqaha have classified partnerships into four categories, namely Sharikat al-'Inan (contractual partnership), Sharikat al-Abdan (skilled trade partnership), Sharikat al-Mufawadah (agency-like partnership) and Sharikat al-Wujuh (creditworthiness or reputation partnership). The most important of all is Sharikat al- 'Inan (contractual partnership). The permissibility of this form of partnership is established by the Qur`an, the Sunnah and practical consensus of the Fuqaha.

The permissibility of Sharikah is supported by the Saying of Allah, the Almighty: ***{"...And, verily, many partners oppress one another, except those who believe and do righteous good deeds, and they are few..."}***.(2)

Among the Sunnah provisions that support the permissibility of partnership is the case of Al-Sa`ib Ibn Abu Al-Sa`ib Al-Makhzumi who was a partner of the Prophet (peace be upon him) in business at the beginning of Islam. On the day when the Prophet (peace be upon him) conquered Mecca, he met Al-Sa`ib, then he (peace be upon him) said: *"Welcome my brother and my partner. He jokes not (i.e. he is serious in business) and do not argue (unnecessarily)."*(3)

Moreover, partnership is one of the main transactions in all societies since the advent of Islam. This constitutes, therefore, a practical consensus for the permissibility and validity of partnerships.

The partnerships for which the jurists have clarified their rules are the origins of the modern corporations, such as joint-stock companies whose

(2) [Sad: 24]

(3) The Hadith had been related by Al-Hakim who deemed it authentic [2: 61]. Al-Dhahabi agreed with Al-Hakim.

financial standing and obligations are related to the volume of the shares of the company and on its juristic personality, not on the personality of the shareholders. Therefore, the general rules for various partnerships in Shari'ah will govern modern forms of corporations. However, the procedural systems relating to representation of partnership companies and bureaucratic, administrative and accounting procedures are required by Maslahah (consideration of the public good or common need), which is an acceptable source for validating human actions provided it is employed in line with the principles of Shari'ah.

The general basis of Sharikah is agency (Wakalah) because each partner is acting as a principal partner, on one hand, and acting in the interest of the partnership, on the other hand, as an agent for the remaining partners. Unlike other partnerships, *Sharikat al-Mufawadah* combines rules of agency and guarantee simultaneously.

**Conclusion of Sharikah Contract**

- It is permitted to conclude a partnership contract with non-Muslims or conventional banks for carrying out permissible operations in association with necessary guarantees that they will observe Shari'ah precepts and principles. The Shari'ah basis for this is the Hadith stating: *"The Messenger of Allah has prohibited concluding partnership with Jews and Christians unless the selling and buying is in the hands of the Muslim"*.[4] The cause of the prohibition is the fear of being involved in interest-based transactions or in concluding impermissible contracts and this fear is absent when there are guarantees to observe and apply Shari'ah rulings.[5] Al Baraka Forum has issued a resolution in support of partnership between Islamic banks and conventional banks.[6]
- The basis for the permissibility of an agreement on amending the terms of partnership and the profit sharing ratio is that this action does not lead to a possibility of precluding a partner from getting a share of profit.[7]

(4) *"Musannaf Ibn Abu Shaybah"* [6: 9].
(5) See: Ibn Qudamah, *"Al-Mughni"* [7: 110-111].
(6) See: Resolution No. (9/1): *"Fatawa Nadwat Al Baraka"* No. 9, (P. 151).
(7) See: Resolution No. (11/8): *"Fatawa Nadwat Al Baraka"* No. 11, (P. 194).

**Capital of Sharikah**

- The basis for the permissibility that Sharikah capital may be contributed in the form of tangible assets other than cash, after valuation, is that the purpose of Sharikah is to give partners a right to use the contributed money freely and to share the profit. This objective is realisable even if the capital is contributed in the form of tangible assets just as it is in the case of a contribution in cash. Therefore, it is just as valid to present tangible assets for Sharikah investment as to present cash. At the liquidation, each one of the partners will be entitled to the equivalent value of the assets presented at the conclusion of the Sharikah.(8) This is the view of the Maliki and the Hanbali scholars.(9)
- The basis for the requirement that a payment of contribution to Sharikah capital in a currency different from the designated currency of partnership must be valued according to the current exchange rate at the time of payment is that this action is a currency exchange between two currencies which is permitted provided it is carried out at the current exchange rate. This is evidenced by the Hadith in which Ibn Umar asked the Prophet (peace be upon him) concerning selling camels at (a place in Medina called Al-Baqi') in a currency and collecting payment in a different currency. The Prophet (peace be upon him) endorsed the transaction provided it had taken place according to the current exchange rate.(10)
- The basis for the requirement that the investments of parties in the capital should be properly determined is that failure to do so will lead to ambiguity in respect to the capital. It is not permissible that the capital of Sharikah be ambiguous since certainty as to the amount of the capital is a benchmark for sharing profit. The equitable distribution of profit is not possible if the amount of capital contributed by each party is ambiguous.(11)
- The basis for rejecting payment of partnership capital in receivables alone is that debts owed to a partner by another partner cannot actually be used in partnership operations, as they are not assets in possession.

(8) *"Al-Mughni"* [7: 124]
(9) *"Hashiyat Al-Dusuqi"* [2: 517]; and *"Al-Mughni"* [5: 17].
(10) The source of the Hadith has been stated earlier.
(11) *"Al-Mughni"* [7: 125].

Again, this may potentially lead to Riba when the partner is the one in debt.(12) However, if the receivables are combined with other assets and the ratio of debt to the total assets is negligible, then debt and the other assets can be presented as a contribution to partnership capital. The basis for this is the principle of *Taba'iyyah* (things dependent on another thing) as per the legal maxim: "A thing which in fact follows from another thing follows it also in law and judgment cannot be given separately for a thing that follows from another" and the legal maxim: "The law is flexible in things that follow from another".

- The basis for allowing current accounts as capital in partnership is that, in spite of their being considered as loan, they are presumed to be possessed by the accountholders because the funds are available on demand. This is because the Institutions are obliged by their regulations and directives of the supervisory bodies to pay the owner on demand or accept cheques against these accounts irrespective of the financial situation of the Institution.

**Managing a Partnership**

- The basis for the right of each partner to participate in the management of the partnership is that partnership is based on elements of agency and trust. The element of agency requires that each party be entitled to be involved in the operations in a manner that is in the interest of the partnership. The element of trust requires that each party act for the benefit of the partnership.(13)
- The basis for not allowing a fixed remuneration for a partner who assists in the management is that this may lead to guaranteeing the capital of this partner, or to his not being exposed to risk of loss, if any, in proportion to his contribution in the capital.
- The basis for the permissibility of appointing, by a separate independent contract, one partner to manage the partnership and the permissibility of paying him wages is that the partner becomes an employee of the company and he is not acting in the capacity of a partner.

(12) *"Hashiyat Al-Dusuqi"* [3: 517]; and *"Al-Mughni"* [5: 17].
(13) See: *"Al-Mughni"* [7: 128].

**Guarantees in Partnership**

- The basis of the requirement that a partner is not liable except in cases of misconduct or negligence, and of the impermissibility of a stipulation to the effect that a partner guarantees the capital of another partner, is that partnership operates on the basis of trust, and to hold a trustee liable for losses (except in the case of misconduct or negligence) is impermissible.(14)
- The basis for allowing a party to a partnership to require a guarantee or a mortgage from another party as security against cases of misconduct and the like is that this requirement does not conflict with the rules for partnership. Again, the general principle of contracts and partnerships is that parties are required to observe stipulated terms as far as possible.(15)
- The basis for the permissibility of a "promise to guarantee" by a third party whose financial liability is independent from the parties to a partnership is that this action is a mere charitable act and an undertaking that is independent of the partnership contract. In other words, a fulfilment of a promise by a third party is not a condition for the permissibility of the contract. In addition, the third party's guarantee does not adversely affect the established Shari'ah principle against guaranteeing capital or profit. A resolution was issued by International Fiqh Academy in support of the permissibility of a third party's promise to guarantee.(16)
- The basis for the requirement that the guaranteeing Institution should not be the owner of the guaranteed Institution or vice versa is that by ownership the transaction becomes in substance a guarantee by a partner of the capital of another partner.

**Outcome of Partnership Investment (Profit and Loss)**

- The basis for the impermissibility of an agreement to determine the profit share on the basis of a lump sum or a percentage of the capital is because this is inconsistent with the sharing of profit and because profit is not realised unless the capital is maintained intact.

(14) See: Ibn Qudamah, *"Al-Kafi"* [2: 230]; and *"Al-Mubdi"* [4: 256].
(15) See: Fatwa (1/5) of Al Baraka First Forum, 1403 A.H.: *"Qararat Wa Fatawa Nadwat Al Baraka"* (P. 18).
(16) International Fiqh Academy resolution No. 30 (5/4).

- The basis for the impermissibility of deferring the statement of the profit ratio of each party until profit is realised is because such a procedure involves uncertainty which may potentially lead to dispute. However, the parties are entitled to amend the profit ratio or to relinquish a right to profit on the date of distribution. This is because the profit belongs to them; hence, it is permissible for them to make amendments or relinquishments.
- The basis for the requirement that the profit share may be either proportionate or disproportionate to the contribution of each party in the capital is that an individual deserves a share in profit on the basis of the funds contributed, the work done or the risk borne. If an individual is involved in any of these three, then it is allowed for the parties to agree on a profit ratio accordingly. This is the opinion of the Hanafi and Hanbali schools.(17)
- The basis for the impermissibility of one party bearing losses or that each party bear a portion of losses that may not be proportionate to the share of each party in the capital is the saying of Ali Ibn Abu Talib (may Allah be pleased with him): "Profit distribution is according to agreement of the partners and loss must be borne in proportion to the contribution in the capital."(18) Therefore, it is a void condition that one party should bear the loss of other parties and such a condition facilitates misappropriation of the property of others.
- The basis for the permissibility of the partners agreeing on any method for allocation of profit, whether fixed or variable during a particular period, is that this agreement is circumscribed with a condition that the method adopted should not contravene any Shari'ah principle, which means the method should not preclude a party from sharing in profit.
- The basis for not allowing final distribution of profit before deduction of expenses and expenditure is that there is no profit unless the capital is maintained intact.

(17) See: Al-Mirghinani, *"Al-Hidayah Sharh Al-Bidayah"* [3: 7-8], Al-Maktabah Al-Islamiyyah edition; Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 62-63]; and Ibn Muflih, *"Al-Mubdi"* [5: 4], Al-Maktab Al-Islami edition

(18) This Athar has been reported by Ibn Abu Shaybah in his *"Musannaf"* [4: 268], Riyadh: Maktabat Al-Rushd.

- The basis for the impermissibility of specifying a lump sum profit amount for one partner is that this action is inconsistent with sharing in profit.
- The basis for not allowing a partner to earn a share of profit and a fee simultaneously is that this fee is a lump sum that may preclude sharing in profit due to the possibility that the partnership business may not realise enough profit to cover it. The basis for allowing a partner to receive, based on a separate contract, a fee is that the contract that entitles a partner to a fee is not part of the partnership contract and because this fee is not inconsistent with sharing in profit, as the partner in this case is considered to be a third party.
- The basis for the permissibility of an agreement that if the profit realised is above a certain ceiling, the profit over such ceiling belongs to a particular partner, is because this constitutes a valid condition that is not inconsistent with profit sharing.(19) Moreover, the capital provider is the one who will bear losses, if any.
- The basis for the permissibility of distributing profit based on constructive valuation is that the use of this method is permitted by Shari'ah(20) and was used in a number of cases, such as Zakah and theft. The basis for the permissibility of constructive valuation is also the saying of the Prophet (peace be upon him): *"If a co-owner of a slave frees his part, the slave will be set free against his property if he has property; otherwise, it will be valued by fair value and freed."*(21)
- The basis for the permissibility of distributing funds to partners on account, i.e. subject to settlement and refund of any additional profit acquired over the contribution to the capital on the date of actual liquidation, is because this action causes no damage to any of the partners since the distributed funds on account are subject to settlement at a later stage.

(19) *"Al-Bahr Al-Zakhkhar"* [5: 83], Dar Al-Kitab Al-Islami edition.

(20) See: Resolution No. (4) of the Islamic Fiqh Academy under the auspices of Muslim World League that was issued in the 16th session held in Mecca on 21-26/10/1422 A.H.; the International Islamic Fiqh Academy resolution No. 30 (5/4) and Fatwa No. (8/2) issued during the Al Baraka's 8th Forum on Islamic Economics in *"Fatawa Al Baraka"* (P. 134).

(21) This Hadith has been related by Muslim, See: *"Sahih Muslim"* [2: 1140].

- The basis for allowing distribution of partnership revenues, including the capital assets, prior to liquidation of the partnership is that the partners suffer no damage from this and also the distribution is subject to review and reimbursement when liquidation is actually effected.(22)

**Termination of Partnership**

- The basis for the rule that termination of partnership will not affect obligations and actions that took place before it is protection of the remaining partners against any potential damage.
- The basis for the impermissibility of a promise by one of the partners to buy assets of the partnership at face value is that this constitutes a guarantee of the capital which is prohibited by Shari'ah. The basis for the permissibility of a promise to buy the assets of partnership at the market value is that this does not constitute a guarantee of capital.

**Modern Corporations**

- The permissibility of modern corporations is dependent on the principle of Shari'ah that human transactions are, in principle, permissible (*Mubah*) as long as there is no clear injunction against them, especially in view of the fact that the categorisation of any one or more of these corporations had parallels in Shari'ah-nominate contracts, such as 'Inan partnership, Mudarabah and the like.(23)

**Stock Companies**

- The basis for the permissibility of underwriting issues of shares without taking consideration is that this is an undertaking that does not involve an impermissible act, such as taking a commission for a guarantee. The International Islamic Fiqh Academy has issued a resolution in this respect.(24)
- The basis for the impermissibility of buying shares using an interest-based loan provided by a stockbroker or other party against a mortgage of the shares is that this is an interest-based transaction secured by

(22) See: International Islamic Fiqh Academy Resolution No. 30 (5/4), and resolution of Islamic Fiqh Academy under the auspices of Muslim World League during its 16th session.

(23) See: Abdul-Aziz Al-Khayyat, *"Al-Sharikat"* [2: 158-159].

(24) See: The International Islamic Fiqh Academy Resolution No. 63 (1/7).

shares.[25] In this case, both transactions are prohibited by an explicit source that indicates that Allah, the Almighty, has cursed a person who lives on interest-based transactions, a person who pays such interest, and a person who notarises or acts as a witness for such transactions.

- The basis for the impermissibility of selling shares that the seller does not own is that this constitutes selling of an item that one does not own or an involvement in a transaction without bearing a risk which is prohibited by Shari'ah.
- The basis for allowing a mortgage of shares is that mortgaging is permissible. Moreover, anything that can be sold may be presented as a mortgage as in the case of shares unless the bylaws of the company state otherwise in which case the conditions stated must be observed.
- The basis for the permissibility of "shares to the order of" (nominative shares) is that this is a form of transferring ownership of shares to another investor. The acceptance by the remaining shareholders of the bylaws of the company that give a right to transfer is an implied consent to the transfer of ownership.[26] The basis for the permissibility of "bearer shares" is that it is a sale of shares by a shareholder to another investor. The acceptance by the remaining shareholders of the bylaws of the company that give a right to sell is an implied consent to the sale. The fact that the identification and personality of the new shareholder (the purchaser) is not known to other shareholders will not affect the sale as they may be provided with this information if need be.[27]
- The basis for the impermissibility of issuing preference (preferred) shares is that preference shares are inconsistent with profit sharing and involve depriving other partners of their fair share of profit.[28]
- The basis for the impermissibility of issuing shares that entitle the holder a participation in the net profit and entitles the company to gradually redeem the participation through the distribution of profits before the termination of the company, is because the funds the certificate holders receive constitute profit in respect of their shares. The claim that the

(25) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).
(26) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).
(27) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).
(28) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).

participations are redeemed in consideration for the distributed profit is invalid. Therefore, the certificate holders remain owners of the shares and are entitled to proceeds when the company is liquidated.(29)

**Joint Liability Company**

- The basis for the permissibility of the undertaking of partners in a joint liability company to be jointly responsible is that the joint liability in this way is subject to the rules for guarantees. The permission granted by each of them to the others to act on behalf of the company is subject to the rules of agency as in the case of Mufawadah partnership which combines elements of guarantee and agency. The partners have consented to be liable jointly because there is no gain at the expense of any of the partners and no one is to be cheated.(30)
- The basis for the impermissibility of bringing in a substitute partner in a joint liability company when the other partners did consent to it is that the personality of the partner is significant for the partners because the liability of the company includes his personal assets and the substitute may not be in the same financial position as the partner.

**Partnership in Commendum**

- The basis for the impermissibility of sleeping partners of partnership in commendum or company limited by shares being entitled to interfere in the management of the company is that they have agreed not to do so and this agreement does not affect the rules of partnership.
- The reason why the financial liability of the sleeping partners in partnership in commendum is limited to their shares is that they are in the position of capital providers in a Mudarabah contract.

**Allotment (Particular) Partnership**

The basis for the permissibility of unilateral termination of participation in this kind of partnership by any of the partners is that, in principle, unilateral termination of participation is allowed provided such action inflicts no damage to any of the partners as per the saying of the Prophet (peace be upon him): *"No harm to be inflicted and no reciprocal harm."*(31)

(29) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).
(30) See: Abdul-Aziz Al-Khayyat, *"Al-Sharikat"* [2: 235].
(31) The Hadith has been related by Ibn Majah in his *"Sunan"* [2: 784].

**Diminishing Partnership**

- The basis for saying that all the general rules for partnerships, especially the rules for 'Inan partnership, are applicable to diminishing partnerships is to safeguard this new form of partnership from becoming a mere interest-based financing transaction in which a client undertakes to pay another party for his finance in addition to a share in the partnership income.
- The basis for the impermissibility of one partner being responsible for the expenses of insurance or maintenance is that this condition is in conflict with the nature of the partnership contract.[32]

(32) See: Fatwa No. (219) of the Fatwas of Kuwait Finance House.

# Appendix (C)
# Definitions

**Contract Partnership (Sharikat al-'Aqd)**

Contract partnership is an agreement between two or more parties to combine their assets or to merge their services or obligations and liabilities with the aim of making profit.

**Partnership of Ownership (Sharikat al-Milk)**

Partnership of ownership (Sharikat al-Milk) is the combination of the assets of two or more persons in a manner that creates a state of sharing the realised profit or income or benefiting from an increase in the value of the partnership assets. This combination of assets for making profit necessitates bearing losses, if any. The ownership partnership is created by events beyond the partners' control such as the inheritance rights of heirs in the legacy of a deceased person. This partnership is also created by the wish of the partners such as when two or more parties acquire common shares in a particular asset.

**Mufawadah Partnership**

Mufawadah partnership is any partnership in which the parties are equal in all respects, such as funds contributed by them, their right to act and their liability, from the commencement of the partnership to the date of its termination.

**Sharecropping Partnership (Muzara'ah)**

Sharecropping is partnership in crops in which one party presents land to another for cultivation and maintenance in consideration for a common defined share in the crop.

**Irrigating Partnership (Musaqat)**

Irrigating partnership is a partnership that depends on one party presenting designated plants/trees that produce edible fruits to another in order to work on their irrigation in consideration for a common defined share in the fruits.

**Agricultural Partnership (Mugharasah)**

Agricultural partnership is a partnership in which one party presents a treeless piece of land to another to plant trees on it on the condition that they share the trees and fruits in accordance with a defined percentage.

**Distribution of Proceeds and Profits**

Distribution of proceeds and profits is a process of termination an undivided ownership in the company by the final distribution of the assets whereby rights of each partner are defined and common shares are partitioned into identified sets for each partner. This is why distribution is defined as identification of undefined shares or proceeds of a particular person.

**Shari'ah Standard No. (13)**

# Mudarabah

**(Revised Standard)**

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The aim of this standard is to explain the Shari'ah rulings for restricted and unrestricted Mudarabah, whether the Islamic financial Institution (Institution/Institutions)[1] is acting in the capacity of a Mudarib (entrepreneur) or in the capacity of an investor.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers Mudarabah contracts between the Institution and the other entities or individuals. It also covers joint investment accounts and special purpose investment accounts if these accounts are administered on the basis of Mudarabah.

The standard does not cover Sukuk of Mudarabah (Mudarabah Certificates) or other types of partnership contracts, as these are covered by separate standards.

## 2. Definition of Mudarabah

Mudarabah is a partnership in profit whereby one party provides capital (Rab al-Mal) and the other party provides labour (Mudarib).

## 3. Agreement of Mudarabah Financing

3/1 It is permissible, on the basis of a general framework or a memorandum of understanding, to conclude Mudarabah financing contracts for a particular sum of money and within a particular defined duration provided that the memorandum of understanding will be later implemented in line with specific or successive Mudarabah transactions.

3/2 The memorandum of understanding should define the general contractual framework, indicating the intention of the parties to use either unrestricted or restricted Mudarabah financing instrument, either through revolving transactions or separate transactions. Also, the memorandum of understanding should indicate the profit ratio, and type of guarantees that shall be presented by the Mudarib to cover situations of negligence, misconduct or breach of contract and other relevant issues in this regard.

3/3 If the Mudarabah contract is actually concluded on the basis of the memorandum of understanding, the contents of the memorandum become an integral part of any future contract, unless the parties had originally agreed to exempt themselves from some of the obligations mentioned therein.

**4. Mudarabah Contract**

4/1 The Mudarabah contract may be concluded using terms such as Mudarabah, Qirad or Mu'amalah.

4/2 Both parties should possess the legal capacity to appoint agents and accept agency. Therefore, a Mudarabah contract may not be concluded in the absence of two contracting parties with absolute legal capacity or of their agents who enjoy legal capacity similar to that of the contracting parties.

4/3 The general principle is that a Mudarabah contract is not binding, i.e. each of the contracting parties may terminate it unilaterally except in two cases:

4/3/1 When the Mudarib has already commenced the business, in which case the Mudarabah contract becomes binding up to the date of actual or constructive liquidation.

4/3/2 When the contracting parties agree to determine a duration for which the contract will remain in operation. In this case, the contract cannot be terminated prior to the end of the designated duration, except by mutual agreement of the contracting parties.

4/4 A Mudarabah contract is one of the trust-based contracts. Therefore, the Mudarib is investing Mudarabah capital on a trust basis in which case the Mudarib is not liable for losses except in case of breach of the requirements of trust, such as misconduct in respect to the Mudarabah fund, negligence and breach of the terms of Mudarabah contract. In committing any of these, the Mudarib becomes liable for the amount of the Mudarabah capital.

## 5. Types of Mudarabah

Mudarabah contracts are divided into unrestricted and restricted Mudarabah.

5/1 An unrestricted Mudarabah contract is a contract in which the capital provider permits the Mudarib to administer a Mudarabah fund without any restrictions. In this case, the Mudarib has a wide range of trade or business freedom on the basis of trust and the business expertise he has acquired. An example of unrestricted Mudarabah is when the capital provider says, "Do business according to your expertise". However, such unrestricted business freedom in an unrestricted Mudarabah must be exercised only in accordance with the interests of the parties and the objectives of the Mudarabah contract, which is making profit. Therefore, the actions of the Mudarib must be in accordance with the business customs relating to the Mudarabah operations: the subject matter of the contract.

5/2 A restricted Mudarabah contract is a contract in which the capital provider restricts the actions of the Mudarib to a particular location or to a particular type of investment as the capital provider considers appropriate, but not in a manner that would unduly constrain the Mudarib in his operations.

## 6. Guarantees in a Mudarabah Contract

The capital provider is permitted to obtain guarantees from the Mudarib that are adequate and enforceable. This is circumscribed by a condition that the capital provider will not enforce these guarantees except in cases of misconduct, negligence or breach of contract on the part of Mudarib.

## 7. Requirements Relating to the Capital

7/1 In principle, the capital of Mudarabah must be provided in the form of cash. However, it may be presented in the form of tangible assets, in which case the value of the assets is the contribution to the Mudarabah capital. The valuation of the assets may be conducted by experts or as agreed upon by the contracting parties.

7/2 The capital of Mudarabah should be clearly known to the contracting parties and defined in terms of quality and quantity in a manner that eliminates any possibility of uncertainty or ambiguity.

7/3 It is not permissible to use a debt owed by the Mudarib or another party to the capital provider as capital in a Mudarabah contract.

7/4 For a Mudarabah contract to be valid and for the Mudarib to be considered as having control over the capital, the capital must be, wholly or partially, put at the disposal of the Mudarib, or the Mudarib must have free access to the capital.

**8. Rulings And Requirements Relating to Profit**

8/1 It is a requirement that the mechanism for distributing profit must be clearly known in a manner that eliminates uncertainty and any possibility of dispute. The distribution of profit must be on the basis of an agreed percentage of the profit and not on the basis of a lump sum or a percentage of the capital.

8/2 In principle, it is not permissible to earn a share of profit in addition to a fee in a Mudarabah contract. However, it is permissible for the two parties to construct a separate agreement independent of the Mudarabah contract assigning one party to perform, for a fee, a business activity that is not by custom part of Mudarabah operations. The independence of this separate agreement means that if the contract of providing this activity is terminated, this will not affect the contract of Mudarabah.

8/3 The parties shall agree on the ratio of profit distribution when the contract is concluded. It is also permissible for the parties to change the ratio of distribution of profit at any time and to define the duration for which the agreement will remain valid.

8/4 If the parties did not stipulate the ratio of profit distribution, then they shall refer to customary practice, if any, to determine the shares of profit. If the customary practice is that the profit is distributed equally, then this will be applied as such. If there is no customary practice in this regard, the Mudarabah contract is regarded void

ab initio, and the party who acts as the Mudarib should receive a common market price for the kind and amount of services that he provided as Mudarib.

8/5 If one of the parties stipulates that he should receive a lump sum of money, the Mudarabah contract shall be void. This rule does not apply to a situation where the parties agree that if the profit is over a particular ceiling then one of the parties will take the additional profit and if the profit is below or equal to the amount of the ceiling the distribution of profit will be in accordance with their agreement.

8/6 It is not permissible for the capital provider to give the Mudarib two amounts of capitals on condition that the profit earned on one of the two amounts would be taken by the Mudarib while the capital provider would take the profit earned on the other amount. It is not also permissible for the capital provider to state that the profit of one financial period would be taken by the Mudarib and the capital provider would take the profit of the following financial period. Similarly, it is not permissible to assign the profit from a particular transaction to the Mudarib and the profit from another transaction to the capital provider.

8/7 No profit can be recognised or claimed unless the capital of the Mudarabah is maintained intact. Whenever a Mudarabah operation incurs losses, such losses stand to be compensated by the profits of future operations of the Mudarabah. The losses brought forward should be set against the future profits. All in all, the distribution of profit depends on the final result of the operations at the time of liquidation of the Mudarabah contract. If losses are greater than profits at the time of liquidation, the balance (net loss) must be deducted from the capital. In this case, as he is a trustee the Mudarib is not liable for the amount of this loss, unless there is negligence or misconduct on his part. If the total Mudarabah expenses are equal to the total Mudarabah revenues, the capital provider will receive his capital back without either profit or loss, and there will be no profit in which the Mudarib is entitled to a share. If profit is realised, it must be distributed between the parties as per the agreement.

8/8 The Mudarib is entitled to a share of profit as soon as it is clear that the operations of the Mudarabah have led to the realisation of a profit. However, this entitlement is not absolute, as it is subject to the retention of interim profits for the protection of the capital. It will be an absolute right only after distribution, i.e. when actual or constructive valuations take place. It is permissible to distribute the realised profit among the parties on account, in which case the distribution will be revised when actual or constructive valuation takes place. The final distribution of profit should be made based on the selling price of the Mudarabah assets, which is known as actual valuation. It is also permissible that the profit be distributed on the basis of constructive valuation, which is valuation of the assets on the basis of fair value. Receivables shall be measured at the cash equivalent, or net realisable value, i.e. after the deduction of a provision for doubtful debts. In measuring receivables, neither time value (interest rate) nor discount on current value for extension of period of payment shall be taken into consideration.

8/9 If the Mudarib has commingled his own funds with the Mudarabah funds, the Mudarib becomes a partner in respect of his funds and a Mudarib in respect of the funds of the capital provider. The profit earned on the two commingled funds will be divided proportionately to the amounts of the two funds, in which case the Mudarib takes the profit attributable to his own funds, while the remaining profit is to be distributed between the Mudarib and the capital provider according to the provisions of the Mudarabah contract.

## 9. Duties and Powers of the Mudarib

The Mudarib should employ his best efforts to accomplish the objectives of the Mudarabah contract. The Mudarib should assure the capital provider that his money is in good hands that will act to find the best ways of investing it in a permissible manner.

9/1 If a Mudarabah contract is concluded on an unrestricted basis, the Mudarib is permitted, in general, to do what entrepreneurs do in his field of activity, including the following:

9/1/1 Attending to all permissible investment or trading fields that are feasible, given the amount of the capital at his disposal, and in which he believes that his expertise, and technical and professional qualifications are likely to give him the ability to compete effectively.

9/1/2 Carrying out the work himself or appointing another person to carry out some work if necessary, such as buying a commodity or marketing it for him.

9/1/3 Choosing as far as possible appropriate places and markets that are seemingly free of risks.

9/1/4 Safeguarding the Mudarabah funds or depositing them in the custody of a trustworthy person whenever appropriate.

9/1/5 Selling and buying on a deferred payment basis.

9/1/6 The Mudarib may do, either by permission or appointment of the capital provider, the following:

a) The Mudarib may, at any time, combine a Mudarabah contract and a partnership (Sharikah) contract, irrespective of whether this takes place at the outset of the contract or after the commencement of Mudarabah operations, and of whether the partnership contribution is from the Mudarib himself or from a third party. The mixture of unrestricted investment deposits with the Institutions' funds is an example of this kind of combination.

b) The Mudarib may accept funds from a third party on a Mudarabah basis if this new contract will not affect his investment and management responsibility in respect of the first Mudarabah contract.

9/2 It is permissible for the capital provider, on the basis of his interests, to place restrictions on the actions of the Mudarib. Thus, Mudarabah operations may be restricted to a specified time and place, so that the Mudarib may only invest the Mudarabah funds during a particular time period or in a specified country or in a market of a particular

country. In addition, the Mudarabah operations may be restricted to investment in certain sectors such as services or trade sectors or a single commodity or a group of commodities. However, restricting the Mudarabah operations to certain commodities is circumscribed with a condition that such commodities must be commonly available so that, other things being equal, the restriction will not prevent the objectives of the Mudarabah contract from being achieved. For example, the commodities to which the Mudarabah is restricted must not be scarce, seasonal (and out of season) or in very limited supply with the consequence that the objectives of the Mudarabah contract cannot be achieved.

9/3 The capital provider is not permitted to stipulate that he has a right to work with the entrepreneur (Mudarib) and to be involved in selling and buying activities, or supplying and ordering. However, the Mudarib should refer to him in performing any action and should not act without consulting him. Also, the capital provider is not entitled to lay down conditions that will restrict movements or actions of the Mudarib, such as a stipulation that the Mudarib must enter into a partnership with others or a stipulation that the Mudarib must mix his personal funds with the Mudarabah funds.

9/4 The Mudarib must carry out all the work that any similar asset or fund manager would be liable, by custom, to do. In this case, the Mudarib is not entitled to a fee for this work as this is part of his responsibilities. If the Mudarib appoints another party on an Ijarah (hiring contract) basis to carry out such work, the wages for the worker must be paid from the personal funds of the Mudarib and not from the Mudarabah funds. The Mudarib may hire against the account of Mudarabah funds another party, at the prevailing rate, to execute work that is not by custom the responsibility of the Mudarib.

9/5 The Mudarib is not entitled to sell items for the Mudarabah operation at less than the common or market price, or to buy items for the Mudarabah operation at a price higher than common prices, unless if such action in either case is intended to achieve an objective that is obviously in the interest of the Mudarabah.

9/6 It is not permissible for the Mudarib to make a loan or a gift or a charitable donation out of the Mudarabah funds. Likewise, the Mudarib is not entitled to waive a right associated with the Mudarabah operation unless the capital provider has consented to his doing so.

9/7 If the Mudarib has a right to receive living expenses from the Mudarabah funds that has been approved by the capital provider, then he is entitled to the amount so approved for him. If there is no agreement on this, then the Mudarib should take living expenses in accordance with custom and reason. The Mudarib is also entitled to travelling expenses in accordance with custom and reason.

**10. Liquidation of a Mudarabah Contract**

**10/1 A Mudarabah contract can be liquidated in the following manner:**

10/1/1 Being a non-binding contract, it can be liquidated by unilateral termination of the contract by one of the parties. [see item 4/3]

10/1/2 With the agreement of both parties.

10/1/3 On the date of maturity if the two parties had earlier agreed to set a time limit for it. [see item 3/4]

10/1/4 When the funds of Mudarabah contract have been exhausted or have suffered losses.

10/1/5 The death of the Mudarib or the liquidation of the institution that acts as Mudarib.

10/2 On the maturity of a Mudarabah operation, the assets should be liquidated in the manner explained in item 8/8.

**11. Date of Issuance of the Standard**

This Standard was issued on 4 Rabi' I, 1424 A.H., corresponding to 16 May 2002 A.D.

# Adoption of the Standard

The Shari'ah Standard on Mudarabah was adopted by the Shari'ah Board in its meeting No. (8) held in Al-Madinah Al-Munawwarah during the period of 28 Safar to 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah during the period of 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2001 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Mudarabah.

On Saturday 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Standard for Mudarabah.

In its meeting held on 18 Muharram 1422 A.H., corresponding to 12 April 2001 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Mudarabah and asked the consultant to make amendments in light of the comments made by the members. The Committee also held a meeting on 20 Jumada II, 1422 A.H., corresponding to 8 December 2001 A.D., and made some amendments in light of the comments made by the members.

The revised exposure draft of the Standard was presented to the Shari'ah Board in its 7th meeting held in Makkah Al-Mukarramah during the period of 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D. The Shari'ah Board made further amendments to the exposure draft of the Standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments with the objective of discussing them in a public hearing.

A public hearing was held in Bahrain during the period of 29-20 Dhul-Hajjah 1422 A.H., corresponding to 2-3 February 2002 A.D. The public

hearing was attended by more than thirty participants representing central Institutions, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Some of the members of the Shari'ah Board responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee in its meeting held during the period of 21-22 Dhul-Hajjah 1422 A.H., corresponding to 6-7 March 2002 A.D., in the Kingdom of Bahrain discussed the comments made on the exposure draft. The Committee made the amendments which it considered necessary in light of both the discussions that had taken place in the public hearing and the written comments that had been received.

The Shari'ah Board in its 8th meeting held on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Standards Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the Standard in its meeting held on Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its 41st meeting held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia during the period of 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the Standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Mudarabah and Its Rationale**

- Mudarabah, known also as Qirad, is a contract that arranges cooperation in business investment between capital on one hand and entrepreneurship on the other, whereby the contracting parties jointly and commonly own the realised profit as per the agreement. The party providing the capital is known Rab al-Mal and the investor is known as Mudarib or 'Amil (literally. worker) or Muqarid.(2)

Mudarabah contract derives its permissibility from the following:(3)

a) From the Qur`an is the Saying of Allah, the Almighty: ***{"Others travelling through the land, seeking of Allah's bounty"}***.(4) This verse is interpreted to mean those who travel for the purpose of trading and seeking permissible income in order to provide for themselves and their family.

b) From the Sunnah is the Hadith that says, "Al-'Abbas Ibn Abdul-Muttalib used to pay money for Mudarabah and to stipulate to the Mudarib that he should not travel by sea, pass by valleys or trade in livestock, and that the Mudarib would be liable for any losses if he did so. These conditions were brought before the Prophet (peace be upon him) and he approved them".(5) Among the Hadiths regarding the permissibility of Mudarabah is the case that states that "Umar Ibn

(2) Al-Marghinani, *"Al-Hidayah Sharh Bidayat Al-Mubtadi"* [3: 202]; Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 56 and 57]; Ibn Rushd, *"Bidayat Al-Mujtahid"* [2: 236]; and Ibn Qudamah, *"Al-Mughni"* [3: 26].

(3) *"Takmilat Al-Majmu'"* [14: 357-360]; *"Subul Al-Salam"* [3: 76]; *"Bidayat Al-Mujtahid"* [2: 236]; *"Al-Hidayah"* [2: 202]; *"Al-Mughni"* [5: 26]; and *"Al-Muhadhdhab"* Printed with *"Al-Majmu'"* [14: 357].

(4) [Al-Muzzammil (The One Wrapped in Garments): 20].

(5) The Hadith has been related by Al-Bayhaqi [6: 111].

Al-Khattab gave one man the funds belonging to an orphan for the purpose of Mudarabah and the man was trading with these funds in Iraq".(6)

c) Ibn Al-Mundhir mentioned that there is generally consensus among the scholars in respect to the permissibility of a Mudarabah contract.(7)

- The rationale for making this contract permissible includes the following:

a) Money cannot increase unless it is associated with work. It is also not permissible to provide money in return for a periodic pre-agreed payment (rent) to a person who is willing to invest it as this will constitute a debt with Riba.

b) The Mudarabah contract is made permissible to facilitate investment cooperation between capital providers who are not prepared to invest and manage their money themselves, and competent business or investment experts who lack adequate capital. In other words, there are some individuals who are rich but lack business or investment know-how and others who have business or investment expertise but lack money. This situation thus calls for the permissibility of the Mudarabah contract so as to combine the interests of the two parties.(8)

Moreover, a Mudarabah contract is an instrument that was commonly used in trade and which usage expanded in modern times to include business, services, and agricultural or horticultural and industrial activities.

a) The business philosophy of conventional banks depends on the concept of renting out money and making profit in doing so, while Shari'ah prohibits this philosophy because of its being Riba. The Mudarabah financing instrument has been an essential instrument to develop Islamic financial Institutions (Institution/Institutions). This instrument is used by these institutions to attract unrestricted or restricted investment accounts and to reinvest these funds in various activities.

(6) The Hadith has been related by Al-Bayhaqi in *"Al-Ma'rifah"* (see: Al-Zayla'i, *"Nasb Al-Rayah"*).
(7) *"Al-Mughni"* [7: 133-134].
(8) *"Takmilat Al-Majmu'"* [14: 371].

**Contract of Mudarabah**

- The basis for the rule that both parties to a Mudarabah contract must be legally capable to appoint, or act as, an agent is because each party acts as an agent of the other party and appoints the other party to act on his behalf. The entitlement to appoint or act as an agent entitles one to conclude a Mudarabah contract.
- The basis for regarding a Mudarabah contract initially as a non-binding contract is that the Mudarib is using the capital provider's funds with his consent in a contractual relationship in which the Mudarib is just an agent, and an agency contract is not binding.
- The basis for making a Mudarabah contract binding once the work has commenced is that a unilateral termination of the contract at this stage might frustrate the objective of the parties to make profit and might cause damage to the Mudarib since he might not receive any compensation for his work.
- The basis for allowing a time limit for the operation of a Mudarabah contract is that a Mudarabah contract is, in essence, an agency contract, which is subject to a designated duration.(9) The International Fiqh Academy has issued a resolution in this respect.(10)
- The basis for considering the Mudarib as a trustee with respect to the Mudarabah funds is that the Mudarib is using another person's money with his consent, and the Mudarib and the owner of the funds share the benefits from the use of the funds. In principle, a trustee should not be held liable for losses sustained by the funds. Rather, the risks of such losses must be borne by the Mudarabah funds.

**Guarantees in a Mudarabah Contract**

- The basis for allowing guarantees in a Mudarabah that would be used in case of misconduct and negligence of the Mudarib is that in such a case the Mudarib then becomes liable for losses and must bear the consequences of these actions.(11)

(9) *"Al-Mughni"* [7: 133-134].

(10) Resolution No. 122 [5: 13].

(11) This is the opinion of the Shari'ah Board of Al Rajhi Company, see *"Al-Mudhakkirah Al-Tafsiriyyah"*. It is also endorsed in the First Al Baraka Forum.

**Requirements Relating to the Capital**

- The basis for it being permissible that the capital of Mudarabah may be constituted by the value of tangible assets contributed is that the objective of Mudarabah is to make profit. This objective can be realised whether the capital is contributed in the form of tangible assets or cash. This rule is based on the view of the Maliki and the Hanbali jurists.(12)
- The basis for the requirement that the capital of Mudarabah should be clearly known and should be defined in terms of quality and quantity in a manner that eliminates any possibility of uncertainty or ambiguity is because recognition of profit is dependent on the recovery of the capital on the date of liquidation. However, recovery of the capital cannot be ascertained if its amount was not known earlier, and this lack of knowledge may potentially lead to a dispute.
- The basis for not allowing a debt owed by the Mudarib to the capital provider be contributed as capital in a Mudarabah contract is because, as a principle, Mudarabah capital must be (at the conclusion of a Mudarabah contract) an asset that is available and cannot be used on the spot for the Mudarabah operations. A debt fails to meet this requirement, as it is a receivable that is not available for use when the contract is concluded. Moreover, considering a debt as capital of Mudarabah involves potential Riba. This is because the creditor may be suspected of having extended the debt tenure in order to get additional consideration (for the extension) from the debtor under the name of Mudarabah.
- The basis for the requirement that the Mudarabah operation is valid only if the capital is presented to the Mudarib is because the Mudarib is the manager of the Mudarabah operation, and the trustworthy trustee for the Mudarabah capital and income. Therefore, it is necessary that the capital be fully released to the Mudarib so that he will be able to protect and invest the capital and achieve the objective of the Mudarabah contract.(13)

(12) *"Hashiyat Al-Dusuqi"* [3: 517]; and *"Al-Mughni"* [5: 17].
(13) *"Al-Hidayah"* [3: 203]; and *"Hashiyat Al-Dusuqi"* [3: 517].

**Rules and Requirements Relating to Profit**

- The basis for the requirement that the profit ratio is known is because profit is the subject matter of a Mudarabah contract and a lack of knowledge as to the subject matter renders a contract void.
- The basis for the requirement that the profit share of each party be a percentage of the profit and not a lump sum is because a Mudarabah contract is a form of partnership for sharing profit. Any condition that allocates a lump sum to one party would not be consistent with the sharing of profit. This is because the Mudarabah operation may not realise a profit other than the lump sum which goes to one party, thus excluding the other party from partnership in profit.
- The basis for the impermissibility of simultaneously receiving a share of profit and a fee for managing a Mudarabah is likewise that the fee is provided in the form of a lump sum and the Mudarabah operation may not realise a profit other than the lump sum, thus precluding the sharing of profit.
- The basis for the permissibility of an agreement to change the ratio of profit distribution at any time is that the profit is a right belonging to the parties and an agreement in the manner described does not lead to a prohibited act, such as preclusion of sharing in profit. Rather, the agreement makes the parties partners in profit.(14)
- The basis for nullifying a Mudarabah contract when the contract is silent on the ratio of profit distribution and there is no customary practice according to which the profit is to be distributed to each party is that the subject matter of a Mudarabah contract is profit. The lack of knowledge as to the subject matter nullifies contracts.
- The basis for nullifying a Mudarabah contract when one party stipulates entitlement to a lump sum is because a Mudarabah is about sharing profit and this form of condition precludes sharing of profit and may potentially lead to one party being wrongfully deprived of his rights.

(14) See: Al Baraka's 11th Forum, Fatwa No. (8); Al Baraka's 4th Forum, Fatwa No. (5). This is also seconded by the Fatwa of the Shari'ah Board of Faisal Islamic Bank, Sudan (P. 107), which was published in *"Dalil Al-Fatawa Al-Shar'iyyah Fi Al-A'mal Al-Masrafiyyah"*, Islamic Economic Centre, International Islamic Bank, (P. 53).

- The basis for not allowing an agreement that the Mudarib be entitled to the profit earned on one of two capital funds, while the profit earned on the other capital fund belongs to the capital provider, is that such an agreement may preclude the sharing of profit and may potentially lead to one party being wrongfully deprived of his rights.
- The basis for stating that profit is not realised unless the capital is recovered or maintained intact is the Hadith in which the Prophet (peace be upon him) said: *"The instance of a Musali (a person who performs prayer) is that of a businessperson who will not secure profit unless the capital is secured. Likewise, a supererogatory prayer is not acceptable unless the obligatory prayer is performed"*.(15) This Hadith shows that distribution of profit prior to recovery of the capital, or unless the capital is maintained intact, is invalid. Moreover, profit is an addition to the capital and such an addition cannot be recognised or realised unless the capital that is the source of the profit is maintained.
- The basis for the requirement that the Mudarib is preliminarily entitled to a profit when realised, i.e. prior to distribution (an encumbrance right), and that the net profit earned will be known absolutely only after allocation through actual or constructive valuation, is analogous to the contract of sharecropping. The Mecca based Islamic Fiqh Academy has issued a resolution in support of constructive valuation.(16)

**Duties and Powers of the Mudarib**

- The basis for allowing the Mudarib freedom of action in an unrestricted Mudarabah is that the Mudarib has the aim of achieving the objective of the capital provider, which is making profit, and this is not possible unless the capital is vigorously put into operation.
- The basis for not allowing the capital provider to stipulate a right to work with the entrepreneur (Mudarib) or to be involved in acts relating to Mudarabah operations is because such a stipulation would curtail

(15) The Hadith has been related by Al-Bayhaqi in his *"Sunan"*, and was narrated by Ali Ibn Abu Talib. Al-Bayhaqi stated that there is a weak narrator in the chain of transmission of this Hadith, *"Al-Mawsu'ah Al-Fiqhiyyah"* [38: 74].

(16) Resolution No. (4) of the Islamic Fiqh Academy under the auspices of Muslim World League issued in the sixth session that was held in Mecca. This is also the view that was endorsed by Al Baraka's 8th Forum, Fatwa No. (2).

the freedom of the Mudarib, limit the investment scope and hinder the Mudarib in achieving the objective of the Mudarabah contract, i.e. making profit.

- The basis for not allowing the Mudarib to make a loan, gift or charitable donation from the Mudarabah fund is because these actions do not benefit the Mudarabah operation, rather, they involve potential loss to the capital provider.
- The basis for allowing the Mudarib, when acting in the interest of the Mudarabah and in the event that the parties did not specify an amount of money for expenses, to obtain personal expenses from the Mudarabah funds as per customary practice is because what is known by custom is deemed to apply as a condition even if the parties did not clearly stipulate it. Again, the permission for the Mudarib to obtain common personal expenses in these cases is granted by custom.

**Liquidation of Mudarabah Contract**

- The basis for allowing liquidation of a Mudarabah contract unilaterally or by agreement of the parties or at the maturity date is because a Mudarabah contract is non-binding if the parties did not stipulate a term for its maturity.
- The basis for allowing constructive valuation is because Shari'ah has endorsed the concept of valuation. In addition, this is allowed because it is a valid tool that passes rights to owners appropriately. The actual valuation of assets for distribution is based on a common sense because this is the principle.
- The basis for allowing a Mudarabah contract be terminated on the grounds of loss of capital is that when the capital has been lost, the Mudarib is not able to put it to work in a business, and that the fund that was assigned for the Mudarabah is no longer in existence, thus entailing the termination of the Mudarabah contract.
- The basis for allowing termination of a Mudarabah contract due to the death of the Mudarib is that a Mudarabah contract is similar to contract of agency or, at least, it includes agency and an agency contract is terminable by the death of the agent.

# Appendix (C)
# Definitions

**Sharikah**

Sharikah is an agreement between two or more parties to merge their assets or to combine their services, obligations and liabilities with the aim of making profit.

A Mudarabah contract is distinguished from a Sharikah (Musharakah) contract in the following respects:

a) The basis for earning a share of profit in Sharikah is the required capital contribution of all parties, whether in the form of cash, commodities, services or liability in the case of reputation partnership and that the subject of the contract is based on a single element, i.e. capital. The basis for earning a profit in a Mudarabah, on the other hand, comes from two elements: the first element is the existence of capital that is subject to, and similar to, the conditions of Sharikah capital; the second element is the work done by the Mudarib that is different from the capital of the venture.

b) In Sharikah, the work, as a general rule, is to be done jointly by the parties, whereas in Mudarabah it is the Mudarib who works.

## Shari'ah Standard No. (14)

# Documentary Credit

## (Revised Standard)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to define documentary credits, their characteristics, Shari'ah rules and regulations so as to facilitate transactions in them by the Islamic financial Institutions (Institution/Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers documentary credit extended by an Institution, either on the basis of client orders or for the use of the institution itself, including all types and forms of documentary credit, the various stages of their execution and the relationships created between the parties to the transaction.

## 2. Definition, Types and Characteristics of Documentary Credit

### 2/1 Definition of documentary credit

A documentary credit is a written undertaking by a bank (known as the issuer) given to the seller (the beneficiary) as per the buyer's (applicant's or orderer's) instruction or is issued by the bank for its own use, undertaking to pay up to a specified amount (in cash or through acceptance or discounting of a bill of exchange), within a certain period of time, on condition that the seller presents documents for the goods conforming to the instructions.

In brief, a documentary credit is an undertaking by a bank to pay subject to conformity of the documents to the contractual instructions.

### 2/2 Procedural stages of documentary credit

2/2/1 The stage of concluding a credit contract: This stage precedes credit, and the contract concluded is usually a sale contract in which the seller stipulates that the price be paid through documentary credit, however, the contract may be a lease contract, agency with commission or any other contract.

2/2/2 The stage of requesting the opening of credit: At this stage the buyer requests the bank to open the credit so that the seller can be notified.

2/2/3 The stage of issuing credit and notifying the seller: At this stage, the bank issues and sends the letter of documentary credit to the buyer, either directly or through an intermediary bank.

2/2/4 The stage of executing the credit: At this stage, the beneficiary presents the documents stipulated in the letter of credit to the bank. The bank examines them in accordance with the credit conditions. If the documents conform to instructions, the bank accepts them, executes the credit and delivers the documents to the buyer, in case it is not the institution itself, after the receipt of partial or full payment of the value or receives a deed of commitment to pay on the date of maturity so that the buyer is able to receive the goods represented by the documents. If the documents do not conform to instructions, the bank reserves the right to accept, reject or seek amendment of the documents.

2/2/5 Coverage by correspondents: If more than one bank participate in the execution of credit, the accounts are settled in accordance with the terms of coverage agreed upon between the banks.

## 2/3 Types of documentary credit

2/3/1 Basic classification

Documentary credit is classified, according to the strength of the undertaking into two types; namely (I) revocable credit, which can be amended or cancelled without consulting the beneficiary, and (II) irrevocable credit, which cannot be amended or cancelled without the consent of the parties.

2/3/3 Other classifications

There are other classifications of documentary credit. These include the following:

- Transferable documentary credit: This credit entitles the beneficiary to request the executing bank to make the credit available, partially or totally, to another beneficiary or beneficiaries.
- Back-to-back credit, which means the credit issued is guaranteed by another credit.

- Revolving or renewable credit, which means the beneficiary can repeatedly submit new documents for new operations within the limits of the credit amount and during its permissibility.
- Red clause or advance payment credit whereby the bank is allowed to pay a certain percentage of the credit before submission of the documents, against an undertaking by the beneficiary to repay that amount if the goods are not shipped or the beneficiary fails to use the credit during the period of its permissibility. Such payment may be made against a letter of guarantee from the beneficiary.
- Import and export credit (depending on the issuing bank).
- Local and foreign credit.
- Confirmed and non-confirmed credits.
- Partial shipment and a non-partial shipment credit.
- On sight or immediate payment credit, deferred payment credit, acceptance credit and negotiable credit.
- Syndicated credit (partnership credit), which describes the state of participation by more than one bank due to the huge amount of credit granted with each bank providing a letter of guarantee, to the extent of its participation, to the leading bank.
- Standby credit (guarantee credit). This credit resembles letters of guarantee with a clause that payment is conditional upon beneficiary's (in this case the contractor's) failure to perform.

**2/4 Characteristics of documentary credit**

2/4/1 Dealing in documentary credit takes place on the basis of the documents alone and is executed without reference to the goods. Documentary credit, in essence, makes it binding for the bank to execute the credit whenever the beneficiary presents, within the duration of the validity of the contract, the documents required by the credit and conforming to the instructions.

2/4/2 Opening of credit by the buyer (orderer), though it may be acted upon with certainty, is not considered a final payment of the price of the goods. The buyer remains liable for the payment until the bank pays the value of the documents, however, the

seller (beneficiary) does not have a right to request payment from the buyer as long as the credit subsists and is valid. If the credit expires before the submission of the documents, the seller has the right to claim payment directly from the buyer, because expiry of the credit in itself does not amount to revocation of the sale contract.

2/4/3 The bank is obliged to pay the value of the credit to the beneficiary when the latter presents the documents that conform to instructions, except upon proof of fraud or forgery of the documents, or in the case of a court decision declaring the sale contract null and void.

2/4/4 Interpretation of the duties and obligations of the parties to documentary credit are subject to International Commercial Terms (INCOTERMS 2000) and the Uniform Customs and Practices for Documentary Credit (UCP 500) when reference is made to INCOTERMS in the sale contract and to UCP in documentary credit.

## 3. Shari'ah Ruling on Documentary Credit

### 3/1 Permissibility of documentary credit

3/1/1 Dealing in documentary credit includes agency for providing procedural services, the most important of which is the examination of documents, and the provision of institutional guarantee to the importer. As both agency and guarantee contracts are permissible, documentary credit becomes permissible subject to the conditions stipulated in this standard.

3/1/2 Opening of all types of documentary credit, its issuance and confirmation, on the basis of the client's order or for the institution itself, are permitted to an Institution. It is also permissible to an institution to participate, or play an intermediary role, in such dealings and to notify, amend or execute in any way such credit, either for its own use or on behalf of another institution or bank, according to the available forms of executing documentary credit, subject to item (3/1/3) below.

3/1/3 It is not permissible for the institution to undertake transactions in documentary credit, in accordance with what is stated in item (3/1/2), either for itself or on behalf of another as a client or institution or by way of collaboration, when such credit pertains to goods that are prohibited by the Shari'ah, or is based on a contract that is void or irregular (according to the Shari'ah) due to vitiating conditions or includes interest, either charged or paid, whether explicitly as in the case of loan upon payment by the beneficiary of amounts not fully or partially covered in similar credit, or impliedly, as in the case of discounts or trading (payment) on bills of exchange with deferred and delayed payments.

It is stipulated for the permissibility of the subject of documentary credit that the contract upon which reliance is placed be a contract that is valid in the Shari'ah insofar as its elements, conditions and type of transaction, whether currency exchange, ordinary sale or another, are concerned, and also with respect to its specific additional conditions.

3/1/4 The bank is obliged to execute the credit when it conforms to instructions, except upon proof of fraud or forgery of the documents, in which case it is under no obligation to execute it. Provided that if the contract concluded prior to opening of documentary credit is nullified by a court decision, the execution of the credit is subject to a new agreement.

**3/2 The contract preceding the opening of credit**

3/2/1 It is permissible for the seller to stipulate in the sale contract that payment be made through documentary credit. Such a condition is valid and its performance is binding upon the buyer.

3/2/2 It is permissible to secure international transactions using documentary credit provided that the secured transactions do not violate the rules of the Shari'ah.

3/2/3 When the contract stipulates that its interpretation is subject to INCOTERMS (issue 2000) or the United Nation's Convention in respect of the International sale of goods or any other reference, then such potential interpretation is circumscribed with a condition that it must not violate the rules of the Shari'ah. [see item 3/2/2]

**3/3 Commissions and expenses in documentary credit**

3/3/1 It is permissible for the institution to charge actual expenses incurred in issuing documentary credit. It is also permissible for the institution to charge a fee for providing the required services, whether such a fee is in the form of a lump sum or a certain percentage of the credit amount, provided that the duration of the credit is not considered in determining the commission. This rule applies to services rendered for both import and export credit, except where the amendment involves a rescheduling of the duration of the credit facility. It is, therefore, permissible for the institution to charge only the actual expenses incurred, in which case it will be a definite sum and not a percentage.

The Institution must abide by the following conditions:

a) The aspect of guarantee per se must not be taken into account when estimating fees for documentary credit. Accordingly, it is not permissible for an institution to charge an amount in addition to the actual expenses incurred if it endorses a credit facility issued by another bank, because endorsing a credit facility is an addition over guarantee. The rule for endorsement applies to participation in the issuance and endorsement of credit as well as issuance of standby credit (guarantee credit), as long as services or obligations are not required.

b) The issuance of a credit facility should not involve Riba bearing profits or become a means for such profits.

c) It is not permissible to use a combination of contracts in documentary credit as an excuse for involvement in the prohibited transactions, such as taking a commission for providing a guarantee or extending a loan.

3/3/2 The rule of item 3/3/1 above equally applies to receiving or payment of commissions and expenses and in a situation where the institution acts as an intermediary in these respects, irrespective of whether the transaction is between the institution and its client (the orderer or beneficiary) or between the institution and other institutions and banks.

3/3/3 The ruling of commission for providing letters of guarantee that was stated in the Shari'ah Standard No. (5) on Guarantees must be applied when determining commissions for the letters of guarantee that accompany documentary credits, such as letters of guarantee provided in the case of advance payment of a portion of the amount or the shipping guarantee that is issued for releasing the goods before the arrival of documents.

**3/4 Guarantees in documentary credits**

3/4/1 It is permissible for the institution to secure the obligations arising out of documentary credit, or to provide documentary credit as security for payment in favour of institutions and banks dealing with it. The institution may act as an intermediary for facilitating documentary credit using other permissible and acceptable forms of guarantee. It is, therefore permissible to use a number of means as a cover for documentary credit including cash, freezing of permissible accounts and negotiable instruments valid according to the Shari'ah, certificates of shares in real estate and withholding the documents of the credit that stand for the goods.

The cover of a documentary credit may be also one of the following: a transferable letter of credit; a back-to-back letter of credit; a letter of guarantee issued by the bank of the beneficiary

against the advance payment in case of advanced payment credits; a letter of guarantee issued by a bank participating in the issuance or confirmation of the credit; relinquishment receivables and commercial papers, such as bill of exchange and promissory notes. This item must be read together with item 3/4/2 below.

3/4/2 It is not permissible for the institution to accept the following types of guarantees: interest-based bonds, shares of companies that deal in prohibited activities, and interest-based receivables. It is also not permissible for the institution to provide any of these guarantees as security for its obligation to other institutions or banks or to act as an intermediary to facilitate such guarantees.

3/4/3 It is permissible for the institution and the applicant for documentary credit to agree on investing the cash cover of the credit in accordance with Mudarabah partnership.

**3/5 Murabahah transactions in documentary credit**

When a client intends to purchase imported goods from the institution through Murabahah financing of the documentary credit, the following must be observed:

3/5/1 Opening of documentary credit should not precede the conclusion of the sale contract between the orderer and the beneficiary (the seller) irrespective of the orderer having taken possession of the goods that are the subject-matter of the contract.

3/5/2 Institution should be the party who purchases from the supplier, and then sells to the client through Murabahah as per the rulings stated in Shari'ah Standard No. (8) on Murabahah, while taking into account item 2/2/2 in respect to cancellation of contract and item 3/1/3 in respect to agency in Murabahah.

### 3/6 Musharakah contract with the client to finance documentary credit for imported goods

3/6/1 In case the institution signs a partnership contract with the client to purchase goods prior to the opening of credit and before the client concludes a sale contract with the supplier, it is permissible to open the credit in the name of either partner. It is permissible for the institution, after receipt of the goods, to sell its share to a third party or to its partner through a spot or deferred payment Murabahah on the condition that the sale to the partner is not based on an earlier exchange of binding promises or stipulated in the Musharakah contract.

3/6/2 It is permissible for the institution to sign a partnership contract with the client in respect of goods purchased by the client on the condition that the institution does not sell its share to the client on a deferred payment basis.

### 3/7 General rules

3/7/1 If the credit transaction includes a provision that it is subject to the prevalent principles and practices that unify documentary credit, it is necessary to qualify such a statement with the stipulation that it will not violate Shari'ah rules and principles. It is preferable that the institution presents alternatives that could be agreed upon between the institution and the correspondent banks.

It is a requirement to explicitly state that a provision stipulating interest will not be acted upon, and also for trading activities that contravene the provisions of the Shari'ah. For valid substitutes. [see Shari'ah Standard No. (17) on Commercial Papers, items 5/2 and 5/3]

3/7/2 It is not permissible for the institution to discount accepted bills of exchange, i.e. to purchase these bills before maturity at less than their nominal value.

3/7/3 It is not permissible for the institution to trade in deferred payment documents or accepted bills of exchange, i.e. to purchase these instruments at less than their nominal value. It is also not permissible for the institution to act as an intermediary, whether by payment or notification, between the beneficiary and the issuing or confirming bank to facilitate such dealings.

3/7/4 It is not permissible for the institution to negotiate, for less than their nominal value, documents payable on sight or payable bills of exchange.

3/7/5 It is not permissible for the institution, as far as possible, to present bills of exchange that it undertakes to pay to clients whose debts to the institution are represented by these bills, so as to get them discounted by other banks that may accept them.

3/7/6 The institution should arrange its relationships with other institutions and correspondent banks on the basis of non-payment of interest and avoidance of prohibited transactions with respect to covering operations between the correspondent banks when such relationships involve settlement of inter-bank obligations resulting from documentary credit and other banking operations.

## 4. Date of Issuance of the Standard

This Standard was issued on 7 Rabi' I, 1424 A.H., corresponding to 8 May 2003 A.D.

# Adoption of the Standard

The Shari'ah Standard on Documentary Credits was adopted by the Shari'ah Board in its meeting No. (10) held in Al-Madinah Al-Munawwarah during the period of 2-7 Rabi' I, 1424 A.H., corresponding to 3-8 May 2003 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah during the period of 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2000 A.D., the Shari'ah Board resolved to give priority to the preparation of a Shari'ah Standard on Documentary Credit.

On Monday 29 Ramadan 1421 A.H., corresponding to 25 December 2000 A.D., a Shari'ah consultant was commissioned to prepare a Shari'ah study and an exposure draft.

In its meeting held in the Kingdom of Bahrain on 15 and 16 Safar 1422 A.H., corresponding to 9 and 10 May 2001 A.D., the Shari'ah Studies Committee discussed the juristic study of the standard and requested the consultant to incorporate the necessary amendments in the light of the conclusions of the Committee and the observations of members. The Committee also discussed the exposure draft in its 10th meeting held in the Kingdom of Bahrain on 14 Rabi' I, 1422 A.H., corresponding to 6 June 2001 A.D., and made some amendments to the exposure draft.

In its meeting No. (11) held in Jordan on 18 and 19 Jumada II, 1422 A.H., corresponding to 6-7 September 2001 A.D., the committee further discussed the exposure draft of the standard and made amendments that were deemed necessary in preparation of the submission to Shari'ah Board.

The revised exposure draft of the standard was presented to the Shari'ah Board in its 8th meeting held in Al-Madinah Al-Munawwarah from 28 Safar to 4 Rabi' I, 1423 A.H., corresponding to 1116 May 2002 A.D. The Shari'ah Board made further amendments to the exposure draft and decided to defer its discussion in the public hearing until views crystallize

on the issue of the contract that is relied upon for documentary credit in the context of the deferment of its two counter-values, known as *Ta`jil al-Badalayn*.

The revised exposure draft of the standard was also presented to the Shari'ah Board in its 9th meeting held in Makkah Al-Mukrramah during the period of 11-16 Ramadan 1423 A.H., corresponding to 16-21 November 2002 A.D. The Shari'ah Board made further amendments to the exposure draft and decided that it should be distributed to specialists and interested parties in order to obtain their comments in preparation of its discussion in a public hearing.

A public hearing in Bahrain on 18 Dhul-Hajjah 1423 A.H., corresponding to 19 February 2003 A.D. The public hearing was attended by more than thirty participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in the field. The members of the Shari'ah Standards Committees (1) and (2), responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) held a joint meeting on 2 Muharram 1424 A.H., corresponding to 5 March 2003 A.D., to discuss the comments that were made during the public hearing as well as the observations received in writing. The two committees made amendments that were deemed suitable.

The Shari'ah Board in its meeting No. (10) held in Al-Madinah Al-Munawwarah during the period of 2-7 Rabi' I, 1424 A.H., corresponding to 3-8 May 2003 A.D., discussed the amendments made by the Shari'ah Standards Committee, and incorporated the amendments deemed suitable. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held on Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments

(additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (41) held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia during the period of 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Documentary Credit**

The permissibility of documentary credit is based on the principle that it relies upon contracts that are valid according to the Shari'ah, such as Kafalah (personal guarantee), Wakalah (agency contract) and Qard (loan).

**Shari'ah Categorization of Documentary Credit**

- The basis for the permissibility of irrevocable documentary credit is a combination of a contract of guarantee and agency. To these two the Qard (loan) transaction is to be added. It derives permissibility from the contract of mortgage (Rahn) as well, because it secures payment. The contract of guarantee creates a liability for payment, while agency determines the performance of acts relating to operations such as communication of the credit notification and initiation of operations pertaining to follow-up and examination of document. The loan element comes into operation when the institution pays on behalf of the client in case of documentary credit that is totally or partially uncovered.(2)
- The basis for the permissibility of a revocable documentary credit is that it is a form of agency contract that is permitted by the Shari'ah. When a third party's right is attached to it, it becomes binding, and this occurs when it leads to acceptance or payment. A revocable documentary credit cannot be classified under the contract of guarantee for two reasons; namely (I) it conflicts with the requirements of guarantee; and (II) an option is not permissible in guarantee contracts.(3)
- The basis for the permissibility of the undertaking of the confirming bank and other similar undertakings of the banks that participate in

(2) Resolution No. (419) of the Shari'ah Board of the Al Rajhi Banking Corporation and Investment and Answer No. (71) of the Shari'ah advisor of Dallah Al Baraka.

(3) Ibn Qudamah, *"Al-Sharh Al-Kabir"*, [3: 59-60], 1951 A.D.

issuance or confirmation of the credit is that it is an act of back up guarantee, which is permissible in the Shari'ah.(4)

- The basis of permissibility of guarantee in irrevocable credit being qualified from the perspective of execution with the condition that documents presented conform to the conditions stipulated, is the ruling of the jurists that Kafalah (guarantee) accepts qualification through a stipulated condition.(5)
- The basis for the ruling that documentary credit terminates with implementation or expiry is that the guarantee for documentary credit is limited in time by a period, and this is the period of validity of the credit. It is permitted to place a time frame on guarantee.(6)
- The basis for the permissibility of the contract relied upon for documentary credit, as well as its conditions, is that it is a sale for which security is provided through guarantee, and this is compatible with the objectives of the contract.

**Contract That Precedes the Opening of Credit**

- The basis for the permissibility of making opening of documentary credit a condition in the sale contract preceding documentary credit is that such a condition is similar to a stipulation to provide a specific guarantor for payment, which is a valid condition acknowledged as an interest for the contract.(7)
- The basis for the permissibility of undertaking international sale contracts and their security through documentary credit is that upon examination, the international sale contracts that are secured through documentary credit pose a difficulty: Do they involve delay of the two counter-values that is prohibited by the Shari'ah?

(4) Ibid., [13: 25-26]; Ala' Al-Din Al-Samarqandi, *"Tuhfat Al-Fuqaha'"*, [3: 407].

(5) Ibn Abidin, *"Radd Al-Muhtar 'Ala Al-Durr Al-Mukhtar"*, [4: 265], Beirut: Dar Ihya` Al-Turath Al-'Arabi, n.d.

(6) Ibid. (P. 265). Ibn Qudamah, *"Al-Sharh Al-Kabir"*, [13: 25-26]; Al-Samarqandi, *"Tuhfat Al-Fuqaha'"*, [3: 402, 404 and 405]; Muhammad Al-Hajjar, *"Fath Al-'Allam Bi-Sharh Murshid Al-Anam Fi Al-Fiqh 'Ala Madhhab Al-Sadah Al-Shafi'iyyah"*, [5: 43], Beirut: Dar Ibn Hazm, 1418 A.H.

(7) See: Wizarat Al-Awqaf Al-Kuwaytiyyah, *"Al-Mawsu'ah Al-Fiqhiyyah"*, letter "Ba", "Bay'", *"Bay' Wa Shart"*, Para (28); Al-Samarqandi, *"Tuhfat Al-Fuqaha`"*, [2: 70]. Mustafa Ahmad Al-Zarqa, *"Al-Madkhal Al-Fiqhi Al-'Amm"*, 1986, (pp. 477-478); Muhammad Al-Hajjar, *"Fath Al-'Allam"*, [5: 19].

The members of the Board differed on this into those who prohibit them due to the cause indicated, and those who permit them -being in a majority with those permitting them disagreeing on the following points:

a) That these contracts -prior to the ascertainment of the goods- do not involve delay in the two counter-values rather they amount to bilateral promises, which are agreements to sell and do not amount to sale itself.

b) That they merely amount to extension of the session of the contract (*Majlis al-'Aqd*), with respect to the agreement, up to the time of ascertainment of the goods.

c) That they do not amount to a delay in the two counter-values, but they are permitted on the basis of general need.

d) That they are, *ab initio*, an exchange of a debt for a debt and this is permitted under the Shari'ah.

e) That the contract preceding the opening of documentary credit amounts to a sale contingent upon the opening of credit.

f) That these contracts do not involve delay in counter-values, because that is attained through a stipulation for delay, while there is no stipulation of delay in this case.

**Commissions and Expenses in Documentary Credit**

- The basis for the impermissibility of receiving compensation for guarantee for the aspect related to documentary credit is that a guarantee is preparatory to extending a loan, and this is not to be compensated. The four Fiqh schools are unanimous on the impermissibility of taking compensation for guarantee. This rule is endorsed by a resolution of the International Islamic Fiqh Academy,[8] a ruling of the Shari'ah Supervisory Board of the Faysal Islamic Bank of Sudan,[9] the Shari'ah Board of Al Rajhi Banking Corporation for Investment[10] and a resolution of the Shari'ah Fatwa and Supervisory Board of the Kuwait Finance House.

(8) International Islamic Fiqh Academy Resolution No. 12 (12/2).
(9) Fatwa No. (14) of the Shari'ah Supervisory Board of the Faisal Islamic Bank, Sudan.
(10) Resolution No. (297) of the Fatwas of the Shari'ah Supervisory Board of Kuwait Finance House.

- The basis for the permissibility of receiving compensation for an agency-related service in documentary credit, whether in a lump sum or as a percentage of a known amount, is that the amount is in lieu of services rendered by the institution, in its capacity as an agent of the client. The majority of the Fuqaha upheld the permissibility of charging wages for agency.(11) The Shari'ah Supervisory Board of Al Rajhi Banking Corporation for Investment has passed a resolution permitting receipt of payment including the services involved in documentary credit without referring to the aspect of guarantee.(12)
- The basis for the impermissibility of charging commissions in consideration for providing long or short term loans, discounting and trading (payment of the value) in documents and deferred payment bills of exchange or for providing facility, are the texts of the Qur`an and the Sunnah laying down the prohibition of Riba.(13)

**Guarantees in Documentary Credit**

- The basis for the permissibility of seeking guarantees explained in this Standard (item 3/4) is that collateral (Rahn) may be money, debt or tangible asset insofar as they might be lawfully owned or created according to the Shari'ah and because the debt to be secured may be a current or future obligation.(14)

(11) Ala` Al-Din Al-Mardawi, *"Al-Insaf"*, [13: 577].

(12) Resolution No. (419) of the Shari'ah Supervisory Board of Al Rajhi Banking Corporation for Investment.

(13) In its Resolution No. (372), the Shari'ah Supervisory Board of Al Rajhi Banking Corporation for Investment stipulated: "It is prohibited in documentary credit to collect from the client any interest at any stage of the credit" (for discounting and trading in commercial papers, see item 2/8 where the resolution provides the Shari'ah basis for this ruling). As regards commission for providing the facility, the facility is preparatory to extending a loan, and hence if commission is prohibited for giving the loan itself it would be obviously correct to prohibit commission for a mere readiness to do so. This conclusion has been adopted in the Al Baraka 8th Forum in its Fatwa No. (13) and the response of the Shari'ah advisor to Dallah Albaraka Group No. (1).

(14) See: Al-Samarqadi, *"Tuhfat Al-Fuqaha`"*, [3: 53-54]; Al-Mardawi, *"Al-Insaf"*, [13: 359]; Al-Hajjar, *"Fath Al-'Allam"*, [5: 44]; Ibn Qudamah, *"Al-Mughni"*, [6: 444-445]; Abu Abdullah Muhammad Ibn Muhammad, *"Mawahib Al-Jalil Sharh Mukhtasar Khalil"*, 2nd edition., [5: 5], Beirut: Dar Al-Fikr, 1978 A.D.; See also Islamic Fiqh Academy Resolution No. (86) 3/9, Jeddah; Fatwa No. (5) of Al Baraka's 5th Forum and Resolutions No. (19 and 283) of Al Rajhi Banking Corporation for Investment.

- The basis for not allowing the Institution to sell its share of partnership, in goods purchased by the client, for a delayed payment to the client is that this amounts to a sale-buy back arrangement (*Bay' al-'Inah*), which is prohibited by the Shari'ah.
- The basis for not allowing negotiability of documents payable on sight including bills of exchange for an amount lesser than their nominal value is that this adopts the form of the sale of debt, which is prohibited.

# Appendix (C)
# Definitions

**Credit Documents**

These are the documents relating to goods detailed in the credit. The documents are divided into two types: basic and additional documents. Basic documents include: Shipping documents, commercial invoice, marine insurance policy, certificate of origin, consulate invoice and promissory note. Additional documents include: Weights certificate, analysis certificate, review and inspection certificate, warehouse receipts, delivery orders, packing review/supervision certificate, test certificate, medical certificate and non-infection certificate. Such certificates are requested to verify certain attributes and characteristics of the commodity and to make sure that it is free of defects and infection. The certificates are required by the authorities of the importing or exporting country.

**Bill of Lading**

A bill of lading is the traditional source of shipping documents. It indicates the party authorized to receive the goods, whether it is the original beneficiary, a party in whose name the bill is backed as a collateral arrangement or an agent assigned to receive the goods. A bill of lading constitutes the practical execution of the shipping contract signed between the shipper and the marine carrier. Shipping is the responsibility of either the buyer or of the seller according to the type of International Sale Contract (Commercial Terms) adopted. A bill of lading is the only shipping document that can be backed.

**Examination of Documents**

It is the process of ensuring that the documents comply with the specifications indicated in the letter of credit. The general conditions for the integrity of documents are detailed through the following four conditions:

- That the documents are submitted during the validity of the credit.
- That they are complete in number.
- That they are complimentary and one document does not contradict another and that each contains the required information or each serves its function.
- That they conform to the conditions of the letter of credit.

In case any of these conditions is missing, for any one of these documents, it is obligatory upon the bank to reject the documents as a whole, even those that are not defective.

**At Sight Credit**

It is credit that has to be paid promptly at sight according to the value of the documents, by the issuing bank, the confirming bank or the paying bank, if the documents conform to the conditions of the credit.

**Deferred Payment Credit**

It is an undertaking given by the issuing, or confirming bank to pay at a future date, being the date fixed in the credit, the value of the documents if they conform to the conditions of the credit. It differs from acceptance credit insofar as the beneficiary does not present a promissory note with the documents.

**Acceptance Credit**

It is the acceptance of the bill of exchange attached to the documents or is signed on behalf of the bank; that is, the bank accepts the obligation of paying the nominal value on the date of maturity.

**Negotiation of Documents**

It is the payment of the value of the documents, or the purchase of the bill of exchange attached to them; that is, its discounting, whether it is to be paid at sight or after a known specified period.

**Acceptance of Documents 'Under Reserve'**

It occurs when the bank chooses to accept the documents at its own risk despite their non-conformance with the conditions of the credit, paying their value or accepting the bill of exchange attached to them, on the condition that

it reserves the right of recourse to the beneficiary if the issuing bank does not accept the discrepancies in the documents. The paying bank usually reserves this right by way of obtaining a letter of guarantee, covering the value of the documents, from the bank of the beneficiary.

**Marine Letter of Guarantee**

It is an undertaking given by the issuing bank to place the original bill of lading, when received, at the disposal of the carrier in lieu of receiving back a letter from him. The carrier in this case is relieved from all responsibility that may arise from the delivery of the goods to the importer, who gives an undertaking to the issuing bank for the acceptance of the documents regardless of any discrepancies in them. This type of letter is usually issued upon arrival of the goods when the documents are to follow or are delayed.

**Correspondent Bank**

It is the bank assigned by the issuing bank to notify the beneficiary of the credit. As a rule, the correspondent bank is under no obligation to pay the value of the credit; its role is confined to that of an intermediary. Correspondent banks are banks with which the institution makes certain arrangements for accepting or covering the value of the credits that it issues or confirms.

In case the beneficiary requests notification through a non-correspondent bank, the issuing bank sends its instructions to one of its correspondent banks asking it to process the notification through the bank nominated by the beneficiary.

**Confirmation of Credit**

It is the merging of the liability of the confirming bank with the liability of the issuing bank making both banks liable for fulfilling the conditions of payment of credit, when the beneficiary presents documents that meet the terms of the credit. The beneficiary has the right to claim payment severally from either bank or jointly from both banks.

**The Paying Bank**

It is a correspondent bank of the issuing bank in the currency of the credit to whom the issuing bank entrusts the payment of the value of the

credit on its behalf, but the paying bank is under no obligation for executing this trust.

**The Covering Bank**

Covering banks are types of correspondent banks with which the bank maintains an account and to whom it delegates the authority to cover disbursement and negotiation payments upon the first presentation.

**Transferable Credit**

It is irrevocable credit by means of which the beneficiary (first beneficiary) requests the bank assigned, or any other licensed institution, to make payment or to undertake to pay in the future or to accept or to negotiate so as to make the credit available, in whole or in part, to the beneficiary or beneficiaries.

**Back to Back Credit**

It is irrevocable credit issued for the same purpose as that of transferable credit whenever a credit is not transferable.

**Revolving Credit**

It is credit that is opened for a fixed value and duration, except that its value is renewed automatically when it is executed or utilised so as to enable the beneficiary to present documents for a new operation within the value of the credit, during the period of its validity, and for the number of times fixed for the credit.

**Advance Credit or Red Clause Credit**

It is credit bearing a paragraph written in red ink to invite attention to its instructions. In this credit, the authorised bank is assigned to pay certain amount according to percentage of the value of the credit to the beneficiary in advance before the goods are shipped and before the documents that necessitate payment are presented.

**Credit Available for Negotiation**

This is credit by which the issuing bank grants to the correspondent bank the legal authority to buy bills of exchange drawn on the basis of documentary

credit upon presentation of bills of exchange that are payable at sight by the issuing bank or are payable in the future to the issuer of documentary credit. Accordingly, the seller is able to receive the value of the credit (bills of exchange) upon presentation of required complete documents that obligate payment of the value of the credit.

## Shari'ah Standard No. (15)

# Ju'alah

## (Revised Standard)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to elaborate the definition of Ju'alah, to distinguish it from Ijarah, to describe its elements, conditions, legal status in the Shari'ah, fundamental rules, and applications in the transactions of Islamic financial Institutions (Institution/Institutions),[1] irrespective of the institution acting as the general offeror (demanding performance) or as the worker (under an obligation to perform), even when this is through another, parallel Ju'alah.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard sets out fundamental rules of the Shari'ah on Ju'alah and its application in activities for which the extent of the work required cannot be precisely determined for it continues throughout the determined period. It is for this reason that it does not cover the contract of Ijarah for employment/service or leasing, just as it does not cover maintenance contracts or stipulations of maintenance in relation to other contracts, such as the requirement of maintenance in a sale contract or an Istisna'a contract (construction contract).

## 2. Definition of Ju'alah

Ju'alah is a contract in which one of the parties (the Ja'il) offers specified compensation (the Ju'l) to anyone (the 'Amil) who will achieve a determined result in a known or unknown period.

## 3. Permissibility of Ju'alah

Ju'alah is permissible deeming the determination of the end result to be realised through it as sufficient, and it is not affected by the uncertainty that prevails with respect to the subject-matter of the contract, that is, the work to be done. It is for this reason that Ju'alah is suitable for activities for which Ijarah, which requires that the desired work be clearly specified, is not.

## 4. Shari'ah Status of Ju'alah

4/1 With due consideration to item (6) below in respect to the revocation of Ju'alah, Ju'alah, in principle, is not a binding contract. The general offeror (Ja'il) or the worker ('Amil) are entitled to revoke it unilaterally, however, it becomes binding for the Ja'il when the worker commences work. If the worker undertakes not to revoke the contract during a specified period, it is binding on him to abide by the undertaking.

4/2 The possession of the worker exercised over the property of the offeror is that of a trustee. He is, therefore, not liable except in the case of negligence, misconduct or violation of the conditions stipulated by the offeror.

## 5. Elements of Ju'alah and Its Conditions

The elements of Ju'alah are: The two parties (the offeror and the worker), the form of the contract and the subject-matter of the contract (the compensation and the work).

### 5/1 The two parties to the contract (the offeror and the worker)

The existence of legal capacity is a condition for both parties to the contract. It is not a condition that the worker be specified, therefore, Ju'alah is concluded by the issuance of an offer directed at the general public. Any person whom the offer reaches may undertake the work himself or with the help of another. If, however, the worker is specified, it is obligatory for him to undertake the work himself or with the express consent of the offeror through someone under his supervision and control.

### 5/2 Form of the contract

The Ju'alah contract is concluded by an offer directed towards a specified worker or towards the general public, irrespective of such an offer being made verbally, in writing or through any other means that indicate an invitation to work and an obligation to pay the compensation. Acceptance of the offer is not stipulated as a condition.

### 5/3 The subject matter of the contract (compensation and work)

The subject matter of the contract is the work that is agreed upon through Ju'alah as well as the compensation for the work.

5/3/1 Work that produces the desired result

5/3/1/1 Among the forms of activity that may be agreed upon on the basis of the Ju'alah contract are the following:

a) An activity that is intended, through the agreement, to produce a result such as the extraction of minerals.

b) Any information in which the offeror has an interest such as presenting a report or study or the completion of scientific works that realise a result, but in which the extent of the work cannot be determined.

c) An activity that is intended, through the agreement, to return lost property to its seeker.

5/3/1/2 It is permissible to stipulate that the job is done within a specified period so that the worker will not be entitled to compensation after this period, except when the period is over and the result is close to realisation, in which case the period will be automatically extended.

5/3/1/3 When the period is over and the worker has done (part of) the work that will benefit the offeror, the worker is entitled to reasonable wages (*Ujrat al-Mithl*).

5/3/1/4 The Ju'alah contract is valid despite uncertainty as to the nature of the work, provided that the required result realised by the work is determined.

5/3/1/5 It is a condition that the work involves some type of effort.

5/3/1/6 It is a condition that the work not be obligatory for the worker.

5/3/2 The compensation

5/3/2/1 The compensation should be known, valuable in the eyes of the Shari'ah, and deliverable. If the compensation is unknown, unlawful or not deliverable, payment of reasonable compensation becomes binding.

5/3/2/2 The compensation may be a portion of the object of work in Ju'alah, for instance, a percentage of a debt agreed upon for collection or the right to utilise, for a determined period, a project whose implementation is agreed upon.

5/3/2/3 As a rule, entitlement to compensation is not established until the work is completed and delivered to the offeror. The following are the exceptions to the rule:

a) Where it is evident that the work undertaken by the worker belongs to someone other than the offeror and has been decreed as such, the worker is entitled to the compensation.

b) Where an accident occurs during work undertaken by the worker causing loss that was not due to the tort or negligence of the worker, the worker is entitled to full compensation.

5/3/2/4 It is permissible to stipulate that all or part of the compensation be paid in advance at the conclusion of the contract or thereafter, even though this is before the completion of the entire work, however, it is considered "subject to accounts" and the worker is not entitled to it without the realisation of the result, the offeror having the right to reclaim it if the work is not realised.

**6. Revocation of Ju'alah**

6/1 If the offeror, or the worker, revokes the contract prior to the commencement of work, the worker is not entitled to compensation.

6/2 If the offeror prevents the worker from working after commencement of the work, the offeror is bound to pay reasonable wages.

6/3 If Ju'alah contract is terminated by the worker after the work is commenced; the worker is not entitled to a reward, except when the parties agree to otherwise.

6/4 If the worker revokes the contract after commencing the work, he has no claim against the offeror, unless they had agreed to the contrary.

## 7. Distinction between Ju'alah and Ijarah

Ju'alah is distinguished from Ijarah on the following grounds:

7/1 Ju'alah is valid despite uncertainty of work deeming the determination of the required result by the offeror as sufficient.

7/2 Ju'alah does not require acceptance.

7/3 Entitlement to compensation depends on completion of work and delivery of result.

7/4 Ju'alah is valid even if the other party is not known.

7/5 As a rule, Ju'alah is terminable, while Ijarah is binding.

## 8. Applications of Ju'alah

Among the applications of Ju'alah in activities where the extent of work is undetermined and in which uncertainty is overlooked are:

### 8/1 Exploration for minerals and extraction of water

Ju'alah contract may be used for the exploration for minerals and the extraction of water in situations where entitlement to wages is contingent upon the finding of minerals or water without reference to the amount of time or the extent of the period.

### 8/2 Collection of debts

Ju'alah is used for collecting debts in cases where the entitlement to compensation is contingent upon the collection of all of the debt, in which case entitlement to the entire compensation is established, or part of the debt so that compensation proportionate to the amount of debt collected is due.

### 8/3 Securing permissible financing facilities

8/3/1 Securing permissible financing facilities means that the worker undertakes some work that leads the institution to agree to the granting of financing facilities to the offeror or to arrange syndicated financing.

8/3/2 Ju'alah contract may be used for securing facilities provided that the condition of the permissibility of Ju'alah is met, that is,

the subject-matter of Ju'alah must be valid such as the creation of debt through Murabahah on deferred payment, Ijarah with deferred rental, raising of loans without interest, issuance of letters of guarantee or the opening of documentary credit with the condition that the transactions are not employed for raising interest bearing loans through stipulations, customary practice or dealings among institutions.

**8/4 Brokerage**

Ju'alah is used in brokerage activities in cases where the entitlement to compensation is contingent upon the conclusion of the contract for which intermediation is undertaken.

**8/5 Discoveries, inventions and designs**

Ju'alah is used for the realisation of scientific discoveries, innovative inventions and designs, such as symbols and trade marks, where entitlement to compensation is contingent upon the realisation of the discoveries, the registration of patents or the creation of designs conforming to the conditions elaborated by the offeror.

## 9. Role of Institutions in Ju'alah

9/1 It is permissible for an institution to have the status of a worker in Ju'alah by contract, for work benefiting others irrespective of the institution undertaking the work itself or by contracting out the work through another Ju'alah that is in the nature of a parallel, unless it is stipulated that the institution will carry out the work itself. It is obligatory that the two Ju'alahs are not linked.

9/2 It is permissible for an institution to have the status of the offeror whether the work benefits the institution or is for the fulfilment of its obligation in a Ju'alah for the benefit of another (parallel Ju'alah) ensuring that the two Ju'alahs are not linked.

## 10. Date of Issuance of the Standard

This Shari'ah Standard was issued on 7 Rabi' I, 1424 A.H., corresponding to 8 May 2004 A.D.

# Adoption of the Standard

The Shari'ah Standard on Ju'alah was adopted by the Shari'ah Board in its meeting No. (9) held during the period of 11-16 Ramadan 1423 A.H., corresponding to 16-21 November 2002 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (7) held in Makkah Al-Mukarramah during the period of 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2002 A.D., the Shari'ah Board resolved to give priority to the preparation of the Shari'ah Standard for Ju'alah.

On Saturday 14 Shawwal 1422 A.H., corresponding to 29 December 2001 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft on the Shari'ah Standards for Ju'alah.

In its meeting No. (1) held on 9 Safar 1423 A.H., corresponding to 20 April 2002 A.D., in the Kingdom of Bahrain, the Shari'ah Standards Committee discussed the exposure draft of the standard and made some amendments.

In its meeting No. (2) held on 20 and 21 Rabi' I, 1423 A.H., corresponding to 1 and 2 June 2002 A.D., in the Kingdom of Bahrain, the Committee also discussed the exposure draft of the standard and asked the consultant to make the necessary amendments in light of comments and discussions of the members.

In its meeting No. (3) held on 20 Rabi' II, 1423 A.H., corresponding to 1 July 2002 A.D., in the Kingdom of Bahrain, the Committee further discussed the exposure draft and made amendments that it deemed suitable in preparation of the submission of the exposure draft to the Shari'ah Board.

The revised exposure draft of the Shari'ah standard was presented to the Shari'ah Board in its 9th meeting held in Makkah Al-Mukarramah during the period of 11-16 Ramadan 1423 A.H., corresponding to 16-21 November 2002 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and resolved that it be distributed to specialists and interested

parties for soliciting their comments in preparation of their discussion in a public hearing.

A public hearing was held in Bahrain on 18 Dhul-Hajjah 1423 A.H., corresponding to 19 February 2003 A.D. The public hearing was attended by more than thirty participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others having interested in this field. The public hearing was based on the observations made whether these transmitted prior to the public hearing or were raised during the public hearing. The members of the Shari'ah Standards Committees (1) and (2) responded to the observations and comments.

The Shari'ah Standards Committees (1) and (2) held a joint meeting on 2 Muharram 1424 A.H., corresponding to 5 March 2003 A.D., in the Kingdom of Bahrain to discuss the comments made during the public hearing as well as those sent received in writing, inserting amendments deemed suitable.

The Shari'ah Board in its 10th meeting held in Al-Madinah Al-Munawwarah during the period of 2-7 Rabi' I, 1424 A.H., corresponding to 3-8 May 2003 A.D., discussed the amendments suggested by the Shari'ah Standards Committee, and incorporated the amendments that it found suitable. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held on Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (41) held in Al-Madinah Al Munawwarah, Kingdom of Saudi Arabia during the period of 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Ju'alah**

Ju'alah contract is permissible according to the majority of the Fuqaha on the basis of the Qur`an, the Sunnah, Ijma' (consensus of Fuqaha) and Ijtihad (reasoning).

- As for the Qur`an, the evidence is in the story of Yusuf (Joseph) and his brother after the announcement of the loss of the King's great beaker, ***{"For him who brings it is the (reward of) a camel load; I will stand surety for it"}.***(2)
- As for the Sunnah, the evidence is in the report from Abu Sa'id Al-Khudri(3) about the stipulation of Ju'l (compensation) if the chief of the tribe was cured through him and the tacit approval of the Prophet (peace be upon him) of this.
- There is Ijma' (consensus of Fuqaha) about the contract of Ju'alah in essence with some disagreement about its scope insofar as some Fuqaha restricted it to reward for the return of a runaway slave, as is recorded in the Sunnah.
- As for Ijtihad (reasoning), there is a general need for Ju'alah in the case of acts that cannot be performed by a person himself nor can he find someone who will volunteer for him. Further, it is suitable for cases for which the contract of Ijarah is not suitable, like the return of lost property from an unknown location.

**Shari'ah Status of Ju'alah**

- The basis for the principle that Ju'alah is not binding for the offeror is that accrual of the compensation is contingent upon a condition, thus,

(2) [Yusuf (The Prophet Joseph): 72].
(3) *"Sahih Al-Bukhari"* [5: 2166].

it resembles bequest, which is not binding. The basis for Ju'alah being non-binding for the worker is that the work to be done is uncertain, thus, it resembles Mudarabah, which is not binding.

- The basis for regarding Ju'alah as binding when the worker has commenced work is that at this stage Ju'alah is similar to Mudarabah in which the Mudarib has commenced work. Like Mudarabah, Ju'alah is considered binding by the Maliki scholars in such a case. The basis for considering it binding when the two parties undertake not to terminate the contract during the period of the contract is that unilateral revocation leads to the loss of the effort put in by the worker or the likelihood of injury for the offeror.
- The basis for the entitlement of the worker to receive reasonable wages, when the contract is revoked after commencement of work, is that the work done by the worker is legally valid and loss is not to be caused to him. He, therefore, has recourse to reasonable compensation as is the case in Ijarah when it is revoked due to a defect.

**Elements of Ju'alah and Its Conditions**

- The basis for the rule that it is obligatory in Ju'alah that all its elements (two parties, form, work and compensation) be found is that it is a contract and must have these elements. Further, Ju'alah is a commutative contract that must have a form to indicate the task required as well as the amount of compensation.
- The basis for permitting the worker to seek assistance from others, when there is no stipulation for his personal services, is that Ju'alah is similar to agency in which seeking help from others is valid.
- The basis for not stipulating the identification of the worker and directing the offer towards the general public is that the offeror does not know of a person who is able to achieve what is required.
- The basis for not stipulating acceptance on the part of the worker, when he is unknown, is that it is not possible to obtain his acceptance.
- The basis for allowing the work to be uncertain is the general need along with the impossibility of determining the extent of work.
- The basis for stipulating that compensation be known is that compensation is like wages and that there is no need to validate Ju'alah when

the compensation is unknown as against the uncertainty about the work and the worker.

- The basis for recourse to reasonable compensation upon the vitiation of the named compensation is analogy constructed upon Ijarah with recourse to reasonable wages upon the vitiation of the named wages.
- The basis for the permissibility of compensation being a portion of the subject-matter of Ju'alah, even though it is uncertain and does not exist, is that it is a type of uncertainty that does not prevent delivery and involves no Gharar (uncertainty) since entitlement to compensation is not established until the task is accomplished.
- The basis for the rule that entitlement to compensation is not established until the work is completed and delivered, is that work in Ju'alah is not determined or certain, therefore, stipulating payment as compensation would amount to compensating something that has not compensation because the work has not been completed.

**Applications of Ju'alah**

- The basis for permitting an institution to undertake Ju'alah, as a worker or as an offeror, is the permissibility of Ju'alah for which natural persons and juristic persons have the same legal capacity.
- The basis for the permissibility of Ju'alah for debt collection, and other similar acts stated in the standard, is that these are acts whose precise determination is difficult and Ijarah is not suitable for them, while Ju'alah is legally valid despite the uncertainty with respect to work.

## Shari'ah Standard No. (16)

# Commercial Papers

## (Revised Standard)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to elaborate the rules pertaining to commercial paper, the types permitted and those not permitted, the rules for dealing in commercial paper, its collection, discounting, possession and the acceptance of the obligation to pay, as well as the elaboration of the Shari'ah regulations for Islamic financial Institutions (Institution/Institutions)(1) for dealing in commercial paper.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers commercial papers to which the Geneva Uniform Convention on the Law of Commercial Papers,(2) confined itself. These are bill of exchange, promissory note and cheque. This standard covers dealings in such commercial papers insofar as they conform to the rules and principles of the Shari'ah. The standard does not cover anything that may possess the attributes of commercial paper other than the three types named above.

## 2. Definition and Shari'ah Characterisation of Commercial Papers

2/1 Bill of exchange: A written, signed, and unconditional order from a person to another person to pay a certain sum of money at sight or at a particular or determinable date to a third person or to the order of that third person or to the bearer of that order.

2/2 Promissory note: A certificate whereby by the issuer (a debtor) promises to pay a certain amount of money at sight or at a particular or determinable date to another person (a beneficiary/creditor). In Shari'ah characterisation, it is considered a certificate of debt.

2/3 Cheque: A certificate that is issued to a particular person, containing an order issued by a person (the drawer) to another person (the drawee) to pay a certain sum of money to a third person (the beneficiary) at sight. In Shari'ah characterisation, it is considered a restricted Hawalah if the drawer is a debtor to the drawee. Otherwise, it is considered an unrestricted Hawalah with respect to the drawer.

(2) Issued on 1349/1350 A.H., corresponding to 1930/1931 A.D., and adopted by a large number of countries.

## 3. Rules for Dealing in Commercial Papers

3/1 It is permissible to undertake transactions in commercial paper of the three types (bill of exchange, promissory note and cheque) on the condition that it does not amount to the contravention of the Shari'ah, like Riba or delay that is legally prohibited in accordance with the details provided in the following paragraphs.

3/2 It is not permissible to use a bill of exchange or promissory note in transactions that require possession (of the counter-values), like deeming the two types of commercial paper as counter-values in the contract of *Sarf* (currency exchange) or as the counter-value for the capital (*Ras al-Mal*) in the contract of Salam.

3/3 It is permitted to use a cheque in the following types of transactions and situations:

a) A cheque, where the owner has a balance, when drawn by the client against the bank or by the bank against another bank or against itself or against one of its branches.

b) A cheque, where the owner has no balance, when drawn by the client against a bank or is drawn by the bank against another bank or against itself or against one of its branches (the so-called overdraft). From Shari'ah perspective, it is a loan (Qard) which is permissible if it is void of Riba.

c) A crossed cheque that binds the payee bank to fulfil its conditions.

d) An account payee cheque that binds payee bank to fulfil its conditions by crediting the amount of the cheque to the beneficiary's account.

e) Travellers' cheques. It is permissible for the institution issuing it to take commission in lieu of intermediation in such issuance or at the time of its payment provided this does not include Riba.

## 4. Endorsement

All forms of endorsements are binding with respect to their legal effects provided that the endorsements fulfil the legal conditions and regulations determined for them.

## 5. Collection of the Amount of Commercial Papers

The collection of the amount of commercial papers is considered an agency with the client appointing the institution as an agent to collect the value of the paper on his behalf. The institution is entitled to commission that is agreed upon between the client and the institution. In the absence of an agreement between them, the practice prevalent among institutions is to be acted upon.

## 6. Discounting of Commercial Papers

6/1 It is not permissible to discount commercial papers, but it is permitted to pay an amount that is less than the value of the paper to the first beneficiary prior to the date of maturity.

6/2 It is not permissible to sell commercial paper that has not become due for an amount similar to its value (*Riba al-Nasi`ah*) nor for an amount that is more than its value (*Riba al-Nasi`ah* plus *Riba al-Fadl*).

6/3 It is permissible to the beneficiary to treat commercial paper that is not yet due as price for ascertained goods or usufruct, but not those that are sold by description as a liability with the condition of actual or legal delivery of goods or usufructuary asset (commodity-based discounting of debts).

6/4 The holder of commercial paper is permitted to purchase goods to be delivered later (on the date of maturity of the paper), and after the debt is established as a liability. The holder of the paper transfers the claim of his creditor to his debtor through this paper. In such a case, the transaction amounts to Hawalah.

## 7. Taking Possession of Commercial Papers

7/1 The receipt of a cheque requiring prompt payment, if it is a banker's cheque or a certified cheque or one that is legally deemed a certified cheques whereby a certain amount is mandatorily maintained in the drawer's account, being drawn among banks or among banks and their branches, constitutes constructive possession of the amount written on it, and it is on this basis that it is permissible to use the

cheque in transactions that stipulate possession such as the exchange of currencies, the purchase of gold or silver with the cheque as well as treating the cheque as capital (*Ras al-Mal*) of Salam.

7/2 The receipt of a cheque that is to be paid promptly, if it is not a banker's cheque or a certified cheque or one that is legally deemed a certified cheque, cannot be considered constructive possession of its amount, and in such a case, it is not permitted to use it for transactions for which possession is stipulated.

7/3 It is permitted to use cheques of bank transfers for transactions when the amount intended to be transferred is in the same currency in which payment is to be made, however, where the currency is different from that in which payment is to be made, it is necessary to first apply the process of conversion between the two currencies, deeming constructive possession to be sufficient, and then undertake the transfer. It is a form combining currency exchange (*Sarf*) and Hawalah.

**8. Acceptance for Payment of the Value of Commercial Papers**

8/1 Acceptance for paying the value of commercial paper on the part of the drawee is considered an undertaking and an obligation to pay the debt represented by the commercial paper to the holder on the date of maturity. This undertaking and obligation must be fulfilled according to the Shari'ah.

8/2 All parties whose signatures appear on the commercial paper including the drawer, the endorser and the guarantor are jointly responsible to pay to the holder the value of the paper in accordance with rules of liability, thus, the holder is entitled to have recourse to them severally or jointly after the refusal of the drawer (or the issuer in case of a promissory note) to pay.

8/3 Tangible security stipulated by the holder of commercial paper to ensure the securing of his right will be deemed a Mortgage (Rahn) and will be governed by the rules of Mortgage (Rahn).

## 9. Date of Issuance of the Standard

This Shari'ah Standard was issued on 7 Rabi' I, 1424 A.H., corresponding to 8 May 2003 A.D.

# Adoption of the Standard

The Shari'ah Standard on Commercial Papers was adopted by the Shari'ah Board in its meeting No. (10) held during the period of 2-7 Rabi' I, 1424 A.H., corresponding to 3-8 May 2003 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (7) held in Makkah Al-Mukarramah during the period of 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D., the Shari'ah Board decided to issue the Shari'ah standard for Commercial Papers and to appoint a Shari'ah consultant for the preparation of the exposure draft of the Shari'ah standard for commercial papers.

On Saturday 14 Shawwal 1422 A.H., corresponding to 29 December 2001 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft on the Shari'ah standards for commercial papers.

In its meeting held in the Kingdom of Bahrain on 4-5 Safar 1423 A.H., corresponding to 17-18 April 2002 A.D., the Shari'ah Standard Committee discussed the exposure draft of the Shari'ah standard on commercial papers and asked the consultant to make necessary amendments to reflect the comments and observations made by the members of the Committee. The Committee discussed the exposure draft of the standard in its meeting held in the Kingdom of Bahrain on 6-7 Rabi' II, 1423 A.H., corresponding to 17-18 June 2002 A.D., and introduced necessary amendments as per observations and comments of the members.

The exposure draft of the standard was also discussed by the Committee in its meeting held in Amman, the Hashemite Kingdom of Jordan on 17 Rabi' II, 1423 A.H., corresponding to 28 June 2002 A.D., and further amendments were incorporated in the standard.

The revised exposure draft of the Shari'ah standard was presented to the Shari'ah Board in its 9th meeting held in Makkah Al-Mukarramah during the period of 11-16 Ramadan 1423 A.H., corresponding to 16-21 November 2002 AD. The Shari'ah Board made further amendments to the

exposure draft of the standard and decided that it be sent to specialists and interested parties in order to obtain their comments in preparation for its discussion in a listenig session.

A public hearing was held in Bahrain on 18 Dhul-Hajjah 1423 A.H., corresponding to 19 February 2003 A.D. The public hearing was attended by more than thirty participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in the field. The members of the Shari'ah Standards Committees (1) and (2) responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) held a joint meeting on 2 Muharram 1424 A.H., corresponding to 5 March 2003 A.D., to discuss the comments made during the public hearing as well as comments received in writing. The two Committees made the amendments considered necessary.

The Shari'ah Board in its meeting No. (10) held in Al-Madinah Al-Munawwarah during the period of 2-7 Rabi' I, 1424 A.H., corresponding to 3-8 May 2003 A.D., discussed the amendments made by the Shari'ah Standards Committee and made amendments considered suitable. The Shari'ah Board unanimously adopted some of the items, while other items were adopted by a predominant majority vote, as recorded in the minutes of the meetings of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held on Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (41) held in Al-Madinah Al-Munwwarah, Kingdom of Saudi Arabia during the period of 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Dealings in Commercial Papers**

- The basis for the permissibility of dealing in a bill of exchange is that it is in the meaning of Hawalah or Qard (loan) contract, which are agreed upon by Ijma' (consensus of Fuqaha), or in the meaning of *Suftajah* (demand note), which is valid according to the preponderant opinion. The evidence for this is the report from a number of Companions (may Allah be pleased with them) who dealt in these instruments. It is reported from Abdullah Ibn Abbas (may Allah be pleased with him) that he used to take silver from traders at Mecca and write down a demand note for them to be paid at Kufa. It is related from Abdullah Ibn Al-Zubayr that he used to take dirhams from traders at Mecca and then write a note drawn upon his brother Mus'ab in Iraq. When Ibn Abbas was asked about this, he saw no harm in the transaction.(3) Al-Muwaffaq Ibn Qudamah,(4) may Allah confer mercy upon him, has related from Ali (may Allah be pleased with him) that he was asked about a similar transaction and he saw no harm in it. Further, in the *Suftajah* is the interest of both the lender and the borrower without harm being caused to either one of them. The lender is secure against the danger of the highway in transporting his dirhams to the destined town, while the borrower benefits from the loan and is also secure against the dangers of the highway being under an obligation to pay in the said town. The Shari'ah does not lay down a prohibition for interests that do no invoke harm.

(3) This has been related by Al-Bayhaqi in *"Al-Sunan Al-Kubra"* [5: 352]; and see Muhammad Nasir Al-Albani, *"Irwa` Al-Ghalil Fi Takhrij Ahadith Manar Al-Sabil"* [5: 328].
(4) *"Al-Mughni"* [6: 436].

- Shaykh Al-Islam Ibn Taymiyyah[5] (may Allah confer mercy upon him) has said: "The correct view is that of permissibility, because both the lender and the borrower benefit from such raising of a loan, and the Shari'ah does not proscribe what benefits them and is in their interest; it proscribes what is harmful for them." In addition to this, there is no text that prohibits a *Suftajah* nor is such meaning implied by the texts. It is, therefore, necessary to maintain its permissibility, especially when there is a general need for it.[6]
- The basis for the permissibility of a promissory note is that it is considered a document acknowledging a debt, and Allah, the Al-Mighty, has commanded the securing of debts, as He, the Al-Mighty, says: ***{"O you who believe! When you contract a debt for a fixed period, write it down. Let a scribe write it down in justice between you..."}***[7]
- The permissibility of a cheque drawn by the client upon a bank, with which he has a balance is that it is in the nature of Hawalah. The *Muhil* (transferor) is the accountholder, the *Muhal* is the beneficiary and the *Muhal Alayh* (transferee) is the drawee bank.
- The permissibility of a cheque drawn by the client upon a bank with which he does not have a balance is that it is Hawalah. This view is held by those who do not stipulate for the permissibility of Hawalah that the transferee be indebted to the *Muhal* (transferor) with Hawalah (transfer) being valid for a person who does not owe a prior debt. Some jurists call this absolute Hawalah or Hawalah upon one with no liability. The second view is that it is an agency for borrowing, and both are (independently) valid. This rule, however, is contingent upon the cheque no invoking Riba by way of an overdraft, for banks usually do not lend without interest. Banks will not accept cheques drawn upon them by clients with no balance except by charging Riba-bearing profits that are due from the client along with the value of the cheque. Consequently, if the cheque drawn by the client upon the bank, where he does not

(5) *"Majmu' Al-Fatawa"* [29: 531].
(6) See: *"Al-Mughni"* [6: 437]; *"Majmu' Al-Fatawa"* [20: 515] and [29: 531]; and Ibn Qayyim Al-Jawziyyah, *"Tahdhib Sunan Abu Dawud"* [5: 152].
(7) [Al-Baqarah (The Cow): 282].

have a balance, includes Riba-bearing profits it is prohibited; it is not permissible to write such a cheque nor to undertake transactions in it.

- The basis for the permissibility of dealing in crossed and account payee cheques, and the obligation of the payee bank to abide by the conditions stipulated by the accountholder for the two types of cheque, is the generality of the Hadith stating: *"Muslims abide by the conditions they stipulate"*.(8) The reason is that such a condition promotes the inherent interest of the contract. Further, the primary principle for conditions and contracts is that of permissibility.

**Endorsement**

The basis for the permissibility of endorsement is that it does not go beyond the meaning of either Hawalah (transfer) or Wakalah (agency), and both are permissible.

**Discounting of Commercial Papers**

- The basis for not permitting discounting of commercial paper is that in reality the discounting of commercial paper amounts to a loan with interest. What affirms this is that the interest charged through discounting varies according to the value of the commercial paper and its date of maturity, and loan with interest is prohibited by agreement.
- The permissibility of paying less than the value of the paper, when the transaction is between the holder and the first beneficiary, is that it belongs to the category of the issue known as "negotiating a deferred debt for part of it paid promptly." This is what is known as *Da' Wa Ta'ajjal* (reduce the amount for hastening payment), and according to one opinion it is permissible to undertake such a transaction. The evidence that supports permissibility is the Hadith of Ibn Abbas (may Allah be pleased with him), stating: *"When the Prophet (peace be upon him) decided to expell Banu Al-Nadir, they said, 'O Messenger of Allah,*

(8) This Hadith has been related by a number of reporters of Hadith. See: *"Sunan Al-Tirmidhi"* [4: 584]; Al-Hakim, *"Al-Mustadrak"* [4: 101]; and *"SunanAl-Daraqutni"* [3: 27]. The Hadith has been narrated by Amr Ibn Awf and is connected to the Prophet (peace be upon him). It has a number of different Isnad (chains of transmission) to the Prophet. This is why Al-Bukhari related it in his *"Sahih"* [4: 451] as a *Mu'allaq* (Suspended) Hadith. Muhammad Nasir Al-Albani has investigated the chains of transmission of this Hadith *"Irwa` Al-Ghalil"* [5: 142-146] and concluded that the Hadith is generally authentic in view of the number of its Isnads.

*you have ordered our expulsion when we have against people debt claims that are not yet due.' The Prophet (peace be upon him) said, 'Reduce the amounts to hasten payments'."*(9) Ibn Abbas (may Allah be pleased with him), was asked about the issue of a person who has a deferred claim against another, and he says to the debtor, "Hasten the payment and I will reduce the amount for you", so Ibn Abbas responded saying, "There is no harm in it". Ibn Abbas (may Allah be pleased with him), was the narrator of the previous Hadith. Further, this issue is the opposite of the issue of Riba. That is, Riba involves an excess in both the period and the amount, which is entirely harmful for the debtor, whereas this issue involves the absolving of the liability of the debtor with respect to the debt with a benefit coming to the creditor through prompt payment. Each one of them benefits without being subjected to harm. This is different from Riba, the prohibition of which is agreed upon and that causes injury to the debtor. The benefit in Riba is exclusively for the creditor (owner of capital). Thus, this case differs from Riba in both form and meaning. The reason is that the excess in Riba as a counter-value for the period leads to a grave hardship, for a single dirham is doubled and multiplied keeping the Dhimmah (liability) engaged without any corresponding benefit. In the case of reduction of the amount and hastening of payment, the liability of the debtor is removed and the prompt payment benefits the creditor. The Law-giver encourages the discharging of debt liabilities. The debtor has been called a person imprisoned by difficulties, and thus in the discharging his liability is a release from these shackles. This is different from his remaining patiently burdened with an excess.(10)

(9) This Hadith has been related by a number of Hadith reporters. See: Al-Tahawi, *"Sharh Mushkil Al-Athar"* [11: 56]; Al-Bayhaqi, *"Al-Sunan Al-Kubra"* [6: 28]; *"Sunan Al-Daraqutni"* [3: 46]; and Al-Hakim, *"Al-Mustadrak"* [2: 52]. Ibn Al-Qayyim said in *"Ighathat Al-Lahfan"* [2: 11]: This Hadith has been related as per relation conditions of *"Al-Sunan Al-Kubra"*. Al-Bayhaqi has classified the Hadith as weak but the men in the chain of transmission of the Hadith are trustworthy. However, the Hadith has been classified as weak due to Muslim Ibn Khalid who is a narrator in the chain of transmission of the Hadith. Nevertheless, he is a trustworthy and reliable jurist as Imam Shafi'i has related Hadiths through him and regard his view as authoritative.

(10) "*Ighathat Al-Lahfan*" [2: 11]; and "I'lam Al-Muwaqqi'in" [3: 313].

- The basis for treating commercial paper as a price for ascertained goods is that it amounts to the sale of a debt, to a person other than the one who owes it, for ascertained goods. This is permitted according to the Maliki school if it takes place after possession so that it does not turn into the delaying of the two counter-values. A resolution pertaining to this has been issued by the Islamic Fiqh Academy of the Organization of Islamic Conference.(11)

**Taking Possession of Commercial Papers**

- The basis for considering a cheque, whether certified or one of the same type, as possession of the amount mentioned in it, is that a cheque is secured by a large number of guarantees that make the possessor the owner of its contents. The beneficiary in this case is able to undertake transactions in it by selling, buying or by making a gift. Further, there is a strong protection provided by state governments to support confidence in cheques. In addition to this, relying upon a cheque means the existence of sufficient funds to cover its amount with the certifier undertaking to retain the funds until the end of the period fixed for payment. It is for this reason that people in general prefer certified cheques over cash for large transactions.
- The basis for not considering an uncertified cheque, or one that is similar to it as far as the possession of its amount is concerned, is the probability that there is no balance to cover it or there is an insufficient balance. The basis for possession is customary practice, and a resolution has been passed by the Islamic Fiqh Academy deeming the receipt of a certified cheque as possession.
- The basis for the permissibility of dealing in cheques for bank transfers, when the intention is to transfer the same currency in which payment is to be made, is that it belongs to the category of *Suftajah*, which is permissible according to one out of two opinions of the jurists.

**Payment Guarantees for the Value of Commercial Paper**

- The basis for considering a guarantee for acceptance as an undertaking and an obligation on the part of the drawee to pay to the legal holder, on

(11) In its 16th session held in Mecca on 21-26 Shawwal 1422 A.H.

the date of maturity, the amount of debt stated on the bill of exchange, is that this undertaking and obligation is to be fulfilled according to the Shari'ah. This requirement is due to the generality of the words of Allah, the Exalted, saying: ***{"O you who believe! Fulfil (your) obligations"},***(12) as well as due to the generality of the saying of the Prophet (peace be upon him): *"Muslims abide by the conditions they stipulate"*.(13)

- The conditions a person stipulates for himself, and by which he is bound, are included in this meaning. There is also the Hadith of Jabir Ibn Abdullah (may Allah be pleased with him), who said: "The Messenger of Allah (peace be upon him) did not pray over (the funeral of) a person who died while owing a debt. A dead person was brought to him (for prayers) and he said, *'Does he owe a debt?'* The people replied, 'Yes, he owes two dinars.' At this Abu Qatadah Al-Ansari said, 'The two dinars are on me, O Messenger of Allah.' The Messenger of Allah (peace be upon him) then offered the funeral prayers for him".(14) In this Hadith, we notice that Abu Qatadah Al-Ansari (may Allah be pleased with him) offers an undertaking and accepts the obligation to pay the debt owed by the deceased, and this is accepted by the Prophet (peace be upon him). In fact, this undertaking and obligation given by Abu Qatadah were deemed sufficient to absolve the deceased from all liability for the debt. In some different texts of the Hadith, it has been reported that after the statement of Abu Qatadah (The two dinars are on me), "The Prophet (peace be upon him) said, *'The right of the creditor is due and the deceased is absolved of it.'* Abu Qatadah responded in the affirmative, so the Prophet (peace be upon him) prayed over him".(15) The removal of all liability for the debt from the deceased was due to the undertaking and obligation given by Abu Qatadah (may Allah be pleased with him), to pay the debt due form this person and because of which he became indebted to the extent

(12) [Al-Ma`idah (The Table): 1].
(13) The source of the Hadith is stated earlier.
(14) This text of the Hadith has been related by Abu Dawud in his *"Sunan"* [9: 193]. However, the Hadith has origin in the two authentic books of Hadith. See: *"Sahih Al-Bukhari"* [2: 467]; and *"Sahih Muslim"* [3: 1237] (H: 1619).
(15) This narration has been related by Imam Ahmad in his *"Musnad"* [3: 330].

of two dinars. Al-Muwaffaq Ibn Qudamah (may Allah confer mercy upon him) said: "The words of the Prophet (peace be upon him): *'The deceased is absolved of it'* mean that 'you have now become subject to the claim for two dinars.' This is by way of emphasis for establishing the claim against him as well as the obligation to pay".(16)

- The basis for permitting the holder of commercial paper to have recourse to all persons who have signed the paper is that by doing so they bind themselves to the extent of the value of the paper in case of non-payment. The Ulama arrived at a consensus on the permissibility of guarantees on the whole.
- The basis for the permissibility of guarantees through tangible assets is that these are treated as Rahn (mortgage) and are governed by the same rules that apply to Rahn. The Ulema arrived at a consensus for the permissibility of Rahn (Mortgage).

(16) *"Al-Mughni"* [7: 85].

# Appendix (C)
# Definitions

**Commercial Papers**

Tradable certificates that represent pecuniary rights payable at sight or after a short period. Customary practice regards them as instruments of payment and they act as substitutes for cash in transactions.

**Bill of Exchange**

A certificate issued in a particular legal form. It consists of an order from a person (known as the drawer) to another person (known as the drawee) to pay a certain sum of money at sight, or at a particular or determinable date, to a third person (called the beneficiary).

**Promissory Note**

A certificate whereby the issuer promises to pay a certain sum of money at a particular or determinable date, or at sight, to another person (called the beneficiary).

**Cheque**

A certificate that is issued in a particular form containing an order issued by a person (known as the payer) to another person (known as the payee) to pay a certain sum of money to a third person (known as the beneficiary) when the cheque is presented.

**Crossed Cheque**

A cheque written in the form of an ordinary cheque except that it is distinguished by two parallel lines on the face of the cheque. The crossing places an obligation upon the payee bank not to pay the value of the cheque to a person other than a client of the payee bank or to another bank.

**Certified Cheque**

A cheque written in the form of an ordinary cheque and distinguished by the word "certified" or "accepted" or whatever gives this meaning, on the face of the cheque along with the date and the address of the payee bank with the signatures of the certifying official whereby the payee bank certifies the authenticity of the signature of the payer and the existence of sufficient funds in his account for payment of the value of the cheque to the beneficiary.

**Banker's Cheque (Bank Draft)**

A cheque issued by the payee bank (to its client) guaranteeing payment of the value of the cheque to a third party.

**Account Payee Cheque**

A cheque written in the form of an ordinary cheque to which the issuer adds a statement indicating that its value should not be paid in cash, but upon conditions stated, like a statement written on the face of the cheque saying "Account Payee" or any other statement bearing the same meaning.

**Travellers' Cheque**

Cheques drawn in varying values by institutions upon their foreign branches or correspondent institutions in the interest of a traveller who will receive their value by merely presenting them for payment to a party that will accept them.

**Cheques for Bank Transfers**

A cheque written by an institution, upon the request of a person, who intends to remit his cash through the institution, by way of cheques, to another location, so that he, his agent, or any other person may receive it.

**Endorsement**

A legal act by means of which ownership in the commercial paper is transferred from one person (known as endorser) to another person (known as the endorsee), or it has the effect, through a statement, of creating an agency for collection or a mortgage.

**Discounting of Commercial Papers**

A process by means of which the holder of commercial paper, through an endorsement, transfers ownership in it to a third party prior to the date of maturity with the institution discounting the value by a determined amount in lieu of early payment.

**Acceptance to Pay**

The undertaking by the drawee to pay the value of the bill of exchange to the lawful holder at the date of its maturity.

**Guarantee or Guarantor**

The bank as guarantor provides a guarantee to the holder for paying the value of the commercial paper by way of a guarantor along with other signatories if the primary debtor refuses to pay.

**Tangible Guarantees**

These are guarantees stipulated by the holder of commercial paper through the creation of a mortgage on real estate, or a mortgage of movables, like commercial paper or negotiable instruments that the debtor endorses over to the holder by way of mortgage or goods that the debtor delivers to the holder as a security for payment.

## Shari'ah Standard No. (17)

# Investment Sukuk

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The aim of this standard is to elaborate the Shari'ah rules for the issuance and trading of investment Sukuk (certificates) as well as the elaboration of their types, characteristics, Shari'ah regulations and the conditions for the issuance of Sukuk and dealings in them for trading by Islamic financial institutions (institution/institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers investment Sukuk. These Sukuk include Sukuk of ownership of leased assets, ownership of usufructs, ownership of services, Murabahah, Salam, Istisna'a, Mudarabah, Musharakah, investment agency and sharecropping (Muzara'ah), irrigation (Musaqat) and agricultural (Mugharasah) partnerships. The standard does not cover shares of joint stock companies, certificates of funds and investment portfolios.

## 2. Definition of Investment Sukuk

Investment Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of the Sukuk, the closing of subscription and the employment of funds received for the purpose for which the Sukuk were issued.

In this standard, Sukuk have been designated as Investment Sukuk in order to distinguish them from shares and bonds.

## 3. Types of Investment Sukuk

Investment Sukuk are of different types, and among these are:

### 3/1 Certificates of ownership in leased assets

These are certificates of equal value issued either by the owner of a leased asset or a tangible asset to be leased by promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the certificates become owners of the assets.

**3/2 Certificates of ownership of usufructs**

3/2/1 Certificates of ownership of usufructs of existing assets

These are two types:

3/2/1/1 Certificates of equal value issued by the owner of an existing asset either on his own or through a financial intermediary, with the aim of leasing the asset and receiving the rental from the revenue of subscription so that the usufruct of the assets passes into the ownership of the holders of the certificates.

3/2/1/2 Certificates of equal value issued by the owner of the usufruct of an existing asset (lessee), either on his own or through a financial intermediary, with the aim of subleasing the usufruct and receiving the rental from the revenue of the subscription so that the holders of the certificates become owners of the usufruct of the asset.

3/2/2 Certificates of ownership of usufructs of described future assets

These are certificates of equal value issued for the purpose of leasing out tangible future assets and for collecting the rental from the subscription revenue so that the usufruct of the described future asset passes into the ownership of the holders of the certificates.

3/2/3 Certificates of ownership of services of a specified party

These are certificates of equal value issued for the purpose of providing services through a specified provider (such as educational benefits in a nominated university) and obtaining the service charges in the form of subscription income so that the holders of the certificates become owners of these services.

3/2/4 Certificates of ownership of described future services

These are certificates of equal value issued for the purpose of providing future services through described provider (such as educational benefits from a university without naming the educational institution) and obtaining the fee in the form of

subscription income so that the holders of the certificates become owners of the services.

**3/3 Salam certificates (Salam Sukuk)**

These are certificates of equal value issued for the purpose of mobilising Salam capital so that the goods to be delivered on the basis of Salam come to be owned by the certificate holders.

**3/4 Istisna'a certificates (Istisna'a Sukuk)**

These are certificates of equal value issued with the aim of mobilising funds to be employed for the production of goods so that the goods produced come to be owned by the certificate holders.

**3/5 Murabahah certificates (Murabahah Sukuk)**

These are certificates of equal value issued for the purpose of financing the purchase of goods through Murabahah so that the certificate holders become the owners of the Murabahah commodity.

**3/6 Musharakah certificates (Musharakah Sukuk)**

These are certificates of equal value issued with the aim of using the mobilised funds for establishing a new project, developing an existing project or financing a business activity on the basis of any of partnership contracts so that the certificate holders become the owners of the project or the assets of the activity as per their respective shares, with the Musharakah certificates being managed on the basis of participation or Mudarabah or an investment agency.

3/6/1 Participation certificates

These are certificates representing projects or activities managed on the basis of Musharakah by appointing one of the partners or another person to manage the operation.

3/6/2 Mudarabah Sukuk

These are certificates that represent projects or activities managed on the basis of Mudarabah by appointing one of the partners or another person as the Mudarib for the management of the operation.

3/6/2 Investment agency Sukuk

These are certificates that represent projects or activities managed on the basis of an investment agency by appointing an agent to manage the operation on behalf of the certificate holders.

**3/7 Sharecropping certificates (Muzara'ah Sukuk)**

These are certificates of equal value issued for the purpose of using the funds mobilised through subscription for financing a project on the basis of Muzara'ah so that the certificate holders become entitled to a share in the crop according to the terms of the agreement.

**3/8 Irrigation certificates (Musaqat Sukuk)**

These are certificates of equal value issued for the purpose of employing the funds mobilised through subscription for the irrigation of fruit bearing trees, spending on them and caring for them on the basis of a Musaqat contract so that the certificate holders become entitled to a share in the crop as per agreement.

**3/9 Agricultural certificates (Mugharasah Sukuk)**

These are certificates of equal value issued on the basis of a Mugharasah contract for the purpose of employing the funds for planting trees and undertaking the work and expenses required by such plantation so that the certificate holders become entitled to a share in the land and the plantation.

## 4. Characteristics of Investment Sukuk

4/1 Investment Sukuk are certificates of equal value issued in the name of the owner or bearer in order to establish the claim of the certificate owner over the financial rights and obligations represented by the certificate.

4/2 Investment Sukuk represent a common share in the ownership of the assets made available for investment, whether these are non-monetary assets, usufructs, services or a mixture of all these plus intangible rights, debts and monetary assets. These Sukuk do not represent a debt owed to the issuer by the certificate holder.

4/3 Investment Sukuk are issued on the basis of a Shari'ah-nominated contract in accordance with the rules of Shari'ah that govern their issuance and trading.

4/4 The trading of Investment Sukuk is subject to the terms that govern trading of the rights they represent.

4/5 The owners of these certificates share the return as stated in the subscription prospectus and bear the losses in proportion to the certificates owned (held) by them.

## 5. Shari'ah Rulings and Regulations

### 5/1 Issuance of investment Sukuk

5/1/1 It is permissible to issue investment certificates by way of subscription on the basis of any of Shari'ah-nominated investment contract.

5/1/2 It is permissible to issue certificates for (to securitize) assets that are tangible assets, usufructs and services by dividing them into equal shares and issuing certificates for their value. As for debts owed as a liability, it is not permissible to securitize them for the purpose of trading.

5/1/3 The issue contract has all the legal effects of the contract upon which the issued certificates are based. This occurs after closing of the subscription and the allotment of the certificates.

5/1/4 The two parties of the issue contract are the issuer and the subscribers.

5/1/5 The relationship between the two parties to the issue contract is determined on the basis of the type of contract and its status in the Shari'ah as well as the following description:

5/1/5/1 Certificates of ownership of leased assets

The issuer of these certificates is seller of a leased asset or an asset to be leased on promise, the subscribers are the buyers of the asset, while the funds mobilised

through the subscription are the purchase price of the asset. The certificate holders jointly own the assets through an undivided ownership sharing the profits and losses on the basis of the partnership that exists between them.

**5/1/5/2 Certificates of ownership of usufructs**

**a) Certificates of ownership of the usufruct of existing assets**

The issuer of these certificates is the seller of usufruct of an existing asset, the subscribers are buyers of such usufruct, while the funds mobilised through subscription are the purchase price of the usufruct. The certificate holders become joint owners of the usufruct sharing its benefits and risks.

**b) Certificates of ownership of described usufruct to be made available in the future**

The issuer of these certificates is the seller of usufruct of an asset to be made available in the future as per specification. The subscribers are buyers of the usufruct through, the funds mobilised through subscription are the purchase price of the usufruct. The certificate holders become joint owners of the undivided usufruct sharing its benefits and risks.

**c) Certificates of ownership of services**

The issuer of these certificates is the seller of services, the subscribers are buyers of the services, while the funds mobilised through subscription are the purchase price of the services.

The certificate holders are entitled to sell the profits of all the types that are listed at (a), (b) and (c) and are entitled to the income from the resale of such usufruct.

5/1/5/3 Salam certificates (Salam Sukuk)

The issuer of the certificates is a seller of the goods of Salam, the subscribers are the buyers of the goods, while the funds realised from subscription are the purchase price (Salam capital) of the goods. The holders of Salam certificates are the owners of the Salam goods and are entitled to the sale price of the certificates or the sale price of the Salam goods sold through a Parallel Salam, if any.

5/1/5/4 Istisna'a certificates (Istisna'a Sukuk)

The issuer of these certificates is the manufacturer (supplier/seller), the subscribers are the buyers of the intended product, while the funds realised from subscription are the cost of the product. The certificate holders own the product and are entitled to the sale price of the certificates or the sale price of the product sold on the basis of a Parallel Istisna'a, if any.

5/1/5/5 Murabahah certificates (Murabahah Sukuk)

The issuer of the certificates is the seller of the Murabahah commodity, the subscribers are the buyers of that commodity, and the realised funds are the purchasing cost of the commodity. The certificate holders own the Murabahah commodity and are entitled to its sale price.

5/1/5/6 Musharakah certificates (Musharakah Sukuk)

The issuer of the certificates is the inviter to a partnership with him in a specific project or determined activity. The subscribers are the partners in the Musharakah contract. The realised funds are the share contribution of the subscribers in the Musharakah capital. The certificate holders own the assets of partnership with the accompanying profits and losses and are entitled to their share in the profits of the partnership, if any.

5/1/5/7 Mudarabah certificates (Mudarabah Sukuk)

The issuer of these certificates is the Mudarib, the subscribers are the owners of capital, and the realised funds are the Mudarabah capital. The certificate holders own the assets of Mudarabah and the agreed upon share of the profits belongs to the owners of capital and they bear the loss, if any.

5/1/5/8 Certificates of investment agency (Wakalah Sukuk)

The issuer of these certificates is the investment agent, the subscribers are the principals and the realised funds are the entrusted capital of the investment. The certificate holders own the assets represented by the certificates with its benefits and risks, and they are entitled to the profits, if any.

5/1/5/9 Muzara'ah certificates (Muzara'ah Sukuk)

a) The issuer of these certificates is the owner of the land (the principal owner or owner of the usufruct of the land). The subscribers are the cultivators on the basis of a Muzara'ah contract (the cultivators or their assignees). The realised funds are the cultivation cost.

b) The issuer of these certificate may be the cultivator (the worker), the subscribers are the owners of the land (investors whose subscription amounts are used to buy the land); and the certificate holders are entitled to a share of the produce of the land as per agreement.

5/1/5/10 Musaqat certificates (Musaqat Sukuk)

a) The issuer of these certificates is the owner (or owner of usufruct) of the land that consists of trees; the subscribers are those who assume the obligation of irrigation through a Musaqat contract, while the realised funds are the maintaining cost of the trees.

b) The issuer of these certificates may be the irrigator (the worker) and the subscribers are the owners of the land (investors whose subscription amounts are used to irrigate the land). The certificate holders are entitled to a share of the produce of the trees as per agreement.

5/1/5/11 Mugharasah certificates (Mugharasah Sukuk)

a) The issuer of these certificates is the owner of land suitable for planting (trees), the subscribers are those who assume the obligation of planting on the basis of a Mugharasah contract, while the realised funds are the cost of maintaining the plantation.

b) The issuer may be the planter (the owner of the work), the subscribers are the owners of the land (investors whose subscription amounts are used to undertake plantation in the land), and the certificate holders are entitled to a share in both the trees and the land as per agreement.

5/1/6 The relationships between the parties, namely the issuer and the subscriber shall be governed by applicable contracts of issuing Sukuk. The mere conclusion of the contract will give rise to legal effects with respect to rights and obligations of the parties.

5/1/7 The issuance of the prospectus represents the issuer's invitation to subscription in which case the act of subscription represents an offer. As for acceptance, it is issuer's approval of the subscription, unless it is expressly stated in the prospectus that it is an offer. In this case, the prospectus will be considered as an offer and the subscription becomes an acceptance.

5/1/8 The following shall be observed in the prospectus of issue:

5/1/8/1 The prospectus must include all contractual conditions, adequate statements about the participants in the issue,

their legal position and rights as well as obligations, such as statements about the issue agent, issue manager, originator, investment trustee, the party covering the loss, payment agent as well as others along with the conditions of their appointment and dismissal.

5/1/8/2 The prospectus of Sukuk must include the identification of the contract on the basis of which the certificates are to be issued, such as sale of tangible leased assets, Ijarah, Murabahah, Istisna'a, Salam, Mudarabah, Musharakah, Wakalah, Muzara'ah, Mugharasah or Musaqat.

5/1/8/3 The contract that forms the basis of the issue must be complete with respect to its elements and conditions and should not include conditions that conflict with its objectives and rules.

5/1/8/4 The prospectus must explicitly mention the obligation to abide by the rules and principles of the Shari'ah, and that there is a Shari'ah Supervisory Board that approves the procedures of the issues and monitors the implementation of the project throughout its duration.

5/1/8/5 The prospectus must state that the investment of the realised funds and the assets into which the funds are converted will be undertaken through Shari'ah-compliant modes of investment.

5/1/8/6 Taking into account item 3/1/5 of the Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations, the prospectus must state that each owner of a certificate participates in the profit and bears a loss in proportion to the financial value represented by his certificates.

5/1/8/7 The prospectus must not include any statement to the effect that the issuer of the certificate accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situations

other than torts and negligence nor that he guarantees a fixed percentage of profit. It is, however, permitted to an independent third party to provide a guarantee free of charge, while taking into account item 7/6 of Shari'ah Standard No. (5) on Guarantees. It is also permitted to the issuer of the certificate to offer some tangible or personal guarantees with respect to its wrongful acts or negligence, while taking into account item 3/1/4/3 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations as well as the contracts stated in that standard.

5/1/9 It is permissible for the institution to undertake to underwrite the unsubscribed issue, in which case the obligation of the underwriter is based on a binding promise. The underwriter should not receive any commission in lieu of such underwriting taking into account item 4/1/2/4 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations.

5/1/10 It is permissible to issue Sukuk on a short-term, medium-term or long-term basis in accordance with the principles of the Shari'ah. The Sukuk may also be issued without specifying a period depending upon the nature of the contract underlying the Sukuk issue.

5/1/11 It is permissible for the issuer or the certificate holders to adopt permissible methods of managing risk, of mitigating fluctuation of distributable profits (profit equalisation reserve), such as establishing an Islamic insurance fund with contributions of certificate holders, or by participating in insurance (*Takaful*) by payment of premiums from the income of the shares of Sukuk holders or through donations (*Tabarru'at*) made by the Sukuk holders.

## 5/2 Trading of Sukuk and their redemption

5/2/1 It is permissible, after closing subscription, allotment of Sukuk and commencement of activity, to trade in and redeem investment

Sukuk that represent common ownership of tangible assets, usufructs or services. As for trading or redemption prior to the commencement of activity, it is necessary to observe the rules of the contract of *Sarf* (currency exchange) along with the rules for debts (receivables) when liquidation is complete and the assets are receivables or when the assets represented by the Sukuk are sold for a deferred price.

5/2/2 In the case of negotiable Sukuk, it is permissible for the issuer to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however, it is not permissible for the issuer to undertake to purchase the Sukuk at their nominal value

5/2/3 The certificates may be traded through any known means, that do not contravene the rules of the Shari'ah, such as registration, electronic means or actual transmission by the bearer to the purchaser.

5/2/4 It is permissible, immediately upon issue and up to the date of maturity, but after the passing of ownership of the assets to the holders of the Sukuk, to trade in Sukuk that represent ownership of existing leased assets or assets to be leased on promise.

5/2/5 It is permissible for the issuer to redeem, prior to maturity, certificates of ownership of leased assets at the market price or at a rate agreed upon, at the date of redemption, between the certificate holder and the issuer.

5/2/6 It is permissible to trade in securities of ownership of usufructs of tangible assets prior to a contract for sub-leasing the assets. When the assets are sub-leased, the certificate represents rent receivables, which makes it a debt owed by the second lessor subject to the rules and regulations for disposal of debts.

5/2/7 It is permissible for the issuer to redeem Sukuk of ownership of the usufruct of tangible assets from the holder, after allotment

and payment of the subscription price, at the market price or at a price agreed upon between the parties at the time of redemption, on the condition that the subscription amount or redemption price is not deferred. [see item 3/4 of Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek]

5/2/8 It is not permissible to trade in certificates of ownership of usufructs of a described asset before the asset from which usufruct is to be made available is ascertained, except by observing the rules for disposal of receivables. When the asset is ascertained, trading in Sukuk of usufructs of such asset may take place.

5/2/9 It is permissible to trade in securities of ownership of services to be provided by a specified party prior to sub-leasing such services. When the services are sub-leased, the certificate represents rent receivables to be collected from the second lessee. In this case, the certificate represents a debt and is, therefore, subject to the rules and regulations of disposal of debts.

5/2/10 It not is permissible to trade in securities of ownership of services to be provided by a party to be specified in the future before the source from which the services would be provided is identified, except by observing the rules for dealing in debts. When the source of services is identified, trading in such Sukuk may take place.

5/2/11 It is permissible to set up a parallel Ijarah on tangible assets by employing the same description for the usufruct that was provided to the holders of the Sukuk in cases detailed in items 5/2/8 and 5/2/10 provided the two lease contracts remain independent.

5/2/12 It is permissible for the second buyer of the usufruct of existing and specified assets to resell them. The buyer is also entitled to issue certificates in this respect.

5/2/13 It is permissible to trade in or redeem Istisna'a certificates if the funds have been converted, within the period of the Istisna'a, into assets owned by certificate holders. If the realised funds are immediately paid as a price in a parallel Istisna'a contract or the manufactured item is submitted to the ultimate purchaser, then trading in Istisna'a certificates is subject to rules of disposal of debts.

5/2/14 It is not permissible to trade in Salam certificates.

5/2/15 It is not permissible to trade in Murabahah certificates after delivery of the Murabahah commodity to the buyer. However, trading of Murabahah certificates is permissible after purchasing the Murabahah commodity and before selling it to the buyer.

5/2/16 It is permissible to trade in Mudarabah, Musharakah and investment agency certificates after closing of subscription, allotment of the certificates and commencement of activity with respect to the assets and usufructs.

5/2/17 It is permissible to trade in Muzara'ah and Musaqat certificates after closing of subscription, allotment of certificates and commencement of activity with respect to the assets and usufructs. This rule applies when the certificate holders own the land. Thus, trading in these certificates is not allowed where the certificate holders act as workers (who undertake to provide agricultural or irrigation works) in which case trading in these certificates is not permissible before the maturity of the fruits and plants.

5/2/18 It is permissible to trade in Mugharasah certificates after closing of subscription, allotment of certificates and commencement of activity irrespective of the certificate holders being owners of the land or workers.

## 6. Date of Issuance of the Standard

This Standard was issued on 7 Rabi' I, 1424 A.H., corresponding to 8 May 2003 A.D.

# Adoption of the Standard

The Shari'ah Standard on Commercial Papers was adopted by the Shari'ah Board in its 10th meeting held on 2-7 Rabi' I, 1424 A.H., corresponding to 3-8 May 2003 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (7) held in Makkah Al-Mukarramah during the period of 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2002 A.D., the Shari'ah Board decided to give priority to the preparation of the Shari'ah Standard for Investment Sukuk.

On Saturday 14 Shawwal 1422 A.H., corresponding to 29 December 2002 A.D., a Shari'ah consultant was commissioned to prepare a juristic study and an exposure draft on the Shari'ah Standards for Commercial Papers.

In its 2nd meeting of Committee (1), held in the Kingdom of Bahrain on 4-5 Safar 1423 A.H., corresponding to 17-18 April 2002 A.D., the Shari'ah Standard Committee discussed the exposure draft of the Shari'ah Standard on Investment Sukuk and asked the consultant to make additional amendments to reflect the comments made by the members of the committee.

In its meeting No. (4) held on 16 and 17 Rabi' I, 1423 A.H., corresponding to 28-27 June 2002 A.D., the committee discussed the exposure draft and made necessary amendments as per the comments and observations of the members and in the light of the recommendations of AAOIFI's First Fiqh Forum in respect to requirements of trading in investment portfolios held in Amman (The Hashimite Kingdom of Jordan) on 16 Rabi' I, 1423 A.H., corresponding to 27 June 2002 A.D.

In its meeting No. (5) held on 2 and 3 Rajab 1423 A.H., corresponding to 9-10 September 2002 A.D., and decided to merge the exposure of this Standard with the exposure draft of the Standard on Securitisation. In its meeting No. (6) held on 19 Rajab 1423 A.H., corresponding to 26 September 2002 A.D., in the Kingdom of Bahrain, the Committee further discussed the

exposure after the merger, made some amendments and decided to present it to the Shari'ah Board.

The revised exposure draft of the Shari'ah Standard was presented to the Shari'ah Board in its 9th meeting held in Makkah Al-Mukarramah during the period of 11-16 Ramadan 1423 A.H., corresponding to 16-21 November 2002 A.D. The Shari'ah Board made further amendments to the exposure draft of the Standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 18 Dhul-Hajjah 1423 A.H., corresponding to 19 February 2003 A.D. The public hearing was attended by more than thirty participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Members of the Shari'ah Standards Committees (1) and (2) responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) held a joint meeting on 2 Muharram 1424 A.H., corresponding to 5 March 2003 A.D., to discuss the comments made about the exposure draft. The two committees made the necessary amendments in light of both the written comments that were received and oral comments that took place in the public hearing.

The Shari'ah Board in its meeting No. (10) held in Al-Madinah Al-Munawwarah during the period of 2-7 Rabi' I, 1424 A.H., corresponding to 3-8 May 2003 A.D., discussed the amendments made by the Shari'ah Standards Committee, and made necessary amendments. The Shari'ah Board unanimously adopted some of the items of the Standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for the permissibility of issuing investment certificates is that such certificates are usually issued on the basis of Shari'ah-nominated contracts. Hence issuance of Sukuk on the basis of any of these contracts becomes acceptable as well.
- The basis for considering the issue prospectus as an offer and the fact of subscription as an acceptance is that valid contracts take place on the basis of anything that indicates consent without specifying a particular form of expression. It is thus not objectionable that an offer comes from one person and acceptance from a large number of persons.
- The basis for the right of certificate holders to management is that they own the property that their certificates represent, and management is part of ownership.
- The basis for permissibility of trading in investment Sukuk when such Sukuk represent shares in tangible assets or usufruct is that the trading is, in fact, on the assets and usufructs. Since these assets may be traded so too the certificates that represent them.
- The basis for impermissibility of trading in Salam certificates is that the certificate represents a share in the Salam debt in which case the certificates is subject to rules of debt trading.
- The basis for permissibility of trading in Istisna'a certificates after conversion of the realized funds into assets is that such assets represent properties that can be disposed of. The basis for the impermissibility of trading in Istisna'a certificates in case of using the realized funds as a price in a parallel Istisna'a and in case of delivering the manufactured asset to the ultimate purchaser is that the certificate represents the price in the liability of the purchaser. The price then is a monetary debt for which trading of the Sukuk at this stage is subject to the rules of debt trading.

- The basis for the impermissibility of trading in Murabahah certificates after the commodity is sold and delivered to the buyer is that the certificates represent a monetary debt against the buyer, in which case trading is not permissible except in accordance with the limitations of debt trading. However, if purchase of the commodity has taken place and is yet to be sold, trading in these certificates is permissible because the certificates represent assets that can be traded.

# Appendix (C)
# Definitions

**Securitisation (Tawreeq)**

Securitisation is known in Arabic terminology as *Taskik* (issues) and *Tasnid* (securities). Securitisation is a process of dividing ownership of tangible assets, usufructs or both into units of equal value and issue securities as per their value.

**Issue Contract**

Issue contract is the contract that form basis for issuance of the investment certificates.

**Issuer of Investment Certificate**

Issuer of investment certificate is the party who uses the realised funds in a Shari'ah-compliant investment instrument. The issuer could be a firm, an individual, a government or a financial institution. The issuer may delegate, for a consideration or commission, the process of arranging the operation of the issue to a financial intermediary, which may be stipulated by the issue prospectus.

**Issue Agent**

It is an intermediary institution that manages the process of issue and performs all procedural arrangements pertaining to the issue on behalf of the issuer against a specific fee to be agreed upon or to be stated in the prospectus of issue. The relationship between the issuer and the issue agent is governed agency contract with remuneration.

**Issue Manager**

Issue manager is the intermediary institution that acts for remuneration on behalf of the subscribers in executing the issue contract.

**Payment Underwriter**

Payment underwriter is the intermediary institution that undertakes to pay dues of certificate holders after when realised.

**Investment Manager**

Investment manager is the party appointed by the issuer or the issue manager to perform all or part of investment operations as indicated in the issue prospectus.

**Investment Trustee**

Investment trustee is the intermediary financial institution charged with protecting the interests of certificate holders, supervising the performance of the issue manager and safe custody of documents and guarantees for consideration stipulated in the issue prospectus on the basis of agency contract

**Trading of Certificates**

Trading of certificates refers to disposal of the ownership right contained in the certificate through selling, pledging, gift or any other permissible means of disposal.

**Muzara'ah (Sharecropping)**

Sharecropping is partnership in crops in which one party presents land to another for cultivation and maintenance in consideration for a common defined share in the crop.

**Musaqat (Irrigation)**

Irrigating partnership is a partnership that depends on one party presenting designated plants/trees that produce edible fruits to another in order to work on their irrigation in consideration for a common defined share in the fruits.

**Mugharasah (Share-Agriculture)**

Agricultural partnership is a partnership in which one party presents a treeless piece of land to another to plant trees on it on the condition that they share the trees and fruits in accordance with a defined percentage.

## Shari'ah Standard No. (18)

# Possession (Qabd)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to elaborate actual possession in contracts along with its related Shari'ah rules as well as the significant applications undertaken by Islamic financial Institutions (Institution/Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers possession in contracts and what acts as a constructive substitute for it (constructive possession). It elaborates the mode of its realisation in immovable and movable property as well as in things that are ascertained and those established as a liability by description. The standard also identifies the person responsible for its costs (maintenance and expenses) in various types of contracts along with their modern applications.

The standard does not cover acts other than contracts, like possession in usurpation (*Ghasb*) and the like. Further, it does not cover the nature of possession with respect to liability for compensation or otherwise, nor to possession in set-offs, as these have their specific standards.

## 2. Definition of Possession

Possession is the gathering of a thing or what takes its rule, according to the requirements of customary practice.

## 3. Mode of Taking Possession

3/1 The basis for determining the mode of possession in things is custom ('Urf). It is for this reason that possession of things has differed in accordance with the nature of things and differences among people with respect to things.

3/2 Actual possession is realised in immovable property through relinquishment and enabling transactions in it.

3/3 Actual possession takes place in movables through physical corporeal delivery. Constructive possession, in ascertained movables as well as in those established as a liability by description, takes place -after their ascertainment by means of one of the methods known for their

ascertainment- by relinquishing (releasing) the thing for the person entitled to it enabling him to deliver it without any obstacle even when no transportation or transmission has taken place. This takes place irrespective of the thing being one that is acquired by hand in practice or is one in which delivery (transmission) is stipulated through one of the customary units of measure -cubic measure, weight or linear measure- or it is a commodity to which these measures do not apply due to their inapplicability or with the possibility of their applicability, but the measures are not applied, as in the case of sale by estimate.

3/4 Constructive possession includes the registration of a mortgage of immovables and (hypothecation) of mobile movables like cars, trains, steamers and airplanes through registration that is valid under the law. Registration stands in place of actual possession with respect to its rules and legal effects.

3/5 The possession of documents, like bills of lading and warehouse receipts, issued in the name of the possessor or acknowledging his interest therein is deemed constructive possession of what the documents represent if the ascertainment of commodities, goods and appliances is attained through them along with the ability of the possessor to undertake transactions in them.

3/6 Prior possession of a tangible thing stands in place of subsequent lawful possession due to a cause acknowledged by the Shari'ah irrespective of the possession of the prior possessor being on the basis of the liability to bear loss (Daman) or one of trust (Amanah) and irrespective of the subsequent constructive possession entailing liability for loss or a burden of trust (Amanah).

3/7 Reciprocal possession stipulated in the contract of *Sarf* (transaction in gold, silver and currencies) is delivery and acceptance of delivery within the session of the contract on a spot basis (*Yadan Bi Yadin*). [see item 2/6 of Shari'ah Standard No. (1) on Trading in Currencies]

## 4. Expenses of Possession

### 4/1 Expenses of possession in financial commutative contracts

4/1/1 The expenses of delivering the sold commodity -for presenting it if it is absent, for ascertaining it through one of the customary units where that entails a claim for ascertainment like wages of employing a cubic measure, weight, linear measure and counting- is the responsibility of the seller. As for the expenses of delivering the price, if any, it is the responsibility of the buyer, unless there is a stipulation or customary practice to the contrary, in which case it is binding to follow such stipulation or practice.

4/1/2 The expenses of conveyancing, witnessing, preparation of instruments that record a sale and the formalities of registration are borne as stipulated by the parties to the contract. If there is no such stipulation on their part, customary practice is relied upon.

4/1/3 Where it is stipulated by the buyer for the seller that the sold commodity be delivered at a particular place, other than the one where it is present at the time of the contract, and that it be delivered at the expense of the seller, the seller is bound to deliver it at the specified place and the expenses of transporting it to such place will be borne by the seller.

4/1/4 The rules for the expenses of possession explained in items 4/1/1, 4/1/2 and 4/1/3 apply to all financial commutative contracts, like Salam, Istisna'a and others. Accordingly, the expenses of delivering the Salam commodity will be borne by the seller, the expenses of delivering the capital (Ras al-Mal) will be borne by the Rab al-Salam (the buyer); the expenses of taking possession of the leased property will be borne by the lessor, the expenses for the delivery of possession of the lease value (wages) shall be borne by the lessee; and the expenses for delivering the subject matter of Istisna'a will be borne by the manufacturer, while the expenses for the delivery of the price shall be borne by the orderer. In all these cases, if there is a customary practice or stipulation to the contrary, then, such practice or stipulation shall be observed.

**4/2 Expenses for delivery of possession in a loan (Qard)**

4/2/1 The expenses for delivery and recovery in a contract for loan, expenses that pertain to its ascertainment through one of the customary units of measure and the like, shall be borne by the borrower.

4/2/2 The expenses for the drawing up of documents, promissory notes, title deeds and the like that are required for transacting a loan contract; its implementation or documentation shall be borne by the borrower. [see Shari'ah Standard No. (19) on Loan (Qard), item 8]

**4/3 Expenses for delivery of possession in a deposit (Wadi'ah)**

The expenses of deposit and withdrawal in a contract of deposit shall be borne by the depositor (the owner of the deposit).

**5. Key Modern Applications of Possession**

5/1 Possession by the beneficiary of a bank draft or personal cheque is deemed constructive possession of the amount payable by the drawee bank. This is deemed possession of the payable amount even though there is delay in the payment of the actual amount, keeping in view what is laid down in Shari'ah Standard No. (1) on Trading in Currencies (item 2/6/5) as well as what is laid down in the Shari'ah Standard No. (12) on Commercial Papers (items 6/1 and 6/2).

5/2 Payments for a credit card are deemed constructive possession of such payments. [see Shari'ah Standard No. (2) on Debit Cards and Credit Cards (item 4/4)]

5/3 A deposit by a person of an amount in a bank account maintained for a debtor, upon his demand or with his consent, is deemed constructive possession irrespective of the deposit being by way of cash, by endorsement or by cheque drawn upon a bank with which an account is maintained, and the depositor is absolved of liability when he is indebted to the extent of such amount.

## 6. Date of Issuance of the Standard

This Standard was issued on 30 Rabi' I, 1425 A.H., corresponding to 19 May 2004 A.D.

# Adoption of the Standard

The Shari'ah Standard on Possession was adopted by the Shari'ah Board in its 12th meeting held in Al-Madinah Al-Munawwarah during the period of 26-30 Rabi' I, 1424 A.H., corresponding to 15-19 May 2004 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (8) held during the period of 28 Safar to 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Al-Madinah Al-Munawwarah, the Shari'ah Board decided to issue the Exposure Draft of Shari'ah Standard on Possession (Qabd).

On 24 Rajab 1423 A.H., corresponding to 1 October 2002 A.D., the Shari'ah Standards Committee decided to assign to a Shari'ah consultant the responsibility of preparing the Exposure Draft of the Shari'ah Standard on Possession (Qabd).

The Shari'ah Standards Committee (1), in its meeting No. (7), which was held in the Kingdom of Bahrain on 16 Muharram 1424 A.H., corresponding to 19 March 2003 A.D., discussed the Shari'ah study and required the consultant to incorporate certain necessary amendments in the light of the discussion and the comments made by the members.

In its meeting No. (8) held on 16-17 April 2003 A.D., in the Kingdom of Bahrain, the Shari'ah Standards Committee (1) discussed the exposure draft of the Standard on Possession in the light of the discussions and the observations of the members, just as the Committee discussed the exposure draft in its meeting held during the period of 25–26 Rabi' II, 1424 A.H., corresponding to 25-26 June 2003 A.D., and made necessary amendments to the draft in the light of the discussion and observations of the members.

In its meeting No. (9) held in Amman, the Hashimite Kingdom of Jordan, during the period of 23-24 Jumada I, 1424 A.H., corresponding to 23-24 July 2003 A.D., the Committee discussed the exposure draft and made necessary amendments in the light of the discussions and the observations of the members.

The revised exposure draft of the Standard was presented to the Shari'ah Board in its meeting No. (11) held in Makkah Al-Mukarramah during the period of 2-8 Ramadan 1424 A.H., corresponding to 27 October - 2 November 2003 A.D. The Shari'ah Board incorporated amendments to the exposure draft of the Standard and decided that it be distributed among specialists and interested parties in order to obtain their comments as a preliminary to the discussion in a public hearing.

A public hearing was held in the Kingdom of Bahrain on 29 Dhul-Qa'dah 1424 A.H., corresponding to 21 January 2004 A.D. The public hearing was attended by more than fifteen participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in the field. The members of the Shari'ah Standards Committees (1) and (2) responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) in a joint meeting in the Kingdom of Bahrain on 30 Dhul-Qa'dah 1424 A.H., corresponding to 22 January 2004 A.D., discussed the comments that were made during the public hearing as well as the observations received in writing. The Committees made amendments that were deemed suitable.

The amended exposure draft was presented to the Drafting Committee in its meeting held in the Kingdom of Bahrain on 25 Safar 1425 A.D., corresponding to 15 April 2004 A.D.

The Shari'ah Board in its meeting No. (12) held in Al-Madinah Al-Munawwarah during the period of 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D., discussed the amendments suggested by the Shari'ah Standards Committee and the Drafting Committee, and incorporated the amendments deemed suitable. The Shari'ah Board unanimously adopted some of the items of the Standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Realisation of Possession in the Shari'ah**

- The basis for the realisation of actual possession with respect to gold, silver and currencies through actual physical possession is the sound tradition reported from Ubadah Ibn Al-Samit (may Allah be pleased with him), that the Messenger of Allah (peace be upon him), said, *"Gold for gold, silver for silver. . . ,"* till he said, *"like for like, equal for equal, from hand to hand. If these species differ, then sell as you like as long as it is from hand to hand"*.(2)
- The basis for acknowledging custom ('Urf) as the basis for the realisation of possession is the consensus (Ijma') of the Jurists (Fuqaha).It is in this regard that Al-Khatib Al-Shirbini says: "The reason is that the Law-giver has used the term possession in an unqualified sense and has deemed it the basis of rules. He did not elaborate it, and there is no definition for it in the language. It is for this reason that recourse is to be had to custom ('Urf)".(3) Ibn Taymiyyah said, "As long as there is no definition for it in the language or in the Shari'ah, recourse must be had to the custom of the people, like possession mentioned in the words of the Prophet (peace be upon him): '*He who buys food is not to sell it until he takes possession of it*'."(4) Al-Khattabi says: "Forms of possession differ for things in accordance with a difference in their own forms and in accordance with the varying practices of the people with respect to them."(5)
- The basis for the realisation of possession in immoveable property through relinquishment is customary practice. The opinion of the

(2) Related by Muslim in his *"Sahih"*.
(3) *"Mughni Al-Muhtaj"* [2: 72].
(4) *"Majmu' Al-Fatawa"* by Ibn Taymiyyah [3: 272].
(5) *"Ma'alim Al-Sunan Li Al-Khattabi"*, [3: 136].

majority of the jurists among the Hanafis, Malikis, Shafi'is, Hanbalis and Zahiris, as well as others besides them, is that possession in immoveable property is delivered through relinquishment and the facilitating of transactions in it.(6) Hanafi jurists have stipulated that if a lock is placed on the immoveable property, then, it is sufficient for the delivery of possession to deliver the key along with relinquishment so as to provide the facility to the possessor to open it without difficulty.(7)

- The basis for considering registration of immoveable property as constructive possession in the case of mortgage (Rahn) is custom and its practice (in countries that have adopted the system of registration of property) whereby registration of mortgage of immovable property by entry in a page of the register of mortgages is deemed delivery of possession under the law (constructive possession) and it acts as a substitute for actual delivery of possession with respect to its legal effects and results. This applies even if the property has in it the household assets of the tenant or is attached to the rights of the lessor over this property, because in such a case too they are considered possession constructively and in fact.(8)
- Add to this the fact that official mortgage grants to the creditor (mortgagee) a personal right over the mortgaged property, which gives him, as a result of the death of the owner or his insolvency, a right prior to all the creditors for the satisfaction of his claim from this property.(9)

**Possession of Ascertained Moveable Property**

- The basis for the realisation of possession in ascertained moveable property, as well as liabilities by description, through relinquishment in favour of one entitled to it and in a manner that enables him to deliver it without any

(6) *"Al-Fatawa Al-Hindiyyah"* [3: 16]; *"Radd Al-Muhtar"* [4: 561], passim; *"Rawdat Al-Talibin"* [3: 515]; *"Al-Majmu' Sharh Al-Muhadhdhab"* [9: 276]; *"Mawahib Al-Jalil"* [4: 477]; *"Kashshaf Al-Qina'"* [3: 202]; *"Al-Mughni"* [4: 333]; *"Al-Muhalla"* [8: 89]; see article (263) in *"Majallat Al-Ahkam Al-'Adliyyah"*; article (435) in *"Murshid Al-Hayran"*; and article (335) in *"Majallat Al-Ahkam Al-Shar'iyyah 'Ala Madhhab Al-Imam Ahmad"*.

(7) *"Radd Al-Muhtar"* [4: 561]; *"Al-Fatawa Al-Hindiyyah"* [3: 16]; see articles (270) and (271) in *"Majallat Al-Ahkam Al-'Adliyya"*; and articles (435) and (436) in *"Murshid Al-Hayran"*.

(8) *"Al-Madkhal Al-Fiqhi Al-'Amm Lil-Zarqa"* [1: 278] and [2: 648] marginal note.

(9) *"Al-Mudhakkirah Al-Idahiyyah Li Al-Qanun Al-Madani Al-Kuwayti"*, (P. 339) as quoted by Muhammad Wahid Al-Din Suwar in his book on Islamic Fiqh, (P. 94).

restriction, whether or not the moveable property needs to be delivered through one of the customary units of measure, is that delivery of a thing literally means delivering it completely without any impediments, so that no one shares it with the possessor, and this is possible by relinquishment. Further, the person who is under an obligation to deliver must have a way through which he can be discharged of his obligation, and what is in his ability is to relinquish it and remove all obstacles. As for actual physical possession (by hand), it is not within his ability to provide that for it is a voluntary act of taking possession. If the obligation to make such a delivery is imposed on him, it would become difficult for him to meet such an obligation.(10)This rule, as well as its basis, has been supported by a resolution of the Islamic Fiqh Academy (OIC).(11)

- The basis for considering the registration of pledges (hypothecation) of mobile moveable property like cars, steamers, airplanes and trains in the official register for the beneficiary (in countries where a system of registration has been adopted for such moveable property) is deemed constructive possession for what it represents. It is the governing custom that considers official registration as the delivery of constructive possession to the beneficiary and acts as a substitute for actual possession with respect to its legal effects and consequences.
- The basis for stipulating the ascertainment (setting aside) of moveable property through customary units of measure for the realisation of possession are the words of the Prophet (peace be upon him): *"He who buys food (wheat) is not to sell it until he has measured it."*(12) insofar as they indicate that possession in this case is not attained except by the use of the cubic measure. Thus, ascertainment in what is estimated by cubic measure is through cubic measure and the remaining types are assigned

(10) *"Bada`i' Al-Sana`i'"* [5: 244]; *"Al-Fatawa Al-Hindiyyah"* [3: 16]; *"Radd Al-Muhtar"* [4: 561]; *"Sharh Al-Majallah Li Al-Atasi"* [2: 200 and after]; *"Al-Mughni"* [4: 111]; *"Al-Ifsah Li-Ibn Hubayrah"* (P. 224); articles (272) to (275) of *"Majallat Al-Ahkam Al-'Adliyyah"*; and articles (437) and (438) in *"Murshid Al-Hayran"*.

(11) Resolution No. 53 (4/6) in its 6th Session (Sha'ban 1410 A.H./March 1990 A.D.).

(12) Related by Muslim in his *"Sahih"*, [10: 169]; Abu Dawud in his *"Sunan"* [2: 252]; and Al-Nasa`i in his *"Sunan"* [7: 285].

a similar rule on the basis of analogy.(13) This is the view of the majority of the Jurists from among the Malikis, Shafi`is and Hanbalis upholding that possession in things that are estimated by cubic measure, weight, linear measure and counting is attained by taking delivery through these measures accompanied by relinquishment.

- The basis for considering the delivery of documents pertaining to commodities, appliances and goods (like bills of lading and warehouse receipts) as constituting constructive possession of what they represent is the customary practice in this respect seeking support from the view of the Malikis that the mode of possession in moveable property that is not subjected to estimation is recourse to custom ('Urf).(14) Further, the basis for stipulating cubic measure for the soundness of possession in food that is estimated by cubic measure in the tradition from the Prophet (peace be upon him) is the custom that was prevalent during the period of the Prophet (peace be upon him) to the effect that possession in things subjected to cubic measure is through cubic measure and for the rest analogy is to be employed. As the determination of the issue of possession in contracts is based on custom, therefore, everything that is taken by custom to be possession in a certain period is to be deemed as possession from the perspective of the Shari'ah. If the custom of the people changes in this respect, the consideration of that mode as possession ceases. The reason is that where the constructive basis of rules is custom, the rules will alter with a change in custom,(15) except for those things that have been specified by the Shari'ah. As far as the custom prevalent in our times is based upon the consideration of the delivery of documents for moveable commodities and goods -even where these are subjected to estimation- as amounting to possession of these commodities and goods, it will be deemed valid from the perspective of the Shari'ah. The basic principle here is what is stated by Al-Wansharisi, "A thing that is acted upon by the people and is preferred by their custom and practice must

(13) *"Mughni Al-Muhtaj"* [2: 173]; *"Kashshaf Al-Qina'"* [3: 201]; and Ibn Qudamah, *"Al-Mughni"* [4: 111].

(14) *"Sharh Al-Khirashi"* [5: 158]; Al-Dardir, *"Al-Sharh Al-Kabir"* [3: 145]; and Al-Baji, *"Al-Muntaqa"* [6: 97].

(15) *"Al-Mughni"* [6: 188]; *"Al-Furuq"* [1: 176]; and Al-Qarafi, *"Al-Ihkam Fi Tamyiz Al-Fatawa 'An Al-Ahkam"*, (P. 231).

be accommodated through the Shari'ah even against disagreement and opposition, as far as possible".(16)

- The basis for considering prior possession of a certain thing as a substitute for subsequent possession on grounds that are acknowledged by the Shari'ah, when it represents it, is that the purpose behind the realisation of possession is to establish control over, and the ability to undertake transactions in, the thing possessed. If this state is found possession is found too. This is based on what is upheld by the Malikis and Hanbalis to the effect that if a person sells a thing, or gives it away as gift or pledges it, while the thing is in the possession of a usurper, borrower, bailee, hirer, agent or another, then prior possession represents absolutely subsequent entitled possession through the contract, irrespective of the nature of possession exercised by the possessor being that of liability or trust and irrespective of the entitled possession being in the nature of trust or liability. As for what arises from this with respect to the possessor being liable for the thing possessed or holding it as a trustee, it has no connection with or effect upon the reality of possession.(17)

**Expenses of Possession**

- The basis for the view that the expenses of possession of the sold commodity are borne by the seller is that the delivery of the sold commodity is obligatory on the seller by virtue of the contract, and the contract is not completed without it; and a thing without which an obligation cannot be fulfilled is also obligatory. Accordingly, this is what was upheld by the majority of the Jurists to the effect that meeting the expenses of the delivery of the sold commodity -by presenting it if it is absent and by ascertaining it if it needs to be ascertained by a customary unit of measure- is the responsibility of the seller. The basis for the view that expenses, if any, of taking delivery of the price are the responsibility of the buyer, is that payment of the price to the seller is obligatory upon the buyer, thus, it is binding on him to bear the burden of all that is required by such delivery. The basis for qualifying this rule to impose the expenses on both parties insofar as there

(16) Al-Wansharisi, *"Al-Mi'yar"* [6: 471].

(17) *"Mayyarah 'Ala Al-Tuhfah"* [1: 111]; *"Bidayat Al-Mujtahid"* [2: 229]; Majd Ibn Taymiyyah, *"Al-Muharrar"*, [1: 374]; Ibn Taymiyyah, *"Nazariyyat Al-'Aqd"*, (P. 236); *"Kashshaf Al-Qina'"* [3: 249 and 373], [4: 253]; and Al-Qarafi, *"Sharh Tanqih Al-Fusul"* (P. 456).

is no condition to the contrary, is extended from the ruling of the majority of the Jurists of upholding conditions. As for the qualification that "there is no custom to the contrary," it is based on the view of the Jurists, insofar as it is stated in their texts that if there is a stipulation or custom to the contrary, then, it is binding to follow such stipulation or custom.(18)

- The basis for the buyer bearing the expenses of constructive possession of what he has purchased, as represented by official registration and attestation for the sale of immoveable property or its mortgage in countries that have adopted a system of registration of transfer of immoveable property, as well as the sale of some mobile moveable property like cars, vehicles, steamers and airplanes or their pledging (hypothecation) in countries that have adopted a system of officially registering such things, and as well as the purchase of shares of corporations -whose trading is permissible according to the Shari'ah in markets for financial paper- is the customary practice in all these things. Further, such a practice secures the interest of the buyer and is supported by the rule that gain is linked to the bearing of expenses. It is also supported by derivation of the rule from what has been stated by the Hanafi Jurists to the effect that the expenses of the drafting of documents, promissory notes and of witnessing, which confirm the transaction of sale, are to be borne by the buyer as long as there is no custom or stipulation to the contrary.
- The basis for the seller bearing the expenses for the delivery of the sold commodity to the buyer with the stipulation of a known place (other than the place of contract where it is present) is what has been stated by the Hanafis and the Hanabalis affirming that such expenses are borne by the seller in case of a stipulation to this effect.(19)

---

(18) *"Al-Zurqani 'Ala Khalil"* [5: 158}; *"Hashiyat Al-Dusuqi"* [3: 144]; *"Al-Bahjah 'Ala Al-Tuhfah"* [2: 144]; Al-Dardir, *"Al-Sharh Al-Saghir"* [3: 197]; *"Al-Mughni"* [6: 188]; *"Sharh Muntaha Al-Iradat"* [2: 192]; *"Mughni Al-Muhtaj"* [2: 73]; *"Bada`i' Al-Sana`i'"* [5: 243]; Al-Atasi, *"Sharh Al-Majallah"* [2: 221]; articles (45-242) in *"Majallat Al-Ahkam 'Ala Madhhab Al-Imam Ahmad"*; articles (288-91) in *"Majallat Al-Ahkam Al-'Adliyyah"*; and articles (67-466) in *"Murshid Al-Hayran"*.

(19) *"Durar Al-Hukkam"* [3: 230]; *"Kashshaf Al-Qina'"* [3: 180]; *"Sharh Muntaha Al-Iradat"* [2: 161]; articles (353), (446) in *"Murshid Al-Hayran"*; article (287) in *"Majallat Al-Ahkam Aal-'Adliyyah"*; and article (342) in *"Majallat Al-Ahkam Al-Shar'iyyah 'Ala Madhhab Al-Imam Ahmad"*.

**Expenses of Possession in Qard (Loan)**

- The basis for the borrower bearing the expenses of delivery and acquisition, which refer to taking of delivery through customary units of measure in a contract of Qard, is that the lender has undertaken a good act, and costs are not to be imposed on one who does a good act.(20) Linked to these with respect to the rule are the expenses of the drawing up of documents, promissory notes and so on, which are matters that are needed for the implementation, execution or verification of the contract of Qard (loan), it is the borrower who bears these costs insofar as these are the requirements or appendages of raising a loan, which is for his interest. The lender is undertaking an act of donation of the benefits of his wealth and the person doing good is not to be made to bear costs over and above his granting of a thing, because "No ground (of complaint) can there be against those who do good."(21) If it is made binding on him to bear the costs of lending and recovery as well as attestation, it would run counter to his good act, and it would lead to the preventing to those who own wealth from lending it.

**Expenses of Possession in Deposit (Bailment)**

- The basis for the depositor bearing the costs of deposit and recovery in a contract of *Ida'* (deposit) is that "The burden of possession on each thing is binding upon the one who benefits from its possession, due to the principle: Gains are based on the bearing of costs."(22)22 It is known that the benefit in deposit and its return belong to the depositor alone, thus, the expenses that are incurred on its deposit and recovery are binding upon him.(23)

**Key Modern Applications of Possession**

- The basis for considering the possession of a bank draft or a personal cheque, accepted for payment by the drawee, as constructive possession of

(20) *"Al-Zarqani 'Ala Khalil"* [5: 158]; Al-Dardir, *"Al-Sharh Al-Saghir"* [3: 197]; and *"Hashiyat Al-Dusuqi"* [3: 144].

(21) [Al-Tawbah (Repentance): 91].

(22) *"Durar Al-Hukam"* [2: 333].

(23) *"Al-Bahr Al-Ra`iq"* [7: 276]; *"Durar Al-Hukkam"* [2: 272]; *"Al-Mughni"* [9: 269]; *"Kashshaf Al-Qina'"* [4: 203]; *"Asna Al-Matalib"* [3: 84]; *"Tuhfat Al-Muhtaj"* [7: 124]; *"Al-Muhalla"* [8: 278]; articles (793) in *"Majallat Al-Ahkam Al-'Adliyyah"*; and articles (1340) in *"Majallat Al-Ahkam Al-Shar'iyyah 'Ala Madhhab Al-Imam Ahmad"*.

the amount accepted is customary banking practice and trading transactions in this respect. The confirmation of this is laid down in a resolution of the International Islamic Fiqh Academy.[24]

- The basis for considering a payment on a credit card as constructive possession of the amount of repayment is banking practice in this respect. Likewise, in the consideration of a deposit by a person of an amount in a bank account of the client, irrespective of this being cash, a bank endorsement, or a cheque accepted for payment by the drawee bank, as constructive possession by the beneficiary. This has been confirmed by a resolution of the International Islamic Fiqh Academy.[25]

(24) Resolution No. (53) 4/6 in its 6th Session (Sha'ban 1410 A.H./March 1990 A.D.).
(25) 25 Resolution No. (53) 4/6) in its 6th Session.

# Appendix (C)
# Definitions

**Al-'Aqar (Immoveable Property)**

It is something that has a permanently affixed foundation and it is not possible to transfer it or move it, along with the subsistence of its shape and form, like land and houses.

**Al-Manqul (Moveable Property)**

It is something that can be transferred and moved. Thus, it includes cash, loans, animals, cars, ships, airplanes, trains, things subjected to cubic measure or weight.

**Bay' Al-Juzaf (Sale by Random Estimate)**

It is the sale of something whose precise quantity is not known, and its quantity is known through estimation without employing a cubic measure, weight, linear measure, count.

**Al-Qabd Bi-Sifat Al-Daman (Possession Creating a Liability for Return)**

It is the acquisition of a thing that leads to the liability for the return of the thing, if it is a fungible commodity, that is, its return to its owner as long as the thing exists, and its value, if it is non-fungible, on its loss or conversion, whatever the cause of this, and this when it occurs without the permission of the owner (as a wrongful act, delict, tort), like the possession by a thief or usurper, or with the permission of the owner, but with the intention of owning it, like the possession of one bargaining for it or one who has expressed the intention to own it. Some Jurists have deemed the possession by the borrower, the mortgagee (pledge), lessor and the independent contractor to be of this nature.

**Al-Qabd Bi-Sifat Al-Amanah (Possession Creating a Trust)**

It is the acquisition of a thing that leads to its treatment as a trust in the possession of the possessor insofar as he does not bear the liability of its

loss, and as long as he has not committed a tort or negligence in its safe-keeping. This occurs with the permission of the owner when there is no intention to own it rather it is for the interest of the owner, like the bailee, agent, dedicated servant, Wali and Wasi, or it is for the interest of the person acquiring it, like the tenant, borrower, and mortgagee, or for their common interest, like the Mudarib, partner, tenant and irrigator.

**'Urf (Custom)**

It is what is practised by the people and what they have come to follow in terms of words, acts or relinquishment. The 'Urf that is acknowledged by the Shari'ah is the one that meets the following conditions:

1. That it should not contradict the Shari'ah. If the 'Urf goes against a Shar'iah Text or one of the principles of the Shari'ah, it is a custom that is void.
2. That the 'Urf should be continuous or predominantly so.
3. That the 'Urf be prevalent at the time of the undertaking of the transaction.
4. That the two parties to the contract should not have expressly stipulated against it. If they express such a stipulation the 'Urf is not admissible.

## Shari'ah Standard No. (19)

# Loan (Qard)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This standard aims to elaborate the rules of the Shari'ah for loan (Qard). Among these are the rules for a benefit (Manfa'ah) arising from a loan whether or not this is stipulated (in the contract), just as it includes the regulations of the Shari'ah that must be followed by Islamic financial institutions (Institution/Institutions).[1] Likewise, the Standard includes the Shari'ah rules for some applications that the institutions need to implement, like current accounts, perquisites in return for loans, service charges for loans, and mutual overdrafts between the institution and its correspondents.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers loans and the accompanying benefits or costs irrespective of the institution being a lender or a borrower.

The Standard does not cover what is not a loan (Qard), like the price in a credit sale and investment accounts, because they have standards specific to them.

## 2. Definition of Qard

Qard is the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it.

## 3. Elements (Arkan) of a Loan (Qard) Contract and Its Conditions

3/1 The contract of loan (Qard) is concluded through offer and acceptance by the use of the words Qard and Salaf or any other word or act that conveys the meaning of Qard.

3/2 The legal capacity for making a donation is stipulated for the lender.

3/3 The legal capacity to undertake transactions is stipulated for the borrower.

3/4 It is stipulated for the subject-matter of the contract that it be known fungible (Mithli) marketable wealth.

3/4/1 The borrower comes to own the subject-matter of Qard (the wealth loaned) through possession, and he becomes liable for (the repayment of) a similar subject-matter.

3/4/2 The applicable rule is the return of an amount similar to the loan amount at the place where it was delivered.

## 4. Rules for Excess Benefit Stipulated in the Qard Contract

4/1 The stipulation of an excess for the lender in loan is prohibited, and it amounts to Riba, whether the excess is in terms of quality or

quantity or whether the excess is a tangible thing or a benefit, and whether the excess is stipulated at the time of the contract or while determining the period of delay for satisfaction or during the period of delay and, further, whether the stipulation is in writing or is part of customary practice.

4/2 It is permissible to stipulate the satisfaction (repayment) of Qard at a place other than that where the loan was made.

## 5. Rules for Excess Benefit Not Stipulated in the Contract

5/1 It is not permissible to the borrower to offer tangible property or extend a benefit to the lender during the period of the Qard when this is done for the sake of Qard, unless giving of such benefits is a practice continuing among the parties from a time prior to the contract of Qard.

5/2 An excess over Qard is permissible in terms of quantity or quality, or offering of tangible property or extending of a benefit, at the time of satisfaction when it is not stipulated or is part of custom, irrespective of the subject-matter of Qard being cash or kind.

## 6. Stipulation of a Period in Qard

It is permissible to stipulate a period in Qard. The borrower is, therefore, under no obligation to return it prior to the termination of the period nor can the lender demand it back prior to the end of the period. If, however, no period is stipulated, it is binding upon the borrower to return its substitute (*Badal*) on demand.

## 7. Stipulation of a Contract in Qard

It is not permissible to stipulate a contract of Bay' (exchange, sale) or Ijarah or other commutative contract within the contract of Qard.

## 8. Stipulation of a Reward for Raising Loans for Another

It is permissible to stipulate a reward for raising loans for another as long as it is not a fictional device (*Hilah*) for dealing in Riba. [see item 8/3/2 of Shari'ah Standard No. (15) on Ju'alah at the end of which it is stated "with the condition that the transactions are not employed for raising interest bearing loans through stipulations, customary practice or dealings among Institutions"]

## 9. Service Charges for Qard

9/1 It is permissible to a lending institution to charge for services rendered in loans equivalent to the actual amount directly spent on such services. It is not permissible to the institution to charge an amount in excess of such a service charge. All charges in excess of the actual amount spent are prohibited, and it is necessary to ensure precision in the determination of the actual charges so that they do not lead to an excess that can be deemed a benefit. The fundamental rule is that each loan bears its own specific charges, unless this becomes difficult as in the case of a group or common loan, in which case there is no restriction in the way of bearing direct collective charges for all the loans on the basis of the entire sum. It is necessary that the method of determining the charges be laid down by the Shari'ah Supervisory Board of the institution in detail, and this is to be done by distributing the expenses incurred among all the loans and each loan is to bear its share proportionately. An explanation of such circumstances is to be presented before the Board along with suitable documents.

9/2 Indirect expenses incurred in rendering services for loans are not included in actual expenses, like the salaries of the employees, the rentals of space, assets and means of transport as well as other management and general expenses of the institution.

## 10. Key Modern Applications of Qard

Among the most important modern applications of Qard are the following:

### 10/1 Current accounts

10/1/1 The reality of current accounts is that these are loans and not deposits. Thus, the institution comes to own the amounts and a liability to repay the amount is established against it.

10/1/2 It is permissible for the institution to demand wages for services rendered to the holders of the current accounts.

10/1/3 It is permissible for the institution to render services related to deposits and withdrawals to the owners of the current accounts with or without compensation like chequebooks and ATM cards and the like. There is no restriction on the institution

if it distinguishes between owners of current accounts with respect to what relates to deposits and withdrawals, like exclusive booths for receiving the owners of some accounts, or like distinguishing between the types or cheques.

**10/2 Perquisites for Qard**

It is not permitted to the institution to present to the owners of current accounts, in lieu of such accounts, material gifts, financial incentives, services or benefits that are not related to deposits and withdrawals. Among these are exemptions from charges in whole or in part, like exemption from credit card charges, deposit boxes, transfer charges and letters of guarantee and credit.

The perquisites and incentives that are not specific to current accounts are not governed by this rule.

**10/3 Charges on credit cards for cash withdrawals from ATMs**

10/3/1 The charges imposed on cards for cash withdrawals from bank teller machines are a charge for services and are independent of the loan.

10/3/2 It is necessary that the charges imposed on credit cards for cash withdrawals from bank teller machines be an amount that is certain within the limits of reasonable charges excluding profit from Qard. It is not permissible to link the charge to the amount withdrawn. It is not permissible to the institution to slice the withdrawals as a device for obtaining repeated charges just as it is not permissible (for this purpose) to take into account the period of repayment of the amount withdrawn. Where there is a difference in currencies, the application of the rate for the prevailing currency is stipulated. [see also item 4/5, Shari'ah Standard No. (2) on Credit and Charge Cards]

**10/4 Overdrafts between the institution and its correspondents**

In order to avoid interest between the institution and its correspondents, there is no restriction if the institution comes to

an agreement with other correspondent banks to place a ceiling upon the overdrafts of one drawn upon the other without any claims for profits (interest). [See item 2/4/a of Shari'ah Standard No. (1) on Trading in Currencies]

## 11. Date of Issuance of the Standard

This Standard was issued on 30 Rabi' I, 1425 A.H., corresponding to 19 May 2004 A.D.

# Adoption of the Standard

The Shari'ah Standard on Qard was adopted by the Shari'ah Board in its meeting No. (12) held in Al-Madinah Al-Munawwarah during the period of 26-30 Rabi' I, 1425 A.H., corresponding to 15-19 May 2004 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (8) held in Al-Madinah Al-Munawwarah during the period of 28 Safar to 3 Rabi' I, 1423 A.H., corresponding to 6-11 May 2002 A.D., the Shari'ah Board decided to issue the Shari'ah Standard on Qard (loan).

On 24 Rajab 1423 A.H., corresponding to 1 October 2002 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare an exposure draft on the Shari'ah Standard on Loan (Qard).

In its meeting No. (7) held in the Kingdom of Bahrain on 16 Muharram 1424 A.H., corresponding to 19 March 2003 A.D., the Shari'ah Standards Committee (1) discussed the Shari'ah study and required the consultant to incorporate necessary amendments in the light of the discussions and observations of the members.

In its meeting No. (8) held in the Kingdom of Bahrain during the period of 16-17 April 2003 A.D., the Shari'ah Standards Committee (1) discussed the exposure draft of the standard on Qard and made necessary amendments in the light of the discussions and the observations of the members. The Committee discussed the exposure draft of the standard in its meeting held on 25 and 26 Rabi' II, 1424 A.H., corresponding to 25 and 26 June 2003 A.D., and incorporated necessary amendments in the light of the discussions and observations of the members.

The Committee discussed the exposure draft of the standard in its meeting No. (9) held it Amman, the Hashimite Kingdom of Jordan, on 23 and 24 Jumada I, 1424 A.H., corresponding to 23 and 24 July 2003 A.D., and made necessary amendments in the light of the discussions and observations of the members.

The revised exposure draft of the Shari'ah Standard was presented to the Shari'ah Board in its meeting No. (11) held in Makkah Al-Mukarramah during the period of 2-8 Ramadan 1424 A.H., corresponding to 27 October-2 November 2003 A.D. The Shari'ah Board made amendments to the exposure draft of the standard and decided that it be sent to specialists and interested parties in order to obtain their comments in preparation for the discussion of the exposure draft in a public hearing.

A public hearing was held in the Kingdom of Bahrain on 29 Dhul-Qa'dah 1424 A.H., corresponding to 21 January 2004 A.D. The public hearing was attended by more than fifteen participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in the field. The members of the Shari'ah Standards Committees (1) and (2), responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) in a joint meeting in the Kingdom of Bahrain on 30 Dhul-Qa'dah 1424 A.H., corresponding to 22 January 2004 A.D., discussed the comments that were made during the public hearing as well as the observations received in writing. The Committees made amendments that were deemed suitable.

The amended exposure draft was presented to the Drafting Committee in its meeting held in the Kingdom of Bahrain on 25 Safar 1425 A.H., corresponding to 15 April 2004 A.D.

The Shari'ah Board in its meeting No. (12) held in Al-Madinah Al-Munawwarah during the period of 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D., discussed the amendments suggested by the Shari'ah Standards Committee and the Drafting Committee, and incorporated the amendments deemed suitable. The Shari'ah Board unanimously adopted some of the items of the Standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for stipulating that wealth given as Qard be known is to enable the borrower to return a similar substitute of the wealth of Qard.
- The basis for the rule that the borrower does not come to own the wealth lent except through possession is that the contract of Qard is one in which commutative aspect and that of donation stand combined, however, the act of donation is predominant. It is for this reason that the rule is similar to that for gift (Hibah) in which ownership is transferred with the taking of possession.
- The basis for the rule that the subject-matter of Qard be a fungible item is that it is only such an item that can be returned by the borrower. Further, fungible items are compensated through similar substitutes in usurpation and destruction.
- The basis for the obligation of returning the counter-value of Qard at the same place where it was granted, when there is no contrary stipulation, is that this is the governing rule.

**Stipulation of an Excess in the Counter-Value of Qard**

- The basis for the prohibition of stipulating an excess in the counter-value of Qard for the lender are evidences from the Qur`an, the Sunnah, consensus of Fuqaha (Ijma') as well as rational arguments that convey the prohibition of Riba (usury) in Qard.

**Stipulation of Repayment in a Land (Place) Other Than That of Qard**

- The basis for the permissibility of repayment in a land other than that where Qard was granted so as to provide a facility to the borrower whether or not the lender benefits from this, is as follows:
  1. The reports(2) from the Companions, may Allah be pleased with them, which indicate the permissibility of stipulating repayment in

(2) *"Al-Musannaf"* by Ibn Abu Shaybah [6: 279]; and *"Al-Sunan Al-Kubra"* by Al-Bayhaqi, [5: 352].

a land other than that where Qard was made. This is a view upheld by the Malikis and the Hanbalis and it was preferred by Ibn Taymiyyah and Ibn Al-Qayyim Al-Jawziyyah.

2. The stipulation of repayment in a land other than that of the Qard is in the interest of both the lender and the borrower without causing injury to either along with the existence of a need. The Shari'ah does not lay down the prohibition of interests that bear no injury. In fact it lays down their permissibility. It does prohibit those that are injurious, but here the benefit is mutual and they are cooperating to arrange this. It, therefore, belongs to the category of cooperation and participation.
3. The basic rule in transactions (Mu'amalat) is permissibility, and the stipulation of repayment of a loan in a land other than that of the Qard is not expressly prohibited by the texts, nor is the meaning expressly stated in the texts so that prohibition could be extended through analogy. Thus, the repayment falls under the rule of permissibility.

**Stipulation of a Period in Qard**

- The basis for the permissibility of stipulating a period in Qard, for Qard can be delayed by stipulating a period, are evidences about the permissibility of a period of delay, the obligation of abiding by conditions and contracts, for the realisation of the purposes of the Qard, and for repelling injury.

**Stipulating a Contract of Sale within the Contract of Qard**

- The bases for the prohibition of stipulating a contract of sale within the contract of Qard are the following:
  1. The saying of the Prophet (peace be upon him): *"A Salaf (loan) and sale (in one contract) are not permitted nor are two conditions in a sale nor the profit from a thing for which the liability for loss is not borne nor the sale of what you do not have".*(3)

(3) Related by Abu Dawud. The text of this Hadith belongs to him as narrated from Abdullah Ibn Amr Ibn Al-'Ass (may Allah be pleased with him), chapter on the person who =

2. The underlying reasoning is that the word Salaf in the words of the Prophet (peace be upon him): *"A Salaf (loan) and sale (in one contract) are not permitted"*, means Qard. The Hadith indicates the impermissibility of combining a Qard and a sale in a single contract. The generality of its meaning includes the impermissibility of stipulating a contract of sale in a contract of Qard as well as the impermissibility of stipulating a Qard contract within a contract of sale.
3. The stipulation of a contract of sale within a contract of Qard is a means towards obtaining an excess in Qard as he may oblige him with respect to the price for the sake of Qard, and in this way the Qard will be created with a stipulated excess, which is Riba. These are means that, by agreement, are to be prevented and blocked.
4. The stipulation of a contract of sale within a contract of Qard removes the contract of Qard from its main purpose, which is to provide a facility. The reason is that Qard is not a commutative contract, it is rather a contract of piety and virtue; thus, it is not valid if compensation is stipulated in it. If Qard is linked to a commutative contract, it will receive a part in the compensation and this will take it out of its required purpose. This will nullify it and nullify the commutative contract linked to it as well.

- The basis for the prohibition of a stipulation by the lender that the borrower gives him a gift is that in reality this amounts to Qard with an excess that is stipulated for the benefit of the lender and this excess is the gift. Thus, it amounts to prohibited Riba and removes the contract from the category of a compassionate contract moving it to one of Riba. Further, this stipulation

= sells what he does not have, *"Kitab Al-Buyu'"*, (H: 3504): *"Sunan Abu Dawud"* [3: 283]; Al-Tirmidhi, chapter on the disapproval of selling what one does not have, *"Kitab Al-Buyu'"* (H: 1234): *"Sunan Al-Tirmidhi"* [3: 526-27]; Al-Nasa`i, chapter on two conditions in a sale, *"Kitab Al-Buyu'"* (H: 4644): *"Sunan Al-Nasa`i"* [7: 340]; Ahmad in *"Musnad Al-Mukthirin Min Al-Sahabah"* (H: 6633): *"Musnad Ahmad"* [2: 3730] through different channels, all of them: From Ayyub, who said: "Amr Ibn Shu'ayb related to me saying, 'My father related to me from ...' till he mentioned Abdullah Ibn Amr reporting it". The Hadith is deemed *hasan* Hadith, but rises to the level of *Sahih Li-ghayrihi* due to its numerous channels.

generates a benefit for the lender and the Jurists have unanimously agreed that any contract that yields a benefit stipulated for the lender is impermissible. The benefit in this stipulation is that the lender will benefit from a second loan from the borrower, and this benefit is not in lieu of anything other than the very Qard that he gave him.

**Stipulation of a Reward for Raising Loans on the Basis of Credit-Worthiness**

- The basis for permitting the stipulation of a reward for raising loans on the basis of credit status is that this is a counter-value for a service rendered, and this is what is upheld by the Jurists that a reward may be acquired for recommendations and lending of status.

**Charges for Services Actually Rendered**

- The basis for the permissibility of the lender charging only what is equivalent to the actual costs incurred is that these are in lieu of the costs alone. The lender is doing a favour and the person doing a favour is not to be penalised. The basis for the prohibition of charging in excess of this is that in such a case it would amount to an excess in lieu of the Qard. Resolution No. 13 (1/3) was issued by the International Islamic Fiqh Academy (OIC) regarding the recovery of actual costs.

**Material Benefits at the Time of Repayment That Are Not Stipulated**

- The basis for the permissibility of giving an excess, in terms of quantity or quality, at the time of repayment by way of generosity and goodwill, when these are neither stipulated nor is there a practice of paying them, is the Hadith reported from Abu Rafi', may Allah be pleased with him, that the Messenger of Allah (peace be upon him) borrowed a very young camel from a man and then wished to present to him one of the camels of the Sadaqah (Zakat), so he asked Abu Rafi` to repay the man his camel. Abu Rafi' returned it to him and said, "I do not find anything there except a full grown four year old camel." The Prophet (peace be upon him) said, *"Give him this camel. The best people are those who do better in of repayment"*.(4) It is reported from Abu Hurayrah that a man came to the

(4) Related by Muslim in his *"Sahih"* in the Book of *"Musaqat"*, chapter on the person who borrows may return what is better.

Messenger of Allah (peace be upon him) seeking alms. The Messenger of Allah (peace be upon him) borrowed food amounting to one-half of a Wasq and gave the man this. When the lender came demanding his loan, he gave him a full Wasq saying, *"One-half of this is your repayment and the other half is a present from me"*.(5)

**Material Benefits Not Stipulated Prior to Repayment**

- The basis for the prohibition of material benefits not stipulated prior to repayment, unless these benefits are not for the sake of Qard or in lieu thereof, are the following:
  1. From Anas Ibn Malik, may Allah be pleased with him, who said: "The Messenger of Allah (peace be upon him) said, `When one of you grants a Qard and a gift is made to him by the borrower or he offers him a free ride on his animal, he is not to accept this from him, unless such a practice was prevalent among them prior to the Qard.'"(6)
  2. Reports of precedents laid down by the Companions, may Allah be pleased with them, which indicate the prohibition of accepting the gift of the borrower and other types of benefits, unless there is an evidence that this is not for the sake of the loan, and that the lender responds with a similar gift or adjusts it as repayment of the debt.

**Current Accounts**

- The basis for the determination that current accounts constitute loans (Qurud), are the following:
  1. That the bank comes to own the deposits in the current accounts and has the right to undertake transactions in the amounts and to seek growth in them (through investment). Further, it is under an obligation to return a similar amount on demand. This is the very meaning of Qard, which is the giving of wealth to one who benefits from it -that is, employs it and consumes it in pursuit of his aims- and then returns its counter-value. This differs from Wadi'ah (deposit) in the terminology of Fiqh, which is wealth deposited with a person for safe-custody so that he does not employ the wealth and returns this very wealth to the owner.

(5) Related by Al-Bayhaqi, *"Al-Sunan Al-Kubra"*, [5: 351].
(6) Related by Ibn Majah in his *"Sunan"* (H: 2457).

2. It is binding on the bank to return a similar amount on demand for the current deposit, and it guarantees such return even upon loss of the wealth, whether or not it was negligent. This is the purpose of the contract of Qard, as against Wadi'ah in Fiqh terminology insofar as the Wadi'ah is a trust in the possession of the custodian, thus, if it is destroyed due to his transgression or negligence, he is held liable for it, but if it is destroyed without such transgression or negligence, he is not liable. Resolution No. 86 (3/9) was issued by the International Islamic Fiqh Academy (OIC) regarding the status of current accounts.

- The basis for the permissibility of the bank demanding service charges -for maintaining current accounts- for the services rendered, is an excess over the duty owed by it, because it is entitled to such charges in lieu of the acts undertaken by it and services rendered to the client.
- The basis for the permissibility of the owner of a current account utilising a chequebook and ATM card without compensation are the following:
  1. The additional benefit arising out of this issue is common for both parties -the lender and the borrower- as both benefit from it, thus, both benefits are set off against each other. In fact, the benefit that goes to the client through the issuance of a chequebook and an ATM card is secondary and is not a primary benefit insofar as the bank has set up this system for serving its own numerous aims and objectives, thus, the benefit accruing to the bank from this system is a primary benefit, while the realisation of the benefit for the client from this system is a consequence of the employment of this system by the bank for its aims and objectives.
  2. The benefit derived by the owner of a current account -the lender- from this system without a counter-value is not a benefit separate from the Qard. In fact, it is a means for the satisfaction of the loans acquired by the bank insofar as these are ways for the repayment of loans for every lender as when he demands them.
- The basis for the prohibition of presents and gifts, when the underlying cause is Qard, insofar as the bank gives these presents and gifts to one who gives it a Qard, is that these are by way of gifts to the lender prior to

the satisfaction of the loan when these are due to the Qard.[7] As for the basis of presents and gifts in general, they are not related to Qard and there is no suspicion about them.

**Overdrafts between the Institutions and Their Correspondents**

- The basis for the permissibility of overdrafts between institutions and their correspondents is general need and that the benefit derived from this practice is not specific to the lender alone. In fact, the benefit is mutual. Further, it does not fall under the category of Qard rather it is a step for transacting with one who deals with you. Thus, the issue does not resemble the case of "You give me a loan and I will give you a loan."[8]

(7) Resolution No. (355) of the Shari'ah Board of Al Rajhi Banking Corporation was issued with respect to presents and gifts in lieu of loans (Qurud).

(8) *"Al-Mughni"* by Ibn Qudamah, [6: 436]; Resolutions and Recommendations of Al Baraka, No. (8/10) and (11/6); Shari'ah Rulings on economic Matters, issued by Bayt Al-Tamwil Al-Kuwayti, [1: 178].

# Appendix (C)
# Definitions

**Benefit Arising from Qard**

It is a benefit or an interest that is derived by the lender in a contract of Qard due to this contract.

**Current Accounts**

These are loans that constitute the current accounts insofar as the bank comes to own these amounts and it is possible for the owner of these accounts to withdraw these amounts at any time he likes.

**Mithlis (Fungibles)**

These are cash, things subjected to cubic measure, weight, linear measure and very similar countable things that do not differ to an extent that their difference will lead to a difference in their value.

**Qimis (Non-Fungibles)**

These are types of wealth whose difference, one from another, leads to a difference in their value, as in the case of animals.

**Legal Capacity for Donation**

It is the ability of the subject (Mukallaf) to grant wealth or a benefit to another in the present or in the future without compensation in lieu thereof and with the usual intention of piety and the doing of good.

**Legal Capacity to Undertake Transactions**

It is the ability of a person to commit an act or to issue a statement in a manner that is acknowledged by the Shari'ah, and the underlying basis is discretion, reason and puberty.

**Deficient Legal Capacity for Execution**

It is the ability of a person to undertake certain transactions and not others so that the execution of such transactions depends upon ratification by another.

Shari'ah Standard No. (20)

# Sale of Commodities in Organized Markets

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to elaborate the foundations on which international commodity sales, between parties from different countries, are based whether the contracts have been concluded for spot or deferred commodities or through derivatives (futures, options, indexes and swaps). The Standard also explains what is permissible out of these according to the Shari'ah and what is not, along with an explanation of the Shari'ah substitutes for them within the Islamic financial institutions (Institution/Institutions).[1]

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers international sales contracts whose subject-matter are commodities and to derivatives of various kinds: Swaps, Indexes, Futures and Options.

The Standard does not cover financial and commercial paper or currencies, because these have their own specific standards, just as it does not cover sales that are concluded outside the organized markets.

## 2. Definition of International Sales and Their Kinds

### 2/1 Definition of international commodity sales

2/1/1 International commodity sales are contracts that are concluded in organized commodity markets under the supervision of specialised Organizations and through intermediaries who coordinate the demand for sales and the demand for purchases by employing standard contracts that contain various conditions and specifications along with a statement of the period and place of delivery. The contract may also stipulate the deposit of a portion of the price as a security for the execution of the contract and opening of an account with the intermediary.

### 2/2 Types of international commodity sales

International commodity sales are divided into three types:

2/2/1 Spot contracts

These are contracts that require immediate delivery and acceptance of delivery, however, delivery and possession may take place within the limit of a day or two days in accordance with the regulations of the market.

2/2/2 Forward contracts

These are contracts in which both counter-values are deferred with the legal effects of the contracts taking place at a determined future date, and delivery and possession take place at that time.

2/2/3 Futures commodity contracts

These are contracts whose legal effects take place at a determined future date either through liquidation between the parties, or cash settlement or through counter-contracts, but they rarely end in actual delivery and possession.

**2/3 Termination of international commodity sales**

International commodity sales end in one of the following ways:

2/3/1 Contracts in which actual delivery takes place for both counter-values or in one of them;

2/3/2 Contracts that end through the operation of liquidation between the two parties;

2/3/3 Contracts that end in cash settlement by agreement; and

2/3/4 Contracts that end in counter-contracts.

## 3. Shari'ah Basis for International Commodity Sales

**3/1 Spot contracts**

Conclusion of spot contracts in the commodity markets is permitted with the following conditions:

3/1/1 That the commodity sold must be in existence and owned by the seller;

3/1/2 That the commodity sold must be ascertained in a manner that distinguishes it from others;

The documents that establish the existence of the commodity, its ownership and distinguish it from others are sufficient proof of the realisation of the two previous conditions.

3/1/3 That the contract should not include a condition that prevents the buyer from taking delivery of the commodity sold and obliges him to accept a set-off for value;

3/1/4 That the price be paid on a spot basis. Delay, without the stipulation of delay, in the delivery of an existing and ascertained commodity, or delay in the acceptance of spot price, does not affect the validity of the contract.

**3/2 Forward contracts (both counter-values delayed)**

3/2/1 These are the selling and buying of commodities with the stipulation of delivery in the near future. They differ from futures transactions insofar as they are not organized in an exchange and they are instruments of hedging that do not submit to financial supervision.

3/2/2 There are two forms for contracts with both counter-values delayed:

3/2/2/1 That the commodity is a liability through description, while the price is deferred, irrespective of the contract being concluded with the word sale or with the word Salam. These contracts are not permitted, because they amount to a Salam contract in which the capital of Salam (Ras al-Mal) is not paid promptly. [see Shari'ah Standard No. (10) on Salam and Parallel Salam]

3/2/2/2 That the commodity is ascertained, but a delay in its delivery is stipulated along with a delay in the price. Such contracts are not permitted.

3/2/3 When the contract is that of Istisna'a, such a contract is valid even when the price is delayed. [see Shari'ah Standard No. (11) on Istisna'a and Parallel Istisna'a, item 3/1/5]

3/2/4 There is no restriction in delaying one of the counter-values: the price, while observing Accounting Standard No. (20) on Deferred Sale; and the commodity sold, while observing Shari'ah Standard No. (10) on Salam and Parallel Salam.

**3/3 Futures transactions in commodities**

It is not permitted to undertake futures transactions according to the Shari'ah, either through their formation or by trading in them. [see items 2/2/3, 5/1]

## 4. Key Applications of International Commodity Sales

**4/1 Permissible applications of international commodity sales:**

4/1/1 Appointing another person as an agent for the purchase of a commodity at a spot price, and the sale of the commodity by the agent to a third person for a deferred price on behalf of the principal along with the determination of compensation for the agent as part amount or percentage of the purchase price of the commodity. These are the operations of the "Investment Agency."

4/1/2 Appointing another person for the management of purchase operations with a spot price and sale on a deferred basis with the manager being entitled to a known undivided share in the profit. These are "Mudarabah" operations. [see Shari'ah Standard No. (13) on Mudarabah]

4/1/3 The agent undertaking -after the purchase of the commodity on account of the principal- to buy it for himself from the principal with the stipulation of distinguishing between the liability of the agent and the liability of the principal for the commodity and this by ensuring two independent offers and acceptances between the principal and the agent. It is possible that this be accomplished through the exchange of two advices, one for notifying ownership by means of agency and the proposal of purchase (offer), and the other for agreement to sell (acceptance). [see Shari'ah Standard No. (8) on Murabahah (appendices A and B)]

4/1/4 Purchase by the institution of a commodity on a spot basis and the subsequent sale of this commodity by the institution to another on a deferred payment basis. In this application the avoidance of

buy-back is stipulated, like the buyer selling what he purchased with a deferred price to one from whom it was initially bought on a spot basis at a price lesser than this (deferred price).

**4/2 International commodity sales prohibited by the Shari'ah**

4/2/1 Transactions in commodities that are not permissible.

4/2/2 Sale of the purchased commodity prior to its ascertainment in a manner that distinguishes the commodity sold from other commodities leading to the overlapping of the liability of the buyer and the liability of the seller due to the mixing up of what is owned by the buyer with what remains with the seller.

4/2/3 Purchase by the agent of a commodity for the institution's account and its sale thereafter to himself without the exchange of two advices of offer and acceptance between the agent-buyer and the institution that owns the commodity so that the liability of the principal (seller) and the liability of the agent selling the commodity to himself come to overlap.

4/2/4 Sale by the agent of the purchased commodity before actually or legally taking delivery. Legal delivery includes the transfer of liability to the buyer (agent) by ascertaining the commodity in a manner that distinguishes it from things other than the commodity sold.

4/2/5 Commodity purchase operations of the institution through agency and purchase thereafter by the agent for his own account on a deferred basis by confining the transaction to an offer by the agent to the institution to enter into the transaction and acceptance by the institution thereof prior to taking possession of the commodity by the institution or without the exchange of the two advices of offer and acceptance.

4/2/6 Purchase of a commodity by an institution on the basis of a spot price and thereafter its sale to the (same) institution itself on a deferred basis, or its sale to a holding institution of the seller institution with complete or majority ownership, or

with effective control, amounts to a buy-back ('Inah) sale. [see Shari'ah Standard No. (8) on Murabahah and item 2/2/4 of Shari'ah Standard No. (11) on Istisna'a and Parallel Istisna'a]

4/2/7 Sale by an agent of a commodity for his client, prior to the transfer of ownership to him through purchase, to an institution that is his principal.

4/2/8 Sale of ascertained specified commodity, without its passing into the ownership of the seller, through fictitious documents or the sale of the same commodity at the same time to more than one institution dealing with the commodity. It is necessary to be precise about the numbers of the title documents of the commodity along with the fixing of liability for the person causing a discrepancy.

4/2/9 The lack of detail about compensation for agency (brokerage) and merging it with the determined purchase price, which is stated as an amount that includes it. The substitute for this is the mentioning of the compensation and then deducting it from the inclusive price, or the addition of the compensation to the purchase price or the determination of the sale price with the specification that what is in excess is the compensation of the agent.

4/2/10 A statement within the general memorandum of agency for purchase and sale of commodities that denies the right of the buyer (principal) to take delivery of the commodity.

4/2/11 The institution making the payment of the purchase price of the commodity contingent upon the agent providing a guarantee for the payment of the sale price by the agent himself or by another person.

4/2/12 Stipulation of a guarantee by the seller for the sale price under all circumstances. He is obliged to provide a guarantee in case of tort, negligence or breach of the provisions of agency like the stipulation that he obtain sureties from the buyers of the

commodities with respect to the deferred period. [see Shari'ah Standard No. (5) on Guarantees]

## 5. Derivatives

Derivatives have a large number of kinds, the most important of which are: Futures, Options, Indexes and Swaps. The Shari'ah rule for derivatives is based on the rule for the contracts employed within their framework, as stated in paragraphs that follow:

### 5/1 Futures

5/1/1 A contract that is binding under law. It is concluded on the trading floor of the exchange for the sale and purchase of commodities or financial instruments for a period linked to the near future. The transaction is arranged with the mentioning of the quantity, type and category along with the statement of the date and place of delivery. As for the price, it is the sole element that varies, and it is ascertained in the trading hall.

5/1/2 The Shari'ah rule for futures contracts

It is not permitted according to the Shari'ah to undertake futures contracts either through their formation or trading. [see para. 4]

### 5/2 Options

5/2/1 A contract by means of which a right is bestowed -but not an obligation- for the purchase or sale of an identified item (like shares, commodities, currencies, indexes or debts) at a etermined price and for a determined period. There is no obligation in this contract except on the person selling this right.

5/2/2 The Shari'ah rule for options

Options indicated above are not permitted neither with respect to their formation nor trading.

5/2/3 Shari'ah substitutes for options

5/2/3/1 The conclusion of a contract pertaining to ascertained assets is permitted according to the Shari'ah, along with the payment of part of the price as 'Arboun (Earnest Money) with the stipulation that the buyer has the right to revoke the contract within a specified period in lieu of the entitlement of the seller to the amount of earnest money in case the buyer exercises his right of revocation. It is not permitted to trade the right established with respect to the earnest money.

5/2/3/2 The conclusion of a contract for commodities in themselves along with the stipulation of an option for establishing the right of revocation for one of the parties, or for both, during a known period. This option is not eligible for trading.

5/2/3/3 The issuance of a binding promise by the owner of assets to sell them, or a binding promise by one desiring to buy them, without specifying a counter-value for the promise. This promise is not eligible for trading.

**5/3 Swaps**

5/3/1 Swaps are agreements between two parties for the temporary exchange of determined financial assets, material assets or interest rates. In some cases the sale of a commodity or deferred currency takes place without the transaction resulting in any exchange of the commodity, while in other cases there may be an option, in return for a counter-value, that gives the owner the right to execute or not to execute the contract.

5/3/2 The Shari'ah rule for swaps

Swaps are not permitted in the forms in which they are practised in commodity exchanges.

## 6. Date of Issuance of the Standard

This Standard was issued on 30 Rabi' I, 1425 A.H., corresponding to 20 May 2004 A.D.

# Adoption of the Standard

The Shari'ah Standard on International Commodity Sales in Organized Markets was adopted by the Shari'ah Board in its meeting No. (12) held in Al-Madinah Al-Munawwarah during the period of 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (8) held in Al-Madinah Al-Munawwarah during the period of 28 Safar to 3 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board decided to issue the Standard on International Commodity Sales in Organized Markets.

On 25 Rajab 1423 A.H., corresponding to 2 October 2002 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare an exposure draft on international commodity sales in organized markets.

The Shari'ah Standards Committee (2) in its meeting held in the Kingdom of Bahrain on 13 Safar 1424 A.H., corresponding to 15 April 2003 A.D., discussed the juristic study and required the consultant to incorporate necessary amendments in the light of the discussion and the observations of the members. The Committee also discussed the exposure draft in its meeting held on Monday 23 Rabi' II, 1424 A.H., corresponding to 23 June 2003 A.D., and made necessary amendments in the light of the discussion and the observations of the members.

The revised exposure draft of the standard was presented to the Shari'ah Board in its 11th meeting held in Makkah Al-Mukarramah during the period of 2-8 Ramadan 1424 A.H., corresponding to 27 October - 2 November 2003 A.D. The Shari'ah Board made amendments to the exposure draft of the standard and decided that it be sent to specialists and interested parties in order to obtain their comments in preparation for its discussion in a public hearing.

A public hearing was held in the Kingdom of Bahrain on 29 Dhul-Qa'dah 1424 A.H., corresponding to 21 January 2004 A.D. The public hearing was

attended by more than fifteen participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in the field. The members of the Shari'ah Standards Committees (1) and (2), responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) in a joint meeting in the Kingdom of Bahrain on 30 Dhul-Qa'dah 1424 A.H., corresponding to 22 January 2004 A.D., discussed the comments that were made during the public hearing as well as the observations received in writing. The Committees made amendments that were deemed suitable.

The amended exposure draft was presented to the Drafting Committee in its meeting held in the Kingdom of Bahrain on 25 Safar 1425 A.H., corresponding to 15 April 2004 A.D.

The Shari'ah Board in its meeting No. (12) held in Al-Madinah Al-Munawwarah during the period of 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D., discussed the amendments suggested by the Shari'ah Standards Committee and the Drafting Committee, and incorporated the amendments deemed suitable. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for the permissibility of international sales transactions that fulfil the required Shari'ah elements and conditions of the validity of sales is their inclusion within the fold of the sale with respect to which the Words of Allah, the Exalted, were laid down: ***{"...Where Allah has permitted trading..."}***,(2) as well as His Words: ***{"...Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent..."}***.(3) The implementation of the international conventions on sales or the implementation of the laws of some countries does not require prohibition of these sales if they do not contain what conflicts with the rules and principles of the Shari'ah, and this is due to the Words of Allah the Exalted: ***{"O you who believe! fulfil (your) obligations..."}***,(4) with the proviso *"except what legalizes the prohibited and prohibits what is legal"*, due to the words of the Prophet (peace be upon him): *"Muslims shall abide by their conditions, except for a condition that legalises the prohibited or prohibits the lawful"*.(5)
- The basis for the prohibition of delaying of both counter-values is that in this there is the creation of two liabilities, along with what the jurists have mentioned with respect to the impermissibility of delaying the capital of Salam. Further, there is opposition to the conditions required by the contract. The basis for the conditions of spot contracts in the commodity

(2) [Al-Bqarah (The Cow): 275].
(3) [Al-Nisa` (Women): 29].
(4) [Al-Ma`idah (The Table): 1].
(5) This Hadith has been narrated by a number of Companions. It has been related by Ahmad [1: 312]; Ibn Majah with a hasan chain of transmission [2: 784], Mustafa Al-Babi Al-Halabi edition, Cairo (1372 A.H./1952A.D.); Al-Hakim (Hyderabad, India edition, 1355 A.H.); Al-Bayhaqi [6: 70, 156], [10: 133], Hyderabad, India edition, 1355 A.H.); Al-Daraqutni [4: 228], [3: 77], Dar Al-Mahasin Lil-Tiba'ah, Cairo (1372 A.H./1952 A.D.).

markets is that these are general conditions of sale and are permitted according to the Shari'ah.

- The basis for the permissibility of contracts in which one of the counter-values is deferred is the validity of *Bay' Mu'ajjal* and Salam.
- The basis for the permissibility of forms of transactions mentioned in the Standard related to international commodity sales is that they are concluded in accordance with the principles of Wakalah (agency), sale with a deferred period, Murabahah sale, and all these are valid contracts.
- The basis for the obligation of issuing an offer by the agent for seeking a sale on his own account and its acceptance by the principal as a seller is the distinction between the liability of the seller (the principal) and the liability of the buyer (the agent).
- The basis for the obligation of specifying the wages of the agent, and not merging it with the price is the Hadith: *"He who hires a hired worker must make known to him his wages"*.[6] This rule of the contract of Ijarah is applicable to agency for wages.
- The basis for the prohibition of stipulating the lack of delivery in commodity sales is that this negates the requirements of sale, which are the transfer of ownership to the buyer and his right to undertake transactions in the sold commodity.
- The basis for prohibiting the stipulation of a guarantee by the agent is that the agent is a trustee and does not provide a guarantee except for cases of transgression, negligence or going against the constraints of agency.
- The bases for the prohibition of deferred transactions in currencies are the Hadiths prescribing the obligation of possession in their sale. This has received support from a resolution of the International Islamic Fiqh Academy emphasising this.[7]
- The basis for the prohibition of derivatives is that these are binding promises that are converted to sale contracts pertaining to the future without an offer and acceptance. The Shari'ah substitutes mentioned in the Standard for derivatives are stated in a resolution of the International Islamic Fiqh Academy.[8]

(6) Related by Ibn Majah in his *"Sunan"* [2: 817]; See also *"Majma' Al-Zawa'id"* by Al-Haythami [4: 98], Dar Al-Rayyan Lil-Turath and Dar Al-Kitab Al-'Arabi.

(7) The International Islamic Fiqh Academy Resolution No. (63) 1/7.

(8) The International Islamic Fiqh Academy Resolution No. (63) 1/7.

- The basis for the impermissibility of options is that the subject-matter of the contract in them is not wealth that can be deemed compensation according to the Shari'ah.(9)
- The basis for the impermissibility of swaps is that no actual exchange of counter-values takes place thereby. Such swaps, as well, usually constitutes interest payment, 'Inah, and deferment of one of the counter-values.

(9) The International Islamic Fiqh Academy Resolution No. (63) 1/7.

Shari'ah Standard No. (21)

# Financial Paper (Shares and Bonds)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to elaborate the rules for the shares of corporations just as it seeks to explain the rules for interest-bearing bonds.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers shares with respect to their issuance and flotation including investment, trading, renting, loaning, pledging and Salam in them, along with the rule for concluding futures, options and swapping contracts on the basis of shares.

The Standard also covers issuance of and trading in interest-bearing bonds. The Standard does not cover investment Sukuk for which there is a separate specific standard.

## 2. Rules for Issuance of Shares

2/1 The issuance of shares is permissible if the objectives for which the corporation was established are permissible according to the Shari'ah, thus, the objectives of its formation should not be transactions that are prohibited, like the manufacturing of liquor, trading in swine or transactions in Riba. If the objectives of the corporation are impermissible, the formation of the corporation is permissible too, and consequentially so is the issuance of shares that constitute such a corporation.

2/2 It is permissible to add a determined percentage to the value of the share at the time of subscription to cover the expenses of issuance as long as this percentage is fixed and determined to be a reasonable amount. [see item 4/1/2/2 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

2/3 It is permissible to issue new shares for increasing the capital of a corporation if such shares are issued at a price that is equivalent to the value of the old shares, which is worked out through expert valuation of the assets of the corporation or on the basis of the market-value whether this is at a premium or at a discount with respect to the price of the issue. [see item 4/1/2/3 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

2/4 It is permissible to underwrite the issue when this is done without compensation in lieu of underwriting. This is an agreement, at the time of the formation of the corporation, with someone who undertakes to purchase the entire issue of shares, or a part thereof. It is an undertaking from the person bound to subscribe at the nominal value to all that remains and has not been subscribed to by another. It is permissible to acquire compensation for work, like the preparation of feasibility studies or the marketing of shares, irrespective of the work being undertaken by the underwriter or someone if such compensation is not in lieu of a guarantee. [see item 4/1/2/4 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

2/5 It is permissible to split the value of the share into instalments at the time of subscription so that one instalment is paid and the remaining instalments are deferred. The subscriber will be considered a participant to the extent of what he has paid up and will be bound to pay his additional capital in the company, and this on the condition that the instalments apply to all the shares and that the liability of corporation remains restricted to the value of the shares subscribed to. [see item 4/1/2/5 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

2/6 It is not permissible to issue preference shares that have special financial features leading to the granting of priority to these shares at the time of liquidation or the distribution of profits. It is permitted to grant certain shares features related to procedural or administration matters, in addition to the rights attached to ordinary shares, like voting rights. [see item 4/1/2/14 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

2/7 It is not permissible to issue *Tamattu'* shares. These are shares that grant the participant compensation in lieu of his shares, whose value is redeemed during the existence of the company, and he is granted *Tamattu'* shares that grant him rights that are available for shares based on capital, except the right to profits and the distribution of assets at the time of winding up, insofar as the *Tamattu'* shares

are entitled to profit lesser than that given to the owner of shares based on capital, just as the owner of *Tamattu'* shares does not have a share in the assets of the company at the time of winding up until the owners of shares based on capital have been granted the value of their shares. [see item 4/1/2/15 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

2/8 The share certificate – or what stands in its place – is a document that is deemed evidence of ownership of the shareholder for his undivided share in the assets of the company. It is permitted that this document be in the name of the owner, to his order, or for the bearer.

## 3. Rules for Dealing in Shares

3/1 A share represents an undivided share in the capital of a corporation, just as it represents an undivided share in its assets and the rights associated with it upon conversion of the capital into tangible things, benefits, debts and so on. The subject-matter of the contract at the time of trading of shares is this undivided share.(1)

3/2 It is permissible to buy and sell shares of corporations, on a spot or deferred basis in which delay is permissible, if the activity of the corporation is permissible irrespective of its being an investment (that is, the share is acquired with the aim of profiting from it) or dealing in it (that is, with the intention of benefiting from the difference in prices).

3/3 Participation or trading in shares for purposes of conversion

Participation or trading is permitted for purposes of conversion for one who has the ability to effect conversion by adopting a resolution for

(1) See the Shari'ah basis for the standard, item (18), for the permissibility of trading in shares of corporations whose assets represent tangible things and profits along with debts and cash that are in excess of the tangible assets and profits with the stipulation that such tangible and cash assets should not be less than one-third. The reason is that the debts and cash can be properly considered as secondary to them. (This explanatory note is intended to complete the text of the Standard for implementing subsequent amending procedures, God willing).

conversion in accordance with the Shari'ah at the first general meeting or by striving for conversion in line with item 3/4/6. [see Shari'ah Standard No. (6) on Conversion of a Conventional Bank into an Islamic Bank]

3/4 Participation or trading (for investment and trading) in the shares of corporations whose primary activity is permissible, but they make deposits or borrow on the basis of interest

The fundamental rule is that of prohibition of acquiring shares of and transactions (investment and trading) in the shares of corporations that sometimes undertake transactions in Riba and other prohibited things even when their primary activity is permissible, but from this rule subscription and transactions (investment or trading) are exempted with the following conditions:

3/4/1 That the corporation does not state in its memorandum of association that one of its objectives is to deal in interest, or in prohibited goods or materials like pork (swine) and the like.

3/4/2 That the collective amount raised as loan on interest – whether long-term or short-term debt – does not exceed 30% of the market capitalization of the corporation, knowingly that raising loans on interest is prohibited whatsoever the amount is.

3/4/3 That the total amount of interest-taking deposits, whether short-, medium- or long-term, shall not exceed 30% of the market capitalization of total equity, knowingly that interest-taking deposits are prohibited whatsoever the collective amount is.

3/4/4 That the amount of income generated from prohibited component does not exceed 5% of the total income of the corporation irrespective of the income being generated by undertaking a prohibited activity, by ownership of a prohibited asset or in some other way. If a source of income is not properly disclosed then more effort is to be exerted for identification thereof giving due care and caution in this respect.

3/4/5 For the determination of these percentages, recourse is to be had to the last budget or verified financial position.

3/4/6 It is obligatory to eliminate prohibited income specific to the share that is mixed up with the earnings of the corporations, and this in accordance with the following:

3/4/6/1 The elimination of prohibited income is obligatory on one who is the owner of the share, whether an investor or a trader, at the end of the financial period, even if the payment is due at the time of issuance of the final financial statements whether quarterly, annual or for other period. Accordingly, elimination is not obligatory for one who sells the shares before the end of the financial period.

3/4/6/2 The subject-matter of elimination is the prohibited income specific to the share whether or not the profits have been distributed and whether or not the corporation has declared a profit or suffered a loss.

3/4/6/3 Elimination is not obligatory for the intermediary, agent or manager out of part of their commission or wages, because this is their right in lieu of the work they have undertaken.

3/4/6/4 The figure, whose elimination is obligatory on the person dealing in shares, is arrived at by dividing the total prohibited income of the corporation whose shares are traded by the number of shares of the corporation, thus, the figure specific to each share is obtained. Thereafter the result is multiplied by the number of shares owned by the dealer – individual, institution, fund or another – and the result is what is to be eliminated as an obligation.

3/4/6/5 It is not permissible to utilise the prohibited component in any way whatsoever nor is any legal fiction to be

created to do so even if this is through the payment of taxes.

3/4/6/6 The responsibility for elimination of the prohibited component of the income, for the benefit of all, falls upon the institution in case it is trading for itself or in case it is managing the operations. In the case of intermediation, however, it is bound to inform the person dealing in them of the mechanism for the elimination of the prohibited component so that he can undertake it himself. The institution may offer these services, with or without a charge, for those dealers who desire them.

3/4/7 The institution will apply the above rules whether it does so directly or through another and whether it is trading for itself or for another by way of intermediation or management of wealth, like funds, or is doing so as the agent of another.

3/4/8 It is necessary to observe these rules throughout the period of participation or trading. If the rules cannot be applied, it is obligatory to give up such investment.

3/5 It is not permissible to purchase shares by raising interest-bearing loans through a broker or another (margin sales), just as it is not permitted to mortgage the shares for such a loan. [see item 4/1/2/6 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

3/6 It is not permissible to sell shares that the seller does not own (short sale), and the promise of a broker to lend these at the time of delivery is of no consequence. [see item 4/1/2/7 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

3/7 It is permissible to the buyer of a share to undertake transactions in it by way of sale to another and the like after the completion of the formalities of the sale and the transfer of liability to him even though the final settlement in his favour has not been made.

3/8 To secure lawful interests, it is permissible to specialised official agencies to organize trading in some shares so that it cannot be undertaken except through specialised brokers or those licensed to undertake the activity. [see item 4/1/2/8 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

**3/9 It is not permissible to lend shares of corporations.**

3/10 It is permissible to mortgage shares that are lawful according to the Shari'ah, and in this respect there is no difference whether the assets of the corporation are cash, tangible assets or debts or they are a combination of cash, tangible assets and debts and irrespective of one type being predominant in them. This is to be done in conformity with the conditions for selling shares at the time of liquidation.

**3/11 The contract of Salam is not permissible in shares.**

3/12 It is not permissible to conclude futures contracts for shares. [see item 5/1 of Shari'ah Standard No. (20) on the Sale of Commodities in Organized Markets]

3/13 It is not permissible to conclude contracts of options for shares. [see item 5/2 of Shari'ah Standard No. (20) on the Sale of Commodities in Organized Markets]

3/14 It is not permitted to conclude swap contracts with respect to shares and their returns.

3/15 It is not permissible to rent shares, whether this is for pledging them or for the purpose of selling the rented shares, and returning shares similar to them, as is done in the stock-markets, or for acquiring their profits or for showing a stronger financial position of the hirer or for another reason.

3/16 It is permitted to lend shares by way of I'arah for the purpose of pledging them or for the purpose of granting their profit to the borrower as is done in stock markets. The borrower does not have the right to sell the shares except for the execution of the terms of the mortgage.

3/17 It is not permissible to undertake trading in the shares of a corporation, when the assets of the corporation are cash exclusively, whether this is during the period of subscription or after that, prior to the commencement of the business of the company or at the time of liquidation, except at their nominal value and with the condition of delivery of possession.

3/18 It is not permissible to undertake trading in the shares of a corporation if the entire assets of the corporation are composed of debts, unless the rules for dealing in debts are observed.

3/19 If the assets of a corporation are composed of tangible assets, benefits, cash and debts, the rule for trading in the shares of such a corporation will differ according to the primary asset, which conforms to the objective of the corporation and its usual activity. If its purpose and activity pertain to trading in tangible assets, benefits and rights, trading in its shares is permissible without taking into account the rules of *Sarf* or transactions in debts, with the condition that the total market value of assets, benefits and rights should not be less than 30% of the total assets value of the corporation including all assets, benefits, rights and cash liquidity (the corporation's debts, current accounts with others, and bonds it holds which constitute debts) irrespective of their size as in such a case these are secondary. If, however, the objective of the corporation and its usual activity is dealing in gold, silver or currencies (*Sirafah*), it is obligatory to undertake trading in its shares in the light of the rules of *Sarf*.

3/20 It is stipulated for the implementation of what is laid down in paragraph 3/18 that it shall not be adopted as a means for bargains in debts and trading in them by merging parts of tangible assets and benefits with the debts as a legal device for transaction in debts.

## 4. Rules for Issuance of Bonds

The issuance of all kinds of bonds is prohibited when these bonds include stipulations for the return of the amount of loan and excess in any form, whether such excess is paid at the time of the satisfaction of the principal amount of loan, is paid in monthly or yearly instalments or in another

manner and whether this excess represents a percentage of the value of the bond, as in the case with most types of bonds, or a part of it, as is the case with zero-coupon bonds. Likewise, prize bonds are also prohibited. This applies irrespective of the bonds being private, public or governmental.

**5. The Rule for Trading in Bonds**

Trading in bonds, both sale and purchase, is prohibited and so is their pledging and endorsement and so on.

**6. Shari'ah Substitute for Bonds**

The Shari'ah substitute for bonds are investment Sukuk. [see Shari'ah Standard No. (17) on Investment Sukuk]

**7. Date of Issuance of the Standard**

This Standard was issued on 30 Rabi' I, 1425 A.H., corresponding to 20 May 2004 A.D.

# Adoption of the Standard

The Shari'ah standard on Financial Paper (Shares and Bonds) was adopted by the Shari'ah Board in its meeting No. (12) held at Al-Madinah Al-Munawwarah from 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board in its meeting No. (7) held at Makkah Al-Mukarramah from 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D., decided to issue the Shari'ah standard on financial paper (Shares and Bonds).

On 25 Rajab 1423 A.H., corresponding to 2 October 2002 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant for the preparation of an exposure draft on the Shari'ah Standard on Financial Paper (Shares and Bonds).

In meeting No. (6) of the Shari'ah Standards Committee (2) held from 14-15 Muharram 1424 A.H., corresponding to 17-18 March 2003 A.D., in the Kingdom of Bahrain, the Committee discussed the Shari'ah standard and required the consultant to incorporate necessary amendments in the light of the discussion and observations of the members.

In meeting No. (7) of the Shari'ah Standards Committee (1) held from 14-15 Safar 1424 A.H., corresponding to 16-17 April 2003 A.D., in the Kingdom of Bahrain, the Committee discussed the exposure draft of the Shari'ah Standard on Financial Paper (Shares and Bonds) and made necessary amendments, just as the Committee discussed the exposure draft of the Standard in its meeting held from 25-26 Rabi' II, 1424 A.H., corresponding to 25-26 June 2003 A.D., and made necessary amendments in the light of the discussion and observations of the members.

In its meeting No. (9) held from 23-24 Jumada I, 1424 A.H., corresponding to 23-24 July 2003 A.D., at Amman, the Hashimite Kingdom of Jordan, the Committee discussed the exposure draft of the Standard and made necessary amendments in the light of the discussion and observations of the members.

The revised exposure draft of the Shari'ah standard was presented to the Shari'ah Board in its meeting No. (11) held in Makkah Al-Mukarramah from 2-8 Ramadan 1424 A.H., corresponding to 27 October - 2 November 2003 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard, and decided that it be sent to specialists and interested parties in order to obtain their comments in preparation for the discussion of the standard in a public hearing.

A public hearing was held in the Kingdom of Bahrain on 29 Dhul-Qa'dah 1424 A.H., corresponding to 21 January 2004 A.D. The public hearing was attended by more than 50 participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in the field. The members of the Shari'ah Standards Committees (1) and (2), responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committees (1) and (2) in a joint meeting in the Kingdom of Bahrain on 30 Dhul-Qa'dah 1424 A.H., corresponding to 22 January 2004 A.D., discussed the comments that were made during the public hearing as well as the observations received in writing. The Committees made amendments that were deemed suitable.

The amended exposure draft was presented to the Drafting Committee in its meeting held in the Kingdom of Bahrain on 25 Safar 1425 A.H., corresponding to 15 April 2004 A.D.

The Shari'ah Board in its meeting No. (12) held at Al-Madinah Al-Munawwarah during the period 26-30 Rabi' I, 1425 A.H., corresponding to 15-20 May 2004 A.D., discussed the amendments suggested by the Shari'ah Standards Committee and the Drafting Committee, and incorporated the amendments deemed suitable. The Shari'ah Board unanimously adopted some of the items of the standard and some items were adopted by the majority vote of the members of the Shari'ah Board, as recorded in the minutes of the meetings of the Shari'ah Board.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Issuance of Shares**

- The basis for the permissibility of the issuance of shares, when the objectives for which the corporation has been established are permissible, is the basis for the permissibility of the corporation (Sharikat al-Musahamah), which is the generality of the evidences conveying the obligation of abiding by contracts and conditions, the generality of the evidences conveying the permissibility of partnership, and the generality of the evidences conveying the permissibility of 'Inan, Mudarabah, Musaqat and Muzara'ah. 'Inan is the basis for the permissibility of participation by two or more persons with their wealth and labour, just as Mudarabah, Musaqat and Muzara'ah are the basis for the permissibility of participation with wealth from one side and labour from the other side whether the subject-matter of the contract is cash, as in the case of Mudarabah, or is tangible assets that are developed with work on these assets, as in the case of Musaqat and Muzara'ah. The evidences for all these forms are well known.
- The basis for the permissibility of underwriting the issue without compensation is that it is an undertaking that does not have a counter-value, which is the taking of compensation for it. In this regard a resolution of the International Islamic Fiqh Academy has been issued.(2)
- The basis for the impermissibility of the issuance of preference shares, that is, in other than the prescribed manner, is that this leads to the severance of participation in profit and the imposition of injustice on the other shareholders.(3)
- The basis for the impermissibility of issuing *Tamattu'* shares is that the owners of these shares claim their rights to profit and their redemption is

(2) International Islamic Fiqh Academy Resolution No. 63 (1/7) on Financial Markets.
(3) International Islamic Fiqh Academy Resolution No. 63 (1/7) on Financial Markets.

only in form as they continue to be owners of these share and are entitled to rights at the time of liquidation.

- The basis for the permissibility of share being in a person's name, at his order, or for bearer is that the Lawgiver wishes to establish rights through writing and other forms, but He has not determined a particular form for this. If -in the case of corporations- this takes place through the issuance of shares on which names of the shareholders are written then this is valid. Likewise, if this is undertaken by recording the names of the shareholders in special registers, or indexes, or in any other way, or even if the names are not recorded at all -neither on the certificates nor elsewhere- then this is permissible.

**Trading in Shares**

- The basis for the permissibility of the sale and purchase of shares of corporations, when the activity of the corporation is permissible, is that the shares are owned by the shareholder, and he has the right to undertake transactions in them as he desires whether this is by way of sale, gift or another way, especially when each one of the shareholders has been granted permission to undertake such transactions through their participation in the memorandum of the corporation and by subscribing to it.
- The basis for the permissibility of participation by one who has the ability to convert or makes an effort to convert insofar as that is a means to alter the rejected and belongs to the category of *al-Amr Bil-Ma'ruf Wa al-Nahy 'An al-Munkar* (enjoining good and forbidding evil), which is an act approved by acknowledged evidences. In this regard a jurstic opinion (Fatwa) has been issued by the Third Seminar on Financial Markets.(4)
- The basis for exempting trading in the shares of these corporations, whose primary activity is permissible, however, they deposit amounts and borrow on the basis of interest, is the application of the rule of removal of hardship and acknowledging of general need, widespread practice, the acknowledged principles of surplus, shortage and predominance,(5)as well

(4) Held in the Kingdom of Bahrain during Jumada I, 1412 A.H., corresponding to November 1991 A.D.

(5) *"Al-Furuq"* by Al-Qarafi [4: 104]; *"Al-Muwafaqat"* [1: 37]; *"Ahkam Al-Qur`an"* by Ibn Al-Arabi [4: 1804]; and *"Qawa'id Al-Ahkam Fi Masalih Al-Anam"* [1: 18, 41-45].

as the permissibility of dealing with one the major part of whose wealth is permissible,[6]along with reliance upon the issue of separation of bargains according to some Jurists.[7] This is upheld by most fatwa issuing organisations as well as the Shari'ah Supervisory Boards of Islamic banks.[8]

- The basis of the impermissibility of buying shares by raising interest-bearing loans from the broker or someone else, is the indulgence in interest and securing this through mortgage, and these are activities prohibited by the Texts along with a curse for those who charge Riba, pay it, write it down and witness it.
- The basis for the impermissibility of the sale of shares that the seller does not own is that this leads to the sale of something that is not within the liability of the seller nor in his ownership, and this is prohibited according to the Shari'ah.
- The basis for the permissibility of undertaking transactions in shares even though the final registration formalities have not been completed is the transfer of the liability for loss (*Daman*) to the buyer. This is attained through constructive possession that is granted through the transacting in what he has purchased.
- The basis for the impermissibility of lending the shares of corporations is that the share at the time of repayment-in consideration of what it represents-does not represent the same thing that it did at the time of lending due to the constant change in the assets of the corporation.
- The basis for the permissibility of mortgaging the shares of corporations is the established principle that a thing can be mortgaged if its sale is permissible. As the sale of shares is permitted, mortgaging them is also permitted. The reason is that the purpose of a mortgage is the securing of a loan and recovering it through the sale price of the asset mortgaged in case recovery is not possible from the debtor. This is what is achieved through the mortgaging of shares and is, therefore, permitted.

(6) *"Bada`i' Al-Sana`i'"* [4: 104]; *"Al-Ashbah Wa Al-Naza`ir* by Ibn Nujaym (pp. 112-114); *"Al-Bayan Wa Al-Tahsil"* [18: 194-95]; and *"Al-Manthur Fi Al-Qawa'id"* [2: 335].

(7) *"Fath al-Qadir* [6: 89-90]; *"'Iqd Al-Jawahir Al-Thaminah"* [3: 439]; *"Al-Sharh Al-Kabir Ma'a Al-Dusuqi* [3: 15]; *"Al-Rawdah"* [3: 420-25]; and *"Majmu' Al-Fatawa"* [29: 48].

(8) Among these is Al Rajhi Organization in its resolution No. 48, 23/8/1422 A.H.

- The basis for the impermissibility of Salam in shares is that the subject-matter of Salam is a debt and not an ascertained thing, while in shares of corporations nothing works except ascertainment. This is done by mentioning the name of the corporation whose shares are desired through Salam thereby rendering the shares an ascertained thing and not a liability for a debt. Shares cannot, therefore, essentially be the subject-matter of the contract of Salam. Further, Salam in shares implies the sale of ascertained things that are not owned and this is not permitted. In addition to this, the constant availability of specified shares in the market and the ability of the buyer to deliver them at the end of the period is something that cannot be guaranteed.
- The impermissibility of concluding futures contracts for shares is that these contracts imply the stipulation of delay in the delivery of an ascertained sold commodity, that is, shares, and this prohibited and not permitted. Likewise, the delay in the price and the priced commodity, for this is the sale of a debt for a debt, which is prohibited by agreement. Further, the seller -mostly- does not own the shares for which the futures contract has been concluded and is, therefore, selling something that is owned by another. This is something over which there is no disagreement among the scholars as to its impermissibility. It is also included primarily in the meaning of the Shari'ah Texts established By Prophet Muhammad (peace be upon him) that convey the prohibition of the sale of something that one does not possess. Again, most of the futures contracts are completed through a cash settlement between the parties, and this is brazen gambling if this is stipulated within the contract. If it is not stipulated in the contract, it is still one type of gambling. Thereafter, the purpose of contracts is the delivery of possession, while in futures contracts delivery of possession is not the primary purpose of the contracting parties. These contracts, thus, create an obligation for, and engage the liability of, each party for a debt that is of no benefit, except by way of Mukhatarah and for waiting for a loss that will inevitably be incurred by one party.
- The basis for the impermissibility of concluding options contracts for shares is the right of option- which is the subject-matter of options

contracts transacted in financial markets- is not included in rights that can be sold. The reason is that this right is not established at all for the seller as it is created through the contract and after its creation it is not related to wealth rather it is related to an abstract thing, that is, sale and purchase. If established rights cannot be sold when these do not relate to wealth, like the right of pre-emption, the right to custody of children, the right of Qisas, then, rights -like the right of option- cannot be permitted in the first instance. Added to this is the fact that dealing in options contracts is based on Gharar, and Gharar is prohibited, just like dealing in options contracts is based upon gambling and games of chance, equally for the buyer and the seller of a right to an option, and this occurs in cases that terminate in a cash settlement between the two parties. The contract for an option falls under the sale by a person of something that he does not own when he writes an option to buy, for he does not own the shares or commodities that he undertakes to sell; and the sale of what one does not own is prohibited according to the Shari'ah.

- The basis for the impermissibility of concluding swap contracts for the dividends of shares is that these contracts include Riba in both its forms if the contracts involve the same currency, or *Riba al-Nasi`h* alone if it involves two different currencies; the sale of a debt for a debt as it is a contract in which both counter-values are deferred; Gharar due to the uncertainty about the amount of the cash at the time of the contract; gambling, as the purpose of these contracts is the acquisition of the difference between the two average returns on the shares and it is not the delivery of possession, which is the purpose of contracts, thus, one of the parties gains and the other inevitably loses, and this is truly gambling. Each one of these prohibitions alone is sufficient to prohibit this type of contracts, then what about all of them collectively?
- The basis for the permissibility of trading in shares or corporations, which include cash assets and debts, without regard for the rules of Sarf and dealing in debts, even when such debts are more than one-half, is that in such circumstances such assets are deemed secondary, and in secondary things matters that are not normally overlooked otherwise are overlooked. If, however, the tangible assets and benefits are less than a third, it is not

permitted to deal in the shares, except by observing the rules of *Sarf* or transactions in debts, because in such a case the assets and benefits are meagre and here debts and cash cannot be deemed secondary to them, and they are the primary objective of the contract, thus, those conditions are to be stipulated for them that would be applied to them if they were desired separately.

- The basis for the permissibility of trading in shares of corporations whose assets include debts and cash, when the objective and activity of the corporation is dealing in things and benefits, without regard for the percentage of debts and cash, is as follows:

  1. The Hadith of Ibn Umar (may Allah be pleased with him) stating: "*... When a person buys a slave, who has wealth, then the wealth is for the seller, unless the buyer stipulates this too.*"(9)The Hadith is explicit on the permissibility of the sale without regard for the genus of the price. The general meaning of the Arabic term "*Mal*" in the Hadith includes all his wealth whether this is cash, debts or goods and whether this is less or more. It indicates that debts or cash, less or more, in comparison with the price of the slave are not taken into account in the Hukm, because they are in this case secondary and are not the primary purpose of the contract.

     Imam Malik relates this Hadith in Al-Muwatta` and then says: "The matter is settled unanimously in our view that if the buyer stipulates the wealth of the slave then it belongs to him, whether this is cash or debt or goods, known or unknown. This applies even if the wealth owned by the slave is more than that with which he is purchased, and irrespective of whether the price is cash debts or goods."(10)

  2. The Hadith of Ibn Umar (may Allah be pleased with him) stating: "*When a person buys a palm-grove after pollination, then the fruit is*

(9) Agreed upon by both Al-Bukhari and Muslim. The text of this Hadith belongs to Al-Bukhari: "*Sahih Al-Bukhari*", "*Kitab Al-Musaqat*", chapter: When the person has a right of way or right to water in an orchard or palm-grove (No. 2250); and "*Sahih Muslim*", "*Kitab Al-Buyu'*", chapter: When a person sells palm-grove with fruit (No. 1543).

(10) See "*Al-Muwatta'*".

*for the seller, unless the buyer stipulates this too."*[11]The Hadith conveys the permissibility of an absolute stipulation on the part of the buyer for the fruit whether or not the fruit has begun to ripen despite the prohibition of the sale of fruit before it has begun to ripen, as is found in the Hadith of Jabir (may Allah be pleased with him)saying: "The Messenger of Allah (peace be upon him) forbade the sale of fruit before it has begun to ripen."[12]As the fruit was secondary to the primary subject-matter, which was the palm-grove, it was overlooked when it would not be if it was the only subject-matter of the contract.

3. Among the established principles of Fiqh according to the scholars is that the secondary is subservient. One who examines the various issues flowing from this principle, and the cases structured upon the principle, will find that these principles as a group convey the meaning that the secondary thing will take the rule of the primary and will not be assigned a separate rule; it will come to be owned along with the ownership of the primary, and something that will not be overlooked separately will be overlooked when the thing is secondary.

   Among the cases derived from the rules are the following:

   a) The subservience of what has not begun to ripen to what has begun to ripen even when what is ripening is very little. It is stated in *"Kashshaf Al-Qina"* as follows: "The ripening of some of the fruit of a tree in a garden is its ripening, that is, of the tree as well as the ripening of all that falls in this category in a single garden. … It becomes valid with what has begun to ripen as it is subsidiary to it."[13]

   b) The sale of a house, whose roof is painted with gold, for gold, or is painted with silver for silver; the sale of a sword ornamented with gold for gold; the sale of milk for milk; or a thing made of wool for wool and so on.

(11) Agreed upon by both Al-Bukhari and Muslim. The text of this Hadith belongs to Al-Bukhari: *"Sahih Al-Bukhari"*, *"Kitab Al-Musaqat"*, chapter: When the person has a right of way or right to water in an orchard or palm-grove (No. 2250); and *"Sahih Muslim"*, *"Kitab Al-Buyu'"*, chapter: When a person sells palm-grove with fruit (No. 1543).

(12) Agreed upon by both Al-Bukhari and Muslim.

(13) *"Kashshaf Al-Qina'"* [3: 287]; see also *"Al-Mughni"* [6: 156].

**Issuance of Bonds**

- The basis for the impermissibility of issuing interest-bearing bonds is that they represent, in their customary nature, a loan and the meaning of a loan is applied to them in their nature according to the Shari'ah. As each loan that yields a benefit is Riba, and the issuance of bonds is based upon loans with interest, their issuance is prohibited according to the Shari'ah.

**Dealing in (Negotiation of) Bonds**

- The basis for the impermissibility of dealing in bonds is what has been settled with respect to their issuance due to their being based on Riba. The reason is that the word negotiation includes the meaning of continuity and the transfer of the bond from one hand to another bearing interest benefits. This means that the buyer of a bond continues to be a creditor of the issuing corporation and demands Riba for his debt. This is impermissible according to the Shari'ah, and all dealing leading to this is impermissible.

# Appendix (C)
# Definitions

**Share**

It is the share of a shareholder in the assets of the corporation and is represented by a certificate that can be negotiated. The term share is also applied to the certificate that represents such share.

**Preference Shares**

These are shares whose bearer is accorded priority over the holder of the ordinary share in the distribution of dividends and in claiming his share in the assets of the corporation at the time of liquidation.

**Tamattu' Shares**

These are shares whose holder is granted compensation for his shares that are offered for redemption during the existence of the corporation, and in exchange for this he is granted Tamattu' shares that grant him the rights that belong to the holder of shares based upon capital, except in dividends and the distribution of assets a the time of its winding up, insofar as the owner of the Tamattu' shares is given a share in the profits less than that given to the shares based upon capital, just as the owner of the Tamattu' shares does not get a share in the assets of the corporation at the time of winding up until the owners of shares based on capital are granted the value of their shares.

**Futures Contract**

It is a contract for a specified thing, or one described as deferred liability, for a deferred prince.

**Option Contract**

It is a contract for compensation for an abstract right granting the owner the right to sell a specified thing, or to buy it for a specified price, during

a determined period, or at a fixed date, either directly or through an organisation that guarantees the rights of the two parties.

**Swap Contract**

It is an agreement between two parties to exchange at a subsequent date the average return on a specified share, or a group of share for the average return on a share or for another financial asset.

**Bond**

It is a financial paper issued by trading establishments and governments in order to raise long-term loans (wealth) in lieu of interest that is paid to the bearer of the bond after periods. They are sometimes issued at a discount with respect to their face value.

## Shari'ah Standard No. (22)

# Concession Contracts

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this Standard is to indicate the rules that govern Concession Contracts for utilization of minerals, water and the likes (Utilization Concession), or construction of projects (Construction Concession), or management of government facilities and projects that provide services to the public (Management Concession). The Standard also highlights the Shari'ah adaptation of such contracts, as well as their underlying procedures, rights and duties. Moreover, it portrays application of Concession Contracts by Islamic financial Institutions (the Institution Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the basic Shari'ah rulings relating to Concession Contracts for utilization, construction or management of projects, and provides guidance to Institutions on application of such contracts. It does not cover legal or consensual concession rights, which are subsidiary rights. This standard does not cover franchises as it should be dealt with by a separate standard.

## 2. Definition of Concession

Concession in this context refers to the act of an authorized party granting another party the right of utilizing, constructing or managing a project for agreed upon consideration.

## 3. Permissibility of Concession Contracts

3/1 The concession contracts described in this Standard are permissible, as set out in the Shari'ah rulings, unless those contracts comprise an element that does not conform to the rules and principles of Islamic Shari'ah. Such contracts are considered to be among the devices that facilitate realization of public interest or the interests pursued by the two contracting parties.

3/2 There is no Shari'ah objection to taking on the procedures required to the offering of concession rights against specific fees or any compensation stipulated in the contract, unless the deal constitutes an element of Riba (usury), Gharar (uncertainty), or any other Shari'ah-banned practices.

## 4. Offering the Concession Right

When offering concession rights, due consideration should be given to justice, equality of chances, and realization of public interest.

## 5. Concession Contracts for Utilization of Minerals, Water and the Like (Utilization Concession):

### 5/1 Definition of utilization concession contracts

A Utilization Concession contract is an agreement between the State and a natural or legal person (Institution) according to which the latter becomes the sole owner of the right of extracting and producing the minerals, water or any other object in question against a specific remuneration, as is shown in item 5/3 below.

### 5/2 Formal procedures of utilization concession

5/2/1 Granting a survey license

The State has the right to require natural or legal persons to obtain permission (license) before conducting survey in a certain area against payment of a specific amount of fee or rent to the State. Such a license does not grant its holder the right of the sole surveyor in that area nor does it grant him the right to conduct works relating to extraction through mining and construction of the required facilities.

5/2/2 Granting exploration licenses

The State has the right to require natural or legal persons to obtain permission (license) before conducting exploration in a certain area for a certain period against payment of a specific amount of fee or rent to the State. Such exploration license may entitle its holder the right to become the sole explorer in that area and the right of conducting the works required for exploration.

5/2/3 Obtaining utilization concession

The exploration licensee, after discovering the minerals, water or any object in question, becomes eligible for the exclusive right of obtaining the utilization concession in the area specified in the license, unless the license stipulates otherwise.

5/2/4 If until the end of the exploration period, the holder of the exploration license (the licensee) does not discover the minerals, water or for whatever the license has been obtained then the licensee is not entitled to utilization concession at the end of that period.

5/2/5 Notwithstanding the procedural order stated in preceding paragraphs, the State may offer exploration or utilization concessions directly, and without resorting to the above-mentioned procedures.

5/2/6 When the State requests a specialized body to conduct survey or exploration on its behalf, the contractual relationship becomes subject to the rulings of "Ijarah" and "Ju'alah". In this case Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek, as well as Shari'ah Standard No. (15) on Ju'alah, should be referred to.

**5/3 Shari'ah perspective on utilization concession contracts**

Utilization of minerals, water resources and the likes cannot take place without exploration, which entails an unknown amount of effort. Whereas the remuneration to which the holder of concession is entitled, is usually a well-defined lump sum amount or percentage share of the output. The Shari'ah classifies such contracts as a form of Ju'alah, where the State is the "*Ja'il*" *(Ju'alah initiator)*, the licensee Institution is the "*'Amil*" (hired party) and the specific amount to be received by the latter is the "*Ju'l*" (compensation amount). [see Shari'ah Standard No. (15) on Ju'alah]

**5/4 Scope of utilization concession contracts**

Since utilization concession contracts are concluded between the State on the one hand and natural or legal persons on the other, the following should be observed:

5/4/1 When adopting the Fiqh viewpoint that considers minerals to be the property of the State, whether such mineral have been extracted from a State-owned or a privately-owned land,

concession contracts may be applied to all types of lands, whether State- or privately-owned.

5/4/2 When adopting the Fiqh viewpoint that gives the right of utilization of minerals to the owner of the land or its usufruct against a fee payable to the State, the following types of lands should not become subject to concession contracts:

5/4/2/1 Privately-owned lands whether vacant or built on.

5/4/2/2 Wastelands that have been contracted for development according to the relevant Shari'ah stipulations and legal rulings.

5/4/2/3 Lands allotted by the State to natural or legal persons, whether through change of ownership title or for temporary utilization.

**5/5 Requirements of obtaining the utilization concession**

A holder of a utilization concession is entitled to undertake all the activities required for utilization, such as establishing refineries and treatment laboratories, acquiring transportation devices and facilities, etc. The holder becomes the sole owner of such rights throughout the period of the concession license thereof.

**5/6 Continuity of utilization**

Concession contracts usually indicate the commitment of the licensee to continue utilization as per contract or the prevailing customary practices. In case the licensee ceases utilization without a reasonable excuse, the licensee may be given a reasonable grace period to restart again and preserve utilization, otherwise the State has the right to cancel the license thereof.

**5/7 Product pricing and purchase by the State**

5/7/1 The State has the right to determine in advance the way in which the licensee should dispose of his share of the extracted products and the value to be paid to him taking into account public interest

5/7/2 In addition to its own share in the product, the State has also the preemptory right of purchasing the quantities it needs from the output, according to the prevailing prices and contractual terms.

**5/8 Expiry of utilization concession contracts**

A utilization concession contract expires at the end of its specified period, or when the two parties agree to prematurely cancel it. The contract can also be cancelled when there remains no more output to be utilized. Moreover, each of the two parties has the right to revoke the contract when the other party breaches a contractual condition or commitment. In this case the breaching party has to compensate the other party for any consequent actual damages.

**6. Concession Contracts for Construction of Projects (Construction Concession)**

**6/1 Definition and forms of a construction concession contract**

6/1/1 Definition of a construction concession contract

A Construction concession contract is a contract between the State and another party according to which the latter constructs a specifically defined project usually related to public utilities.

6/1/2 Forms of construction concession contracts:

Construction concession contracts may take several forms including the following:

6/1/2/1 When the licensee constructs the project according to certain specifications, on a piece of land owned by the State, and the State becomes the owner of the project, while the licensee is entitled to the usufruct of the project for a specific period. After this period, the ownership of the usufruct is transferred to the State.

6/1/2/2 When the licensee constructs the project according to certain specifications on a piece of land owned by the State, and the project and its usufructs become

the property of the licensee for a specific period after which the ownership of the project (and its usufruct) goes to the State.

6/1/2/3 When the licensee constructs the project according to certain specifications on a piece of land owned by the State, and the project becomes a property of the State, while the two parties agree to share the revenue for a specific period after which the project belongs to the licensee.

6/1/3 In all three cases set out in 6/1/2, the licensee becomes entitled to collection of fees or rent for provision of services to the public.

**6/2 Shari'ah perspective on construction concession contracts:**

Construction concession contracts vary with regard to their Shari'ah adaptation, according to the following conditions:

6/2/1 If the commitment of the licensee includes construction works as well as provision of materials, which is the predominant case, the contract is that of "Istisna'a". The value of the contract is the right which enables the licensee to utilize the project for one's own benefit for a specific period before handing it over to the State.

6/2/2 If the project is constructed on a piece of land that the licensee obtained on lease from the State against handing over the project thereto after a specific period, the contract is that of "Ijarah" and the rent is the project itself which will be handed over to the State at the end of the contractual period.

**6/3 Remuneration for construction concession contracts**

6/3/1 When the remuneration for construction of the project is determined in terms of the right to utilize the project for a specific period, the contract is considered as "Istisna'a" against a price determinable in terms of utilizing the constructed facility for a specific period before handing it over to "al-Mustasni'".

6/3/2 If the remuneration for the construction of a project is determined in terms of a certain amount of money, the licensee retains the ownership of the project to ascertain one's right to get the price through utilization of the project. Licensee has also the right of arranging a clearance deal with the licensor so that the licensee can receive the full price and hand over the project to the licensor before the end of the contract period. Otherwise, the licensee keeps on utilizing the project until the receipt of the full amount agreed upon.

## 7. Application of Utilization Concession Contracts by Institutions

Institutions can apply utilization concession contracts either through direct relationship with the State, or by playing an intermediary role in the contract between the State and the licensee. Application of such contracts may take place in one of the following forms:

### 7/1 Ju'alah

It is possible to apply Ju'alah or Parallel Ju'alah where the licensee receives a specific share of the output as remuneration.

### 7/2 Ijarah

Ijarah contract may be applied where the State gives the land on lease to the licensee for a rent payable as a predetermined share of the output. The licensee may, in turn, give the land on lease to a third party to establish the project thereon (sub-contracting).

### 7/3 Mudarabah

Mudarabah may be applied where the State provides the land to the licensee to utilize it on the basis of a predetermined rate of profit sharing. The Institutions may either implement the project directly or through two-steps Mudarabah.

### 7/4 Musharakah

In utilization concession contracts, Musharakah - whether fixed or diminishing - may be applied as follows:

7/4/1 In fixed Musharakah, the Institution contributes a share in the required capital besides the State or the party that executes the

concession license, and the Musharakah continues up to the end of the contract's period.

7/4/2 In diminishing Musharakah, the Institution contributes a share in the required capital, and undertakes (the Institution or the party that executes the concession license) to sell its share in the project gradually to the State.

## 8. Application of Construction Concession Contracts by Institutions

Institutions may apply construction concession contracts whether through direct relationship with the State, or by entering as an intermediary party in the contract between the State and the licensee. Application of such contracts may take place in one of the following forms:

### 8/1 Ijarah and Ijarah Muntahia Bittamleek

In this case, the licensee hires the land from the State with the aim of constructing the project thereon and presenting the project back to the State based on Ijarah Muntahia Bittamleek. The licensee may, use a sub-contract of operating or diminishing Ijarah, to rent out the land to another party to construct the project thereon.

### 8/2 Istisna'a

Istisna'a and Parallel Istisna'a contracts may be applied where the State is "al-Mustasni"" and the Institution becomes "al-Sani' (the licensee is a parallel Mustasni')" and the price of the product is the income generated from the fee or rent collected from the public for provision of the services.

### 8/3 Musharakah

In construction concession contracts Musharakah, whether fixed or diminishing, may be applied as follows:

8/3/1 In fixed Musharakah, the Institution contributes a share in the required capital besides the State or the party that executes the concession license, and the Musharakah continues up to the end of the contract's period.

8/3/2 In diminishing Musharakah, the Institution contributes a share in the required capital, and undertakes (the Institution or the party that executes the concession license) to sell its share in the project gradually to the State.

## 9. Disposing of the Concession License

Since the concession license is a financial right, its owner may dispose it of through selling, leasing, mortgaging, partnership or securitization according to Shari'ah rulings, as well as the conditions imposed by the licensor.

## 10. Management Concession Contracts

### 10/1 Definition of management concession contracts

These are contracts between the State and other parties according to which the right of managing public utilities and providing services to the public is given against a specific price.

### 10/2 Shari'ah perspective on management concession contracts

10/2/1 When the price for offering management concession is determined as a lump sum amount of money or a percentage of total income, the contract between the State and the licensee is that of Ijarah. The licensor in this case has the right to receive rent for offering the concession license, in addition to the amount/percentage of income the licensor deserves during the period of the contract. If the price of the management concession is a percentage of the profit (net income after expenses and allocations), the contract between the State and the licensee becomes Mudarabah wherein the capital is the original facility or the project itself.

10/2/2 In both cases mentioned in item (10/2/1) above, the contract between the State and the project's utilizer is either that of Ijarah or *Bay'* (sale) contract, as per the nature of the activity in question.

**10/3 Cancellation of the management concession contract**

Management concession contract is a fixed-term contract. It may be rescinded by the State when the licensee breaches a condition or fails to meet one's contractual obligations. The licensee may also rescind the contract on condition that the licensee takes the measures that ascertain the provision of the services to the public.

**10/4 Pricing of services**

It is permissible for the licensor to fix or adjust the price of the services to be delivered by the licensee in a way that leads to establishing justice and preservation of the interests of both the licensee and the beneficiaries.

**10/5 Observation of the contract's conditions**

The licensor has the right to perform (directly or through deputation) monitoring and inspection to ascertain observation of the conditions and specifications stipulated in the contract. It has also the right to impose penalties stipulated in the contract, in case of breach of contractual obligations on the part of the licensee.

## 11. Date of Issuance of the Standard

This Standard was issued on 22 Rabi' I, 1426 A.H., corresponding to 2 May 2005 A.D.

# Adoption of the Standard

The Shari'ah Board has adopted the Standard on Concession Contracts in its meeting No. (14) held in Dubai on 21–22 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (7) held on 9–13 Ramadan 1422 A.H., corresponding to 24–28 November 2001 A.D., in Makkah Al -Mukarramah to issue a Shari'ah Standard on Concession Contracts.

On 12 Jumada I 1423 A.H., corresponding to 22 July 2002 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare a draft standard on concession contracts.

In its meeting No. (5) the Shari'ah Standards Committee (2) held on 1 Rajab 1423 A.H., corresponding to 8 September 2002 A.D., in the Kingdom of Bahrain, the committee discussed the Shari'ah study and advised the consultant to introduce the necessary amendments, in light of the discussions and observations of its members.

In the joint meeting of the Shari'ah Standards Committees (1) and (2) on 21 January 2004 A.D., held for discussing the observations made in the public hearing that had been convened on the same day in the Kingdom of Bahrain, the committee discussed the draft standard on concession contracts and introduced necessary changes. The committee also requested the consultant to review the document in light of the discussion and comments of its members.

The committee once again discussed the draft standard in its meeting in Dubai on 28 Rabi' I, 1425 A.H., corresponding to 16 June 2004 A.D., and made further changes therein.

The revised draft of the standard was then submitted to the Shari'ah Board in its meeting No. (3) held in Makkah Al-Mukarramah on 26-30 Sha'ban 1425 A.H., corresponding to 10–14 October 2004 A.D. The Board

made some changes on the document and decided to present it to some experts for their comments before discussing it later in the public hearing.

A public hearing was held in the Kingdom of Bahrain on 15 Safar 1426 A.H., corresponding to 25 March 2005 A.D. and attended by more than 35 participants representing central banks, Institutions, accounting firms, Shari'ah scholars academics and other concerned parties. Several comments were made before and after the public hearing. Some members of the Shari'ah Standards Committees (1) and (2) responded to the queries raised during the session.

In the meeting of the Shari'ah Standards Committees (1) and (2), held in the Kingdom of Bahrain on 15-16 Safar 1426 A.H., corresponding to 25-26 March 2005 A.D., the comments made during the public hearing were discussed and some appropriate changes were made.

The Shari'ah Board convened its meeting No. (14) on 21–23 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D., in Dubai (U. A. E) and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Concession for Utilization of Minerals**

- The right of the State to regulate survey or exploration of minerals, water and the like by offering exclusive rights of utilization, stems from the fact that such an act by the State leads to realization of public interest and prevention of disputes. This reasoning is adopted by the fuqhaa who argue that development of wasteland requires State permission. The basic assumption here, knowingly, is that when the State disposes of public property, its act is supposed to be that of serving the cause of public interest, which should always surpass private interest.
- The distinction between survey on the one hand, and exploration and concession on the other, and the fact that only the latter two can enable the licensee to have the exclusive status as a contractor, stems from the fact that survey is based on mere expectation, while exploration is like *Tahjir* (retention) in wasteland development, which usually precedes utilization. Thus, offering the exclusive right to the explorer can be based on the saying of the Prophet (peace be upon him): *"Whom who develops a piece of wasteland shall become its owner."*(2)
- The ruling that gives the one who discovers the minerals the priority in utilizing them is extracted from the fact that exploration resembles wasteland development, which entitles to ownership of the developed land.
- The alternate viewpoint of the Maliki School, which considers minerals as the property of *Bayt al-Mal* (treasury) even when discovered in a private land, leans towards the fact that no body, the landlord included, can claim the honor of bringing these minerals into being. Putting the mi-

(2) This Hadith has been Related by Al-Bukhari in his *"Sahih"* [3: 139], Al-Shaab Publications, 1378 A.H.

nerals at the disposal of the State, therefore, does not leave any room for dispute between the property owner and the one who discovers the minerals.

- The viewpoint of the majority of the Fuqaha, including the Maliki School, that the minerals are the property of the landowner, focuses on their perspective that deems land ownership as underground resources. Moreover, the fact that the *Kharaj* imposed on land is one fifth indicates that the remaining four fifths are the property of the landowner.
- Eligibility of the holder of the concession for utilization of minerals to other rights pertaining to production and transportation devices is due to the fact that such rights constitute the complementary requirements. This reasoning also holds true for eligibility of the licensee to the easement rights pertinent to one's license.
- The condition that the licensee should sustain the activity in question originates from the Shari'ah ruling on the case of a person who retains a piece of wasteland for a period of time without developing it. In this connection it has been narrated that Caliphate Umar Ibn Al-Khattab said: "When somebody develops a piece of wasteland that had been left for three years undeveloped by its original owner, the land becomes the property of the developer"(3)
- Eligibility of the State to purchase the quantity it requires from the output of the project is justifiable by the need to realize public interest without harming the licensee, since purchasing takes place according to the procedures and conditions available to other clients. With regard to the right of the State to fix the price of the product, the justification is hinged on the need to prevent social injury that could result from charging unduly high prices by licensee.
- The State is given the right of amending concession contracts for minerals when necessary, because the acts of the State are normally considered to be in pursuance of public interest, which should always surpass private interest.

(3) Related by Abu Yusuf in *"Al-Kharaj"* (P. 61), Dar Al-Ma'arif edition. Al-Hafiz said in *"Al-Dirayah"* that this Hadith has been narrated by reliable people.

**Concession for Construction of Projects**

- Project construction contracts are permissible because they come under commitments that should be honored by virtue of the divine ordain of Allah, Exalted be He, Who says: ***{"fulfill (all) obligations"}***[4] and also the Hadith of the Prophet (peace be upon him): *"Muslims honor all their obligations except those which permit prohibited deeds or prohibit permitted deeds"*[5]
- Permissibility of remunerating the licensee by allowing him to benefit from the project before handing it over to the licensor, relates to the fact that in Istisna'a, temporary benefiting from the product may constitute the price of its production. That is to say, the price can be either money or usufruct including that of the product in question. This viewpoint has been confirmed by a similar resolution of the Al Baraka Seminar.[6] The other viewpoint referred to in this Standard is that the price should be fixed first, and then the licensee is given the chance to utilize the project until he gets the remuneration agreed upon, regardless of any specific period of time. The basis for this viewpoint is that a predetermined period may not be sufficient for getting the full price. This viewpoint, therefore, seems to visualize the relationship between the State and the Institution as a management relationship, as well as a clearance arrangement with regard to the price to be paid and the period of utilization.
- Permissibility for Institutions to enter into concession contracts with the State directly or as intermediaries is clear because they do this in a permissible contractual form such as Ju'alah, Mudarabah, Musharakah, Istisna'a and Ijarah. All these contractual forms are permissible whether performed directly or though entering as an intermediary between the State and the other original party to the contract.

(4) [Al-Ma`idah (The Table): 1]

(5) Narrated by several companions of the Prophet (peace be upon him) and quoted by: Ahmad [1: 312], Ibn Majah [2: 784], Mustafa Al-Babi Al-Halabi, Cairo, 1372 A.H./1952 A.D.); Al-Hakim (Hyderabad Publications, India, 1355 A.H.); Al-Bayhaqi [6: 70 and 156], [10: 133], Hayderabad Publications, India, 1355 A.H.); Al-Daraqatni [4: 228], [3: 77], Dar Al-Mahasin, Cairo, 1372 A.H./ 1952 A.D.).

(6) Resolutions and Recommendations of the 17th Seminar of Al Baraka, Resolution No. 13/2, (P. 220).

**Management Contracts**

- Permissibility for the State to offer concession licenses for management of public utilities is justified by the fact that the State has the right of regulating such facilities and collecting fees, and therefore it can transfer this right to a second party. The management contract in this case is Ijarah and the government has the right of identifying the lessee on the ground of common interest.
- Permissibility of fixing the contract's value in terms of money is that the deal is considered as Ijarah, and determination of the contract's value as a specific share of the project's income could embody uncertainty (*Jahalah*) pertaining to the possibility of realizing the agreed upon amount during the contract's period. The relationship between the State and the licensee, in this sense, is considered as an Ijarah deal. If such relationship is considered as Mudarabah, the basis for determination of the contract's value will become a given share of the project's profit, which can be determined only after preservation of the project's capital, which is the managed asset in this case. The Hanbalis permit Mudarabah on income-generating assets like animals. The reason behind the justification for sharing the net profit after allocations is the preservation of the project's capital.
- Permissibility for licensor to rescind the contract when the other party breaches a condition or fails to fulfill an obligation is derived from the commitment of Muslims to honor contractual obligations according to the Hadith of the Prophet (peace be upon him) stating: *"Muslims shall honor their obligations"*(7)

(7) Narrated by several companions of the Prophet (peace be upon him) and quoted by: Ahmad [1: 312], Ibn Majah [2: 784], Mustafa Al-Babi Al-Halabi, Cairo, 1372 A.H./1952 A.D.); Al-Hakim (Hyderabad Publications, India, 1355 A.H.); Al-Daraqatni [4: 228] and [3: 77], Dar Al-Mahasin, Cairo, 1372 A.H./ 1952 A.D.).

Shari'ah Standard No. (23)

# Agency and the Act of an Uncommissioned Agent (Fodooli)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this Standard is to clarify the Shari'ah rulings that govern the activities of Islamic financial Institutions (Institution/Institutions)[1] in appointing agents or becoming agents of others, whether in arranging contracts and disposing of property, or undertaking procedural tasks, or managing/investing funds. The Standard also indicates the underlying conditions of Agency, elaborates on its various forms, spells out its repercussions, and outlines the responsibilities of both the Principal and the Agent. Moreover, the Standard aims to embark upon the Act of an Uncommissioned Agent "Fodooli" and the Shari'ah rulings thereon.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers agency and the acts of an uncommissioned agent in concluding contracts on financial transactions (such as sale, Ijarah and compensatory reconciliation), disposing of assets, providing services and conducting practical acts such as receipt, payment and delivery. The Standard also covers areas such as fund management, real estate and investment agency. However, it does not cover agency and the act of an uncommissioned agent in several other affairs of life such as worshipping (like Zakah, for which there is a separate standard), personal affairs, penalty affairs, legal prosecution/advocacy, and documentary credits (which have also been dealt with in a separate standard).

## 2. Agency

### 2/1 Definition, permissibility and characteristics of agency

2/1/1 Agency is the act of one party delegating the other to act on its behalf in what can be a subject matter of delegation and it is, thus, permissible.

2/1/2 Agency is, basically, a non-binding contract for both the parties thereto. However, it may sometimes become a binding contract. [see 3/4 below]

### 2/2 Basic elements of agency

2/2/1 The basic elements of agency include the form, the subject matter of agency, and the two parties to the contract (the principal and the agent).

2/2/2 The form of agency comprises any act that customary practices traditionally consider a delegation of the right to acting by someone on behalf the other. Such delegation comprises of

offer and acceptance which has no standard form of wording and may be expressed through utterance of words, writing, messaging or gesture. In accepting non-paid agency, silence is also considered as sufficient acceptance, while a negative response is indicative of rejection of agency.

2/2/3 Agency may take place in any of the following forms:

2/2/3/1 Immediate Agency, as usually the case, where the contract becomes effective as soon as it is entered into.

2/2/3/2 Conditional Agency: where the validity of the contract is made subject to fulfillment of a certain condition, for instance when a debtor agrees to put his own assets under the management of his creditor in case of default.

2/2/3/3 Future Agency: where the contract becomes valid only at a specific date in the future.

2/2/3/4 Agency, whether free or limited, shall be subject to specific conditions. In case of free agency, consideration should be given to customary practices, interest and the state of the principal.

2/2/4 While conditionality and limitation may be resorted to in concluding agency contracts, they may also be confined to the disposal of the subject matter of agency. In this case, though the agency contract is immediately effective, disposal is made subject to the fulfillment of a specific condition, such as resorting back to the principal before disposal. The conditions set by the principal should be observed such as offering him a guarantee or lien.

2/2/5 The subject matter of agency is for what the contract is entered into. [see item 3/3]

2/2/6 The two parties to the contract are the principal and the agent. [see items 3/1 and 3/2]

## 3. Conditions on the Agency Parties

### 3/1 Conditions on the principal

3/1/1 The principal should possess legal capacity to enter into contract.

3/1/2 The principal should have the right to dispose of the asset in question. Agency, therefore, is not acceptable from a legally incapable person like a lunatic or an indiscriminating minor. A partially capable person, such as a discriminating minor, may appoint an agent for matters that result in absolute benefit to him, such as accepting donations from others, but he cannot appoint an gent in harmful matters like making donations. In acts that may be harmful or useful, such as buying and selling, a partially capable person may appoint an agent, but the acts of that agent remain pending the approval of the principal's guardian or whosoever enjoys the similar right on behalf of the principal.

### 3/2 Conditions on the agent

3/2/1 The agent should have full legal capacity, because a lunatic or an indiscriminating minor cannot become an agent. A discriminating minor may become an agent, provided that all the contractual commitments are the sole responsibility of principal.

3/2/2 The agent should be aware of his status as an agent. When somebody acted on behalf of another and later on, the former comes to know that he is an agent of the latter, the preceding act does not fall under the agency contract. If, however, he does so with the intention of performing the act regardless of agency, the case should be subjected to the rules governing the act of an uncommissioned agent (*Fodooli*). [see item 8]

### 3/3 Conditions on the subject matter of agency

3/3/1 The subject matter of agency should be known to the agent. However, minor *Jahalah* (unknowability) that does not lead to

dispute, or temporary uncertainty, may be dispensed with. It can also be overlooked when, in absolute agency, the principal authorizes the agent to channel the funds in any form of investment. Nevertheless, the agent should observe the interest of the principal, as well as the norms and customary practices if necessary.

3/3/2 It should be owned by the principal, or he has the right of deposing thereof.

3/3/3 It should be something that can be disposed of through agency. This includes all types of financial contracts and dealings that a person can perform personally. Any contract that a person is permitted by Shari'ah to be involved in personally can be performed through agency.

It should not involve a Shari'ah-banned practice, like trading in impermissible commodities or committing usurious lending.

## 4. Types of Agency

**4/1 Agency may take the following forms:**

4/1/1 Specific versus general agency. General agency includes all methods of disposing of assets provided that the interest of the principal and the customary practices are well observed. Disposal of assets here does not include making donations, unless the principal authorizes the agent to do so.

4/1/2 Limited versus absolute agency. Absolute agency is bound by customary practices and the interest of the principal. It is not permissible in absolute agency to sell at less or buy at more than the market price, nor is it permissible to perform barter and deferred payment sales, except with the prior consent of principal.

4/1/3 Paid versus non-paid agency. [see item 4/2]

4/1/4 Binding versus non-binding agency. [see item 4/3]

4/1/5 Temporary versus continuous agency. [see item 4/4]

## 4/2 Paid agency

4/2/1 Paid agency is permissible in Shari'ah, whether remuneration is explicitly stipulated in the contract or ascertained in accordance with the customary practices, as when the agent doses provide such service except for remuneration.

4/2/2 When agency is paid, it falls under the Shari'ah rulings on Ijarah. [see item 4/3]

4/2/3 The amount payable as remuneration for agency should be known, whether in lump sum or as a share of a specific amount of income. It may also be defined in terms of an amount of income to be known in the future, as when remuneration is linked to an indicator that may be quoted at the beginnings of different intervals of time. However, it is not permissible to leave remuneration for agency undetermined and allow the agent to take an unspecified share from the entitlements of the principal.

4/2/4 When remuneration for agency is not specified, it may be measured in terms of the prevailing market rate for similar effort.

4/2/5 Remuneration for agency may be any gain in excess of a specific amount of output of the operation, or a share of the output.

4/2/6 A certain share of the output may be added to the specific remuneration of the agent, as a motivation.

4/2/7 When the agent, for no reasonable excuse, refrains from carrying on agency that he has been paid for, and the work he has done was beneficial, he becomes entitled to the remuneration commensurate with the part of work done, and within the limits of the contract value for that part of work. The agent in this case is bound to indemnify the principal for any actual loss resulting from his refusal to continue the work.

When the principal, for no reasonable excuse, forces the agent to discontinue the work before the end of the agency period,

the agent becomes entitled to the full remuneration agreed upon.

When the principal, for a valid reason, forces the agent to discontinue the work before the end of the contract, the agent becomes entitled to remuneration for that part of work he has already performed.

4/2/8 Damage of the subject matter of agency does not relieve the principal from paying remuneration to the agent for the part of the work the latter has already performed. When the damage occurs because of misconduct or negligence of the agent, he is bound to indemnify the principal for it.

**4/3 Binding agency**

Agency is, basically, not binding, because each of the two parties has the right to revoke the contract without denying its effects that may continue after revocation. However, agency becomes binding in the following cases:

4/3/1 When it involves rights of others, as when the mortgagor appoints the mortgagee as an agent, or when the mortgagor is authorized to seize the mortgaged asset or sell it on maturity. Agency in the latter case is binding to the mortgagor (the debtor). A further example of binding agency is a case when the owner of an income-generating asset assigns the collection of his entitlements to an agent manager.

4/3/2 When agency is a paid agency. [see item 4/2]

4/3/3 When the agent commences tasks that cannot be discontinued or phased out without causing injury to him or to the principal. Agency in this case remains binding until it is possible to suspend the work, or phase it out without causing injury to any of the two parties.

4/3/4 When the principal or the agent undertakes not to revoke the contract within a certain period.

### 4/4 Temporary agency

4/4/1 Basically, agency has no time limit beyond which the contract becomes no longer valid, because the agent can be terminated at any time. The two parties, however, may agree on a certain period after which the agency becomes invalid without a request from any of them to revoke the contract.

4/4/2 The effect of specification of a time limit for agency is confined to restrain the agent from commencing new operations subsequently.

4/4/3 Unless the contract stipulates otherwise, the agent may commence new operations during the contract period even if the effects of such operations will succeed the period of the contract.

## 5. Commitments of the Principal and the Agent

### 5/1 Commitments of the principal

5/1/1 In contract of procurement agency, the price and other expenses should be borne by the principal. Besides the price of purchased commodity, the principal should reimburse the agent expenses such as those of transportation, storage, taxation, maintenance and insurance. In paid agency, such expenses should not be stated in the contract as payable by the agent now or in the future.

5/1/2 In paid agency, the principal should pay the agent the amount of remuneration agreed upon in the contract. [see item 4/2]

### 5/2 Commitments of the agent

The agent is considered as a trustee in holding the asset in question, and therefore, he is not bound to indemnify the principal for that asset in case of damage. He shall be held responsible for indemnity only when the damage results from his own misconduct, negligence or breach of terms or stipulations of the contract. Breach of contract for this purpose does not include acts that serve the interest of the

principal, like selling at a higher or buying at a lower price. In this regard, Shari'ah Standard No. (5) on Guarantees indicates under item 2/2/2 the following:

"It is not permissible to combine agency and personal guarantees in one contract at the same time (i.e. the same party acting in the capacity of an agent on one hand and acting as a guarantor on the other hand), because such a combination conflicts with the nature of these contracts. In addition, a guarantee given by a party acting as an agent in respect of an investment turns the transaction into an interest-based loan, since the capital of the investment is guaranteed in addition to the proceeds of the investment, (i.e. as though the investment agent had taken a loan and repaid it with an additional sum which is tantamount to Riba). But if a guarantee is not stipulated in the agency contract and the agent voluntarily provides a guarantee to his principals independently of the agency contract, the agent becomes a guarantor in a different capacity from that of agent. In this case, such an agent will remain liable as guarantor even if he is discharged from acting as agent".

## 6. Stipulations on the Agent

### 6/1 Performing deals with one's self and relatives

6/1/1 When an agent conducts deals with his ascendant or descendant relatives, who are neither under his guardianship, nor are the agent's spouse, the deal is permissible unless it encompasses injustice or favoritism. In case of deals that involve relatives who are under the guardianship of the agent, or deals that involve the agent's spouse, the agent should obtain the consent of the principal.

6/1/2 An agent should not conduct deals with his own self or with his son/daughter who is still under his guardianship, or with his partner (*Sharik*) in the same contract.

6/1/3 The agent should not act for both parties to the contract.

6/1/4 An agent may purchase what he has bought for the principal, by way of offer and acceptance. The deal should be concluded

in such a way that the guarantees stemming from the agency contract and the sale contract are kept separate. After the completion of the conclusion of the sale contract, the commodity becomes under the guarantee of the purchaser/agent. [see Shari'ah Standard No. (8) on Murabahah – item 3/1/5]

**6/2 Monitoring of the provisions and rights of the contract**

Monitoring the provisions of contract is the responsibility of principal, whereas monitoring the activities stipulated in the contract (except donations that should be assigned to the principal) is the responsibility of agent. Nevertheless, the principal, by virtue of ownership, may pursue the agent's activities.

**6/3 Breach of contract stipulations**

6/3/1 When the agent breaches the contract in a way that does not serve the interest of the principal, the latter is free to maintain the contract or declare it invalid. Breach of the contract on the part of the agent may relate to the subject matter of agency or part thereof, the price, on spot or deferred payment, possession (purchase), or transfer of ownership (sale). [see items (8) and 5/2]

6/3/2 When the agent breaches the contract by purchasing at a price that exceeds both the market price and the price set forth by the principal, he should compensate the principal for the difference between the purchase price and the market price. Similarly, if the breach is by selling at less than the price specified by the principal, compensation should be for the difference between the selling price and the market price. Hence, the case here is similar to what happens in Mudarabah or investment agency whereby selling is stipulated to take place for a profit not less than a specified proportion. And hence, the agent (or the Mudarib) doesn't guarantee that proportion, but his guarantee is limited to any amount less than the price of a similar fungible good.

**6/4 Appointing a sub-agent**

The agent has no right to appoint a sub-agent except with the permission of the principal. Once a sub-agent is appointed, his termination does not spontaneously follow the termination of the first agent, but the principal can terminate him.

**6/5 Appointing more than one agent**

When more than one agent are appointed in the same contract, none of them should become the sole decision-maker unless with the authorization of principal. If they have been appointed by separate contracts, each of them has the right to discharge their responsibilities independently, unless the principal requires joint action from them.

**7. Expiry of Agency**

**7/1 The agency contract expires in the following cases:**

7/1/1 The contract expires when the principal or the agent dies or loses legal capacity or when the Institution undergoes bankruptcy or liquidation.

7/1/2 When the principal terminates the agent or the latter resigns. In case of termination, the principal has to inform the agent [see item 4/2/7], for compensation of loss resulting from refusal by the agent to continue the work, or forced discontinuation of work imposed by the principal before the expiration of contract or agency term, in regard to the consequent remuneration or damage compensation.

7/1/3 When the agent completes the work assigned to him in fixed-task agency or the principal performs the task in question.

7/1/4 When the principal no longer owns the asset in question or the principal has lost the right of disposing thereof. Agency also expires if the principal has performed the work, or the subject matter of agency no longer exists.

7/1/5 At the occurrence of the incidence that has been stipulated for ipso facto expiry of the agency.

7/1/6 At the expiry of the contract term in temporary agency. In this case, the contract may be extended to the required term when necessary. [see item 4/3]

7/2 Interminable agency remains effective even after the death of the principal or liquidation of the Institution. It continues up to the end of the subject matter of agency.

**8. Act of an Uncommissioned Agent (Fodooli)**

8/1 An uncommissioned agent (Fodooli) is a person who discharges (in the absence of any need or urgency) the affairs of others without being an agent or having a right to do so by virtue of Shari'ah. The deal becomes subject to the rulings on the Fodooli, even when the acts of a real owner makes him appear an agent.

8/2 The approval or denial of a contract concluded by an uncommissioned agent is subject to the discretion of the owner. Approval of such contract by the owner should also precede revocation of the contract by either of the two parties; otherwise, a new contract has to be initiated. If the owner of the property does not approve the act of the uncommissioned agent, the act becomes binding to the latter, if he did not declare at the time of signing the contract that he had no authority.

8/3 The rulings on the uncommissioned agent are applicable to all financial contracts, including compensatory contracts like sale, purchase, rent and hiring contracts, donations by way of gift, and investment agency contracts.

8/4 When the owner of the asset approves the act of the uncommissioned agent, the contract becomes effective, and subject to all rulings on agency. The approval shall be retroactively effective, based on the date of such an act.

**9. Date of Issuance of the Standard**

This Standard was issued on 23 Rabi' I, 1426 A.H., corresponding to 30 April 2005 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Shari'ah Standard on Agency and the Act of An Uncommissioned Agent in its meeting No. (14) held in Dubai on 21 – 22 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (10), held on 2–7 Rabi' I, 1424 A.H., corresponding to 3–8 May 2001 A.D., in Al-Madinah Al-Munawwarah to issue a Shari'ah Standard on Agency and the Act of Uncommissioned Agent.

On 17 Sha'ban 1423 A.H., corresponding to 13 October 2002 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare a draft standard on Agency and the Act of Uncommissioned Agent.

In its meeting No. (10) held on Friday and Saturday 26-27 Safar 1425 A.H., corrsponding to 16-17 April 2004A.D., in the Kingdom Of Bahrain, the Shari'ah Standards Committee (2) discussed the Shari'ah study and advised the consultant to make necessary changes in light of the discussions and observations of its members.

In its meeting No. (11) held on Wednesday 28 Rabi' II, 1425 A.H., corrsponding to 16 June 2004 A.D., in Dubai (U.A.E), the Shari'ah Standards Committee (2) discussed the draft Standard on Agency and the Act of Uncommissioned Agent (Fodooli) and introduced some changes thereto in light of the discussions and observations of the members.

Once again, the committee discussed the draft standard in its meeting held on 24–25 Rajab 1425 A.H., corresponding to 9-10 September 2004 A.D., and made further changes in light of the discussions and observations of its members.

The revised draft of the standard was then submitted to the Shari'ah Board in its meeting No. (13) held in Makkah Al-Mukarramah on 26-30

Sha'ban 1425 A.H., corresponding to 10–14 October 2004 A.D. The Board made some changes in the document and decided to send the amended document to a number of experts for their comments before discussing it in a public hearing.

A public hearing was held in the Kingdom of Bahrain on 15 Safar 1426 A.H., cooresponding to 25 March 2005 A.D., and attended by more than 35 participants representing central banks, financial Institutions, accounting firms, Shari'ah scholars, academics and other concerned parties. Several comments were made before and after the public hearing. Some members of the Shari'ah Standards Committees (1) and (2) responded to the quires made during the session.

In the meeting of the Shari'ah Standards Committees (1) and (2), held in the Kingdom of Bahrain on 15-16 Safar 1426 A.H., corresponding to 25-26 March 2005 A.D., the comments made during the public hearing were discussed and some changes were made to the document.

The Shari'ah Board convened its meeting No. (14) on 21–23 Rabi' I, 1426 A.H., corresponding to 30 April - 2 May 2005 A.D., held in Dubai (U.A.E) and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Permissibility of agency by Shari'ah is demonstrated in the noble Qur`an, where Allah, Exalted be He, says: ***{"...So send one of you with this silver coin of yours to the town, and let him find out which is the good lawful food..."}.***(2) Similitude of this incidence to agency is that the one who was sent to the town to buy the food was the agent of the others.(3) In Sunnah, a Hadith was narrated by Urwah Al-Bariqi (may Allah be pleased with him) who said that the Prophet (peace be upon him) had given him one dinar to purchase a sacrificial sheep for the Prophet,(4) an incidence that involves agency. As regards to Ijma' (consensus of Fuqaha), the author of the *"Al-Bahr Al-Zakhkhar"* and others have demonstrated permissibility of agency. Also, in common sense agency is well demonstrated in terms of the help of others that one may sometimes need, especially for things that he cannot do himself.(5)
- Permissibility of initiating agency in any wording which indicates initiation thereof is based on the fiqh principle that "What matters in contracts are intentions and meanings rather than wording and constructions". Therefore, whatever indicates delegation, which is the essence of agency, is acceptable for initiating the contract. The underlying reason for consideration of silence as acceptance in case of non-paid agency is that acceptance in this case is considered to have been given implicitly(6). Effectiveness of the agency contract can be linked to fulfillment of a certain condition or to a future date because agency is delegation of power rather than an act of ownership

(2) [Al-Kahf (The Cave): 19].
(3) Related by Al-Bukhari, Abu Dawud and Al-Tirmidhi: *"Al-Talkhis Al-Habir"* [3: 304].
(4) *"Nayl Al-Awtar"* [5: 352]; *"Fath Al-Qadir"* by Ibn Al-Humam [6: 554]; *"Al-Mughni"* by Ibn Qudamah [5: 203]; and *"Al-Bahr Al-Zakhkhar"*.
(5) *"Al-Bahr Al-Ra`iq"* by Ibn Nujaym [7: 153].
(6) *"Al-Minhaj"* by Al-Nawawi [2: 164]; and *"Fath Al-Qadir"* [6: 553].

transfer that could be required immediately. On the contrary, a person may need to tie delegation to the occurrence of a certain incidence, or to a specific date in the future.

- The principal shall possess the right of disposing of the asset in question because the agent is going to derive such right from him; hence the former cannot delegate a right that he does not own(7).
- As for the detailed rulings pertaining to partial legal capacity of the agent, these rulings hold true for all dealings including agency.
- The ruling that agency should be known to the agent is manifested in the fact that knowledge in this case is a necessity for completion of the process of offer and acceptance, and hence distinction between a real agent and an uncommissioned agent.
- Imposition of four conditions on the subject matter of agency is necessary to facilitate conclusion and validity of the contract that cannot be attained without these four conditions namely: existence of the asset, asset ownership by the principal, possibility of disposing of the asset through agency and the absence of any Shari'ah restriction that prevents the deal.
- Permissibility of paid agency stems from the fact that agency is a useful work for which the agent has the right to ask remuneration. An agent who is known to be providing agency services only against payment is entitled to remuneration even when remuneration is not explicitly mentioned in the contract, because a customary practice is acceptable as long as it does not encounter a Shari'ah restriction. Non-paid agency is also permissible because it is considered, in this case, as a form of donation.
- The justification for the clauses relating to remuneration of the agent is that such clauses are essential to make remuneration well known at either the time of the contract conclusion or in the future. Temporary uncertainty about the exact amount of the remuneration is overlooked because knowledge of the amount in the future will leave no room for dispute.(8) Permissibility of adding a certain share of the profit to the principal remuneration rests on the fact that such addition does not distort knowledge of the principal

(7) *"Al-Lubab"* by Al-Maydani [2: 139].

(8) *"Al-Insaf"* [5: 403]; *"Al-Rawdah"* by Al-Nawawi [4: 301]; *"Al-Khurashi"* [7: 5]; *"Al-Fatawa Al-Hamidiyyah"* [1: 324]; and *"Tadhkirat Al-Fuqaha`"* by Al-Hilli [2: 114].

amount. In this case, the commitment to offer the agent a certain share of the profit is in the sense of a pledge to offer donation. Thus, the offered share of the profit can be considered as a conditional gift, or as Ju'alah. There is another viewpoint that considers the pledged share of the profit as a subsidiary addition to the principal remuneration, and concludes that in a subsidiary we can overlook what we cannot overlook in the principal.

- Agency is, originally, non-binding because it is an act of delegation that neither the principal nor the agent should be forced to continue. The exceptional cases of binding agency have been dealt with to preserve whatever rights of others involved therein. Moreover, an exceptional treatment is also needed for paid agency that should be subjected to the rulings on Ijarah, as well as the case when there is a pledge not to revoke the contract within a specific period because breaching such commitment may cause injury to others.
- It is permissible to specify a time limit for agency, because agency is nothing but a contract that could have a specific duration, like Ijarah for instance.
- The justification for defining the commitments of the principal and the agent is – as set out in the Standard- the need to honor contractual obligations of agency and pursue the acts and liabilities that emerge from it.
- The agent is considered as a trustee in holding the asset because he works for the interest of others (the principal) and trusteeship is the normal status in similar engagements. Moreover, the principal's act of choosing the agent for the purpose in question is an indication of his good faith on him, and therefore the principal should not reverse that good faith, except for misconduct, negligence or breach of the contract's limitations.
- Impermissibility of combining agency and guarantee in the same contract, is based on their opposing implications, in addition to the fact that guarantee by the agent entails a suspicion of Riba (usury). Therefore, the status of the agent as a trustee contradicts with provision of guarantee.
- Impermissibility for the agent to represent both parties to the contract – as per the Hanafi School and the predominant view in the Shafi'i School – is to avoid assigning both offer and acceptance to the same party, and hence prevent any probable self bias. Adopting the viewpoint of these two Schools is, therefore, most suitable for Institutions to avoid malpractices and

misleading formalism in making transactions and prevent overlapping of guarantees.

- Monitoring of the contract's provisions is assigned to the principal because he is the principal party of the contract, whereas the agent, who is just a contractor, has to monitor the activities of the contract.
- Suspension of an agent act that breach the contract without adding to the benefit of the principal, until obtaining the principal's approval conforms to the normal Shari'ah practice of exerting the best possible effort to rectify an act of a Muslim.(9) The act here remains pending approval of the principal to safeguard him against injury.
- An agent who breaches the contract by selling or buying at a price other than the price agreed upon has to indemnify the principal for the difference between the price he accepted/offered, and the market price. The justification for this ruling is the need to establish justice and compensate the principal for loss, without committing the Shari'ah-banned practice of accepting capital on pre-fixed return, which entails a suspicion of Riba. This case has been discussed in *"Al-Mughni"* by Ibn Qudamah, who referred also to another viewpoint that suggests revocation of the deal.(10)
- Agency in selling a mortgaged asset is treated as an exceptional case where the contract does not expire on the death of the agent (agency to be pursued by inheritors), in order to preserve the rights of the mortgagee. Moreover, such agency is originally irrevocable before fulfillment of its purpose, for thereto is attached others' rights.
- The justification for adopting the fiqh viewpoint that advocates suspending the act of the uncommissioned agent rather than revoking the deal (for uncertainty about its confirmation by the principal), is the fact that an act of a Muslim should, as far as possible, be preserved from cancellation.(11) Preservation of the act against cancellation is possible here through suspension, in addition to the fact that the act may prove to be useful to the

(9) *"Al-Mughni"* by Ibn Qudamah [5: 135-136].

(10) Ibid.

(11) In *"Al-Bada'i'"* [5: 177], it is stated: "The act of the Muslim should, as far as possible, be perceived as correct"; and in *"Fath Al-Qadir"* [2: 445], it is stated: "Making the best possible effort to rectify the act of the Muslim".

owner of the property in question. In this connection, Ibn Al-Humam said: "When the case is viewed from the standpoint of Gharar (uncertainty), the contract appears to be invalid, whereas if it is viewed from the standpoint of benefit and absence of harm the contract appears to be permissible. Therefore, Ibnul Humam supports reconciliation of the two standpoints by suggesting permissibility with suspension."[12] It has also been narrated that the Prophet (peace be upon him) said: *"Whoever can offer a benefit to his Muslim brother, should do so"*. If, however, the act turned to be harmful to the principal, he can revoke it by virtue of the right he has.

Moreover, permissibility of suspending the act of the uncommissioned agent until approval of the principal can also be derived from the Hadith narrated by Hakim Ibn Hizam (May Allah be pleased with him) stating that the Prophet (peace be upon him) gave him one dinar so as to buy a sheep that the Prophet (peace be upon him) wanted to sacrifice. Hakim purchased the sheep for one dinar and sold it for two. Then he purchased another sheep for the Prophet (peace be upon him) for one dinar and handed over the remaining dinar to him. The Prophet (peace be upon him) took the remaining dinar and spent it on charity and then prayed to Allah to bless Hakim's trading business.[13]

(12) *"Fath Al-Qadir"* [5: 317].

(13) Related by Abu Dawud and Al-Tirmidhi.

## Shari'ah Standard No. (24)

# Syndicated Financing

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to highlight syndicated financing operations that take place either between Islamic financial Institutions (Institution/Institutions),[1] or between these Institutions and conventional banks.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers syndicated financing operations, whether those arranged among Institutions, or between them and conventional banks, and the Institution-agent relationships relating to such operations.

## 2. Definition of Syndicated Financing

It refers to the participation of a group of institutions in a joint financing operation through one of the Shari'ah-compliant modes of financing. The accounts of the syndicated financing operation are kept independent from the accounts of the participating Institutions.

## 3. Projects Financed Through Syndication

Syndicated financing should be channeled towards investment activities that are permissible in Shari'ah. It should not be totally or partially directed towards projects that encounter Shari'ah restriction or constitute Riba.

## 4. Modes of Providing Syndicated Financing to Customers

Syndicated financing should be provided to customers through Shari'ah-compliant modes of financing, including the following:

4/1 Sale through bargaining, Murabahah or installments.

4/2 Ijarah and Ijarah Muntahia Bittamleek.

4/3 Salam and Parallel Salam.

4/4 Istisna'a and Parallel Istisna'a.

4/5 Mudarabah.

4/6 Muzara'ah, Musaqat and Mugharasah.

4/7 Investment Sukuk.

## 5. Participation of the Institutions with Conventional Banks in Syndicated Financing

5/1 Originally, syndicated financing shall take place among Islamic financial Institutions.

5/2 There is no Shari'ah restriction against participation of conventional banks and Islamic financial Institutions in syndicated financing, as long as subscription and utilization of funds are arranged according to Shari'ah-compliant forms.

5/3 Originally, the syndication should be led by an Islamic financial Institution. However, there is no Shari'ah restriction against appointing a conventional bank to lead the syndication and initiate, on its own or with Islamic financial Institutions, the mechanisms and conditions of operation management. Assigning the role of the Musharakah lead manager to a conventional bank as indicated above is acceptable only if the contracts, projects financed and the modes of financing are all Shari'ah-compliant.

5/4 Arrangement, implementation and follow up of syndicated financing operations should take place under supervision of the Shari'ah supervisory boards of the Institutions participating in the syndication. Preferably, a joint committee of the Shari'ah supervisory boards of these Institutions could be formed and delegated to make decisions that become binding to all parties.

5/5 It is not prohibited for Islamic financial Institutions to provide syndicated financing to certain parts of a project that also receives financing for its remaining parts from other sources through conventional modes. This could be done on condition that the accounts and lead manager arrangements of the two types of financing are kept separate. It is well known that usurious lending and borrowing is a Shari'ah-impermissible practice and the responsibility thereof falls right on the party who commits it.

## 6. Shari'ah-Compliant Methods of Arranging the Relationship Between the Syndication Parties

The relationship between the Institutions participating in a syndicated financing operation may be arranged in one of the following forms:

6/1 **Mudarabah:** The syndication manager acts as a Mudarib and becomes the exclusive operation manager according to the Mudarabah contract. [see Shari'ah Standard No. (13) on Mudarabah, item 8/9]

6/2 **Musharakah:** The institutions participate jointly in providing the funds and bearing any losses proportionately, whereas profits are shared as agreed upon. In this case, the Institutions may select a joint committee to undertake management, or they may delegate one of them to manage the company against an increase in its profit share or a lump sum payment. A separate management contract in this case should be signed with the selected Institution. [see Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern corporations]

6/3 **Paid agency:** In this case, the work to be done should be clearly defined, along with estimation of the period of agency. The agent shall become entitled to remuneration whether profit is actually materialized or not. Furthermore, the agent may be given a bonus as a lump sum amount or a share of profits above a certain limit. [See Shari'ah Standard No. (23) on Agency and the Act of an Uncommissioned Agent (Fodooli)]

6/4 **Non-paid agency:** The lead manager in this case undertakes to manage the operations for no reward, and the financing Institutions share the profit.

**7. Preparatory Tasks and Commissions**

7/1 It is permissible for the leading Institution to receive commission for performing the preparatory tasks such as conducting feasibility studies, organization, mobilization of participatory funds, preparations of contracts etc. The commission thus obtained may be equal to, less or more than the actual cost the Institution incurs for carrying out such tasks. Furthermore, an Institution performing such tasks against the commission may or may not be a lead manager.

7/2 Musharakah It is not permissible to receive commitment commission. [see Shari'ah Standard No. (17) on Investment Sukuk and Shari'ah Standard No. (8) on Mudarabah, item 2/4/1]

**8. Provision of Guarantee and Suretyship by the Syndication Manager**

8/1 In dealing with the syndication funds the lead manager (being a Mudarib, partner or an agent) is considered as a trustee, and therefore he should not guarantee these funds except in case of miscon-

duct, negligence or breach of conditions embodied in syndication arrangement. [see Shari'ah Standard No. (5) on Guarantees, item 2/2/2]

8/2 It is not permissible for the Institution that manages the syndication as a Mudarib, partner or an agent to guarantee the debtors of his partners, or to guarantee the contributions of these partners against exchange rate fluctuations. [see Shari'ah Standard No. (5) on Guarantees and Shari'ah Standard No. (23) on Agency and the Act of an Uncommissioned Agent (Fodooli)]

**9. Exchange Rates**

9/1 A specific currency should be fixed for the syndicated financing operation. However, the participating parties may pay their contributions in other currencies on condition of revaluating the contributions in terms of the syndication currency, and according to the prevailing exchange rate on the same day of contributions payment.

9/2 It is permissible for any of the participating Institutions to receive all its profits and entitlements in a currency other than the currency of the syndication on the condition of revaluing the receipts in terms of syndication currency and , according to the prevailing exchange rate on the day of receiving such amounts.

9/3 It is impermissible for the investment agent or any other party of the Musharakah or the Mudarabah to provide a commitment to safeguard any other party against exchange rate fluctuations. [see Shari'ah Standard No. (1) on Trading in Currencies, item 2/9/3]

**10. Exit in Syndicated Financing**

10/1 It is permissible to agree on a closed syndicated financing operation that does not allow premature exit.

10/2 It is permissible for an Institution to dispose of its share in the investment to an external or internal party before liquidation, as per the contract conditions, and at the value agreed upon, if the physical assets and usufructs of the company exceed its cash money, debts and financial rights. If the company's cash money, debts and finan-

cial rights are predominant, Shari'ah rulings on currency exchange and debt-related transactions should be referred to and applied. It is, however, not permissible to agree beforehand on such transfer of shares at nominal value or on guarantee of a certain limit of profits. [see Shari'ah Standard No. (17) on Investment Sukuk and Shari'ah Standard No. (21) on Financial Paper (Shares and Bonds)]

## 11. Date of Issuance of the Standard

This Standard was issued on 23 Rabi' I, 1426 A.H., corresponding to 2 May 2005 A.D.

# Adoption of the Standard

The Shari'ah standard on Syndicated Financing was adopted by the Shari'ah Board in its meeting No. (14) held in Dubai on 21–22 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (10) held on 2 – 7 Rabi' I, 1424 A.H., corresponding to 3–8 May 2001 A.D., in Al-Madinah Al-Munawwarah to issue a Shari'ah Standard on Syndicated Financing.

On 7 Dhul-Hajjah 1424 A.H., corresponding to 29 January 2004 A.D., the Shari'ah Standards Committee decided to appoint a Shari'ah consultant to prepare a draft standard on Syndicated Financing.

In its meeting No. (11) held on 25-26 Safar 1425 A.H., corresponding to 15-16 April 2004 A.D., in the Kingdom Of Bahrain, the Shari'ah Standards Committee (1) discussed the Shari'ah study and advised the consultant to make necessary changes in the light of the discussions and observations of its members.

In its meeting No. (12) held on 28 Rabi' II, 1425 A.H., corresponding to 16 June 2004 A.D., in Dubai (U.A.E) the Shari'ah Standards Committee (1) discussed the draft Standard on Syndicated Financing, introduced some changes and asked the consultant to make further necessary changes in the light of the discussions and observations of its members.

Once again, the committee discussed the draft standard in its meeting held on 24–25 Rajab 1425 A.H., corresponding to 9–10 September 2004 A.D., and made further changes in the light of the discussions and observations of its members.

The revised draft of the standard was then submitted to the Shari'ah Board in its meeting No. (13) held in Makkah Al-Mukarramah on 26-30 Sha'ban 1425 A.H., corresponding to 10–14 October 2004 A.D. The Board made some changes in the document and decided to present it to some experts for their comments before discussing it in a public hearing.

A public hearing was held in the Kingdom of Bahrain on 15 Safar 1426 A.H., corresponding to 25 March 2005 A.D., and attended by more than 35 participants representing central banks, financial Institutions, accounting firms, Shari'ah scholars, academics and other concerned parties. Several comments were made before and after the public hearing. Some members of the Shari'ah Standards Committees (1) and (2) responded to the quires made during the session.

In the meeting of the Shari'ah Standards Committees (1) and (2), held in the Kingdom of Bahrain on 15-16 Safar 1426 A.H., corresponding to 25-26 March 2005 A.D., the comments made during the public hearing were discussed and some changes were made in the document.

The Shari'ah Board held its meeting No. (14) on 21–23 Rabi' I, 1426 A.H., 4 April – 2 May 2005 A.D., in Dubai (U.A.E) and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Syndicated Financing**

- Permissibility of syndicated financing is derived from Musharakah, which encounters no Shari'ah restriction.

**Projects Financed Through Syndication**

- The ruling that syndicated financing should be directed only towards activities that do not entail dealing in a Shari'ah-impermissible commodity or service, is dictated by the need to abide by the directives outlined in the Holy Qur`an verses and the noble Hadith of the Prophet (peace be upon him). These divine sources prohibit usury, alcoholic drinks, drugs, gambling, pork, illegitimate carcasses, prostitution, nightclubs, statues, etc, as well as impermissible acts like deception, bribe, cheating in weight and measurement, and all types of prohibited sales, etc.(2)

**Participation of Institutions with Conventional Banks in Syndicated Financing, and Permissibility of Assigning the Role of the Lead Manager to a Conventional Bank**

- Partnership between a Muslim and a Non-Muslim is not prohibited or cannot be judged right away as invalid, except in case of Shari'ah-banned dealings. This is so because what really matters is the conformity of the deal in question to the rulings of Shari'ah, rather than whether the deal has been made by a Muslim or a Non-Muslim. This viewpoint has been adopted by the Al Baraka Seminar,(3) as well as the Fourth Fiqhi

(2) For a detailed account of prohibited dealings, their various modern forms, and the Shari'ah bases of their prohibition. See: Dr. Ahmad Muhiddin Ahmad: Operations of Islamic Investment Companies in the International Market, (pp. 27–43).

(3) The text of the Fiqhi opinion is "There is no Shari'ah restriction on participation of conventional banks with Islamic banks in a syndicated financing that observes Shari'ah rulings in its operations, on condition that conventional banks should not assume the entire task of managing the operations, or making decisions on Shari'ah related issues.", Resolution No. (9/1), The Fatawa of the Al Baraka Seminars (P. 151).

Seminar of the Kuwait Finance House (1995). This case also does not come under the Hadith stating that the Prophet (peace be upon him) prohibited involiving in partnership with a Jew or a Christian unless purchase and sale take place by the hands of the Muslim.(4) It is clear that the emphasis of prohibition here relates to avoidance of Riba and invalid contracts, and therefore, no justification for prohibition will remain if due preventive measures against prohibited practices are well catered for. Also, the viewpoint of the Shafi'i, Maliki, Hanbali and Hanafi Schools(5) who advocate *Karahah* (disinclination towards the deal) does not include this case. The reason is that the Musharakah can avoid Shari'ah-banned practices by explicit reference to the firm commitment of the conventional Institution that leads the syndication to Shari'ah rulings in transactions, besides tightening the control and supervision of the Shari'ah boards of the participating Institutions throughout the various stages of the syndicated financing operation.

**Preparatory Tasks and Commissions**

- Permissibility of receiving commissions for performing preparatory tasks, originates from the fact that such tasks are beneficial to the partners and do not embark on any Shari'ah-impermissible practice. As regards the justification for the ruling that the commission can be equal to, less or more than the actual cost of providing the tasks, it is because the two parties are free to make what is known as a permissible condition, or resort to mutual consent. This same viewpoint was the Fiqhi opinion of the Al Baraka Seminar as well as the Fiqhi Seminar of the Kuwait Finance House (1995).(6)

(4) See: *"Al-Majmu' Sharh Al-Muhadhdhab"* [14: 93].

(5) Ibn Qudamah, *"Al-Mughni"* (Part 4); Al Nawawi, *"Al-Majmu'"* [13: 504]; Al-Buhuti, *"Sharh Muntaha Al-Iradat"* [2: 319]; *"Al-Mudawwanah"* [5: 70]; and Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 61].

(6) The text of the Fiqhi opinion of the Al Baraka Seminar is "The preparatory tasks performed by the bank that creates the operation entitles it to a remuneration which could be equal to, less or more than the actual cost of performing the tasks". The Fiqhi opinion of the Fourth Seminar of the Kuwait Finance House is "The preparatory tasks performed by the bank that initiates the operation entitles it to remuneration to be determined through mutual consent, whether the bank has been assigned the role of management or not."

- Receiving commitment commission is prohibited because such commission is paid for exercising the right of contracting, which is a matter of will and desire, rather than a subject matter of compensatory deals.(7)

**Provision of Guarantee and Suretyship by the Lead bank**

- A lead bank should not provide guarantee except in case of misconduct and negligence. Being a partner in the operation, it is supposed to be holding the assets as a trustee, and hence, it should not provide any guarantee. Stating such guarantee in the contract constitutes a violation of the Shari'ah rulings on trusteeship. When the managing bank commits misconduct or negligence, or resort to fraud and trickery in the studies it prepares, it should then indemnify the partners for the injury it has deliberately caused to them.
- A bank that manages the syndication through Mudarabah or Musharakah should not provide a warranty cover against default of the debtors of its partners, or guarantee the contributions of these partners against exchange rate fluctuations, because provision of guarantee by a partner or a Mudarib to his other partners/owners of the capital is prohibited by Shari'ah.
- When the bank manages the syndication as an agent, it may provide a warranty cover for the debtors of his partners in a separate contract and without referring to warranty in the agency contract. The justification here is that the bank does not provide such warranty in its capacity as an agent of the partners, and the warranty thus provided against default of the debtors will remain valid even if the agency contract is revoked.

**Exchange Rates**

- Permissibility for the parties of the syndication to make their contributions in currencies other than that of the syndication on condition that such contributions be revaluated according to the prevailing exchange rates is derived from a Hadith narrated by Ibn Umar (may Allah be pleased with him). Ibn Umar said: "When I told the Messenger of Allah (peace be upon him) that I used to sell camels at Al-Baqi' in dinars and receive the value in dirhams, he (peace be upon him) said: *'No harm if you apply the exchange rate of the same day and finalize the deal with your partner before leaving*

(7) Shari'ah Standards, AAOIFI, Shari'ah Standard on Murabahah.

*each other'."*[8] This case also implies combining currency exchange and Hawalah (transfer of money), which has been approved by a resolution of the Islamic Fiqh Academy.[9]

- The Hadith narrated by Ibn Umar also justifies the fiqhi opinion that the participating Institutions can stipulate receiving their profits and other entitlements in a currency other than that of the syndication, and according to the prevailing exchange rate on the day of receiving such profits and entitlements.
- Prohibition of commitment of one party of the Musharakah or Mudarabah to safeguard the other party against exchange rate fluctuations is because such commitment leads to the impermissible case of a partner or a Mudarib provides to the other partner guarantee against loss of capital.

**Controls on Disassociation**

- Participating Institutions can agree on a closed syndicated financing operation where premature exit is not allowed. Such a condition is regarded as a proper condition in Shari'ah, and it does not contradict with the aim of the contract. Moreover, imposing a condition against premature exit does not lead to permitting what Shari'ah has prohibited or prohibiting what it has permitted, nor does it seem to be a probable cause of future dispute.[10] Therefore such condition should be honored in abidance to the divine order of Allah, Exalted be He, in the holy Qur`an: ***{"O you who believe! Fulfill (all) obligations..."}***[11]
- Agreement beforehand on exit at nominal value or on guaranteeing a certain amount of profit is prohibited because such condition entails exact Riba, or a suspicion of it. Moreover, it involves other Shari'ah-

(8) Related by Abu Dawud, Al-Nasa`i, Ibn Majah and Al-Hakim who deemed it authentic. Al-Zahabi agreed with Al-Hakim. The Hadith has been narrated both as *Marfu'* (Traceable) Hadith to the Prophet, and *Mawquf* (Discontinued) Hadith to Ibn Umar, *"Al-Talkhis Al-Habir"* [3: 29].

(9) International Islamic Fiqh Academy Resolution No. 184/9.

(10) Regarding contractual conditions see: *"Tabyin Al-Haqa`iq"* [4: 43]; Ibn Al-Humam, *"Sharh Fath Al-Qadir"* [5 :215]; Al-Buhuti, *"Kashshaf Al-Qina'"* [3: 192–193]; Al Nawawi, *"Al-Majmu' Sharh Al-Muhadhdhab"* [9: 364–368]; and *"Al-Khurashi 'Ala Mukhtasar Khalil"* [5: 80–81].

(11) [Al-Ma`idah (The Table): 1].

impermissible practices like the case of one party providing a guarantee against the loss of the share of the other party in the capital, or guarantees a predetermined rate of profit for him.

## Shari'ah Standard No. (25)

# Combination of Contracts

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to explain the process of combining more than one contract in one set. The Standard also aims to elucidate the characteristics, Shari'ah status and Shari'ah controls relating to the process of Contracts' Combining. Furthermore, the Standard indicates the Shari'ah rulings on Muwata`ah (prior agreement) and provides guidance on the main applications of combined contracts in Islamic financial Institutions (Institution/Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers transactions that comprise more than one contract combined together in one set. The scope of the discussion in this respect covers the definition, forms, controls, characteristics, and concessions relating to the process of Combination of Contracts and explores the characteristics of Muwata`ah and the Shari'ah rulings pertaining thereto. The discussion also embarks on contemporary applications of combined contracts.

## 2. Concept of Combination of Contracts

2/1 Combination of contracts is a process that takes place between two parties or more, and entails the simultaneous conclusion of more than one contract. Hence, combination of contracts may take any of the following forms:

2/1/1 Combining more than one contract without imposing any of them as a condition in the other, and without prior agreement (Muwata`ah) to do so.

2/1/2 Combining more than one contract while imposing some of them as conditions in the others, without prior agreement to do so.

2/1/3 Combining more than one contract subject to prior agreement (Muwata`ah), but without imposing any of them as a condition in the others.

2/1/4 Agreement to conclude the deal through any of different contractual forms as will be finally decided in the future.

**2/2 Forms of combined contracts**

2/2/1 Combined contracts may have a single lump sum counter value. For instance, a party may sell his piece of land to the other and

simultaneously rents his car to the same party for one month, both against one thousand dinars.

2/2/2 Combined contracts may be concluded for separate values. For instance, one party may sell his house to the other for one thousand dinars, and rent his car to the same party for one hundred dinars per month.

2/2/3 Some of the combined contracts may be stipulated as conditions in the other contracts. One party, for instance, may say to the other party that I will sell you my house for ten thousand dinars, on condition that you undertake to rent the house to me for two years for one thousand dinars per year. The sale of the house in this manner could also be concluded on condition that the buyer of the house undertakes in return to sell his car to the seller for two thousand dinars.

2/2/4 Combined contracts may take the form of an exhaustive contractual statement comprising a number of successive parts and stages, which finally lead to realization of the desire of the two parties to conclude the deal in question. A good example in this regard may be seen in a number of present day financial transactions like Ijarah Muntahia Bittamleek, Murabahah, and Diminishing Musharakah.

## *3.* Shari'ah Status of Combination of Contracts

It is permissible in Shari'ah to combine more than one contract in one set, without imposing one contract as a condition in the other, and provided that each contract is permissible on its own. Combining contracts in this manner is acceptable unless it encounters a Shari'ah restriction that entails its prohibition on exceptional basis.

## 4. Shari'ah Controls on Combination of Contracts

4/1 Contracts' combining should not include the cases that are explicitly banned by Shari'ah like combing sale and lending in one contract.

4/2 It should not be used as a trick for committing Riba such as agreement between two parties to practice *Bay' al-'Inah* or *Riba al-Fadl.*

4/3 It should not be used as an excuse for practicing Riba. The two parties could misuse, for instance, Contracts' Combining when they conclude a lending contract that, at the same time, facilitates some other compensatory gains to them. For example, they could stipulate in the contract that the borrower should offer accommodation in his house to the lender, or should grant him a present. Contracts' Combining could also be misused by imposing excess repayment in terms of quantity or quality on the borrower. [see Shari'ah Standard No. (14) on Loan (Qard) – item 1/4]

4/4 Combined contracts should not reveal disparity or contradiction with regard to their underlying rulings and ultimate goals. Examples of contradictory contracts include granting an asset to somebody as a gift and selling/leasing it to him simultaneously, or combining Mudarabah with lending the Mudarabah capital to the Mudarib, or currency exchange with Ju'alah, or Salam with Ju'alah for the same contract value, or leasing with selling (i.e. hire-purchase in its traditional form).

**5. Shari'ah Concessions for Combination of Contracts**

5/1 In principle, the Shari'ah concessions that can be granted to implicit and subsidiary contracts at the time of combining contracts cannot be granted to the same contracts when concluded independently. Here, implicit and subsidiary contracts refer to contractual commitments that are not explicitly embodied in the deal agreement or those which succeed the original commitments of the transaction. The concessions to be granted in this case should be judged in the light of traditions, practice and professional experience, and subjected to clearance by the Shari'ah Supervisory Board of the Institution.

5/2 Concessions granted to implicit and subsidiary contracts comprise relief from the following impermissible acts:

5/2/1 Gharar, which affects financial contracts, may be overlooked in implicit and subsidiary contracts.

5/2/2 Jahalah, which also affects financial contracts, may be ignored with regard to the object of a subsidiary contract.

5/2/3 Sale-based Riba and violation of currency exchange rules (as when spot delivery is ignored in a contract that combines currency exchange with money transfer) are also forgivable in subsidiary and implicit contracts.

5/2/4 Selling of a debt for another debt may be ignored when it comes in the context of a subsidiary contract. A fitting example here is purchasing (on debt) the shares of an indebted company.

5/2/5 Subsidiary and implicit contracts may also relieved from some prerequisites that underline the validity of contracts (such as offer and acceptance) when such relief is dictated by need or desire to achieve a permissible interest.

**6. Prior Agreement (Muwata`ah) for Combination of Contracts**

6/1 Muwata`ah or Tawatu' in Fiqh terminology has several meanings; most important among which are stated below:

6/1/1 Explicit or implicit intention of the parties to the contract to use a certain trick for practicing Riba through a Shari'ah accepted contractual form.

6/1/2 An unrevealed prior agreement between the two parties to perform a Shari'ah-permissible act or deal for the sake of finding a Shari'ah-accepted exit (acceptable trick).

6/1/3 Coincidence of the intentions of parties to the contract at the stage of preparatory negotiations that precede the signing of the contract as indicated in item (2/2/4) above.

6/2 In Fiqh perception, Muwata`ah for combining contracts has three distinct characteristics:

6/2/1 It is an agreement between two parties to conclude contracts and fulfill pledges in the future.

6/2/2 When Muwata`ah is stipulated as part of the contract it becomes a condition precedent to the conclusion of the contract, and the contract becomes subject to the relevant Shari'ah rulings with regard to permissibility, enforceability, and validity.

6/2/3 Enforceability of Muwata`ah in Shari'ah is similar to enforceability of conditions precedent to the signing of contracts. A condition that precedes the signing of the contract has the same validity and binding nature of the normal conditions of the contract, since the former constitutes the bases of the contract that have been mutually agreed upon between the two parties.

6/3 Muwata`ah to combine contracts takes several forms, which may be grouped into the following four types:

6/3/1 Muwata`ah to form up Riba tricks, in which the two parties agree to practice, for instance, *Bay' al-'Inah* or its reverse, or *Bay' al-Wafa`* (*Bay' al-Raja`*), or *Riba al-Fadl*. In this case, Shari'ah prohibits Muwata`ah and the contract so designed is invalid.

6/3/2 Muwata`ah for Riba excuses is prohibited by Shari'ah whereby the two parties agree to combine a loan with another transaction, or stipulate that the borrower has to present a gift to the lender, or make excess repayment in terms of quantity or quality.

6/3/2/1 Prohibition of Muwata`ah to use such tricks, which are permissible in principle, should be judged in the light of two conditions:

**First,** the intention to use the permissible act as a means of concluding a prohibited deal should be obvious and beyond all doubts.

**Second,** there should be no obvious need or lawful interest that justifies resorting to such a trick.

6/3/3 Muwata`ah for obtaining Shari'ah Exits, which refers to tricks that do not violate Shari'ah rules, or contradict with Shari'ah objectives, or result in any harm to others, is permissible.

6/3/4 Muwata`ah for combining contracts that contradict to or oppose each other is prohibited because it leads to performing of an act that has been strictly banned by Shari'ah. [see item 4/4]

## 7. Contemporary Applications and General Rules for Combination of Contracts

7/1 One of the most distinguishable forms of contemporary financial transactions is the contractual arrangements which comprise a number of contracts and pledges that the parties agree beforehand to execute in a specific manner and according to agreed number of successive stages. Such arrangements aim to achieve a given purpose or interest of the parties to the contract such as performing Murabahah on Order of Purchase, Ijarah Muntahia Bittamleek, or Diminishing Musharakah.

7/2 Muwata`ah, when provided for in the contract and used for combination of contracts, should be observed by, and remain binding to the parties to the contract, subject to permissible commercial and banking conventions. [see item 6/2/2]

7/3 The pledges contained in such combined contract sets are binding to their respective parties.

7/4 These newly devised sets of combined contracts should observe the general rules of Shari'ah with regard to structure, rulings, requirements and conditions in order to be Shari'ah compliant. [see item 5/2]

7/5 These contract sets should also observe the Shari'ah rulings pertaining to combination of contracts, and may make use of the Shari'ah concessions in this respect.

7/6 Failure of any of the parties to combined contracts to honor its contractual commitments gives the other party right of claiming indemnity for the actual injury encountered.

## 8. Date of Issuance of the Standard

This Standard was issued on 23 Rabi' I, 1426 A.H., corresponding to 2 May 2005 A.D.

# Adoption of the Standard

The Shari'ah standard on Combination of Contracts was adopted by the Shari'ah Board in its meeting No. (15) held in Makkah Al-Mukarramah on 22–26 Sha'ban 1427 A.H., corresponding to 26 September – 2 October 2005 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (10) held on 2–7 Rabi' I, 1424 A.H., corresponding to 3–8 May 2003 A.D., in Al-Madinah Al-Munawwarah to issue a Shari'ah Standard on Combination of Contracts.

On 17 Sha'ban 1423 A.H., corresponding to 13 October 2003 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare a draft standard on combination of contracts.

In meeting No. (10) of the Shari'ah Standards Committee (2) held on Friday and Saturday 27-28 Safar 1425 A.H., corresponding 16-17 April 2004 A.D., in the Kingdom of Bahrain, the committee discussed the Shari'ah study and advised the consultant to incorporate the necessary changes, in the light of the discussions and observations of the meeting.

In meeting No. (11) of the Shari'ah Standard Committee (2) held on Wednesday 28 Rabi' II, 1425 A.H., 16 June 2004 A.D., held in Dubai (U.A.E) the Committee discussed the draft standard on combination of contracts and introduced necessary changes in it in the light of discussions and comments of the meeting.

The revised version of the Standard was submitted to the Shari'ah Board in its meeting No. (13) held in Makkah Al-Mukarramah on 30 Sha'ban 1426 A.H., 14 October 2004 A.D., and further changes were incorporated in the document. The Board then decided to send the document to concerned experts for review and comments before discussing it in a public hearing.

AAOIFI held public hearing in the Kingdom of Bahrain on 15 Safar 1426 A.H., corresponding to 25 March 2005 A.D. More than 35 participants representing central banks, institutions, accounting firms, Shari'ah scholars,

university teachers and other interested parties attended the public hearing. Several observations were made in the public hearing to which members of the Shari'ah Standards Committees (1) and (2) duly responded.

In a meeting held in the Kingdom of Bahrain on 15-16 Safar 1426 A.H., corresponding to 25-26 March 2005 A.D., the Shari'ah Standards Committees (1) and (2) discussed the comments and observations made during the public hearing, and incorporated necessary changes in the document.

The Shari'ah Board discussed the draft standard in its meeting No. (14) held in Dubai (U.A.E) on 21-23 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D. and decided, in the light of the comments and observations of the meeting, to send the draft standard to the Shari'ah Standards Committee (2) for study.

In its meeting No. (15) held on 22–25 Sha'ban 1426 A.H., corresponding to 26-29 September 2005 A.D., in Makkah Al-Mukarramah, the Shari'ah Board discussed the amendments proposed by the Shari'ah Standards Committee and the Drafting Committee and made the changes in the draft Standard, where it deemed necessary. Consequently, the Shari'ah Board approved the Standard (unanimously for some clauses and with the majority for others), as indicated in the minutes of the Board's meetings.

# Appendix (B)
# The Shari'ah Basis for the Standard

- It is permissible to combine more than one contract in a single transaction as long as each of these contracts is permissible on its own. This is so because freedom of contracting and honoring commitments is acknowledged in principle by the general teachings and directives of Shari'ah, unless such contracts and commitments lead to violation of Shari'ah rulings.(2) Ibn Al-Qayyim said, "It is permissible in principle to form up contracts and conditions, except for what has been prohibited by Shari'ah."(3)
- According to the majority of the Hanafi, Shafi'i and Hanbali Fuqaha, the set of combined contracts can always be judged in the light of its individual components. Therefore, if the transaction comprises a number of contracts that each of them individually satisfies permissibility requirements, the combined set of such contracts is also permissible. (4)
- Based on the above fact the Hanbali and Shafi'i Fuqaha, as widely reported, indicate permissibility of combing two contracts, for the same contract value, even if the two contracts differ with regard to Shari'ah status and rulings.(5) Ibn Taymiyyah indicated permissibility of combining two contracts having two separate values.(6)
- Prohibition of combining contracts in specific cases on exceptional basis, as indicated by Al-Shatibi, stems from the fact that the act of combining

(2) *"Majmu' Fatawa Ibn Taymiyyah"* [29: 132]; and *"Al-Qawa'id Al-Nuraniyyah Al-Fiqhiyyah"*, (P. 188).
(3) *"I'lam Al-Muwaqi'in"* [1: 344]; and *"Jami' Al-Rasa`il"* by Ibn Taymiyyah [2: 317].
(4) *"Kashshaf Al-Qina'"* [3: 478]; *"Al-Bayan"* by Al-Umrani [5: 148]; *"Al-Majmu' Sharh Al- Muhadhdhab"* [9: 388]; *"Tabyin Al-Haqa`iq"* [4: 174], *"Al-Bada`i'"* [6: 58]; and *"I'lam Al- Muwaqi'in"* [3: 354]; *"Al-Mubdi'"* [5: 43].
(5) *"Al-Mughni"* [6: 39 and 355]; *"Al Majmu'"* [9: 388]; *"Sharh Al-Sunnah"* by Al-Baghawi [8: 67].
(6) *"Nazariyyat Al-'Aqd"* by Ibn Taymiyyah (P. 191); and *"Al-Ikhtiyarat Al-Fiqhiyyah Min Fatawa Ibn Taymiyyah"* (P. 122).

could sometimes generate Shari'ah restrictions that do not hold true when the combined acts are taken up individually. Examples of acts that become prohibited when combined, though they are individually permissible, include combining sale and lending, marrying two sisters, or marrying a woman and her aunt.(7)

- The absence of any exceptional Shari'ah restriction in the particular case of combining constitutes the first control on contracts' combining due to the directives of the Prophet (Peace be upon Him) who has been quoted to have prohibited combining sale with lending,(8) or combining two sales in one deal,(9) or two transaction in one transaction.(10)
- The second control, which prohibits using Contracts' Combining as a trick for practicing Riba is based on the directives of the prophet (peace be upon him) which indicate prohibition of *Bay' al-'Inah*(11) and *Riba al-Fadl*. As regards *Riba al-Fadl*, it has been reported that the Prophet (Peace be upon Him) instructed one of his employees to sell his low-quality dates first and then buy the high-quality dates he wanted, instead of resorting to exchange of more quantity of low-quality dates for less quantity of high-quality dates.(12) Ibn Al-Qayyim said, "This indicates that the employee was directed to commence the process of purchasing the high-quality dates after the complete finalization of the former transaction; i.e., selling his low-quality dates. If, instead, he agreed beforehand with another party

(7) *"Al- Muwafaqat"* [3: 192].

(8) Al-Tirmidhi said: "This is a good authentic Hadith": *"Al-Muwatta'* "[2: 657]; *"Mukhtasar Sunan Abu Dawud"* by Al-Munziri [5: 144]; *"Musnad Al-Imam Ahmad"* [2: 178]; *"'Aridat Al-Ahwazi"* [5: 249]; *"Sunan Al-Nasa`i"* [7: 295]; and *"Nayl Al-Awtar"* [5: 152].

(9) Ibn Al-Arabi confirmed that these has been the directives of the Prophet (peace be upon Him): *"Al-Qabas"* [2: 842]; *"Mukhtasar Sunan Abu Dawud"* by Al-Munziri [5: 98]; *"Al-Muwatta`"* [2: 663]; *"'Aridat Al-Ahwazi"* [5: 239]; *"Sunan Al-Nasa`i"* [7: 295]; and *"Nayl Al-Awtar"* [5: 152].

(10) *"Musnad Al-Imam Ahmad"* [1: 198]; *"Nayl Al-Awtar"* [5: 152]; *"Fath Al-Qadir"* [6: 81]. Al-Haythami said: "Ahmad always reports from reliable sources": *"Majma' Al-Zawa`id"* [4: 84].

(11) *"Musnad Al-Imam Ahmad"* [2: 42, 48]; *"Al-Sunan Al-Kubra"* by Al-Bayhaqi [5: 316]; *"Subul Al-Salam"* [3: 14]; *"Mukhtasar Sunan Abu Dawud"* by Al-Munziri; and *"Tahdhib Al-Sunan"* by Ibn Al-Qayyim [5: 99, 104].

(12) Related by Al-Bukhari, Muslim, Al-Tirmidhi, Al-Nasa`i and Malik: *"Sahih Al-Bukhari"* [3: 97]; *"Sahih Muslim"* [3: 1208]; *"'Aridat Al-Ahwadhi"* [5: 249]; *"Al Muwatta`"* [2: 632]; and *"Sunan Al-Nasa`i"* [7: 244].

to conduct the two deals successively, the second contract will not become an independent contract, because it is a mere completion of the first one. The directives of the Prophet (Peace be upon Him), apparently necessitate two separate contracts that neither of them is related to or based on the other".(13)

- The third control, that prohibits using combined contracts as an excuse for dealing in Riba, is based on the directives of the Prophet (Peace be upon Him) which forbid combining lending with selling.(14) In this regard, the Fuqaha unanimously agree that when the two parties stipulate in the loan contract that the borrower should reward the lender by offering him free accommodation, or grant him a present, or the borrower should make excessive repayment in terms of quantity or quality, the contract becomes null and void. In other words, any loan arrangement that comprises a prior condition on a benefit to be rendered to the lender by the borrower is considered Riba.(15)
- The fourth control, which indicates that the contracts to be combined should not be contradicting with each other in terms of purpose or Shari'ah rulings, stems from the fact that contracts, as indicted by Al-Qarafi, are devices for using appropriate means to achieve specific objectives. Obviously, the same contracting requirement cannot always fit at the same time two contradicting positions(16). Therefore, contracts that contradict each other in their rulings and effects cannot be combined together in the same transaction.
- The Shari'ah concessions sanctioned to subsidiary and implicit contracts are based on several statements in *"Al-Qawa'id Al-Fiqhiyyah"*, including the following:
  - What can be forgiven in a subsidiary contract cannot be forgiven in other contracts.(17)

(13) *"I'lam Al-Muwaqi'in"* [3: 238]; and *"Ighathat Al-Lahfan"* [2: 103].

(14) Related by Abu Dawud, Al-Tirmidhi, Al-Nasa`i, Ibn Majah, Ahmad, Al-Shafi'i and Malik. [See footnote No. (3) in Shari'ah Standard No. (19): Loan (Qard)].

(15) *"Al-Mughni"* [6: 436]; *"Al-Sharh Al-Kabir 'Ala Al-Muqni'"* [12: 432]; *"Al-Zakhirah"* [5: 289]; *"Al-kafi"* by Ibn Qudamah [2: 93]; *"Al-Mubdi'"* [4: 209]; and *"Majmu' Al-Fatawa"* by Ibn Taymiyyah [29: 334].

(16) *"Al-Furuq"* [3: 142].

(17) Article (54) of *"Majallat Al-Ahkam Al-Fiqhiyyah"*; and *"Al-Ashbah Wa Al-Naza`ir"*, (P. 120).

- What can be forgiven in implicit contracts cannot be forgiven in independent contracts.(18)
- Concessions that can be sanctioned to implicit provisions cannot be sanctioned to ordinary provisions.(19)
- Provisions in ordinary contracts entail more validity requirements than provisions in implicit and subsidiary contract.(20)
- Implicit contracts are relieved of what independent contracts cannot be relieved of.(21)
- Provisions that hold true in implicit contracts may not hold true in ordinary contracts.(22)

- Shortcomings like Gharar, which affect financial transactions such as sale contracts and the like, may be forgiven when the contract subject matter or the contract itself is subsidiary. The Prophet (peace be upon him) said: *"When somebody purchases a palm tree, that has not yet been pollinated, the fruits of the tree should belong to the seller unless the buyer stipulates in the contract that he should be entitled to the fruits".*(23) This Hadith indicates that the reason for ignoring the gharar involved in the act of the buyer who stipulates in the contract that the anticipated fruits of the palm tree should belong to him, is the fact that getting the fruits is an implicit aspect of the contract. As is the case with gharar, excessive Jahalah is also forgivable in subsidiary and implicit contracts.
- Ignoring sale-based Riba and non-fulfillment of the Shari'ah requirements of currency exchange in subsidiary contracts is based on the Hadith of the Prophet (peace be upon Him) which states: *"When somebody buys a slave who has money, the slave's money should go to the seller, unless the buyer*

(18) *"Fatawa Al-Ramli"* [2: 115].
(19) *"Bada`i' Al-Fawa'id"* by Ibn Al-Qayyim [4: 27].
(20) *"Bada`i' Al-Sana`i'"* [5: 58].
(21) *"Al-Manthur Fi Al-Qawa'id"* by Al-Zarkashi [3: 378].
(22) *"Radd Al-Muhtar"* [4: 170].
(23) *"Sahih Al-Bukhari"* with *"Fath Al-Bari"* [5: 49]; *"Sahih Muslim"* with Al-Nawawi elaborations [10: 191]; *"Sunan Abu Dawud"* [2: 240]; *"Sunan Al-Nasa`i"* [2: 260]; *"Sunan Ibn Majah"* [2: 745]; *"Muwatta` Al-Imam Malik"* [2: 617]; *"Musnad Al-Imam Ahmad"* [2: 6, 9, 54, 63, 78, 102 and 150]; and *"'Aridat Al-Ahwazi"* [5: 253].

*stipulates in the contract that he should get the money.*(24) The justification for this is that the buyer may have taken into consideration (at the time of making his offer) the amount of money the slave could have, be it big or small, and explicitly determined a portion of the price for it, though he did not declare such portion independently. Hence, it becomes clear from this Hadith that it is permissible to buy a slave along with his money without observing the Shari'ah requirements of currency exchange, and regardless of whether the amount of money that the slave has is big or small, known or unknown.(25)

- Permissibility of *Bay' al-Kali` Bil-Kali`* (selling a debt for another debt) in subsidiary and implicit contracts although it is prohibited in original and independent contracts, is based on the previous Hadith about purchasing a slave along with the money he has. In this respect, Imam Malik indicated in "*Al-Muwatta`*" the permissibility of selling a slave and providing in the contract for the status of the money he owns, even if that money is a debt owed to the slave by a third party and the slave is himself sold on deferred payment. That is to say, Malik seems to have based his opinion on the apparent and general meaning of the Hadith and the ruling practice in Al-Madinah.(26)
- Permissibility of relieving, upon need or probable interest, subsidiary and implicit contracts from some of the bases and conditions of contracts' validity, can be derived from a statement by Al-Sayuti in *"Al-Ashbah Wa Al-Naza`ir"*. In that statement, Al-Sayuti indicates permissibility of abandoning offer and acceptance (the form) in case of implicit sale, or accepting deferred, instead of spot, delivery/payment in such sales. Such rulings in fact come as further ramifications of the Fiqh principle that "Subsidiary contracts can be relieved from what other contracts cannot be relieved from"(27)

(24) *"Sahih Al-Bukhari"* with *"Fath Al-Bari"* [5: 49], *"Sahih Muslim"* [3: 1173]; *"Sunan Abu Dawud"* [2: 240]; *"Sunan Al-Nasa`i"* [7: 261]; *"Sunan Ibn Majah"* [2: 746]; *"Muwatta` Al-Imam Malik"* [2: 611]; *"Musnad Al-Imam Ahmad"* [2: 9 and 78]; and *"'Aridat Al-Ahwazi"* [5: 252].

(25) *"Al-Qabas"* by Ibn Al-'Arabi [2: 805]; *"Al-Mughni"* by Ibn Qudamah [6: 96]; and "*Al-Zurqani 'Ala Al-Muwtta`*" [3: 253].

(26) *"Al-Zurqani 'Ala Al-Muwtta`"* [3: 253].

(27) *"Al-Ashbah Wa Al-Naza`ir"* by Al-Sayuti (pp. 120 and 377).

- Muwata`ah for combining contracts is considered as an enforceable condition that precedes the signing of the contract, because Muwata`ah, traditionally as well as in fiqh terminology, is an agreement between the two parties to sign contracts and honor pledges in the future. Therefore Ibn Taymiyyah said, "When the two parties agree beforehand to do specific things, and then sign a general contract, the contract should honor that prior agreement".(28)
- A condition that precedes the contract should be regarded as binding and enforceable as a one that comes in the text of the contract, because traditionally there is no difference between the conditions stated in the contract and those agreed upon beforehand, even if such prior conditions are not mentioned at the time of signing the contract. This is only natural since these conditions form the bases of the contract, which the two parties have agreed to observe. This viewpoint is supported by a number of traditionally accepted norms such as:
  - A condition, which the two parties agree to observe, resembles a one explicitly mentioned in the contract.
  - Traditionally acceptable conditions resemble explicitly stated conditions.
  - Intentions in contracts deserve observation.

  Moreover, enforceability of prior conditions was the ruling practice in Al-Madinah and the predominant opinion in Al-Imam Ahmad's School.(29)
- Prohibition of Muwata`ah for devising Riba tricks is because Muwata`ah in this case is a means used for practicing Riba. Consequently, since the end objective (which is Riba) is prohibited, the means used for achieving it must also be prohibited. As indicated in *"Al-Qawa'id Al-Fiqhiyyah"*, "means are discarded on discarding of objectives"(30)

(28) *"Nazariyyat Al-'Aqd"* by Ibn Taymiyyah (p. 204).

(29) *"I'lam Al-Muwaqqi'in"* [3: 105, 145, 212 and 241]; *"Kashshaf Al-Qina'"* [5: 98]; *"Bayan Al-Dalil 'Ala Butlan Al-Tahlil"* (P. 533); *"Majmu' Al-Fatawa"* by Ibn Taymiyyah [29: 336]; *"Al-Fatawa Al-Kubra"* by Ibn Taymiyyah [4: 108]; *"Al-Madkhal Al-Fiqhi Al-'Aam"* by Al-Zarqa [1: 487]; and *"Al-'Uqud Wa Al-Shurut Wa Al-Khiyarat"* by Ahmad Ibrahim (P. 711).

(30) *"Al-Furuq"* by Al Qarafi [2: 33]; and *"Al-Qawa'id Al-Kubra"* by Al-'Izz Ibn Abdul-Salam [1: 161 and 168].

- Prohibition of Muwata`ah as an excuse for Riba, originates from the application of the principle of *Sadd al-Zara`i'*. This principle aims to prohibit permissible practices that could be used as a means for accomplishing Shari'ah-banned objectives.(31)
- However, application of the principle of *Sadd al-Zara`i'* should be based on two requirements as indicated by the Maliki Fuqaha. The first requirement is that resort to the *Zari'ah* (excuse) should be very frequent and excessive in view of normal practice, and the second requirement is the presence of a strong accusation that rules out the possibility of any good intention behind using the excuse(32). Application of the principle of *Sadd al-Zara`i'* should also observe the non-existence of any need or lawful interest for using the *Zari'ah*, as has been emphasized by several fiqh principles such as:
  - Prohibition for the sake of blocking the way to excuses is less forceful than prohibition per se".(33)
  - Practices that originate from the need for devising acceptable Shari'ah exits deserve more Shari'ah concessions than other practices.(34)
  - Acts that are prohibited for the sake of blocking the way to excuses become permissible in case of need or desire to achieve a lawful interest.(35)
- Permissibility of Muwata`ah for devising acceptable Shari'ah exits can be derived from the statements of several Fuqaha who indicate that using Shari'ah accepted means to achieve permissible objectives is permissible. According to those Fuqaha practicing acceptable Shari'ah exits and helping others to devise them is a permissible and reward-worthy practice as long as it abides by the directives of Allah, Exalted be He, leads to avoidance of sins, and facilitates achievement of lawful interests.(36)

(31) *"Sharh Tanqih Al-Fusul"* (P. 449); *"Al-Furuq"* by Al-Qarafi [2: 32]; and *"Al-Qabas"* [2: 876].
(32) *"Al-Muwafaqat"* [4: 198]; *"Al-Ma'unah"* by Al-Qadi Abdul-Wahhab [2: 996]; and *"'Iqd Al-Jawahir Al-Thaminah"* [2: 441].
(33) *"I'lam Al-Muwaqqi'in"* [2: 140].
(34) *"Al-Ashbah Wa Al-Naza`ir"* by Al-Sayuti (P. 158).
(35) *"Zad Al-Ma'ad"* [4: 78]; *"Tafsir Ayat Ashkalat"* by Ibn Taymiyyah [2: 682]; *"Majmu' Al-Fatawa"* by Ibn Taimaih [23: 214-215], [32: 228-229]; and *"I'lam Al-Muwaqqi'in"* [2: 142].
(36) *"Ighathat Al-Lahfan"* [1: 339, 383 and 385] and [2: 86].

- Prohibition of Muwata`ah for combining contracts that contradict each other in rulings and objectives is because Muwata`ah in this case is used as a means of doing an unacceptable act. According to Shari'ah, means always follow ends with regard to permissibility and prohibition(37). It has been indicated in "*Al-Qawa'id Al-Fiqhiyyah*" that: "Disregarding the ends leads to disregard of the means".(38)
- Recognition of Muwata`ah when it precedes contemporary transactions, that comprise a set of successive and inseparable contracts forming up a single transaction, is the present day commercial and banking tradition that considers Muwata`ah in this case as binding to the two parties. In fact, Muwata`ah in this sense is part of a whole system that tends to completely collapse when any of its individual components looses balance. Violating Muwata`ah in this case will jeopardize the fulfillment of the objectives of the contracting parties, and may cause them serious injuries.
- The pledges that relate to an agreement are binding to the two parties since, according to its nature and Fiqh status, and as perceived by most of the Fuqaha, such pledges are similar to the conditions stipulated in the agreement. Enforceability of such pledges also stems from the fact that they constitute the basis for the transaction. It is well known that Shari'ah-accepted conditions stipulated in a contract are binding from both the fiqhi as well as the legal viewpoints. Moreover, in present day commercial and banking traditions, such pledges are also considered as binding. Otherwise, it will not be possible for the two parties to form up a definite perception about the purpose and objectives of the contract, and hence they will not be able to sign it.

(37) *"Al-Muafaqat"* [2: 212].
(38) *"Al-Qawa'id"* by Al-Muqri [1: 329].

# Appendix (C)
# Definitions

**Zara`i'**

Zara`i' are the apparently permissible practices used as a means of doing a prohibited act. Therefore, *Sadd al-Zara`i'* means prohibition of permissible practices that can be used for committing Shari'ah-restricted acts. However, prohibition in this sense is subject to two restrictions. The first is the existence of a clear intention of the person in question to use the permissible practice for the sake of accomplishing Shari'ah-banned objectives, and the second is that resorting to prohibition should be only after wide spread of such misconduct in the society.

**Subsidiaries**

Subsidiary contracts or objectives in financial transactions refer to the consequent contracts or objectives that follow the original ones. The subsidiary status of these contracts or objectives is usually determined according to tradition, practice and the experience of those who are in the field.

**Transaction**

It is a binding contractual relationship that carries no optional choices.

**'Inah**

It is a sale whereby one party, for instance, sells the commodity to the other for one hundred dollars, on deferred payment basis, and repurchases it from the other for eighty dollars payable on spot. In fact, the sale transaction here is nothing but a mere trick for practicing usurious lending, and the commodity is used for no purpose other than facilitating the usurious transaction. The deal in this case has nothing to do with the purposes and objectives of sale, nor does it contain any element of them. In other words 'Inah takes place when one party buys a commodity from the other

on deferred payment basis and before making payment sells back the same commodity to the other for a less amount of money payable on spot.

**Reverse 'Inah**

It takes place when one party sells the commodity to the other party for a spot price, and the seller repurchases the same commodity from the buyer or from his agent for a higher deferred price.

***Bay' al-Raja`* (*Bay' al-Wafa`*)**

It is a sale whereby the seller keeps the intention to buy back his sold commodity. One of the most popular forms of this type of sale is when one party, who wants to obtain an interest-bearing loan, agrees to sell an income-earning asset to the lender. The lender will thus become entitled to the income of the asset as long as it remains in his ownership. The buyer then undertakes to return the sold asset to the seller whenever the seller pays back the same price to him. In this manner, the borrower (artificial buyer) succeeds to get the loan amount against payment of the agreed upon interest.

**Shari'ah-Banned Tricks**

It refers to those permissible contractual arrangements and other practices, which may be used to achieve prohibited goals like permitting what Shari'ah has prohibited, like escaping duties, deceiving people and performing other Shari'ah-banned practices.

**Shari'ah Exit (Shari'ah-Acceptable Trick)**

A Shari'ah exit is an act that is performed for the sake of avoiding commitment of sins, or achieving a permissible objective, or refraining from prohibited acts, or realizing a Shari'ah-acceptable interest.

**Separation of the Transaction**

Separation of a transaction means dividing the object of the same contract, into portions. To Fuqaha, it means a situation in which the provisions of the contract do not cover all the components of its object, or they may cover all of them first, and then shrink down to cover only some of them later on. Thus, either the single transaction is broken down into a number of portions, or only

some parts of it are separated in this manner. When separation takes place in this manner in a single transaction between a single buyer and a single seller and for a single price, the buyer should have the option to conclude the deal or not.

## Shari'ah Standard No. (26)

# Islamic Insurance

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to present the Shari'ah rules that govern Islamic Insurance, as well as the characteristics, basic aspects, principles and types of Islamic Insurance. The standard also aims to indicate the controls that Islamic financial Institutions (Institution/Institutions)[1] should observe in this connection.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers Islamic Insurance in terms of its definition, Shari'ah status, characteristics, principles, basic elements, types, and how it differs from Conventional Insurance. The Standard also sets out the controls to be observed by the Islamic financial Institutions offering products based on Islamic insurance. However, it does not cover social insurance schemes arranged by the state.

## 2. Definition of Islamic Insurance in Contrast with Conventional Insurance

Islamic Insurance is a process of agreement among a group of persons to handle the injuries resulting from specific risks to which all of them are vulnerable. A process, thus initiated, involves payment of contributions as donations, and leads to the establishment of an insurance fund that enjoys the status of a legal entity and has independent financial liability. The resources of this fund are used to indemnify any participant who encounters injury, subject to a specific set of rules and a given process of documentation. The fund is managed by either a selected group of policyholders, or a joint stock company that manages the insurance operations and invests the assets of the fund, against a specific fee.

As for Conventional Insurance, it is a Mu'awadah (mutual compensation) contract that seeks to make profit out of the insurance operation itself, and, hence, is subject to Shari'ah rulings on financial dealings that involve Gharar (uncertainty). Consequently, conventional insurance is banned by Shari'ah.

## 3. Status of Islamic Insurance According to Fiqh (Islamic Jurisprudence)

Islamic insurance is based on the commitment of the participants to make donations for the sake of their own interest. The participants,

therefore, protect their group by payment of contributions that constitute the resources of the insurance fund, and assign the management of that fund to a committee of policyholders, or to a joint stock company that possesses the license of practicing insurance business. In the latter case, the company assumes this job on the basis of a remunerated Wakalah (Agency) contract. In addition to managing the insurance operations, the committee of policyholders or the company also assumes the responsibility of investing the assets of the fund through Mudarabah or investment agency.

3/1 The managing company is entitled to its own capital and returns on capital, the agency fee, and its specific share of the profits earned by investing the insurance assets through Mudarabah or investment agency. The company also bears all the expenses of its operations including those relating to its tasks for investing the insurance assets.

3/2 The policyholders fund is entitled to the contributions and the returns thereon, the provisions and reserves relating to insurance business, and the insurance surplus. The fund bears all direct expenses pertaining to management of insurance operations.

**4. Contractual Relationships in Islamic Insurance**

There are three contractual relationships in Islamic insurance, including:

4/1 The Musharakah (partnership) among the participants, which leads to the establishment of a company that has articles of association and all other documents. The relationship between the participants may be confined to a Musharakah contract if a company manages the fund. [see Shari'ah Standard No. (12), on Sharikah (Musharakah) and Modern Corporations]

4/2 The relationship between the company and the policyholders' fund which is a Wakalah relationship in regard to management, and a Mudarabah or investment agency relationship in regard to the investment of the fund's assets.

4/3 The relationship between the policy holders and the fund which takes the form of donation commitment at the stage of making

contributions, and indemnification commitment at the stage of providing compensation for injury as per regulations and underlying constituent documents.

## 5. Principles and Shari'ah Bases of Islamic Insurance

Islamic insurance is based on the following principles and rules of Shari'ah, which shall be explicitly mentioned in the articles of association or the rules or the documents of the corporation:

5/1 Donation commitment, as it should be stipulated that the participant donates his contribution and the returns thereon to the insurance account for payment of indemnity, and may undertake to bear any deficit that may occur, as per regulations.

5/2 The company that arranges the insurance deal should maintain two separate accounts: one for its own rights and liabilities, and the other for the rights and liabilities of the policyholders.

5/3 The company should assume the role of the agent in managing the insurance account, and the role of the Mudarib or agent in investing the insurance assets.

5/4 The insurance account is entitled to the insurance assets and their returns on investment, and should bear the liabilities relating to these assets.

5/5 The adopted rules may comprise disposal of the surplus in a way that serves the cause of common interest of the participants, such as accumulation of reserves, reduction of the contribution, charitable donations and partial/full distribution of the surplus among the participants. The managing company is not entitled to any share of the surplus.

5/6 When the company is liquidated, all provisions and accumulated reserves pertaining to insurance should be spent on charitable purposes.

5/7 Preference should be given to policyholders to participate in management of the insurance operations through appropriate legal arrangements that enable them to exercise their control rights and protect

their interest. Such arrangements could include, among others, representation of policyholders in the Board of Directors.

5/8 Company shall adhere to the rules and principles of Islamic Shari'ah in all its activities and investments, especially in refraining from provision of insurance coverage for Shari'ah-banned items, activities or purposes.

5/9 A Shari'ah Supervisory Board shall be formulated for issuance of Fatawa (plural: Fatwa, i. e. juristic opinion) that are binding to the company, and establishment of an internal unit for Shari'ah monitoring and auditing.

**6. Types of Islamic Insurance**

6/1 Property Insurance: which entails indemnification for actual injury, and comprises insurance against fire, car accidents, airplane accidents, liability, breach of trust, etc. [See Shari'ah Standard No. (5) on Guarantees – item 6/4]

6/2 Person Insurance: which includes insurance against the risk of disability and death, and is sometimes known as *Takaful* (mutual support). It corresponds to conventional life insurance.

6/2/1 Insurance against the risk of disability or death takes place as follows:

6/2/1/1 Submission of a request for participation indicating all personal affairs and characteristics, that need to be known for offering the insurance coverage to the insured, along with the particulars of the entitlements and obligations of the insured.

6/2/1/2 Specification of the contribution amount.

6/2/1/3 Specification of the benefits payable to the beneficiary as per agreement.

6/2/1/4 In case of death, the *Takaful* entitlements should be distributed among the deserving persons, parties or purposes as indicated in the documents, and accord-

ing to the regulatory rules issued by the Shari'ah Supervisory Board. In case the deceased was entitled to some investment balances, then the same should be distributed among the inheritors according to the Islamic rules of inheritance.

6/2/1/5 In case of insurance against death, it should be stipulated in the insurance policy that the insured (the beneficiary) or his inheritor should not be entitled to any compensation when the death is caused by a murder wherein the said beneficiary or inheritor is involved.

**7. Participation in Islamic Insurance**

7/1 Non-Muslims may participate with Muslims in the various types of Islamic insurance.

7/2 The contribution may be determined according to the actuarial principles based on statistical techniques. In this regard, due consideration should be given to whether the risk involved is fixed or variable, and to the contribution/risk tradeoff besides determination of the type and period of the risk coverage, and specification of the insurance amount.

7/3 The risk that constitutes the subject matter of insurance should be one that could probably occur. It should not be something that relates to the absolute will of the participant, and should not encounter any Shari'ah prohibition.

**8. Commitments of the Participant in Islamic Insurance**

The participant (insurance seeker) should observe the following commitments:

8/1 Submission of the required information about the risks to be insured against, and informing the company of any new circumstances that may increase these risks after concluding the contract. If it is proved that the participant had committed fraud or deceit, or submitted false information, he is then subject to partial or full deprivation

from indemnity. In case of unintentional misrepresentation by the participant, the indemnity shall become proportionate to the accurate information he presented.

8/2 Payment of contribution on time as per agreement. If the participant refrains from or delays payment of his contribution, the company has the right to terminate the contract or pursue legal enforcement of payment.

8/3 Informing the company, in its capacity as an agent of the policyholders' fund, of occurrence of the risk insured. Notification should be made during the period stipulated in the insurance policy, or within reasonable time if such period is not provided for in the policy. If the participant fails to make such notification, the company has the right to claim indemnity from him for the actual loss incurred by the insurance account due to such breach of commitment.

**9. Conditions in Islamic Insurance Policies**

9/1 There is no Shari'ah restriction on providing for special conditions in the insurance policy. Special conditions may relate to periods of insurance, denial of indemnity in specific cases as when the participant fails to notify the company about occurrence of risk on time, or charging the participant with a specific portion of the indemnity. A condition thus stipulated in the insurance policy remains binding as long as it does not contradict with the rules of Shari'ah or the prerequisites of the contract.

9/2 It is permissible to stipulate in the insurance policy special cases that lead to deprivation from indemnity provided that justice, preservation of rights, and avoidance of abusive conditions are well observed.

**10. Commitments and Jurisdictions of the Joint Stock Company**

10/1 The Company shall assume the various tasks of managing the insurance operations including; preparation of insurance policies, collection of contributions, payment of indemnities, and all other technical tasks. The Company performs such tasks against a specific fee, which should be stated in the agreement in order to obtain the participant's approval thereon by signing the contract.

10/2 The Company is entrusted with the duty of achieving common interest while undertaking the management of the insurance operations. However, it should not guarantee the insurance assets except in case of misconduct, negligence or breach of contractual obligations.

10/3 The Company shall bear its pre-operating expenses as well as all other expenses that relate to conducting its own business or the investment of its own funds.

10/4 The statutory reserve of the Joint Stock Company is deducted from its share capital and becomes part of its shareholders equity, a case that also holds true for all other capital-related deductions. No deduction shall be made from the policyholders fund or profits for the benefit of the shareholders of the Joint Stock Company.

10/5 For the sake of serving the policyholders' interest, it is permissible to deduct part of their funds or profits to be used as reserves or allocations pertaining to the insurance fund. Such deductions, however, should by no means belong to the shareholders of the Joint Stock Company. The accumulated balance of the insurance account shall be spent on charity purposes in case of liquidation.

10/6 The Company claims indemnity from the party who causes the injury, whether through breach of contractual commitment or any similar misbehavior. In this case, the Company represents the participants in disposing of all the tasks that relate to the case, such as filing of lawsuits, realization of the consequent rights, and depositing the proceeds in the insurance account.

10/7 When the Company invests the policyholders' funds through Mudarabah, it should bear the expenses that are normally borne by the Mudarib [see Shari'ah Standard No. (13) on Mudarabah]. However, if the Company invests such funds through investment agency, the deal shall be subject to Shari'ah rulings on remunerated agency.

10/8 When the insurance assets along with indemnities received from re-insurance companies fall short of covering indemnity commitments, the Company may cover the deficit from project financing or *Qard Hasan* (interest-free or benevolent loan) debited to the account of the insurance fund. In this regard, the deficits resulting from commitments of the current year may be covered from the surpluses of the succeeding years. The Company may also claim settlement of the deficit from policyholders if they undertake to do so in the insurance policy.

10/9 The insurance account shall bear all the expenses and fees that relate to insurance activities.

10/10 There is no Shari'ah restriction on reconciling between the Company and the party who causes the injury, if such reconciliation is in the interest of the participants, and conforms to the relevant Shari'ah rulings.

**11. Indemnity**

11/1 The participant shall receive either the loss, he incurred because of the injury, or the insurance amount; whichever is less, and as per regulations.

11/2 The participant should not receive both the indemnity and the compensation from other parties for injury caused to him.

11/3 In Property Insurance, indemnity should be confined to what has been provided for in the regulations, and may comprise subsidiary losses that can be appropriately estimated according to the actual injury.

**12. Insurance Surplus**

12/1 The insurance surplus is part of the assets of the insurance account and should be disposed of according to what has been stated in item 5/5 of this Standard.

12/2 Distribution of the surplus or part thereof among the policyholders should be in one of the following forms, provided that the selected form is explicitly mentioned in the regulations:

12/2/1 Distribution of the surplus among the policyholders in proportion to their respective contributions, and regardless of whether the policyholder has received indemnity during the financial period or not.

12/2/2 Distribution of the surplus among the policyholders who have not received indemnity during the financial period.

12/2/3 Distribution of the surplus among policyholders after deducting the amounts of indemnity they receive during the same financial period.

12/2/4 Distribution through any other method approved by the Shari'ah Supervisory Board.

**13. Expiry of Insurance Policy**

The insurance policy expires in any of the following cases:

13/1 At the end of the period agreed upon in the insurance policy. In case of property insurance, it is permissible to stipulate that the contract is automatically renewable unless the participant informs the company, within a specific period before expiry of the contract, of his desire to cease contract's renewal.

13/2 Termination of the policy by the company or the participant, if the policy provides for the right of termination to each of the parties to contract.

13/3 Complete damage of the insured property (in case of property insurance), without nullifying the entitlement of the participant to the indemnity, subject to the contract's conditions.

13/4 Death of the insured person in case of persons' (life) insurance, without nullifying the entitlement of the beneficiary to the insurance benefits, subject to the contract's conditions.

**14. Date of Issuance of the Standard**

This Standard was issued on 23 Rabi' I, 1426 A.H., corresponding to 2 May 2005 A.D.

# Adoption of the Standard

The Shari'ah standard on Islamic Insurance was adopted by the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7-12 Jumada I, 1427 A.H., corresponding to 3-9 June 2006 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Makkah Al-Mukarramah to issue a Shari'ah Standard on Islamic Insurance.

On 12 Jumada I, 1424 A.H., 12 July 2003 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare a draft standard on Islamic Insurance.

In its meeting No. (10) held on 23–24 Jumada II, 1424 A.H., corresponding to 23–24 July 2003 A.D., in Amman, the Hashemite Kingdom of Jordan, the Shari'ah Standards Committee (1) discussed the Shari'ah study and advised the consultant to incorporate the necessary changes, in the light of the discussions and observations of its members.

The Shari'ah Standards Committee (1) once again discussed the draft of the Standard in its meeting No. (11) held on 25–26 Safar 1425 A.H., corresponding to 15-6 April 2004 A.D., in the Kingdom of Bahrain and incorporated further changes in it. The committee also requested the consultant to review the document on the light of the discussions and incorporate necessary changes.

A third round of discussions on and amendments in the draft of the Standard also took place in meeting No. (12) of the Shari'ah Standards Committee (1) held on 28 Rabi' II, 1425 A.H., corresponding to 16 June 2004 A.D. in Dubai, United Arab Emirates.

The revised version of the Standard was then submitted to the Shari'ah Board in its meeting No. (13) held in Makkah Al-Mukarramah on 26 Sha'ban – 1 Ramadan 1425 A.H., corresponding to 10–15 October 2004 A.D. and further changes were incorporated in the document.

In its meeting No. (14) held in Dubai, United Arab Emirates on 21–24 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D., the Shari'ah Board discussed the draft of the Standard and decided, in the light of the discussions and comments of the members, to transfer it to the Shari'ah Standards Committee (1) for thorough study.

The Shari'ah Standards Committee (1) studied the draft of the Standard in its meeting No. (17) held in Kingdom of Bahrain on 4–5 Sha'ban 1426 A.H., corresponding to 8–9 September 2005 A.D.

The revised draft of the Standard was again submitted to the Shari'ah Board in its meeting No. (15) held in Makkah Al-Mukarramah, on 22–26 Sha'ban 1426 A.H., corresponding to 26–30 September 2005 A.D. The Board decided to send the document to concerned experts for review and comments before discussing it in a public hearing.

AAOIFI held a public hearing in the Kingdom of Bahrain on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D. More than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and other interested parties attended the session. Several comments and observations were posed, to which the members of the Shari'ah Standards Committees (1) and (2) duly responded.

In its meeting held in the Kingdom of Bahrain on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D., the Drafting Committee discussed the comments and observations made in the public hearing and made the changes that it deemed necessary.

In its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7–12 Jumada I, 1427 A.H., corresponding to 3–9 June 2006 A.D., the Shari'ah Board discussed the amendments proposed by the Drafting Committee, incorporated some changes in the document and approved the Standard (unanimously for some clauses and with the majority for others), as indicated in the minutes of the Board's meetings.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Commercial Insurance is prohibited because it involves Gharar (uncertainty). In this regard Muslim, *Ashab Al-Sunan* (compilers of the books of Sunan) and others quoted Abu Hurayrah as having said: *"The Prophet peace be upon him prohibited sales which involve Gharar"*.(2)
- The Fuqaha define Gharar in several ways, which -in brief- indicate that it is a process that has unknown/unrevealed consequences and outcomes.(3)
- Some contemporary scholars believe that Gharar is similar to betting and gambling.(4)
- Resolutions of Fiqh forums on insurance include the resolution of the Islamic Fiqh Academy in its first session held in 1398 A.H., which endorsed a preceding resolution on the subject issued by the Council of Eminent Shari'ah Scholars of the Kingdom of Saudi Arabia in its session No. (10) held in Riyadh on 4 April 1397 A.H. A third resolution on the subject was issued by the International Islamic Fiqh Academy - Resolution No. 9 (9/2).
- Permissibility of cooperative/mutual/social insurance stems from the fact that it is based on cooperation and donation, rather than on Mu'awadah (exchange contract). It is well known among the Fuqaha (Maliki School)

(2) *"Sahih Muslim", Kitab: Al-Buyu'* [3: 1153]; *"Sunan Abu Dawud"* [2: 228] (H: 3367); *"Sunan Al Nasa`i"* [2: 217]; *"Sunan Ibn Majah"* [2: 739]; *"Sunan Al-Tirmidhi"* [3: 532]; *"Sunan Al-Darimi"* [2: 167]; *"Al-Muwatta`"* [2: 664]; *"Musnad Al-Imam Ahmad"* [1: 203] and [2: 367 and 439]; *"Sunan Al-Bayhaqi"* [5: 226]; and *"Musannaf Ibn Abu Shaybah"* [8: 194], Section (2).

(3) See: *"Sharh Al-'Inayah Ma'a Fath Al-Qadir"* [5: 192]; *"Tabyin Al-Haqa`iq"* [4: 46]; *"Al-Taj Wa Al-Iklil"* [4: 362]; *"Fath Al-'Aziz Bi-Hamish Al-Majmu'"* [8: 127]; *"Matalib Uli Al-Nuha"* [3: 25]; *"Al-Qawa'id Al-Nuraniyyah"* (P. 116); *"Nazariyyat Al-'Aqd"* (P. 224). See: *"Al-Gharar Wa Atharahu Fi Al-'Uqud"* by Al-Siddiq Al-Amin Al-Darir (published by Saleh Kamil Center for University Thesis), (P. 54).

(4) See: Husayn Hamid, *"Al-Gharar"* (P. 72).

that Gharar has no impact on donation contracts. This viewpoint is well supported by a number of Quranic verses and sayings of the Prophet (peace be upon him) which instruct Muslims to promote cooperation.

- Consequently, several resolutions were issued by Fiqh forums regarding permissibility of cooperative insurance. Such resolutions include, the resolution of the Islamic Research Academy of Al-Azhar Al-Sharif, the resolution of the Islamic Fiqh Academy of the World Muslim League referred to earlier, and the resolution of the International Islamic Fiqh Academy, which states that: "The contract that respects the origins of Islamic dealings is the cooperative insurance Contract which is based on donation and cooperation…". The fact that cooperative insurance is permissible, also does not seem to have encountered any dispute among contemporary Muslim Fuqaha.(5)
- Permissibility of cooperative insurance and non-permissibility of commercial insurance is in fact due to the following differences:

  a) The conventional insurance contract is a financial Mu'awadah (exchange contract) that aims at making profit out of the insurance operations. Therefore, its permissibility should be judged in the light of the Shari'ah rulings on financial transactions. Consequently, such rulings prohibit the conventional insurance contract, which involves Gharar.

  b) In the Islamic insurance contract, the company assumes the role of the agent of the insurance account, whereas in the commercial insurance contract the company is an original party that signs the contract in its own name.

  c) The company in commercial insurance owns the premiums against its commitment to pay the insurance amount; whereas in Islamic insurance, it is the insurance account rather than the company that owns the contributions.

  d) In Islamic insurance the residual premiums and the returns on them, that remain after deduction of expenses and indemnity amounts,

(5) Fatawa of the Shari'ah Advisory Board of Al Rajhi Banking & Investment Company, Fatwa No. (40).

become the property of the policyholders account, and constitute a surplus, which can be distributed among the policyholders. This cannot be imagined in commercial insurance where the company owns and receives the premiums as soon as it signs the contract. In commercial insurance, the premiums constitute part of the revenue and profits of the company.

e) In Islamic insurance, the returns on investment of the premium assets belong to the policyholders account, after deduction of the Mudarib share for the company, whereas such returns belong to the company in commercial insurance.

f) Islamic insurance aims at achieving cooperation among the members of the society, rather than generating profits from the insurance operations, whereas commercial insurance is profit-oriented.

g) The company in Islamic insurance earns profits through investment of its own funds and its share in Mudarabah, as it assumes the role of the Mudarib and the insurance account assumes the role of the Rab al-Mal (owner of the capital).

h) In Islamic insurance, the insurer and the participant are in fact the same person although they differ in recognition, whereas the insurer and the participant are totally different in commercial insurance.

i) The company in Islamic insurance adheres to the rules of Islamic Shari'ah and the Fatawa of its Shari'ah Supervisory Board, while in commercial insurance there are no such commitments.

j) In Islamic insurance, the allocations from the insurance account, which remain there until the time of liquidation of the company, are spent on charity purposes, and do not go to shareholders, whereas in commercial insurance such amounts go to shareholders.

- The Shari'ah ruling that the Islamic insurance contract is an act of donation that both parties are bound to honor, is measured by analogy to what is known in Fiqh as *Nihd*,[6] or donation pledge. It has been narrated that

(6) Al-Bukhari in his *"Sahih"* [15: 128] commented on *Nihd* or *Nahd* where he said (….since Muslims did not see any harm in *Nihd*, in which the members of =

Ali and Ibn Mas'ud said: "A gift, if specifically defined, is binding, whether received or not." It has also been narrated that Abu Bakr and Umar indicated that a gift does not become binding before receipt.(7) Malik however reconciled the two viewpoints by indicating that Ali, Ibn Mas'ud and the others seem to have focused on the fact that the contract as such is binding, while Abu Bakr and Umar seem to have focused on the fact that the receipt of the gift is a prerequisite of finalizing the contract. The latter viewpoint was justified by the desire to leave no room for an excuse that Umar explicitly mentioned.(8) The obligatory nature of the donation contract can also be derived from the saying of the Prophet (peace be upon him) that: *"A person who withdraws his gift is like a dog that withholds its vomit"*.(9)

- The basis of the Shari'ah ruling that the company should not guarantee the insurance assets is that the company is an agent, and the Fuqaha unanimously agree that an agent should not guarantee the property except against misconduct, negligence or breach of the contract.
- The justification for stating the nine principles of Islamic insurance in the articles of association of the company is the need to preserve the element of donation in the contract and emphasize it as a basic aspect of the company, and hence preserve the cooperative nature and permissibility of the insurance operation. Otherwise, the insurance operation becomes a Mu'awadah transaction, and therefore subject to impact of Gharar as mentioned earlier. In other words, emphasis on the nine principles is because they constitute the fundamental differences between Islamic insurance and commercial insurance. Several Fatawa were issued to

= of the group consume different amounts of the food to which they have equally contributed) and he narrated some sayings of the Prophet (peace be upon him) that support this practice. In *"Fath Al-Bari"* [5: 129], Ibn Hajar indicated that *Nihd* was an ancient practice of Muslim travelers who used to contribute equally to the stock of food they need during their journey, and leave each of them free to consume the portion of the food he needs. At the end of the journey, they distribute the food leftover among themselves, unless they decide to keep it for another journey. This is quite similar to the treatment of the surplus in Islamic Insurance.

(7) See: *"Al-Muwatta`"* [2: 468]; and *"Nasb Al-Rayah"* [4: 122].

(8) *"Bidayat Al-Mujtahid"* [2: 534].

(9) *"Sahih Al-Bukhari"* [5: 190]; and *"Sahih Muslim"* (H: 1622].

demonstrate these differences including, Fatwa No. (12/11) issued by the 12th Seminar on Islamic Economics of the Al Baraka Group, Fatwa No. (42/3) issued by the Shari'ah Supervisory Board of the Al Rajhi Company, Fatwa of the Shari'ah Board of Faisal Islamic Bank and Fatwa of the Islamic insurance Company of Jordan.(10)

- The general framework of the contract and the nature of its conditions have been set up along the lines of binding contracts in Islamic jurisprudence, and the peculiar characteristics of the insurance contracts as far as the insured is concerned.
- The ruling that the insurer and the insured must fulfill their commitments is based on the Shari'ah prerequisite of honoring contracts. Since the insurance contract is a binding contract, all its conditions should be honored unless they violate the rules of Islamic Shari'ah. Such reasoning is well supported by various Quranic Verses and sayings of the Prophet (peace be upon him) that explicitly instruct Muslims to honor their contracts and conditions. In this regard, Allah, the Almighty, says: ***{"O You who believe! Fulfill (all) obligations..."}.***(11) The Prophet (peace be upon him) also says *"Muslims are at their conditions"*.(12)
- The company could manage the insurance account against fee or free of charge because the relationship here is viewed as agency, which the Fuqaha unanimously approve, with or without remuneration. The Fatawa in this regard comprise those of the 12th Seminar on Islamic Economics of the Al Baraka Group (Fatwa No. (12/11), the resolution of the Islamic Fiqh Academy of the Muslim World League – Makkah Al-Mukarramah (Fatwa No. 961), and Fatwa No. (51) of the Council of Eminent Scholars of Saudi Arabia.
- The basis of assigning the investment of the assets of the insurance fund to the company is the Mudarabah contract, which the Fuqaha unanimously declare as permissible. Arrangement of investment in this manner entails

(10) See: *"Fatawa Al-Ta`min"*, Dallah Al Baraka Group, Dr. Abdul-Sattar Abu Ghuddah and Dr. Izzul-Din Khoja (eds.), (pp. 99-108).

(11) [Al-Ma`idah (The Table): 1].

(12) Related by Al-Bukhari in his *"Sahih"* [4: 451]; and Al-Tirmidhi with *"Tuhfat Al-Ahwazi"* [4: 584]. Al-Tirmidhi deemed it a good, authentic Hadith.

specification of a profit share for each party, and entitlement of the insurance fund to its respective share. The relevant Fatawa in this regard include the Fatwa of the Shari'ah Supervisory Board of Faisal Islamic Bank,(13) Fatwa No. (12/11) of the 12th Seminar on Islamic Economics of the Al Baraka Group and the Shari'ah Standard No. (13): Mudarabah.

- The emphasis on honoring commitments in general – including commitment of the company to furnish *Qard Hasan* to the insurance account – is based on the Shari'ah requirement of honoring pledges that are binding to either of the two parties. This viewpoint to which some leading Fuqaha subscribe is well supported by Qur`an, Sunnah and reported Muslim practice, such as the divine Quranic instruction: ***{"...Fulfill (all) obligations..."}*** has been taken by the Fuqaha to comprise any Shari'ah-accepted commitment of the Muslim. There are also several sayings of the Prophet (peace be upon him) which indicate that Muslims are bound to honor their contracts, covenants and pledges.(14) Several resolutions of Shari'ah forums and Shari'ah Boards were also issued in this connection including, resolution No. 40 – 41 (2–5/3) of the International Islamic Fiqh Academy(15) and the Fatwa of the Shari'ah Supervisory Board of the Islamic Insurance Company of Jordan.(16)
- The ruling that responsibility of providing the evidence lies with the participant depends on the general rules in the Qur`an, the Sunnah and the opinion of the Ulema that evidence should be established by the claimant. This has been indicated in several Fatawa including Fatwa No. (14/6) of the United Shari'ah Board of Al Baraka Group.
- Permissibility of the two types of Islamic insurance (mentioned in this Standard) rests on the various evidences of permissibility of Islamic insurance in general, as discussed earlier, and are supported by various Fatawa of Shari'ah Boards. Such Fatawa include Fatwa No. 2/9 of the 2nd Al Baraka Seminar on Islamic Economics, Fatwa No. 10/3/5 of the 10th Al Baraka seminar on Islamic Economics, and other Fatwa issued by the Shari'ah

(13) See: Chapters on Mudarabah in books of various schools of Fiqh, and the term "Mudarabah" in the Kuwaiti Encyclopedia.

(14) See: *"Mabda` Al-Rida Fi Al-'Uqud: Dirasah Muqaranh"* (Principle of Consent in Contracts: A Comparative Study) and its references.

(15) See: Magazine of the International Islamic Fiqh Academy, Issue No. (5), (2/754– 965).

(16) *"Fatawa Al-Ta`min"*, (P. 106).

Supervisory Boards of Dubai Islamic Bank, Kuwait Finance House, Qatar Islamic Bank and the Islamic Insurance Company – Jordan.(17)

- The rulings relating to the contract as such are based on the general principles of contracts in Islamic Shari'ah, which emphasize avoidance of fraud and deceit and the need to observe the time limits indicated in the contracts. Shari'ah rulings on compensation have also been resorted to in this connection, in addition to the Fatawa and resolutions issued by various forums such as the Islamic Fiqh Academy of the Muslim World League, the Supreme Council of Ulema of Saudi Arabia and the Shari'ah boards of Islamic banks and Islamic insurance companies.(18)
- The jurisdictions of the company are determined on the basis of its articles of association, the various documents that govern the contractual relationship, the general principles of contracts and conditions, insurance conventions, and some Fatawa of Shari'ah boards.
- The rules that regulate the relationship between the company and the policyholders are based on the articles of association, which consider this relationship as an agency contract (remunerated or free of charge) for the management of the insurance operations, and Mudarabah for the investment of the insurance assets.
- Indemnity is based on the general Shari'ah directives emphasizing the principle that "one should neither tolerate harm nor cause it to others"(19) as well as the general principles and rules of Fiqh that advocate fair, and at the same time, non-obsessive indemnification for injury. Furthermore, inferences on indemnity could also be drawn from the cooperative nature of this donation-oriented contract, in addition to some Fatawa such as Fatwa No. (3) of the 10th Al Baraka Seminar on Islamic Economics, and the various Fatawa of the Shari'ah boards of Islamic banks and Islamic insurance companies.(20)

(17) *"Fatawa Al-Ta`min"* (pp. 193–206).
(18) ibid.
(19) This Hadith has been related by Malik in *"Al-Muwatta`"*, *"Kitab Al-Aqdiyah"*; Ahmad in *"Musnad Al-Imam Ahmad"* [1: 313] and [5: 527]; and Ibn Majah in his *"Al-Hashiyah"* [2: 782].
(20) *"Fatawa Al-Ta`min"*, (P. 153).

- Treatment of the insurance surplus is based on the cooperative nature of the contract and the practice of the *Sahabah* [companions of the Prophet (peace be upon him)] with regard to *Nihd*, as reported by Bukhari.(21)
- Possibility of contract termination stems from the fact that the insurance contract is a time-specific contract, and therefore it expires at the end of its stipulated period just like Ijarah (hiring). The insurance contract also expires on the damage of the insured property (or death of the insured), as there will be no object of commitment.

(21) Al-Bukhari in his *"Sahih"* [15: 128] commented on *Nihd* or *Nahd* where he said (….since Muslims did not see any harm in *Nihd*, in which the members of the group consume different amounts of the food to which they have equally contributed) and he narrated some sayings of the Prophet (peace be upon him) that support this practice. In *"Fath Al-Bari"* [5: 129], Ibn Hajar indicated that *Nihd* was an ancient practice of Muslim travelers who used to contribute equally to the stock of food they need during their journey, and leave each of them free to consume the portion of the food he needs. At the end of the journey, they distribute the food leftover among themselves, unless they decide to keep it for another journey. This is quite similar to the treatment of the surplus in Islamic Insurance.

# Appendix (C)
# Definitions

**Premium**

It is the amount of the contribution, which the participant donates, along with its related profits, for the benefit of the insurance scheme.

**Insurance Amount**

It is the amount paid by the company out of the insurance account at the occurrence of the risk insured against.

**Risk Insured Against**

It is the probable, legally acceptable, accident.

**Commercial Insurance**

It is a contract between an insured party and a technical insuring body, stipulating that the former pays the latter a specific number of financial installments or a lump sum amount, against the commitment of the latter to bear a risk that can be insured against, through payment of an estimated financial indemnity to the insured or the beneficiary, on the occurrence of the risk. [Clause No. (747) of the Egyptian law, Clause No. (773) of the Kuwaiti Law and Clause No. (983) of the Iraqi Law].

**Cooperative Insurance**

A collective insurance contract is a contract whereby each participant undertakes to pay a specific amount of money as donation to indemnify any member of the group who encounters the risk insured against.

**Islamic Insurance**

It is a kind of cooperative insurance, which covers all types of risks, under the management of a specialized company that adheres to the rules and principles of Shari'ah. In this sense, Islamic insurance differs from coopera-

tive insurance as the latter only covers a specific group of beneficiaries who might encounter risks, for instance, merchants, sailors and the like while Islamic insurance is available to the general public. Islamic insurance also differs from cooperative Insurance with regard to adherence to the rules and principles of Islamic Shari'ah as well as in some technical aspects pertaining to premiums. In cooperative insurance, premiums may be variable at the beginning; whereas in organized Islamic insurance, premiums are specific due to use of precise statistical studies.

**Mutual Insurance, the Alternate to Life Insurance**

It is the insurance that covers the risks of death, inability, injury or illness, for the individual or the group, through payment of the insurance amount to the participant or the beneficiary, as per the agreement.

**Surplus**

The Surplus comprises of residual premiums of the participants (the insured) in addition to the reserves and profits, after deducting all expenses and indemnity amounts (paid or payable during the same year). The residual amount, thus computed, is considered as surplus, rather than profit.

**Gharar**

It is what one cannot predict its unrevealed/unknown consequences. Something that may occur/materialize or may not(22).

**Participant**

The Participant is a person who accepts the cooperative insurance scheme, signs the insurance policy and undertakes to observe its consequent commitments. It may be referred as the insured, the insured for and the policyholder.

**Insurance Account**

It is the account established by the company by virtue of its articles of association, to accommodate the premiums of the participants and the returns thereon as well as the reserves. Such account has an independent

(22) See: *"Al-Gharar Wa Atharahu Fi Al-'Uqud"* (P. 53).

financial liability towards its own claims and commitments, though it is represented by the company for its all affairs. This account is also known as the insurance fund, the policyholders account or the portfolio of the participants group.

## Shari'ah Standard No. (27)

# Indices

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to present basic information about Indices with special emphasis on their nature, functions, Shari'ah status of their various applications, and to what extent Islamic financial institutions (Institution/Institutions)[1] may apply them.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers definition of Indices, methods of their calculation, their main types, their various forms of applications, and the Shari'ah status of each of these forms. The Standard also sets out the Shari'ah rulings that govern Indices.

## 2. Definition and Main Applications of the Index

1/2 An Index is a statistically computed figure based on a selected package of financial papers or commodities dealt in organized or non-organized financial markets, or in both. Each paper/commodity is given a specific weight, according to its market value, and the total value is divided by a constant figure. Among the best-known indices at present are the Consumer Price Index, and the Dow Jones and FTSE indices in the financial markets.

2/2 An Index that is well designed to measure the market situation, indicates the general economic situation of the country, and may help in forecasting its future developments before any change takes place and, thus, facilitates investment decisions. An index may also provide a signal to investors about the future movement of the prices of financial papers, or demonstrate a certain downward or upward trend of such prices. Due to the inconsistency that might occur between one index and another, indices are used besides other analytical methods, as well as the experience and knowledge about the market situations and the predominant models of transactions.

2/3 The upward and downward movements of an index reveal the directions of the market, and hence the market is denoted as a rising or a declining market.

## 3. Bases of Calculation and Characteristics of Indices

3/1 Calculation of indices is a process that depends on several aspects including past and current price forecasts, market projections, time intervals, upper and lower limits of dealing prices, and display charts.

3/2 Indices differ from each other in several aspects such as the components of the index or the type of data it attempts to summarize, the weight it assigns to each component, and the method of calculation thereof. There are, however, some common characteristics among all well-known indices in the capital and commodity markets, regardless of the data that each index attempts to analyze. Most important among these characteristics are accuracy, objectivity and transparency.

Accuracy refers to proper specification of the components of the index, sources of its data input, time of obtaining the data, method of calculating the weights, and basis of rounding off the numbers.

Objectivity entails presentation of the detailed calculations of the index to leave no room for difference of opinion with regard to determination of the value of the index on a specific date or at a specific place.

Transparency entails pre-specification of the time, place, and method of announcing the readings of the index so that the process does not involve *Jahalah* (ignorance or uncertainty).

3/3 There are some general principles that govern almost all indices, such as:

3/3/1 The absolute value of the index has no implication when presented as a single figure. The value of the index, at a given point of time, becomes meaningful only when compared to the past and future values of the index. Only then, the trend and percentage of change may be observed. For instance, an increase of 9 points in the value of the index may represent 2% of its previous value.

3/3/2 The values of the index at different periods may be multiplied or divided by any constant figure (i.e., increasing or decreasing

the figures of the index by the same percentage like division of shares), without affecting the accuracy of its implications. That is to say, the implications of the index are confined to what it represents of the average upwards and downwards changes in the weights of its components from time to time.

## 4. Types of Indices

Indices are classified according to different considerations:

**4/1** With regard to their general or specific nature, indices may be classified into the following categories:

- General Indices that measure the market situation in general.
- Sectoral Indices that measure the market situation of a certain sector or industry, such as the transport sector.

**4/2** Indices that precede price movements may be classified, with regard to central and area fluctuations, into the following categories:

- Centered Oscillating Indices, which measure price changes during a specific period in the past, and indicate probable future events.
- Ranged Oscillating Indices (band) that fluctuate between two areas, like overbuying or overselling.

## 5. Permissible Methods of Using Indices

5/1 It is permissible in Shari'ah to use indices to discern the magnitude of change in a certain market, or to judge the performance of specialized managers by comparing the returns they achieve to the indices. Indices may be used to form up an idea about a portfolio or to estimate its systematic risks instead of monitoring the performance and risks of each financial paper independently. Moreover, Indices may also be used for forecasting the future situation of the market and discovering the pattern of changes that the market may undergo. Therefore, using indices for guidance in operations that relate to real transactions is permissible in Shari'ah.

5/2 It is permissible to use indices as a benchmark for comparison of funds and investment bonds, or for correlating the remuneration of

the manager or the bonus of the agent to the investment, or the bonus of the Mudarib to the results of the Mudarabah.

5/3 It is permissible to use an index like LIBOR, or a certain share/commodity price index, as a basis for determining the profit of a Murabahah pledge, provided that the contract is to be concluded on a specific profit that does not vary with further changes in the index. [see Shari'ah Standard No. (8) on Murabahah – Item 4/6]

5/4 It is permissible to use the index to determine the portion of the variable *Ujrah* (rent) that represents the return. [see Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek – para 5/2/3]

5/5 It is permissible that work rules, regulations and the arrangements, pertaining to money-based employment contracts, stipulate a provision on wage indexation.Wage indexation here refers to periodical adjustment of wages according to changes in the price level, as determined by the concerned bodies. However, in case of accumulation of unpaid wage that takes the form of debt, Shari'ah rulings on debts should be observed.

5/6 It is permissible to link the deals to be undertaken by the Mudarib or the agent to a specific index, so that he can dispose of the commodity at the market price when the index reaches a certain reading, or purchase a certain amount of the commodity at a specific reading of the index.

5/7 It is permissible to connect the fulfillment of a binding pledge on the part of a buyer or a seller to the rate of increase or decrease of a specific index in comparison to the price of the commodity at a particular date, so that any further increase may be added to the price of the commodity.

5/8 It is permissible to link the amount of a donation to a charitable body, in case of delayed settlement, with a particular index, at one end.

## 6. Impermissible Methods of Using Indices

6/1 Shari'ah prohibits trading in indices or taking advantage of their changes in the financial markets, through payment or receipt of

money on the mere occurrence of certain readings of the index, and without selling or buying the real assets which the index represents or any other assets. Such dealing is prohibited even if it is practiced for the sake of hedging against potential risk.

6/2 It is prohibited in Shari'ah to conclude option contracts on indices. [see Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets – item 5/2]

6/3 It is also prohibited in Shari'ah to conclude contracts on the Index Contracts' Multiplier.

6/4 It is also prohibited in Shari'ah to link a contract that should not be suspended, like selling, to a specific index.

6/5 It is prohibited in Shari'ah to connect the amount of a cash debt, at the time of lending, to the price index.

## 7. Development of an Islamic Index

The following points should be observed while developing an Islamic Index:

7/1 Adherence to Shari'ah precepts, in addition to the technical controls relating to the components of the index, and its applications.

7/2 There should be a Shari'ah Supervisory Board for the Index, to ensure observation of the Shari'ah precepts in the components and applications of the index, and to conduct periodical review and reporting relating thereto.

## 8. Date of Issuance of the Standard

This Standard was issued on 12 Jumada I, 1427 A.H., corresponding to 3–9 June 2006 A.D.

# Adoption of the Standard

The Shari'ah standard on Indices was adopted by the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7–12 Jumada I, 1427 A.H., corresponding to 3–9 June 2006 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah board decided in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Makkah Al-Mukarramah, to issue a Shari'ah Standard on Indices.

On 12 Jumada I, 1424 A.H., corresponding to 12 July 2003 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare a draft Standard on Indices.

The Committee (2) discussed the draft Standard in its meeting No. (15) held in Manama, Kingdom of Bahrain, on 8 Jumada I, 1426 A.H., corresponding to 15 June 2005 A.D., and made necessary changes thereto in the light of the discussions and comments of its members.

The Committee (2) once again discussed the draft Standard in its meeting No. (16) held in Manama, Kingdom of Bahrain, on 4–5 Sha'ban 1426 A.H., corresponding to 8-9 September 2005 A.D., and incorporated necessary changes therein in the light of the discussions and observations of the meeting.

The revised draft of the Standard was submitted to the Shari'ah Board in its meeting No. (15) held in Makkah Al-Mukarramah on 22–26 Sha'ban 1426 A.H., corresponding to 26-30 September 2005 A.D. The Shari'ah Board decided to send the draft Standard to specialized experts for review and comments before discussing it in a public hearing.

AAOIFI held a public hearing in the Kingdom of Bahrain, on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D. More than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, academics and other interested parties attended the public hearing. Several

observations were made in the session to which members of the Shari'ah Standards Committees (1) and (2) duly responded.

The draft Standard was presented to the Drafting Committee in a meeting held in Kingdom of Bahrain on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D., and several amendments were proposed in the meeting.

The Shari'ah Board discussed in its meeting No. (16) held in Al-Madinah Al-Munawwarah, on 7-12 Jumada I, 1427 A.H., corresponding to 3-9 June 2006 A.D., the amendments proposed by the Drafting Committee and accepted some of them. The Shari'ah Board then approved the Standard, unanimously for some of its clauses and by majority for others, as indicated in the minutes of the Board's meetings.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Developing indices is permissible in Shari'ah because they constitute a method of forecasting and a means of observing the state of circumstances (inferences). Resorting to inferences is a well-recognized practice in judicature and financial transactions. Ibn Al-Qayyim in his book on Judicial Methods presented a number of proofs on permissibility of using inferences.
- Permissibility of using indices to forecast the market situation is derived from acceptability of using inferences for judgment. As indicated above, Shari'ah does not object to using inferences to make current or future judgment based on past events, or to initiate practical actions in the light of probable developments.
- Selling or buying indices is prohibited because it is nothing more than payment or receipt of money for the mere existence of a certain reading or figure. Such an act constitutes a form of gambling and an illegal act of gaining money. Hence, prohibition of selling or buying indices has been well emphasized by the Resolution of the International Islamic Fiqh Academy which states that it is not permissible to sell or buy an index, because this constitutes pure gambling. It is an act of selling an imaginary object that never exists.(2)
- Prohibition of concluding option contracts that are based on indices, or on the index contracts' multiplier, rests on the same reasons for prohibition of trading in indices, in addition to prohibition of dealing in options themselves. Such transactions obviously deal with wills and intentions rather than with real commodities. Moreover, prohibition of dealing in options has been clearly stated in a resolution issued by the International Islamic Fiqh Academy.(3)

(2) Resolution No. 63 (1/7), Resolution of the Islamic Fiqh Academy (P. 127).
(3) Resolution No. 63 (1/7), Resolution of the Islamic Fiqh Academy (P. 127).

- The justification for periodical adjustment of wages subject to changes in the level of prices is to pursue application of a fair wage policy, and protect the money income of the employees against deterioration of purchasing power due to inflation. It is permissible to provide for such a condition in the contract because conditions between contracting parties are permissible in principle, unless they lead to reversing what has been permitted or prohibited by Shari'ah.

# Appendix (C)
# Definitions

**Index Multiplier**

A specific ratio added to the difference in the price of the index on expiry of the date of the transaction.

**Centered Oscillating Indices**

These are the indices that fluctuate around a given center or point. They measure price change in a past period, and are used for forecasting probable future events. Such indices precede market movements and measure the rate of price change during the period under study.

**Ranged Oscillating Indices**

These are indices that fluctuate between two specific ranges, such as the limit of overbuying and the limit of overselling.

**Benchmark**

It refers to any index that represents the performance of a whole industry or a particular activity. It can be used as a standard for measuring the performance of investment funds and investment units, or used as an indicator for fixing remuneration for management or bonus for the investment agent or the Mudarib.

**Hedging**

It is a method for mitigating investment risks (such as market risks) by using financial instruments available in the market to curb down the risks that may arise from severe price changes.

**Divider**

It is the total price of the two shares, divided by the average price before division.

**Index Contracts' Multiplier**

It is a decimal or simple number, multiplied by the nominal value of a contract that has been connected to the performance of a certain index, to calculate the value of the contract based on the performance of that index.

## Shari'ah Standard No. (28)

# Banking Services in Islamic Banks

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to indicate banking services provided by Islamic financial Institutions (Institution/Institutions),[1] and the Shari'ah opinion on the fees charged for such services.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers the most important banking services that do not involve lending and borrowing, and which the Institutions render to their customers, directly or through other parties, with the aim of facilitating internal and external operations and activities performed by these customers.

It does not cover loan and investment services, or other banking services for which separate Shari'ah standards have already been issued, such as trading in currencies, debit and credit cards, investment accounts, and investment Sukuk.

## 2. Types of Banking Services and Their Shari'ah Status

Institutions may provide banking services against fees payable in lump sum or as a percentage share of the value of the service in question, as indicated in the following cases:

### 2/1 Custodian services

Institutions may receive Shari'ah-accepted documents and financial papers from their customers as a custodian of such documents/ financial papers, and may charge fees for such services.

### 2/2 Contracting agency services

A customer may use the institution as an agent for concluding contracts such as sale, purchase, and lease contracts, against a fee payable to the institution.

### 2/3 Subscription arrangement services

2/3/1 The institution may act as an agent of the founding shareholders of a Shari'ah-accepted and technically licensed joint stock company, in performing the various steps of the public issue, or issuing new

shares to increase the capital of the company, and may receive fees for such services. However, the fees thus earned by the Institution should not comprise any remuneration for extending credit, if it happens to be part of the service.

2/3/2 The Institution may arrange, and receive fees for, engaging a third party to underwrite the subscription. The Institution may also underwrite the subscription itself, without charging any fees for the mere act of underwriting. However, the Institution may charge the actual expenses it incurs in providing other services like conducting studies or marketing the shares. [see Shari'ah Standard No. (5) on Guarantees, item 6/7]

**2/4 Services of conducting studies and consultancies**

2/4/1 The institution may conduct, against a fee or free of charge, feasibility studies or other studies relating to issuance of shares.

2/4/2 The institution may act as an agent of its customers, for a fee or free of charge, in performing services that relate to real estate properties (residential buildings, commercial blocks, offices, etc.) as well as movable assets.

**2/5 Collection and payment services**

2/5/1 The institution may accept requests of its customers to collect their dues with, or pay their commitments to other parties. For instance, it can perform collection of cheques, debt notes, and promissory notes from debtors, or vouchers of shares and Sukuk owned by the customers, and deposit the proceeds in their accounts. It can also make payments on behalf of its customers and charge their accounts. For all such services, the Institution may receive fees from the customers or their agents.

2/5/2 The institution may pay wages and salaries on behalf of its customers.

2/5/3 The institution may execute standing collection and payment orders.

2/5/4 The institution should refrain from collection when it realizes that it involves an impermissible practice, or leads to discounting of a commercial paper. [see Shari'ah Standard No. (16) on Commercial Paper, item 5]

**2/6 Accounts' services**

2/6/1 The institution may provide additional services to the owners of its investment or current accounts when they desire so, and charge fees for such services.

2/6/2 The institution may provide free services to the owners of its investment or current accounts, provided that the services rendered to the owners of the current accounts are not set as a precondition or constitute a traditionally observed prerequisite for opening the account. [see Shari'ah Standard No. (19) on Loan (Qard), item 10/2]

**2/7 Services of safe deposit vaults**

2/7/1 The institution may provide the services of leasing safe deposit vaults to its customers. This is done through signing a contract according to which the Institution allocates a safe deposit vault within its premises for the customer to use against a specific fee. The deal here is based on Ijarah (hiring) contract that entitles the customer to the vault's usufruct.

2/7/2 The institution is responsible for ensuring the safety of the vault. However, it does not guarantee the safety of items kept in vault except in case of misconduct or negligence in keeping the vault.

**2/8 Services of cards and their related bodies**

See Shari'ah Standard No. (2) on Debit Card, Charge Card and Credit Card.

**2/9 Zakah account services**

See Shari'ah Standard No. (35) on Zakah, item 2/2.

**2/10 Suretyship services**

See Shari'ah Standard No. (5) on Guarantees, item 6

### 2/11 Cheques services

See Shari'ah Standard No. (16) on Commercial Papers, item 3/3 and item 7.

## 3. Date of Issuance of the Standard

This Standard was issued on 12 Jumada I, 1427 A.H., corresponding to 8 June 2006 A.D.

# Adoption of the Standard

The Shari'ah standard on Banking Services in Islamic Banks was adopted by the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al -Munawwarah on 7–12 Jumada I, 1427 A.H., corresponding to 3-8 June 2006 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (10) held on 2–7 Rabi' I, 1424 A.H., corresponding to 3–8 May 2003 A.D., in Al-Madinah Al-Munawwarah to issue a Shari'ah Standard on Banking Services and Facilities in Islamic Banks.

On 29 Safar 1425 A.H., corresponding to 19 April 2004 A.D., the Shari'ah Standards Committee (2) decided to commission a Shari'ah consultant to prepare a draft standard on Banking Services and Facilities in Islamic Banks.

In the meeting of the Shari'ah Standards Committee (2) on 14-15 Safar 1426 A.H., corresponding to 24-25 March 2005 A.D., in the Kingdom of Bahrain, the committee discussed the study and advised the consultant to incorporate the necessary changes, in the light of the discussions and observations of the Committee members.

In the meeting No. (17) of the Shari'ah Standards Committee (1) held on 8-9 Sha'ban 1426 A.H., corresponding to 8-9 September 2005 A.D., in the Kingdom Of Bahrain, the Committee discussed the draft standard and introduced necessary changes therein.

The Shari'ah Board discussed, in its meeting No. (15) held on 22–26 Sha'ban 1426 A.H., corresponding to 26-30 September 2005 A.D., in Makkah Al-Mukarramah, the draft of the Standard, and decided, in the light of the discussions and observations of the members, to send it to Shari'ah Standards Committee (1) for review.

A joint committee comprising the members of Shari'ah Standards Committees (1) and (2) discussed the Standard in a meeting held on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D., in the Kingdom of Bahrain, and incorporated necessary changes.

The revised draft of the Standard was submitted to the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7–12 Jumada I, 1427 A.H., corresponding to 3–8 June, 2006 A.D. The Shari'ah Board made further changes in the document and decided to send it to the concerned experts for review and observations before discussing it in a public hearing.

AAOIFI then held, in the Kingdom of Bahrain on 6 Rajab 1427 A.H., corresponding to 31 July, 2006, the public hearing which was attended by more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session to which the members of the Shari'ah Standards Committees (1) and (2) duly responded.

The Shari'ah Board adopted, in its meeting No. (17) held in Makkah Al-Mukarramah on 26 Shawwal – 1 Dhul-Qa'dah, 1427 A.H., corresponding to 18–23 November, 2006 A.D., the Standard (unanimously for some clauses and with the majority for others), as indicated in the minutes of the Board's meetings.

# Appendix (B)
# The Shari'ah Basis for the Standard

- It is permissible for the Institutions to provide banking services that do not involve interest-based lending and borrowing, because such services serve a permissible interest of the clients.
- Institutions may charge fees for providing banking services, because the fees so charged constitute a remuneration which the Institutions deserve for the tasks they perform, since it is permissible in Shari'ah to get reward for performing tasks that result in permissible benefits to others.
- The fee charged by the institutions may be a lump sum amount or a percentage of the value of the service, because when the percentage remuneration is calculated it becomes like the lump sum amount.

Shari'ah Standard No. (29)

# Stipulations and Ethics of Fatwa in the Institutional Framework

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to indicate the meaning of Fatwa (Shari'ah opinion), elucidate the eligibility conditions for issuance thereof, and define its appropriate means and scope. The standard also aims to identify the observed methods of Fatwa presentation and explain how an erroneous Fatwa can be rectified.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers the area of Fatwa because it is one of the tasks assigned to Shari'ah Supervisory Boards (Board/Boards) of the Islamic Financial Institutions (Institution/Institutions).[1]

## 2. Definition of Fatwa and Istifta` (Seeking Fatwa)

2/1 The term Fatwa refers to a Shari'ah opinion presented to a person who seeks it with regard to an incidence that has already occurred (the Fatwa incidence) or is expected to occur. It does not refer to answering queries pertaining to hypothetical incidences.

2/2 Istifta` refers to the act of seeking the Shari'ah opinion on an incidence that has already occurred or expected to occur.

## 3. Shari'ah Ruling on Fatwa and Istifta`

3/1 Originally, Fatwa is a collective duty that can be discharged of by any one of those who are able to do it. Fatwa could, however, become the personal duty of the individual if he happens to be the only one in the community who is eligible to issue it.

3/3 The board has to provide Fatwa to the Institution by virtue of their relationship.

3/4 It is the duty of the Institution to seek Fatwa on incidences that actually occur or are expected to occur. It should also seek Fatwa for every operation that it intends to pursue.

3/5 Although the seeker of the Fatwa is free to use his best efforts to determine the most appropriate source (both in terms of knowledge and integrity) from whom he will seek the Fatwa, yet according to

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

the rules and regulations, Institutions have to seek Fatwa from their own boards.

**4. Scope of Fatwa (Content)**

Fatwa in Institutions is confined to operational financial rulings and issues pertaining to them such as some rulings on worshipping, as well as permissibility and prohibition in some concerns such as Zakah.

**5. Conditions on Mufti (Fatwa Issuers)**

5/1 A board member shall be well versed in Fiqh (Islamic Jurisprudence), well informed of the contributions of diligent Fiqh scholars, and has the ability to use the Shari'ah-accepted methods of deriving reasonable rulings on emerging issues. He shall also be known for his discernment, cautiousness and knowledge about the circumstances and traditions of people, and should always remain alert against the different means of human misbehavior. Competence in Fiqh is usually manifested by the vast reputation of the scholar or his distinguishable contributions especially in the area of financial transactions performed by institutions.

5/2 Issuing Fatwa to institutions does not require competence in all areas of Fiqh. Fatwa can be issued by a scholar who is competent only in the area of financial transactions performed by institutions.

5/3 The member of the Board shall have no personal interest in the matter for which the Institution seeks Fatwa.

**6. Duties of the Institution That Seeks Fatwa**

6/1 The Institution is obliged to follow the Fatwa once it is issued regardless of whether it meets the satisfaction of the management or not. This obligation holds true when the Fatwa entails enforcement or prohibition of a certain act. When the Fatwa entails permissibility of the act in question, the institution has the right to refrain from following it, if it believes that for practical needs it has to do so. In this case, however, rejection of the board Fatwa should be reported to the General Assembly of the institution.

6/2 Fatwa should be sought again if there are new developments that should be presented to the Board. New developments may include change or improvement of conception, occurrence of new circumstances, or non-existence of some of the underlying reasons of the previous Fatwa.

6/3 The institution should not follow the Fatwas of other Shari'ah Advisory Boards except with permission of its own Board.

6/4 The institution should not demand Fatwa according to a specific *Madhab* (School of Fiqh) even if it is the official school in its host country, or the school that official Fatwa bodies adhere to. However, attention should be given to situations where the legal or judiciary system in the country observes a specific school, and the issue in question may be taken to the courts in the future.

**7. Methods and Means of Fatwa**

7/1 Fatwa should basically be founded on what has been explicitly stated in the Qur`an and the Sunnah along with what has been supported by Ijma' (consensus of Fuqaha) or proved by Qiyas (analogical deduction). After resorting to the preceding sources, the judgment of the Mufti (issuer of the Fatwa) with regard to the different viewpoints of the Fuqaha (scholars of Fiqh); i.e, Istihsan (Shari'ah approbation) and *Maslahah Mursalah* (public interest) may be considered as the basis for issuance of Fatwa.

7/2 Fatwa should not be based on a personal viewpoint that does not cater for the sources referred to in item (1/7) above, or contradict with the general texts of the Qur`an and the Sunnah that have explicit indications. Moreover, Fatwa shall also not fall in disparity with well-established Ijma' or the general rules derived from the Qur`an and the Sunnah.

7/3 Absence of explicit directives in the Qur`an and Sunnah on a given issue, or non-existence of the issue in the prevailing Fiqh literature, do not justify refraining from seeking Fatwa on that issue. Fatwa in this case may be derived through Shari'ah-sanctioned rules and methods of deduction.

7/4 The board may coordinate with the Institution to transfer the Fatwa, if necessary, to a board that is considered to be more reliable due, for instance, to its larger membership, or its inclusion of more specializations, such as Fiqh academies, AAOIFI Board and the Supreme Shari'ah boards.

7/5 Among the means that may be used for reaching the appropriate Shari'ah ruling on a given issue are the following:

7/5/1 Building detailed knowledge about the issue of the Fatwa through questioning the one who seeks it, consulting other boards, resorting to experts and specialized parties, and taking into consideration the prevailing norms and tradition.

7/5/2 Tracing the Shari'ah ruling on the issue in the different schools of Fiqh, and exerting due endeavors to ascertain if the issue encounters the existence of contradicting proofs, or it is an issue that has not been specifically dealt with in the Qur`an and the Sunnah or discussed by the Fuqaha.

7/5/3 Making use of collective Fatwas, such as the resolutions of the Islamic Fiqh Academy, other Shari'ah Advisory Boards, seminars, and conferences.

7/6 The board should issue Fatwa whenever the Institution approaches it for that purpose, except when it feels that the Institution may use the Fatwa for committing a impermissible action. In that case, the board may either refrain from issuing the Fatwa, or make it subject to certain restrictions.

7/7 Endeavors should be made for disseminating the Fatwas of the Institution and exchanging them with other Institutions and related bodies.

## 8. Fatwa Controls

8/1 Derivation of presumptive indications from the texts, or usage of unattested narrations about the Prophet (peace be upon him) should be avoided. Moreover, all the Sunnah texts used for supporting the Fatwa should be well-documented.

8/2 Fatwa issuers, while issuing the Fatwa, shall signify keenness to quote *Ijma'* and opinions of diligent Fuqaha from their accredited sources, as well as concentration on those opinions which have gained more accreditation in each School of Fiqh, and should resort to available Fiqh literature on principles of issuing Fatwa.

8/3 When the Fatwa offers the chance for choice between two permissible actions, preference shall be given to the easier. If choosing one of the two permissible actions would result in realization of a lawful interest while choosing the other would leave the door open for blight, leaving the door open for blight should be avoided, and efforts shall be exerted to resolve the repercussions that may subsequently result.

8/4 Fatwa issuers shall not always pursue Shari'ah exemptions to make matters easier for Institutions. A Shari'ah exemption should be sought only when it results from thorough examination of the issue and appropriate reasoning. Moreover, it has to be ensured that making use of the Shari'ah exemption does not embody a related act that the Fuqaha unanimously consider as prohibited, or lead to issuing different Fatwas for two identical incidences. Misuse of Shari'ah exemptions in this manner is known in Fiqh as "*Talfiq*" (fabrication).

8/5 Fatwa issuers shall not direct Institutions to impermissible tricks for escaping Shari'ah restrictions, or violating the objectives of Shari'ah legislation.

8/6 Fatwa shall not be issued hastily, declaring (for instance) prohibition of an act for the mere sense of condemnation that the one feels towards new habits and traditions, unless such habits and traditions contradict with the rules and principles of the Shari'ah. Similarly, declaring permissibility of an act shall not come for the mere sake of following rules and traditions.

8/7 It shall be made clear, when necessary, that declaring permissibility of an act is by no means amount to recommending that act or making a call for performing it.

## 9. Text of Fatwa

9/1 The Fatwa shall be clearly stated so that it may not be misunderstood by the layman, or taken to mean different things to those who have bad intentions.

9/2 When there are more than one Fiqh opinion on the same issue, the board shall declare the specific opinion that it subscribes to. If the issue is controversial the board has to explain the specific bases of its choice.

9/2 When the Fatwa has more than one aspect all such aspects have to be clearly indicated.

9/3 In principle, mentioning the proof is not an underlying condition for issuing the Fatwa, and the Institution has no right to impose it as a condition for accepting it. However, the board has to refer to the bases of its Fatwa.

9/4 The Fatwa statement shall be precise, concise and free from any confusing details and preachy expressions that have nothing to do with serving the purpose. If, however, the subject requires detailed statement for the sake of public interest or so as to convince the regulatory and supervisory bodies, it would be better to add such expressions, in order to justify the ruling, indicate the goal behind it, and warn against falling into blights.

9/5 There is no harm to provide more information than what has been requested by the seeker of the Fatwa in order to leave no room for confusion, or to distinct the opinion from other similar opinions, or to serve a future need of the Fatwa seeker.

## 10. Fatwa Manuscript (Document)

10/1 In principle, Fatwa can be issued by uttering, signaling or acting, but for Institutions it should be written to become an evidence or a document that can be referred to.

10/2 Fatwa shall be started by the Verse of *Basmalah* (i.e., In the name of Allah, the Most Gracious, the Most Merciful), along with praise to Allah and blessings on Prophet Muhammad (peace be upon him).

At the end of the Fatwa, the same expressions could be repeated or, in stead, expressions like *"Allahu A'lam"* (Allah knows best) could be introduced to indicate closing up of the Fatwa statement.

10/3 Fatwa shall be clearly handwritten or typed, and each page of it shall be initialed. It should also carry the date of its issuance and the official stamp of its issuing source, if such stamp is available.

10/4 Clear linkage between the Fatwa request and the Fatwa statement should be indicated. Preferably, there shall be a precise summary of the question.

10/5 When the Fatwa is issued by the concerned board of the Institution, the content of the Fatwa shall be stated in the formal proceedings of the board meeting.

**11. Retreat from a Mistaken Fatwa**

11/1 The board has to retreat from its Fatwa if it is proved to be wrong on reviewing, or on examination by a higher body. In such case, the board has to inform the Institution so as to rectify the ruling and its consequent effects. The Institution on its part has to correct all the actions that had been based on the wrong Fatwa and refrain from adopting it any more.

11/2 The board, on its own initiative or on request of the institution, has the right to review a previous Fatwa even if such revision would lead to issuing a new Fatwa that contravenes the former one. In such case, the Institution has to follow the new Fatwa in the future and rectify the effects and repercussions of the old one.

**12. Morals of Fatwa (Ethics of Fatwa Issuers)**

12/1 Being slow and cautious in explaining the Fatwa, and avoiding over-courage in making Fatwa decisions.

12/2 Avoidance of issuing different Fatwas, on the same subject and the same issue, according to the source of the Fatwa request.

12/3 Fatwa issuer should avoid issuing Fatwa when he is mentally involved in a personal affair that leaves him no room for offering correct judgment.

12/4 Keeping the secrets of the Institution and its employees, as well as the application mechanisms, which have been revealed to the board in the Fatwa process. Dealing with such secrets should not surpass the limits of illustrating the Fatwa, to indulge into unnecessary disclosure of information on technical means and procedures of application.

## 13. Date of Issuance of the Standard

This Standard was issued on 1 Dhul-Qa'dah 1427 A.H., corresponding to 23 November 2006 A.D.

# Adoption of the Standard

The Shari'ah standard on Controls and Ethics of Fatwa in the Institutional Framework was adopted by the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al-Munawwarah on 1 Dhul-Qa'dah 1427 A.H., corresponding to 23 November 2006 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (14) held in Dubai (U.A.E) on 21–23 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D., to issue a Shari'ah Standard on Controls and Ethics of Fatwa in the Institutional Framework.

On 29 Jumada I, 1426 A.H., corresponding to 6 July 2005 A.D., the Shari'ah Standards Committee decided to commission a Shari'ah consultant to prepare a study on Controls and Ethics of Fatwa in the Institutional Framework.

The study was discussed in a meeting of a joint committee comprising Shari'ah Standards Committees (1) and (2) held in Makkah Al-Mukarramah on 8–9 Rabi' I, 1427 A.H., corresponding to 6–7 April 2006 A.D., and the consultant was advised to incorporate necessary changes, in the light of the discussions and observations raised in the meeting.

The revised draft of the Standard was submitted to the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7–12 Jumada I, 1427 A.H., corresponding to 3–8 June 2006 A.D. Further changes were introduced in the draft and the board decided to send it to the concerned experts for review and observations before discussing it in a public hearing.

AAOIFI then held, in the Kingdom of Bahrain on 6 Rajab 1427 A.H., corresponding to 31 July 2006 A.D., a public hearing which was attended by more than 30 participants representing central banks, institutions, accounting firms, Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session to which the members of the Shari'ah Standards Committees (1) and (2) duly responded.

In its meeting No. (17) held in Makkah Al-Mukarramah on 26 Shawwal – 1 Dhul-Qa'dah, 1427 A.H., corresponding to 18–23 November, 2006 A.D., the Shari'ah Board accepted the changes proposed by the participants in the public hearing and adopted the Standard (unanimously for some clauses and with the majority for others), as indicated in the minutes of the Board's meetings.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Fatwa is considered as a collective duty that can be discharged of by any one of those who are able to do it, because it is one of the religious functions that serve public interest. Therefore, what is required is to have someone in the Muslim community who can issue Fatwa, rather than to have each and every individual of the community able to do so. Fatwa would become the duty of a specific individual or a group only if that individual or group is the only one who can issue it. If Fatwa were to become the duty of every member of the society, things would be more complicated.(2)
- It is the duty of the institutions to seek Fatwa because otherwise they would not be able to meet their commitments to observe the rules of the Islamic Shari'ah. Therefore, Institutions should approach the boards for obtaining Fatwa. Similarly, it is the duty of the board to issue Fatwa to the Institution due to the relationship that binds the two by virtue of the decision of the general assembly (equity owners) of the Institution.
- Acceptance of the Fatwa of a Shari'ah scholar whose knowledge is confined to only one branch of Fiqh, such as financial transactions in institutions, is based on the viewpoint that Ijtihad (reasoning) and Fatwa may be made partially.(3)
- Preventing the Institution to adopt the Fatwas of other boards, except when allowed by its own board to do so, stems from the need to bar the way to any tendency of fabrication or attempt to pursue Shari'ah exemptions without observing their relevant controls or their context and circumstances, an act which leads to adoption of irrelevant Fatwas.
- Permissibility of referring the Fatwa to a higher Shari'ah board or to a Fiqh forum for reconsideration, or making use of collective Fatwa, rests on the

(2) *"Sifat Al-Fatwa Wa Al-Mufti Wa Al-Mustafti"*, Ibn Hamdan Al-Hanbali (P. 52)
(3) ibid. (P. 28).

fact that an opinion that gains support from a large group of eligible scholars is likely to be more reliable. Moreover, collective Fatwa may facilitate more coordination, and avoidance of discrepancies in the Fatwas of the different boards on the same subject.

- Withdrawal or refraining from dissemination of a certain Fatwa for fear of being misused is based on the principle of *Sadd al-Zara`i'* which advocates the prohibition of a permissible act if it would (certainly or probably) lead to blight.
- Pursuing Shari'ah exemptions is prohibited because it leads to relaxation of the rules of the Islamic Shari'ah and induce loss of keenness to observe them. Therefore, some Fuqaha hold that pursuing Shari'ah exemptions amounts to *Fisq* (rebellion against Allah's Obedience).(4)
- Choosing the easier ruling when two alternative options are available is supported by the Qur`an in Allah's Saying: ***{"Allah intends for you ease, and He does not want to make things difficult for you"},***(5) and by the Sunnah in the Prophetic Hadith stating: *"Make things easier not harder..."*.(6) All these directives are to be considered after reviewing the specific proofs.(7)
- The controls relating to the text of the Fatwa are meant to ensure that the Fatwa would achieve its goal without deviating to an invalid meaning. As indicted by Ibn Hamdan(8) in his book *"Sifat Al-Fatwa"*, drawing attention to these controls and what the ancestor Fuqaha had said about them is meant to ensure the appropriateness of the Fatwa.
- Permissibility of offering additional information with the Fatwa is shown by the statement of the Prophet (peace be upon him) when he was asked about using seawater for *Wudu`* (ablution): *"Seawater is pure and sea carcasses are permissible"*.(9)

(4) *"I'lam Al-Muwaqqi`in"* by Ibn Al-Qayyim [1: 222]; and *"Sifat Al-Fatwa Wa Al-Mufti Wa Al-Mustafti"* by Ibn Hamdan (P. 32).
(5) [Al-Baqarah (The Cow): 185]
(6) *"Sahih Al-Bukhari"* (H: 69); and *"Sahih Muslim"* (H: 1734).
(7) *"Rasm Al-Mufti"* by Ibn Abidin (P. 11).
(8) *"Sifat Al-Fatwa Wa Al-Mufti Wa Al-Mustafti"* by Ibn Hamdan (pp. 58–66).
(9) *"Sunan Ibn Majah"* (H: 386 and 388).

- The controls on the Fatwa document aim to preserve Fatwa from being misused.(10)
- The ruling that a wrong Fatwa should be rectified is supported by the incident when the Caliphate Umar in one case issued a Fatwa that denied some of the brothers the right of inheritance, and later on he issued another Fatwa that granted such brothers the inheritance right. Having done so he said: the former case was subject to my previous Fatwa, and the new one is subject to the new Fatwa.(11)
- Avoidance of hasty Fatwa should be observed because it was the practice of the *Sahabah* (Companions of the Prophet) and the other leading Fuqaha who succeeded them. In issuing Fatwa, one should not feel shy to say: I do not know, or to postpone the Fatwa until he is in a position to answer it properly.(12)

(10) See more elaborations on *"Sifat Al-Fatwa Wa Al-Mufti Wa Al-Mustafti"* by Ibn Hamdan (P. 63).
(11) *"Jama' Al-Jawami'"* by Al-Subki (with elaborations by Al-Mahalli) [2: 391].
(12) *"Sifat Al-Fatwa Wa Al-Mufti Wa Al-Mustafti"* by Ibn Hamdan (pp. 6-11).

# Appendix (C)
# Definitions

- Judgment entails the issuance of a verdict which is binding to the two litigants. In this sense, Fatwa differs from judgment as the latter entails offering a Shari'ah ruling without enforcing commitment towards it. Fatwa also differs from education, because the latter is not restricted to a specific incident. Therefore, Fatwa is quite distinct from an initiation to teach Shari'ah rulings, or a mere act of seeking knowledge about hypothetical incidences.

## Shari'ah Standard No. (30)

# Monetization (Tawarruq)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

The purpose of this standard is to indicate the essence of Monetization and explain the Shari'ah conditions for its validity, as well as the controls pertaining to its application in Islamic financial Institutions (Institution/ Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the different applications of monetization, whether the beneficiary is the customer or the institution.

## 2. Definition of Monetization and Its Distinction from *Bay' Al-'Inah*

Monetization refers to the process of purchasing a commodity for a deferred price determined through Musawamah (Bargaining) or Murabahah (Mark-up Sale), and selling it to a third party for a spot price so as to obtain cash.

Whereas 'Inah refers to the process of purchasing the commodity for a deferred price, and selling it for a lower spot price to the same party from whom the commodity was purchased.

## 3. Mutawarriq (Monetization Beneficiary)

3/1 The Monetization beneficiary may be a customer who purchases the commodity from the Institution and sells it to a third party to obtain liquidity. It may also be the Institution itself when it purchases the commodity from the customer or another Institution and sells it to a third party to obtain liquidity. The controls for both cases are shown in items (4) and (5) below.

3/2 The institution should not perform Monetization for the benefit of conventional banks when it discovers that such banks are going to use the liquidity for interest-based lending instead of Shari'ah-compliant operations.

## 4. Controls on Monetization Transactions

4/1 The requirements of the contract for purchasing the commodity on deferred payment bases should be fulfilled, for both Musawamah and Murabahah transactions, with due consideration to Shari'ah Standard

No. (8) on Murabahah. There shall also be a real commodity that the seller owns before selling it. If the process is to involve a binding promise, it shall be from only one party. As regards the commodity sold, it shall not be gold or silver or any type of currency.

4/2 The commodity sold shall be well identified so as to become distinct from the other assets of the seller. This may be done by separating the commodity from the other assets of the seller, or recording the numbers of its identifying documents such as storing certificates. [see Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets, item 4/2/2]

4/3 If the commodity is not made available at the time of signing the contract, the client shall be given a full description or a sample that indicates the quantity of the commodity and the place of its storage, so that his act of purchasing the commodity becomes real rather than fictitious. In this sense, using local commodities for Monetization is more preferable.

4/4 The commodity shall be actually or constructively received by the buyer, and there remains no further condition or procedure for receiving it.

4/5 The commodity (object of Monetization) must be sold to a party other than the one from whom it was purchased on deferred payment basis (third party), so as to avoid 'Inah which is strictly prohibited. Moreover, the commodity shall not return back to the seller by virtue of prior agreement or collusion between the two parties, or according to tradition.

4/6 The contract for purchasing the commodity on deferred payment basis, and the contract for selling it for a spot price shall not be linked together in such a way that the client looses his right to receive the commodity. Such linking of the two contracts is prohibited whether it is made through stipulation in the documents, acceptance as a normal tradition, or incorporation in the procedures.

4/7 The client shall not delegate the Institution or its agent to sell, on his behalf, a commodity that he purchased from the same Institution and, similarly, the Institution shall not accept such delegation. If, however, the regulations do not permit the client to sell the commodity except through the same Institution, he may delegate the Institution to do so after he, actually or constructively, receives the commodity.

4/8 The Institution should not arrange proxy of a third party to sell, on behalf of the client, the commodity that the client purchased from the Institution.

4/9 The client shall not sell the commodity except by himself or through an agent other than the Institution, and shall duly observe the other stipulations.

4/10 The Institution shall provide the client with the information that he or his appointed agent may need for selling the commodity.

**5. Controls on Monetization When the Institution Is the Beneficiary**

5/1 Monetization is not a mode of investment or financing. It has been permitted when there is a need for it, subject to specific terms and conditions. Therefore, the Institutions shall not use Monetization as a means of mobilizing liquidity for their operations, and exert no effort for fund mobilization through other modes such as Mudarabah, investment agency, Sukuk, investments funds, and the like. The Institution shall resort to monetization only when it faces the danger of a liquidity shortage that could interrupt the flow of its operations and cause losses for its clients.

5/2 The institutions shall avoid proxy in selling the Monetization commodity, even if proxy is to be arranged with a third party. In other words, Institutions shall use their own bodies for selling the monetization commodity, though using brokers for this purpose is permissible.

**6. Date of Issuance of the Standard**

This Standard was issued 1 Dhul-Qa'dah 1427 A.H., corresponding to 13 November 2006 A.D.

# Adoption of the Standard

The Shari'ah standard on Monetization was adopted by the Shari'ah Board in its meeting No. (17) held in Makkah Al Mukarramah on 26 Shawwal – 1 Dhal-Qa'dah 1427 A.H., corresponding to 18-23 November 2006 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

The Shari'ah Board decided in its meeting No. (7) held on 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D., in Makkah Al Mukarramah, to issue a Shari'ah Standard on Monetization, as practiced by banks.

On 17 Sha'ban 1423 A.H., corresponding to 3 October 2005 A.D., the Shari'ah Standards Committee (2) decided to commission a Shari'ah consultant to prepare an exposure draft on Monetization.

On 6 Rabi' I, 1426 A.H., corresponding to 15 April 2005 A.D., the Shari'ah Standards Committee (2) decided to commission another Shari'ah consultant to redraft the Monetization Standard in the typical format of the other Shari'ah Standards.

The Committee (2) discussed the exposure draft in its meeting No. (15) held in Manama, Kingdom of Bahrain on 8 Jumada I, 1426 A.H., corresponding to 15 June 2005 A.D., and introduced necessary changes in the light of the comments and observations of the members.

A joint committee comprising members from Shari'ah Standards Committees (1) and (2) discussed the exposure draft in a meeting held in the Kingdom of Bahrain on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D., and introduced further changes in the light of the comments and observations of its members.

In its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7-12 Jumada I, 1427 A.H., corresponding to 3-8 June 2006 A.D., the Shari'ah Board discussed the amendments suggested by the joint meeting of the two Shari'ah Committees and accepted what it deemed appropriate.

AAOIFI then held a public hearing in the Kingdom of Bahrain on 6 Rajab 1427 A.H., corresponding to 31 July 2006 A.D. The public hearing was attended by more than 30 participants representing central banks, Institutions, accounting firms, Shari'ah scholars, university teachers and other interested parties. Several observations were made in the public hearing to which the members of the Shari'ah Standards Committees (1) and (2) duly responded.

In its meeting No. (17) held in Makkah Al-Mukarramah on 26 Shawwal – 1 Dhul-Qa'dah 1427 A.H., corresponding to 18-23 November 2006 A.D., the Shari'ah Board discussed the changes proposed by the participants in the public hearing, accepted some of them, and adopted the Standard (unanimously for some clauses and with the majority for others), as indicated in the minutes of the Board's meetings.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Differentiation between Monetization and 'Inah with regard to permissibility and prohibition stems from the fact that, contrary to the former, the latter is a trick for practicing Riba (usury). 'Inah takes place between two parties who are in fact a borrower and a lender. The lender sells the commodity to the borrower for a deferred price and buys it back from him for a less price payable on spot. The majority of the Fuqaha subscribe to prohibition of 'Inah and permissibility of monetization, except Ibn Taymiyyah and Ibn Al-Qayyim who consider monetization as prohibited or worthy of aversion.
- Permissibility of constructive receipt of the commodity has already been catered for in the Shari'ah Standard No. (18) on Possession (Qabd) and the Shari'ah Standard No. (1) on Trading in Currencies.
- Permissibility of monetization transactions that observe the Shari'ah controls indicated in this Standard can be traced in the texts of the Qur`an and the Sunnah that permit sale transactions. It has also been confirmed by two resolutions issued by the Islamic Fiqh Academy of the Muslim World League,(2) and the Standing Committee of the Supreme Board of Shari'ah Scholars of the Kingdom of Saudi Arabia (Fatwa No. 19297), as well as the Fatwas of several Shari'ah Supervisory Boards. Therefore, monetization is an exit for avoiding Riba rather than a trick for performing it, as it is usual-

(2) Resolution of the 15th Session which imposes no condition other than that Monetization should not be performed like 'Inah. Also, the Resolution of the 17th Session which comprises other conditions (well-observed in this standard) most important of which is non-commitment of the bank to become the agent of the client in selling the commodity which "makes Monetization similar to 'Inah" – using the same words of the Resolution - and non-violation of the condition relating to receipt of the commodity: (the Resolution here did not impose actual receipt only, similar to what it did in its 11th Session where it considered legal receipt to be sufficient in currency exchange, which requires more controls than sale transactions).

ly practiced by those who do not want to be involved in interest-based borrowing. It has been reported by Abdullah Ibn Al-Mubarak(3) that 'A`ishah (may Allah be pleased with her) practiced it.

- Prohibition of joining together the contract for purchasing the commodity and the contract for selling it is justified by the fact that joining them together would impose a commitment on the client to sell the commodity right away. Hence, such immediate transfer of the ownership of the commodity may not enable the client to receive it. This is again the same reason for prohibition of agency-related commitments.
- Permissibly of resorting to agency of the Institution when the client, by virtue of law, cannot sell the commodity directly, is meant to safeguard the deal from being nullified by the law.
- The ruling that the Institution shall provide detailed information about the commodity to the client aims at preventing fictitious transactions and helping the client to obtain liquidity. Such requirement holds true whether the commodity in question is a commodity, a car, shares of a company, international goods, or local goods. The latter are more suitable for monetization due to the easiness of ensuring their existence, and the chance available to the client to actually hold them if he so desires.
- The ruling that the Institution shall provide the client with a full description or a sample of the commodity is to ensure that the latter's act of purchasing the commodity is actual rather than fictitious.
- Monetization (where the client or the Institution is beneficiary) shall be subjected to strict controls and restrictions so that institutions fulfill the main objectives underlying their presence and the interest of customers to make dealings with them.
- Principally, institutions have to show strict commitment towards using modes of investment and financing such as the various forms of Musharakah (Partnership) and exchange of goods, usufructs and services that conform to the very nature and basic activities of Islamic banking. Hence, imposition

(3) Al-Azhari Al-Shafi'i, *"Al-Zahir"* (P. 216); and *"Al-Fa`iq Fi Ghrib Al-Hadith"* [2: 108]. For permissibility of Monetization see also Al-Mardawi, *"Al-Insaf"* [4: 250]; *"Kashshaf Al-Qina""* [2: 447] and [3: 185]; *"Al-Mughni"* [4: 127]; Al-Sarakhsi, *"Al-Mabsut"*, [11: 211]; and Al-Nawawi, *"Al-Rawdah"* [3: 416].

of controls and restrictions on monetization would curb any tendency for expanding monetization to the extent that jeopardizes the extensive use of the original modes of investment and financing. Therefore, Institutions shall not use monetization except in the limited scope defined in this Standard. They shall also restrict the use of monetization to the cases of clients whose transactions cannot be disposed of through other modes of financing and investment such as Musharakah, Mudarabah, Ijarah, Istisna'a and the like. Monetization may also be used as a means for helping the clients to dispose of their previous interest-based debts, after ensuring that they have developed genuine intention not to deal in usurious transactions any more.

Shari'ah Standard No. (31)

# Controls on Gharar in Financial Transactions

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This standard aims at defining Gharar (uncertainty), indicating its types and impacts and emphasizing controls that need to be applied when Gharar is to the extent which nullifies transactions.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers the impact of excessive, medium and minor Gharar on transactions performed by Islamic financial institutions (Institution/Institutions).[1] In this respect the standard will set out the Shari'ah rulings pertaining to the case when Gharar is involved in exchange-based contracts/commutative contracts (*'Uqud al-Mu'awadat*) including partnerships, and the case when Gharar is involved in donation contracts/non-commutative contracts (*'Uqud al-Tabarru'at*). The standard will also make special reference to the case when Gharar is involved in a contract's condition.

## 2. Definition and Types of Gharar

2/1 Gharar is a state of uncertainty that exists when the process of concluding a transaction involves an unknown aspect. In other words, Gharar refers to the status of results that may or may not materialize.

2/2 Degree-wise, Gharar can be excessive, medium or minor. As regards its effect on the transaction, Gharar can be to the extent which nullifies the contract or it may not be so.

## 3. Shari'ah Status of Gharar

It is impermissible in Shari'ah to conclude a contract or stipulate a condition that involves a degree of Gharar which could jeopardize the fulfillment of the contracts stipulations. The degree of Gharar for this purpose is judged as per item (4) below.

## 4. Controls on Gharar Which Violates Transactions

Gharar violates the transaction when it satisfies the following four conditions:

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

a) If it is involved in an exchange-based contract or any contract of that nature.

b) If it is excessive in degree.

c) If it relates to the primary subject matter of the contract.

d) If it is not justified by a Shari'ah-recognizable necessity.

**4/1 First Condition: When Gharar is in an exchange-based contract or a similar contract:**

This includes, for instance, sale, lease and partnership contracts, whereas Gharar does not affect donation contracts such as gift and will contracts.

In an exchange-based contract Gharar can be either in the form or subject matter of the contract.

**4/2 Second Condition: When Gharar is excessive**

4/2/1 Gharar is excessive when it becomes a dominating and distinctive aspect of the contract, and is capable of leading to dispute. However, assessment of Gharar for such purpose could differ according to place and time, and has to be determined in the light of normal practice ('Urf). Examples of excessive Gharar include selling of fruits before production, signing a lease contract for an unspecified period, and sale of a Salam commodity that is not usually available on date of delivery. Gharar in any of these forms sets the contract null and void.

4/2/2 Minor Gharar is the degree of Gharar that a contract could hardly avoid, and is not sufficient to generate dispute. This includes transactions like sale of a house to a buyer who has not seen its foundation, or leasing the house for one month while months differ in length. Such type of Gharar does not affect the contract.

4/2/3 Medium Gharar falls between excessive and minor and its examples are: sale of underground commodities or commodities that cannot be known unless broken, or leasing of fruit trees.

Medium Gharar can also exist in contracts like Ju'alah (payment of a specific reward for a task if accomplished), guardianship, companies and fixed-term Mudarabah. Medium Gharar does not affect the contract.

**4/3 Third Condition: When Gharar relates to the primary object of the contract**

If Gharar relates to the primary subject matter of the transaction, it sets the contract null and void, as when unripe fruits are sold (apart from the trees and without a stipulation for awaiting harvesting). If, instead, Gharar is in a corollary (*Tabi'*) of the primary subject matter, it has no effect on the contract. The example here is selling the unripe fruits along with the trees, or selling the nonexistent part of the plants along with the part that already exists. A further example of Gharar in a corollary is a fetus sold along with the pregnant sheep, or milk in the udder of a sold sheep.

**4/4 Fourth Condition: When no Shari'ah-recognizable need has necessitated Gharar in the contract**

Need in this context (which could be public or private) refers to the situation when refraining from commitment of impermissible Gharar leads to severe hardship, though may not amount to mortality. Need should also be inevitable; i e, there should be no permissible way of accomplishing the task, except through the contract that involves excessive Gharar. Commercial insurance, in the absence of Takaful (solidarity insurance) can be cited here as a fitting example.

**5. Scope of Gharar in Exchange-Based Contracts *('Uqud al-Mu'awadat)***

Gharar in this type of contracts could be in the form, object or terms of the contract.

**5/1 Excessive Gharar in the form of the contract**

Gharar is said to be in the form of the contract when it relates to offer and acceptance rather than to the object of the contract. Practical types of such Gharar comprise the following:

5/1/1 Combining two sales in one sale (*Bay'atayn Fi Bay'ah*)

Combining two sales in one sale nullifies the contract, and the examples of that is selling a good for one thousand pounds in cash or two thousands on deferred payment, without concluding any of the two deals.

5/1/2 Sales in which the deal is finalized subject to random selection of the sold object

Sales become void when the sold item is randomly selected. One example of such type of sale is *Bay' al-Hasah* (sale by stone throwing), in which the seller throws a stone and the buyer has to accept the item on which the stone falls. Another example is *Bay' al-Munabadhah* (throwing of the sold commodity), where the seller throws to the buyer one of the commodities he wants to sell. Such sale could also be conducted by using a programmed machine to determine the sold good irrespective of the choices of the seller and the buyer.

**5/2 Gharar in the object of the contract**

5/2/1 Gharar in sold or leased objects and the like

5/2/1/1 Gharar which results from ignorance of the essence of the sold commodity nullifies the contract. This type of Gharar takes place when, for instance, a sale contract is concluded without indicating what the sold commodity is. Ignorance of the essence of the sold commodity would consequently result in ignorance of the type and characteristics of that commodity.

5/2/1/2 Gharar which stems from ignorance of the type of the sold commodity nullifies the contract, as when a car is sold without specifying its type, or when an amount of currency is sold (through a currency exchange contract) without indicating the type of that currency or having a generally accepted tradition for its determination.

5/2/1/3 Gharar which results from lack of knowledge of the sold commodity in particular (non-specification of the commodity) nullifies the contract. The example of this is sale of a non-specified car from a number of cars in a car showroom, or sale of a piece of land in a residential area without the option of specification.

5/2/1/4 Gharar due to ignorance of the specific characteristics of the sold commodity (for commodities that usually differ in nature) nullifies the contract. This happens when a nonexistent commodity is sold without describing it.

5/2/1/5 Gharar due to ignorance of the amount of the sold commodity, such as *Bay' al-Juzaf* (sale of an unknown quantity), nullifies the contract, except when there exist the conditions that make Gharar forgivable. Such conditions include: viewing the sold commodity at the time of sale, or when estimation is possible in the case of the commodity in question, or if what really matters for that specific commodity is the quantity as a whole rather than the individual components. In such cases, Gharar does not nullify the contract.

5/2/2 Gharar in the price or rent of the contract's object

Gharar could arise when, for instance, a commodity is sold without mentioning the price, or when the price is left to be determined by one of the two parties of the contract, or by a third party. Another example here is the case of somebody purchasing a commodity for an amount of money in a bundle or in his pocket. A third example is purchasing the commodity by using a currency which the buyer ignores its issuer and has no indication that could help him to know it. In all these cases, Gharar nullifies the sale contract.

However, there are some cases where Gharar in the price is permitted, as - for instance - when the sale contract is concluded

at the market price on the day of purchase, or at the price to be set by the market on the day of purchase, or at the price people usually sell at.

Sale with forgivable Gharar in price could also include purchasing commodities through *Bay' al- Istjrar*, in which the buyer obtains the goods regularly from the seller for a price to be determined subject to the price that people normally sell at, or subject to an index, and even after consumption of the goods in question.

A similar sale contract is that which comprises selling, at unit price, of a quantity of the commodity which the buyer can see, yet does not know its exact amount or total value. That is to say, one could sell a quantity of grains at the price per kilogram, or he could rent a car at a rent per mile, so that the payable amount of rent is determined after reaching the target destination.

Furthermore, such sales may include concluding a lease contract at the rent normally paid for similar property, or for a variable rent to be indicated by a specialized index.

In all these preceding cases, the contract does not become null and void.

**5/3 Gharar relating to ignorance of the contract's period**

5/3/1 The contract becomes null and void when its duration is not stipulated. If, however, Gharar is removed by knowledge of the contract's duration, or abandonment of the duration, at the time of contracting, the contract becomes valid.

5/3/2 Gharar can be forgiven in postponement of the price until known seasons such as season of harvesting. In this case, the two parties should observe the normal date of the season rather than the event of harvesting.

**5/4 Gharar pertaining to failure in delivery**

Gharar which relates to failure in delivery nullifies the contract. Examples of such Gharar include selling of fish in the water, unless it is

found in a confined place and does not require fishing. Such type of Gharar can also be seen in the sale (without option) of a commodity to be imported from abroad, and one is not sure whether a license for its importation would be obtained or not.

**5/5 Gharar relating to sale of non-owned commodities**

Gharar relating to sale of a non-owned commodity nullifies the sale contract. It refers to the case when the seller does not (personally) have the commodity at the time of signing the contract, and has to purchase it from the market. Salam and Istisna'a are exceptional cases here (subject to their respective conditions).

**5/6 Gharar that results from sale of non-held commodities**

A person shall not sell a commodity (whether it is a real estate or movable property) that he does not guarantee through actual or constructive holding. In the absence of actual or constructive holding, it will not be possible to determine the party that possesses (and hence guarantee) the sold object. Therefore, selling a commodity that one does not own nullifies the sale contract.

Actual holding in this context refers to receiving the good in hand, or receipt of the exact quantity in case of commodities measured in terms of volume or so. If the deal in question pertains to a Juzaf commodity (a commodity of an unknown quantity) holding would require shifting the commodity to another location. Holding in all cases, other than the preceding ones, shall be judged as per normal practice.

As regards constructive holding, it indicates the act of releasing the commodity and facilitating the process of its holding.

**5/7 Gharar resulting from sale of nonexistent commodities**

It is impermissible to sell a commodity that neither existents at present, nor does its existence in the future is ensured. Mu'awamah sale (sale of fruits to be delivered over several years) is a good example of such transactions.

**5/8 Gharar which results from lack of viewing the sold commodity (*Bay' al-Ayn al-Gha`ibah*)**

5/8/1 It is impermissible to sell a commodity without enabling the buyer to view it or obtain its full description. Nevertheless, a commodity can be sold on the basis of mere description, whether description is to be made by the seller or someone else. Description should include all those characteristics which could affect the price. The buyer should then conclude the deal if the commodity is exactly as described, otherwise he is free to conclude the deal or not.

5/8/2 It is permissible to sell an asset that the buyer has seen sometime before the time of signing the contract, provided that the asset has undergone no change since that time.

5/8/3 A sale can be concluded on the basis of a model that indicates the characteristics of the sold commodity.

**6. Impact of Gharar on Documentation Contracts**

**6/1 Impact of Gharar on Rahn (Mortgage) contracts**

Rahn (Mortgage) can permissibly involve a degree of Gharar that is not allowed in sale. For instance, a lost car or a farm that has not yet reached the stage of giving yield can be the object of a mortgage contract. Nonetheless, such property cannot be sold for settlement of the debt, unless the lost car is found or the farm has reached the stage of giving yield. [see Shari'ah Standard No. (5) on Guarantees]

**6/2 Impact of Gharar on suretyship (Kafalah) contracts**

Suretyship (Kafalah) can also involve a degree of Gharar that is not permitted in sale. Suretyship can be conditional (provided that the condition does not contradict with the stipulations of the contract); or it can be for an unknown period; or it may relate to a future obligation. [see Shari'ah Standard No. (5) on Guarantees]

**6/3 Impact of Gharar on agency (Wakalah) contracts**

Agency (Wakalah) is permissible with Gharar, if there are indications or traditions that can be used for specifying its subject matter. For

instance, agency can be conditional, or its subject matter can be identified through some of its forms. This shall, however, hold true when agency is free of charge, otherwise it shall be treated like Ijarah (hiring) and, thus, affected by Gharar. It is also permissible to make general agency contracts. [see Shari'ah Standard No. (23) on Agency and the Act of an Uncommissioned Agent (Fodooli)]

## 7. Impact of Gharar Which Stems from the Conditions of the Contract

The condition which results in Gharar in the form or subject matter of the contract:

A contract becomes null and void if it contains a condition that causes Gharar in its form, as when it contains an option without time limit. A contract can also become null and void for involving Gharar in its subject matter, as in the case of "*Bay' al-Thunya*" which refers to partial sale of a property, while retaining the remaining part as an exception (e.g., selling a multistory building with the exception of one floor without specifying it). Such sale is permissible only if the retained part of the property is specified.

## 8. Date of Issuance of the Standard

This Standard was issued on 26 Sha'ban 1428 A.H., corresponding to 9 September 2007 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Controls on Gharar in Financial Transactions in its meeting No. (19) held on 26-30 Sha'ban 1428 A.H., corresponding to 8-12 September 2007 A.D., in Makkah Al-Mukarramah, Kingdom of Saudi Arabia.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (14) held on 21-23 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D., in Dubai (U.A.E.), the Shari'ah Board decided to issue a Shari'ah Standard on Controls on Gharar in Financial Transactions.

On 20 Jumada II, 1426 A.H., corresponding to 26 July 2005 A.D., the Shari'ah Standards Committee decided to commission a consultant to prepare a study on Controls on Gharar in Financial Transactions.

The study was discussed in a joint meeting of the Shari'ah Standards Committees (1) and (2), held in Makkah Al-Mukarramah on 8-9 Rabi' I, 1427 A.H., corresponding to 6-7 April 2006 A.D. The joint committee then advised the consultant to introduce the necessary changes in the Standard, in the light of the discussions and observations of the meeting.

The revised draft of the Standard was discussed in another joint meeting of the Shari'ah Standards Committees (1) and (2), held in Al-Madinah Al-Munawarah, on 7-12 Jumadah I, 1427 A.H., corresponding to 3-8 June 2006 A.D. The consultant was again advised to introduce changes in the Standard as per the discussions and observations of the meeting.

In its meeting No. (17) held in Makkah Al-Mukarramah, on 27 Shawwal – 1 Dhul-Qa'dah 1427 A.H., corresponding to 18-23 November 2006 A.D., the Shari'ah Board discussed the changes in the Standard which had been made by the joint meeting of Shari'ah Standards Committees (1) and (2), and introduced changes that it deemed necessary.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 18 Safar 1428 A.H., corresponding to 8 March 2007 A.D.

More than 30 participants attended the session as representatives of central banks, institutions, and accounting firms. The session was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (19) held in Makkah Al-Mukarramah during 26 Sha'ban – 1 Ramadan 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the amendments that had been suggested in the public hearing, introduced changes that it deemed necessary and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Gharar is divided into excessive, medium and minor, because there is a degree of Gharar which contracts could hardly avoid, whereas there is an excessive degree of Gharar that could become a distinguishing aspect of the contract, such as *Bay' al-Gharar* (aleatory sale). In order to specify the two extreme limits of Gharar (excessive and minor) there should be a midpoint of Gharar (medium Gharar). Regarding controls on excessive Gharar, Abu Al-Walid Al-Baji said: "It is the degree of Gharar which becomes so dominant in the contract, that the contract is described in terms of it."(2)
- Prohibition of concluding a contract or making a condition that involves Gharar is based on the Hadith (Prophetic tradition) which states: *"The Prophet (peace be upon him) has forbidden aleatory sale"*.(3) Al-Nawawi said: "This Hadith is a great origin of Shari'ah injunctions on sales and covers an unlimited number of issues."(4)
- Assessing excessive Gharar in terms of the four conditions mentioned in this Standard is justified as follows:
  1. If Gharar is in an exchange-based contract: Involvement of Gharar in exchange-based contracts would lead to unlawful acquisition of the wealth of other people, whereas it is not so in donation contracts. No dispute would arise in the case of donation contracts, since the recipient of the donation would incur no loss.
  2. If Gharar is excessive: This is due to the consensus of the Shari'ah scholars on the impact of excessive Gharar on contracts. They have derived this conclusion from cases in which, due to involvement of excessive Gharar, contracts have been nullified by Hadiths (Prophetic traditions).

(2) *"Al-Muntaqa"* by Al-Baji [1: 41].
(3) Related by Muslim in his *"Sahih"* [3: 156] with comments by Al-Nawawi et al; and used by Al-Bukhari as a heading of a chapter in his *"Sahih"*: *"'Umdat Al-Qari"* [11: 264].
(4) Al-Nawawi comments, in *"Muslim"* [10: 156].

3) If Gharar is in the primary subject matter of the contract rather than in a corollary: This is based on the *Qa'idah* (Fiqh Principle): "What can be forgiven in corollaries is not so elsewhere". [item (45) of *Qwa'id Al-Majallah*]

4) If it is not justified by a Shari'ah-recognizable need: This is because Shari'ah has come for the sake of relieving people from hardship, as Allah, the Almighty, states: ***{"..and has not laid upon you in religion any hardship"}***.(5) This holds true whether the need is public or private, as per the Fiqh Principle which states: "Need, whether public or private, enjoys the same status of necessity". [*Qwa'id Al-Majallah*, item (33)]

- A contract which contains Gharar in its form is null and void because it will remain unconcluded. Gharar in this case tends to make finalization of the contract probable rather than definite. This has been derived from a number of similar cases on which strict prohibiting texts are available, such as the types of sales referred to in the Standard as well as other cases indicated in Fiqh sources.(6)
- The contract is null and void when its subject matter involves Gharar in its kind, nature, type or characteristics, because Gharar in these aspects is excessive and there are Shari'ah texts which prohibit similar sales. Moreover, such cases involve a great deal of Jahalah (ignorance) and, thus, may lead to dispute. Jahalah here cannot be resolved by offering the buyer the option of viewing for instance.
- The basis for nullity of a contract that involves Gharar in the amount of its subject matter is the consensus of the Shari'ah scholars on denial of ignorance of the amount, whether of the commodity sold or the price. It is also because ignorance of the amount leads to dispute that hinders delivery and receipt.(7) Permissibility of the cases which satisfy the conditions mentioned in this Standard (5/2/1/5 and 5/2), is due to the fact that such conditions make Gharar forgivable.

(5) [Al-Hajj (The Pilgrimage): 78].

(6) *"Bidayat Al-Majtahid"* [2: 153]; *"Fath Al-Qadir"* [5: 196]; *"Al-Mjmu'"* [9: 340]; *"Al-Sharh Al-Kabir"* by Al-Dardir [3: 2]; *"Al-Muqaddimat"* by Ibn Rushd (The Grand Father) [2: 221]; *"Al-Mughni"* [4: 207]; and *"Al-Bahr Al-Zakhkhar"* [2: 293].

(7) *"Hashiyat Ibn Abidin"* [4: 28]; and *"Al-Bada`i'"* [5: 158].

- Invalidity of the contract when its duration is unknown rests on the fact that it could generate dispute. Prohibition has been reported about a sale contract known as "*Bay' Habal al-Habalah*", which denotes a type of sale in which the price is postponed until the fetus of the camel is born and has given birth to another camel. The Qur`an has also indicated that indebtedness should have a specific duration: ***{"O you who believe! when you contract a debt for a fixed period, write it down"}.***(8)
- The nullity of the contract due to Gharar that relates to failure in delivery can be justified in terms of the excessive degree of Gharar it involves. A sale contract is meant to safeguard the rights of both parties (the seller and the buyer). If, instead, the seller is to get the price, while the buyer is unable to get the sold object, this will violate the very objective of the contract.
- impermissibility of the act of someone selling what he does not own stems from the Hadith which states: *"The Prophet, peace and blessings be upon him, has forbidden people from selling things that they do not own"*.(9) Prohibition of selling non-possessed property is also due to the excessive Gharar that failure in delivery could comprise. Gharar relating to failure in delivery is, in fact, the reason behind prohibition of selling a property which the seller does not hold, even legally. This has been derived from a Hadith(10) in this connection. Moreover banning sale of non-possessed property comes under the Fiqh Principle which states: "Any property that neither existent at present nor does its existence in the future is ensured should not be sold". In this regard also, many scholars have explicitly mentioned that sale of nonexistent property falls under Bay' al-Gharar (aleatory sale).(11)
- The Shari'ah basis of the details mentioned in this standard about sale of a nonexistent asset is the degree of Gharar involved therein. Gharar in this type of sale can be avoided only if the asset in question is well des-

(8) [Al-Baqarah (The Cow): 282].
(9) Related by Al-Tirmidhi in *"Al-Sunan"* [1: 159].
(10) Related by Muslim in his *"Sahih"* (1529) in the following words *"If you purchase food, do not sell it until you hold it"*.
(11) *"Nayl Al-Awtar"* [5: 244]; *"Al-Bahr Al-Zakhkhar"* [3: 381]; *"Al-Majmu' Sharh Al-Muhadhdhab"* [9: 258]; and *"Al-Muhadhdhab"* by Al-Shirazi.

cribed; otherwise absence of viewing may hinder the conclusion of the contract. The Hanafi scholars argue that the buyer should have the option of viewing so that the risk of Gharar can be avoided.

- The ruling that Gharar does not affect Rahn contracts is based on the fact that the Rahn (Mortgage) contract is not meant in itself, since it is a corollary contract signed for documentation.
- Similarly, the ruling that Gharar does not affect agency in the strict Shari'ah sense is based on the same reasons mentioned in the case of mortgage, besides the fact that agency is primarily based on donation.
- Suretyship is permissible with Gharar because suretyship is a corollary contract based on delegation of the right of disposal. However, if suretyship is paid for, it becomes an exchange-based contract and, thus, affected by Gharar.
- Nullity of a contract which involves Gharar in any of its conditions originates from what has been discussed above about aleatory contracts.

# Appendix (C)
# Definitions

**Ghurur and Taghrir (Deception)**

The difference between Gharar, and (Ghurur or Taghrir) is that the latter results from a statement, or an act, or a position which a person resort to for the sake of deceiving others, whereas Gharar does not involve any deception.

**Jahalah (Ignorance)**

The difference between Gharar and Jahalah is that Jahalah refers to lack of knowledge about the details of something, in spite of knowledge about its occurrence. In this sense, Gharar is more comprehensive than Jahalah. Therefore, all things that are unknown involve Gharar, whereas not all things that involve Gharar are unknown.

**Qimar (Gambling), Murahanah (Betting) and Gharar**

Gharar is similar to Qimar and Murahanah in that it entails a result which could be accomplished or not. However, Gharar does not resemble Qimar and Murahanah in constituting a means that each party uses for acquiring money from the other party. Therefore, Qimar is more specific than Gharar, because not all Gharar is Qimar.

**Definition of the Mudaf (Postponed)**

Idafah (postponement), refers to delay of the contract's effectiveness to a specific time in the future, and hence Idafah does not involve uncertainty like Gharar.

## Shari'ah Standard No. (32)

# Arbitration

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to define Arbitration and indicate its conditions and scope. It also discusses the Shari'ah status of arbitrators, arbitration document and verdicts, methods of initiating and implementing arbitration, and how arbitration is implemented in Islamic financial institutions (Institution/Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers arbitration as practiced in financial transactions and other activities and relationships which take place among institutions, or between Institutions and their clients or employees or other parties; whether inside or outside the host country of the institution.

## 2. Definition of Arbitration

2/1 Arbitration is an agreement between two parties or more to designate an external party for resolving a dispute between them through issuance of a binding verdict.

2/2 Arbitration in this standard refers to (Islamic Arbitration) which observes the rules and conditions of Shari'ah.

## 3. Forms of Resorting to Arbitration and Arbitration Parties

3/1 Arbitration can be sought through agreement of the two parties at the time of dispute, or in fulfillment of a previous agreement between them to seek arbitration instead of resorting to law. Arbitration can also be legally imposed on the two parties.

3/2 Seeking Islamic arbitration should be stipulated in the agreements in which the two parties cannot be forced to resort to laws that contradict with Shari'ah.

3/3 Arbitration parties are the two (or more) conflicting parties who seek arbitration.

## 4. Permissibility of Arbitration

Arbitration is permissible whether it is sought by two natural or legal persons, or by a natural person and a legal person.

## 5. Shari'ah Status of Arbitration

5/1 Arbitration is binding in the following cases:

a) When it is stipulated as a condition in the contract

b) When the two parties agree on seeking arbitration on dispute, and pledge to observe its verdicts.

5/2 Arbitration is not binding for an arbitrator who is not entitled to remuneration. Such an arbitrator can terminate himself after accepting the task. If the arbitrator is paid for his job, arbitration becomes binding for him. In this latter case, if the arbitrator terminates himself after accepting the task, he should bear any actual harm that may result from his act. [see Shari'ah Standard No. (34) on Hiring of Persons]

## 6. Basic Elements of Arbitration

6/1 The basic element of arbitration is its form, which refers to the process of exchange of offer and acceptance between the two parties seeking arbitration, and the arbitrator.

6/2 Valid arbitration has to fulfill the following requirements:

6/2/1 Existence of dispute between two parties or more, around a permissible right.

6/2/2 Agreement between the two parties on arbitration, and their mutual consent on accepting the verdicts of the arbitrator.

6/2/3 Acceptance of the arbitrator to do the arbitration task.

## 7. Scope of Arbitration (What Should Be Resolved Through Arbitration in Shari'ah)

7/1 Arbitration is permissible in whatever a party is entitled to relinquish his right in.

7/2 Arbitration is impermissible in the following cases:

7/2/1 What constitutes a right of Allah, Glory be to Him, such as Hudud (Shari'ah penalties).

7/2/2 Cases that entail proving or disproving of a verdict that concerns a third party.

7/3 When the arbitrator issues a verdict on an issue that should not be resolved through arbitration; his verdict is null and void.

**8. Characteristics and Appointment of the Arbitrator**

8/1 An Arbitrator shall have the full eligibility for performing his task.

8/2 In principle, an arbitrator shall be a Muslim. However, a non-Muslim arbitrator could be appointed when acute need so requires, in order to arrive at a Shari'ah-accepted verdict (in this regard, item 11/1 below shall be observed).

8/3 It is permissible to appoint one arbitrator or more, and – preferably – the number of arbitrators is to be odd, otherwise, the two parties (the seekers of arbitration) may appoint a chairman for the arbitration panel, whose vote shall be the casting vote when other votes are equal.

8/4 Each of the dispute parties may appoint one arbitrator, and the appointed arbitrators may appoint a final arbitrator if they are permitted to do so by the disputing parties.

8/5 When any of the two parties refrains from appointing an arbitrator from his own side as per the contract, the other party has the right to resort to the judiciary for appointing an arbitrator to represent the refraining party, provided that the arbitration condition in the contract does not specify another way for appointing such arbitrator.

8/6 The arbitrator has no right to appoint an alternate arbitrator to replace him, without the permission of the party that appointed him, because he has been accepted as an arbitrator in person. However, the arbitrator could have this right if arbitration is assigned to an Institution or an arbitration committee whose members are appointed with due consideration for its declared conditions of selection.

8/7 An agent or a Mudarib does not have the right of accepting arbitration, except with the consent of the principal for the agent and the owners of

the capital for the Mudarib, or on the basis of a clause in the Mudarabah conditions such as conditions in investment accounts. No one should become part of the arbitration on behalf of an institution that has a legal personality except its official representative.

**9. Arbitration Document**

9/1 The arbitration document originates from agreement of the two parties of the dispute on arbitration, and acceptance of the arbitrator to perform the task, and is called (the arbitration contract) or (the arbitration agreement).

9/2 The arbitration document should include the names of the two parties of the dispute, the name of the arbitrator, the overall subject of dispute, the date specified for arbitration and the fees payable to the arbitrator if any.

9/3 The arbitration condition is the commitment of the two parties of the arbitration contract or agreement to resolve their disputes through arbitration. If such condition is stipulated in any agreement or contract, there will remain no need for agreement on arbitration at the time of dispute.

9/4 The arbitrator should apply the rulings of Shari'ah. If he is obliged to apply a certain law, he should still not violate the rulings of Shari'ah.

9/5 The two parties of the arbitration have the right to impose any permissible limitation on the arbitration so as to serve a permissible purpose of their own. Permissible limitations may include, for instance: issuance of the verdict within a specific time limit or in view of a certain School of Fiqh or a certain law that does not contradict the Shari'ah; or consultation with exerts specified in name or by description. In the latter case, however, the arbitrator is not bound to accept the viewpoints of the experts.

9/6 When the period specified for arbitration expires without issuance of the verdict, the arbitrator becomes terminated, unless the two parties agree on extending the period. The arbitration period starts at the

time when the arbitration document has been signed by all the parties seeking arbitration, and ends up at the time when the arbitration verdict has been signed by all these parties.

9/7 It is permissible to conclude a verbal arbitration contract, however, Institutions should document the arbitration verdict in writing.

9/8 Acceptance of arbitration does not require attestation in the arbitration document, though such attestation is preferable.

## 10. Methods of Judgment, Procedures and Proving in Arbitration

10/1 The arbitrator is free to use any legally accepted method of judgment, such as confession, evidence (attestation), oath taking, or refraining from oath (Nukul), while he should not make judgment on the basis of his own opinion. When the arbitrator rejects an attestation, his rejection should not constitute a reason for denial of that attestation in other arbitrations or in the judiciary, unless the same attestation is also rejected by the judiciary.

10/2 The arbitrator has the right to request all the documents and proofs relating to the dispute, or copies of such documents verified in comparison to originals. He has to show such documents to the two parties so as to seek their opinions on them. The arbitrator has also the right to request verbal or written statements from the two parties of the dispute or the witnesses, and to consult experts if needed.

10/3 The Arbitrator is neither required to follow the procedural rules of the judiciary, nor is he obliged to observe laws, unless such laws are part of public order.

10/4 The arbitrator is not supposed to stick to the legally stipulated rules of evidence. Instead, he has the right to make use of any other evidence, provided that the acceptance of that evidence does not contradict with the rules of Shari'ah.

10/5 The arbitration verdict is issued by consensus or majority and in the case of equal votes the party which includes the chairman is considered to have the casting vote, unless some other arrangements are proposed in the arbitration document or the rules of the arbitrating entity.

## 11. Issuance of the Arbitration Verdict

11/1 A valid arbitration decision should lead to a verdict that conform to the rules of Shari'ah.

11/2 The final arbitration decision should resolve all points of dispute and lead to fair specification of the rights of the arbitration parties. When arbitration ends up with partial resolution of the points of dispute, arbitration is incomplete since it has not enabled the disputing parties to avoid resorting to legal suing. In this case, the disputing parties have the right to demand a further decision from the arbitrator so as to resolve the remaining points of dispute.

11/3 Arbitration should not go beyond the subject matter of dispute, because tackling of any further issue does not fall within the mandate of the arbitrator, unless the two parties of the dispute agree to add it.

11/4 The arbitrator has the right, subject to his own discretion or on request of the disputing parties, to issue a commentary on the arbitration decision, or introduce corrections for any material mistakes that might be involved therein.

11/5 The arbitrator can issue his decision in a number of preparatory or partial decisions, or identify the responsibility without estimating indemnification.

11/6 It is preferable that the Shari'ah or basis of the arbitration decision be mentioned (reasoning), yet this does not constitute a condition for valid arbitration, unless the law so requires.

11/7 In principle the arbitration decision is to be issued in a session attended by the arbitrators if they are many (or most of them, after invitation). It can also be issued by circulation among members after being prepared by the final arbitrator, or the chairman of the arbitration panel, or any other authorized member. In the case of issuance by circulation, consensus among members should be reached.

11/8 The arbitration decision is to be issued under the signature of all members of the arbitration panel (when they are many) including those who raise objections against it, and objecting members should be allowed to state their objections on the document. The arbitration decision may also be issued under the signature of most of the members, after indicating the reasons that made some members refrain from signing. Nevertheless, the decision has to be issued at the knowledge of all members as per the minutes of the session convened for that purpose.

11/9 The arbitration decision includes: the text of the verdict; names, identities and addresses of the two parties of the dispute; reference to the date and number of the arbitration document; summary of the subject matter of dispute; claims of the two parties of the dispute and the supporting documents; names of witnesses and experts whose help was sought if any; names of arbitrators, date and place of issuing the verdict; signatures of arbitrators; signatures of the parties of dispute if possible; and reasons of the decision reached unless the arbitration document comprises exemption from such reasoning and there is no legal condition to that effect.

11/10 The arbitration decision should not necessarily be issued in the presence of the two parties of the dispute, although it is better to be so for shortening the procedure of communicating it to them.

11/11 It would be better to include in the conclusion of the arbitration decision a request or a recommendation to the judiciary or the concerned legal authorities to use every permissible means for its implementation.

11/12 The arbitration decision should not necessarily meet the consent of the two parties of the dispute. It should spontaneously be binding to them, unless it is revoked for being counter to the rules of Shari'ah or public order.

11/12 The arbitration decision can be issued on the basis of reconciliation as prescribed by Shari'ah or on the basis of consensual agreement.

## 12. Communication and Validity of the Arbitration Decision

12/1 The arbitration decision shall be communicated to the two parties of the dispute through the normal procedures, unless a specific way of communication is identified in the arbitration document or by any other legal authority.

12/2 The validity of the arbitration decision does not require attestation of witnesses on communication of the decision to the two parties of the dispute or the consent of these parties to it, although such attestation is recommendable for avoiding conflict.

12/3 The validity of the arbitration decision does not require its official registration or submission to the concerned court, yet this has to be done if it is required for legitimizing the implementation of the decision. In that case, the date specified for finalization of such procedure should be observed.

12/4 If the arbitration decision is written in more than one language, the language to be adopted in case of dispute should be specified.

12/5 A signed copy of the arbitration decision shall be handed over to each of the two parties of the dispute, while each one of the arbitrators (if many) shall retain a signed copy as well.

## 13. Implementation of the Verdict (the Form of Implementation), or Its Revocation

13/1 In principle, the two parties of the dispute should implement the arbitration verdict willingly. In case one party refrains from doing so, the other party has the right to present the verdict to judiciary for execution. Therefore, arbitration should not be resorted to if its verdict cannot be implemented.

13/2 For legitimizing the execution of the arbitration verdict, it is permissible to approach courts that do not observe the rules of Shari'ah.

13/3 The arbitrator does not have the right to retreat from his verdict, unless when he declares that he has committed a mistake in it.

However, in case of committing a mistake, the arbitrator can cancel or amend his verdict in view of the rules of the Islamic Shari'ah and in the way that would ensure justice.

## 14. Arbitration Expenses and the Arbitrator's Fees

14/1 It is permissible for the arbitrator, if he is not a volunteer or a government employee designated for doing arbitration, to receive fees for the task. The amount or percentage of such fees should be indicated in the conditions of arbitration in case of Institutional arbitration, or agreed upon in the arbitration document.

14/2 When the arbitration process leads to incurring of any expenses, such as transportation expenses for the arbitrator, witnesses and experts, or typing expenses, or fees payable to the arbitrator, the arbitration decision must specify the party that should bear them. It should be noted here that the expenses pertaining to the application of any of the disputing parties should be borne by that party alone, whereas common expenses are to be shared by the dispute parties, unless it is proved that one party has been deliberately intending to cause harm to the other through such expenses. In this latter case, the party that has been intending to cause harm should bear such expenses. All these preceding points hold true in the absence of a prior agreement which assigns the payment of the expenses to a specific party or to the condemned party.

## 15. Date of Issuance of the Standard

This Standard was issued on 30 Sha'ban 1428 A.H., corresponding to 12 September 2007 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Arbitration in its meeting No. (19) held on 26-30 Sha'ban 1428 A.H., corresponding to 8-12 September 2007 A.D., in Makkah Al-Mukarramah, Kingdom of Saudi Arabia.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 12 Rajab 1427 A.H., corresponding to 6 August 2006 A.D., the Shari'ah Board decided to issue a standard on Arbitration.

On 21 Sha'ban 1427 A.H., corresponding to 14 September 2006 A.D., a joint meeting of the Shari'ah Standards Committees (1) and (2) was held in the Kingdom of Bahrain, and discussed the study. The meeting requested the consultant to introduce necessary amendments in the light of the discussions and observations of the joint committee members. The meeting discussed also the Standard on Arbitration which was ready in the same session, and introduced necessary changes in it, in the light of the discussions that took place.

In its meeting No. (17) held in Makkah Al-Mukarramah, on 27 Shawwal – 1 Dhul-Qa'dah 1427 A.H., corresponding to 18-23 November 2006 A.D., the Shari'ah Board discussed the changes in the standard which had been made by the joint meeting of Shari'ah Standards Committees (1) and (2), and introduced changes that it deemed necessary.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 18 Safar 1428 A.H., corresponding to 8 March 2007 A.D. More than 30 participants attended the session as representatives of central banks, institutions, and accounting firms. The session was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (19) held in Makkah Al-Mukarramah, on 26 Sha'ban – 1 Ramadan 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the amendments that had been suggested in the public hearing, introduced changes that it deemed necessary and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- In one sense, arbitration seems like agency on behalf of the two parties, although it also seems to involve private custodianship in another sense.
- According to Shari'ah arbitration could take place verbally, yet it is preferable – for Institutions in particular – to document it in writing. In order to be legally accepted, arbitration needs to be written and signed by the arbitrators and the parties of the dispute.
- In principle, selection of arbitrators should be subject to the same Shari'ah conditions for selection of judges including non-partiality. In case of necessity, some of these conditions could be dropped such as the condition that the arbitrator should be a Muslim. Nevertheless, a non-Muslim arbitrator should not issue a verdict that contradicts with Shari'ah.

# Appendix (C)
# Definitions

**Sulh (Reconciliation)**

It refers to a request of relinquishment of what the arbitrators consider to be the right of one of the two parties of the dispute. Such request shall not be made to a party who is an agent, unless he is delegated to do reconciliation. Preferably, the issuance of a reconciliation decision is to be based on a clear clause in the arbitration document indicating that arbitrators have the right to pursue reconciliation.

**Consensual Settlement**

It refers to the case when the two parties of the dispute agree, outside the arbitration task, on a settlement which they both accept, and request the arbitrators to issue a decision based on that settlement. The arbitrators in this case shall concur to the request of the two parties, unless the proposed settlement is impermissible, or contrary to public order.

**Arbitration Document**

It is a document signed by the two parties to pursue arbitration on a dispute which has arisen between them.

**Arbitration Agreement**

It is a prior condition or a contract stipulating resort to arbitration when dispute arises.

**Material Mistakes**

It refers to unintentional mistakes in names or numbers, when proofs or documents indicate the aspects which need correction.

**Institutional Arbitration**

It is the selection of an Institution that comprises competent arbitrators to resolve the dispute. In this case, there is no need for designating the arbitrator in name.

## Shari'ah Standard No. (33)

# Waqf

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This standard aims at indicating the basic Shari'ah rulings on Waqf, which constitute the basis for practical application in this area. The standard also indicates the role of Islamic financial Institutions (Institution/Institutions)[1] in supervision, management and investment of Waqf properties.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard presents the definition of Waqf and discusses its types, Shari'ah rulings, basic elements, and the conditions that pertain to each of these elements. It also covers the conditions required in the Waqf and the Waqif (donor), and illustrates the appropriate methods for Waqf utilization, investment, supervision and management. Furthermore, the standard covers the crucial role that Islamic financial Institutions could play in the development of Waqf, and the appropriate methods of Waqf investment.

This standard, however, does not cover other philanthropic Institutions such as Irsad (allocation of public property for public utilities) and financial trusts which resemble Waqf in some aspects.

## 2. Definition, Shari'ah Rulings, Rationale of Permissibility and Types of Waqf

### 2/1 Definition of Waqf

In Arabic language the word Waqf or Habs means preventing something from movement. In Shari'ah terminology, Waqf refers to making a property invulnerable to any disposition that leads to transfer of ownership, and donating the usufruct of that property to beneficiaries.

### 2/2 Shari'ah status of Waqf

Waqf is permissible in Shari'ah, as has been emphasized by the Sunnah (Prophetic traditions) and Ijma' (consensus of Fuqaha). Waqf is also a binding commitment, and, therefore, declaring a property as Waqf would spontaneously deprive its donating owner the right of ownership.

**2/3 Permissible types of Waqf**

There are several types Waqf of which most important is the charitable Waqf (*al-Waqf al-Khayri*), the family Waqf (*al-Waqf al-Ahli*), the joint Waqf (*al-Waqf al-Mushtarak*) and self-dedicated Waqf (*al-Waqf 'Ala al-Nafs*).

2/3/1 Waqf is said to be charitable when its income/usufruct is dedicated for a charitable purpose.

2/3/2 A family Waqf is the Waqf in which the income/usufruct is reserved for specifically described persons, usually family members and relatives. The income/usufruct of such Waqf goes to a charitable purpose when none of these persons is existent.

2/3/3 Joint Waqf refers to the case in which the property is donated to family as well as charitable purposes, and the income/usufruct here is shared accordingly.

2/3/4 In case of self-dedicated Waqf the donor retains the income/usufruct of the donated property for himself as long as he is alive, and indicates the charitable purpose which shall be entitled to the income/usufruct of the Waqf after his death.

**3. Basic Elements of Waqf**

The basic elements of Waqf include: The form of donation, the Waqif (the donor) and the donated property.

**3/1 The form of the Waqf**

3/1/1 The form of the Waqf comprises "offer" only, as it does not necessitate "acceptance". When a legally competent beneficiary rejects a Waqf that has been earmarked for him, his rejection has to be concurred to, yet the Waqf shall still remain valid. In this case the Waqf- or the share of the rejecting beneficiary if beneficiaries are many - should go to charitable purposes.

3/1/2 Formation of Waqf can take place verbally, in writing, or in any form of disposition which is normally considered as indicating it.

3/1/3 Waqf can be declared as effective starting from a future date, as when the donor declares his property to become Waqf starting from next year.

3/1/4 In principle Waqf should be eternal. Nevertheless temporary Waqf is also permissible when the donor desires to get back his property after a specific period.

**3/2 The Waqif (donor)**

3/2/1 The Waqif can be a natural or a legal person. If the Waqif is a legal person, the Waqf decision should be made by the general assembly and not the board of directors.

3/2/2 The Waqif must be legally eligible for disposing of his property.

3/2/3 The Waqf decision of a person whose legal competence is restricted because of irrationality is invalid, except when he declares his property as Waqf for himself as long as he is alive. The validity of the Waqf decision of a person whose legal competence is restricted because of indebtedness depends on confirmation by his creditors. When the creditors refrain from confirming the Waqf of the indebted person, the Waqf becomes invalid.

**3/3 The beneficiary**

3/3/1 The Waqf should not be made for an impermissible purpose, although it may not be for a charitable purpose since the very beginning of its inception.

3/3/2 It is permissible to make Waqf for the benefit of non-Muslims, provided that the cause to be served does not involve a sin. It is also permissible to make Waqf for the benefit of the rich.

3/3/3 The Waqf beneficiary need not be present at the time of declaring the Waqf.

3/3/4 When the beneficiary/beneficiaries of the Waqf is/are no longer existent, the benefits of the Waqf should go to charity purposes.

## 3/4 The Waqf property

3/4/1 The Waqf property should fulfill the following conditions:

a) It shall be a Shari'ah-accepted property

b) It shall be known

c) The Waqif shall be the sole owner of the property in which nobody else should have a right of disposition at the time of establishing the Waqf. If the Waqif himself has the option of disposing of the property, the Waqf shall become valid, and the option is spontaneously cancelled.

3/4/2 The Waqf has a legal personality and financial liability which make it capable of giving and accepting commitment. The legal personality of the Waqf is quite separate from the personality of its manager.

3/4/3 Types of Waqf properties

3/4/3/1 Waqf is permissible in real estate along with permanent furniture and fittings.

3/4/3/1 Waqf is permissible in movable assets, whether such movable assets are part of a real estate or independent.

3/4/3/2 Waqf is permissible in money. The income generated from utilization of the money is to be spent, while retaining the principal amount. Utilization may include, for instance, Shari'ah-based lending as well as permissible and safe investments like Mudarabah where the profit share owned by the Waqf goes to beneficiaries.

3/4/3/4 Waqf is permissible in Shari'ah-accepted shares and Sukuk. In this case, the income earned by these shares or Sukuk is to be spent on the Waqf beneficiaries. In case of liquidation the Shari'ah rulings on *Istibdal* (exchange of Waqf property) should be applied.

3/4/4 Waqf in common property

3/4/4/1 Waqf can be a common property, whether such property is divisible or not. The whole common property in this

case (not shares or Sukuk), can be leased and the Waqf gets its respective share of the rent.

Alternatively, the share of the Waqf in the common property can be leased, so that the usufruct can be utilized through time-based and place-based Muhaya`h (succession), while the rental income goes to the beneficiaries of the Waqf.

3/4/4/2 When the Waqf superintendent or the Waqf partner asks for the division of an indivisible Waqf, the refraining party should be forced to accept selling. The income obtained from selling the Waqf in this manner should be used for purchasing a Waqf property of the same kind.

If such request for division is made in case of a divisible Waqf, the refraining party should be forced to accept division.

3/4/5 Waqf as a floor in a building, and easement eights (*Irtifaq* or *Ta'alli*)

Waqf can be a floor in a building. It can also enjoy easement rights (*Haqq al-Irtifaq*) in a building that has not yet been constructed. In this case the Waqf can enjoy the right of *Ta'alli* (transcendence) when the upper floor is declared as Waqf while the owner of the lower floor is unable to perform construction. The lower floor in such case can be built at the cost of the Waqf (on permission of the concerned authorities) and the cost reimbursed to the Waqf from the income generated through its leasing.

3/4/6 Waqf as a usufructs

Waqf can be a usufruct of an asset which the Waqif acquires through rent. The Waqif can lease the asset once again, and the proceeds go to the Waqf beneficiaries. The Waqf, in this case, is to be made temporary according to the period of the original

rent. Waqf can take place in this manner when the owner of the property does not deprive the lessee the right of subleasing.

## 4. Condition in Waqf

### 4/1 Conditions pertaining to the Waqf contract

4/1/1 The Waqif has the right to make his Waqf subject to all conditions which do not contradict with Shari'ah, and his conditions shall be as enforceable as Shari'ah conditions. The conditions of every Waqif must be understood with due consideration to the prevailing norms in his environment. Such conditions may include, for example, designating a certain superintendent for the Waqf and specifying his remuneration package. The designated superintendent could be an individual, a group of people, or an institution.

4/1/2 Regarding the form of the Waqf, the Waqif can make a condition that his debts should be settled from the Waqf income; after his death, or he may stipulate a condition that the income of his Waqf should go to him first as long as he is alive, then to his family, and finally to charitable purposes. Another condition of the Waqif could be that the Waqf income has to be spent first on any member of his family who becomes poor, and then on charity purposes.

4/1/3 A condition stipulated by the Waqif is invalid when it comprises an impermissible element, or when it violates the Shari'ah rulings on Waqf or cause harm to the Waqf property. In such cases the condition should be rejected and the Waqf shall remain valid. Examples of invalid conditions include: absolute forbiddance of *Istibdal* (exchange) of the Waqf, or forbiddance of the dismissal of the Waqf superintendent for any reason.

A condition stipulated by the Waqif also becomes invalid when it tends to hinder the interests of the Waqf, or jeopardize the process of benefiting from it. The example of this is a condition which requires starting - at all times - with distribution of the

Waqf income among the beneficiaries, even if the Waqf is in need of maintenance or renovation.

4/1/4 When the Waqif stipulates a condition that the Waqf should be benefited from through residence, the Waqf can be benefited from either in that manner, or through leasing, and vice versa.

## 5. Supervision and Management of Waqf

### 5/1 Controls on supervision and management of Waqf

Supervision and management of Waqf should observe the Shari'ah rulings on Waqf, then the conditions of the Waqif which do not contradict with Shari'ah or hinder the interests of the Waqf as perceived by the judiciary.

### 5/2 Tasks of the Waqf superintendent

The Waqf Superintendent should perform the following tasks, among others:

5/2/1 Management, maintenance and development of the Waqf.

5/2/2 Leasing of the assets or usufructs of the Waqf (through operating-lease contracts), and leasing of the Waqf lands.

5/2/3 Development of the Waqf properties either directly in Shari'ah-sanctioned methods of investment, or through Islamic financial institutions.

5/2/4 Increasing the Waqf money by investing it through Mudarabah and other similar forms.

5/2/5 Changing the operational form of the Waqf assets with the aim of maximizing the benefit that results to the Waqf and its beneficiaries. This may include, for instance, converting a residential building into a commercial building, or constructing buildings for rent on an agricultural land, provided that this would satisfy the demand of the people, generate more income for the Waqf and is done with the permission of the concerned authorities.

5/2/6 Defending the rights of the Waqf, ensuring its sustainability, payment of fees to agents in case of law suits filed against the Waqf, and payment of expenses for documentation of the assets and the rights of the Waqf.

5/2/7 Settlement of the debts of the Waqf.

5/2/8 Payment of the entitlements of beneficiaries

5/2/9 Replacement of the Waqf either by selling it for a cash amount and purchasing a new asset, or exchanging it with a new asset, subject to the conditions of *Istibdal* (exchange). [see item 9]

5/2/10 Safeguarding the Waqf properties against occupation or seizure by others.

5/2/11 Using solidarity insurance to safeguard the Waqf assets, whenever possible.

5/2/12 Preparation of the Waqf accounts, and submission of statements and reports on them to the concerned authorities.

**5/3 What shall not be done by the Waqf Superintendent**

The Waqf superintendent shall not do the following:

5/3/1 Neglecting the conditions of the Waqif.

5/3/2 Leasing the Waqf to himself or to one of his dependant sons - even if such leasing is at more than the normal rent – except through the judiciary. He should not also lease the Waqf to one of his direct relatives (Usul and Frua') or to his spouse, for less than the normal rent of similar property. In this case, minor injustice (Ghabn) is not forgivable, although it is forgivable in leasing to nonrelatives.

5/3/3 Using the Waqf income for increasing the Waqf properties, except when this is done in fulfillment of a condition stipulated by the Waqif.

5/3/4 Mortgaging the Waqf assets for a debt to be obtained for the Waqf or the beneficiaries.

5/3/5 Lending the Waqf assets, and if he does so, the borrower has to pay the normal rent for similar assets.

5/3/6 Borrowing for the Waqf, except in fulfillment of a condition stipulated by the Waqif, or on permission of the legal authorities, and in case of necessity. In borrowing for the Waqf the following should be observed:

5/3/6/1 Establishing a debt obligation on the Waqf is permissible through permissible means of borrowing, or deferred payment purchase, or any other permissible mode of financing. Establishing the debt through any of these modes has to be for the sake of maintaining and developing the Waqf, as per a condition stipulated by the Waqif, or on permission of the legal authorities, and due to necessity. In establishing the debt, due consideration shall also be given to the ability of the Waqf to bear such debt and sufficiency of its income for repayment. These restricted forms of establishing debt obligations on the Waqf do not include the case when the Waqf superintendent pays a certain amount of money from his own sources for an interest which concerns the Waqf, and the Waqf has sufficient income to be resorted to for settlement of such debt.

5/3/6/2 Cases which justify borrowing for the Waqf, when borrowing is not sanctioned by a condition stipulated by the Waqif:

a) Need for maintenance or necessary development of the Waqf and absence of sufficient Waqf income for that.

b) Payment of financial commitments – if any – when the Waqf does not have sufficient funds.

c) Inability to pay the wages of the employees working in the Waqf or those who serve its purposes, and fear from endangering the benefits of the Waqf.

5/3/6/3 Borrowing should not be for the sake of spending on the beneficiaries of the Waqf.

**5/4 Spending the excess income of the Waqf of a mosque**

In principle the income of the Waqf of a specific mosque is to be spent on its own interests. If there is still an excess amount of income which has not been spent, it is permissible to transfer such amount to another mosque that does not have enough income to cover its expenses, or the cost of its maintenance and renovation.

**5/5 Judicial supervision on Waqf management**

5/5/1 By virtue of public guardianship, the judiciary has the authority of overseeing the supervision and management of the Waqf, preservation of its assets, and development of its sources. The judiciary has also the right of investigating the overall status of the Waqf, looking into any complaints raised against the Waqf superintendent or any other party, and subjecting the Waqf superintendent to disciplinary action.

**6. Controls on Leasing of Waqf Assets**

6/1 In principle, a long period of leasing should not be the normal practice for Waqf assets, except for obvious interest, and provided that a variable rent, linked to an accurate and well known index, is going to be sought. [see Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek, item 5/2/3]

**6/2 The normal rent of similar property as a condition**

Waqf assets or usufructs should not be leased at less than the rent of similar property. When leasing at a lower rent is inevitable it should be considered in view of the actual necessity, and hence, excessive injustice (*Ghabn Fahish*) can be accepted. If there happen to be a new tenant who can pay the rent of similar property, the Waqf superintendent has the right to terminate the previous contract, unless the old tenant accepts the rent increment. If the normal rent for the Waqf in question has risen because of developing the Waqf

land and constructing a new building on it at the cost of the Waqf, the tenant is obliged to accept rent increment. If land development and construction of the building is done at the cost of the tenant, he is not bound to accept the rent increment.

**6/3 Some permissible forms of Waqf leasing**

6/3/1 Signing a lease contract with the aim of keeping the Waqf land in the hands of the tenant as long as he pays the normal rent for similar property as it changes according to circumstances. This type of contract is known as (*Hikr*) and is subject to the following conditions:

6/3/1/1 The Waqf has no income to be used for its development.

6/3/1/2 There is no person who is willing to have fixed-term rent and make advance payment so as to be spent on developing the Waqf.

6/3/1/3 *Istibdal* (exchange) of the Waqf is not possible

6/3/2 *Haqq al-Qarar* (right to stay) which a tenant deserves when he pays at the time of signing the lease contract a lump sum amount, known as (*Kardar*) for development of the Waqf, and a rent which is below the rent of similar property. This form of Waqf leasing is permissible when dictated by necessity, and if there is no tenant who is willing to pay the normal rent for similar property along with a lump sum amount for development of the Waqf. In some countries, this contractual form is known as (*al-Khulu*).

**7. Application of Modes of Investment for Development of Waqf Income and Assets**

**7/1 It is permissible to invest Waqf income, in the following cases:**

1- As per a condition stipulated by the Waqif.

2- During the waiting period (prior to identification of beneficiaries).

3- Excess income, after payment to beneficiaries.

Investment in these cases should be through permissible methods such as Mudarabah, Musharakah, Murabahah, Ijarah, and Salam, and in low risk investments.

**7/2 For development of the Waqf land, the following is permissible:**

7/2/1 Application of the Istisna'a through B.O.T. contracts. [see Shari'ah Standard No. (11) on Istisna'a and Parallel Istisna'a, item 3/2/1]

7/2/2 Application of diminishing Musharakah, where the Waqf and the financing partner construct the building through joint financing (excluding the Waqf land), and the Waqf gradually owns the building. [see Shari'ah Standard No. (12) on Sharikah (Musharakh) and Modern Corporations, item 5/8]

7/2/3 Application of Ijarah Muntahia Bittamleek for a specifically described property to be delivered in the future. In this case, the Waqf land is leased to the financier who constructs a building on it and delivers it to the Waqf to execute the lease contract. At the end of the contracting period, the Waqf becomes the owner of the building. [see Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek, item 3/5]

7/3 All appropriate means should be adopted for development of Awqaf, with due consideration to Shari'ah rulings on Waqf and the conditions stipulated by the Waqifs, as well as present day requirements.

7/4 Help in this regard should be sought from Islamic financial institutions, specialized in Waqf investments.

**8. Maintenance, Renovation and Replacement of Waqf Assets**

**8/1 Maintenance and renovation of Waqf assets, and allocation of reserves for that purpose**

8/1/1 Spending on maintenance, reparation and renovation of the Waqf assets should precede distribution of the Waqf income among beneficiaries. In this connection, due consideration shall be given to the technical schedules of periodical maintenance.

Maintenance and reparation of Waqf assets also do not require a prior condition to be stipulated by the Waqif.

8/1/2 Maintenance and renovation requirements (maintenance reserve) shall be retained from the Waqf income every year even if the Waqif has not stipulated such a condition. The reserve, thus deducted, can be invested in a safe and easy to liquidate form of investment, and the returns be added to the principal amount. The beneficiaries shall have no right on the maintenance reserve, unless part of it turns out to be in excess of actual needs.

8/1/3 In the absence of sufficient amounts for maintenance and renovation of a leased Waqf asset, the Waqf superintendent has the right to allow the tenant to make such maintenance and renovation, against having the priority to continue as a tenant of the Waqf asset until getting full repayment of his debt.

8/1/4 Solidarity insurance shall be used for maintenance or renovation of the Waqf assets.

**8/2 Making allocations for replacement of Waqf assets**

It is permissible to deduct from the Waqf income (after distribution to beneficiaries) periodical amounts commensurate to the economic lifetime of the depreciating Waqf assets, so as to use the accumulated amount for replacement of these assets (depreciation allowance).

**9. *Istibdal* (Exchange) of Waqf Assets**

9/1 *Istibdal* refers to the process of selling the Waqf asset and purchasing a new one instead, so as to maximize the interest of the Waqf.

9/2 *Istibdal* can take place according to a condition stipulated by the Waqif, or when the Waqf becomes ruined (even if prevented by the Waqif). *Istibdal*, in such cases, takes place by selling the Waqf property and purchasing a new one instead, so as to maintain the Waqf as it was before.

*Istibdal* is also permissible when there is no way of benefiting from the Waqf (e.g., the Waqf has become in a deserted area), or because of fear from seizure of the Waqf by others, or when benefiting from the Waqf becomes extremely difficult.

9/3 *Istibdal* should be subject to the following conditions:

9/3/1 The Waqf must have reached the stage of generating no income, while there is no money for its development.

9/3/2 There should be no excessive injustice in the sale price.

9/3/3 *Istibdal* should meet the satisfaction and interest of the Waqf.

9/3/4 *Istibdal* should be permitted by the judiciary.

9/3/5 If the Waqf is a real estate it should also be exchanged for a real estate. When there is no risk of misuse, a real estate Waqf can be sold for cash, and the money kept with the judiciary until a new real estate is purchased.

## 10. Date of Issuance of the Standard

This Standard was issued on 28 Jumada II, 1429 A.H., corresponding to 2 July 2008 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Waqf in its meeting No. (21) held on 24-28 Jumada II, 1429 A.H., corresponding to 28 June – 2 July 2008 A.D., in Dar Al-Taqwa Hotel, Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 5 Rabi' I, 1427 A.H., corresponding to 4 April 2006 A.D., the Secretariat General decided to assign to a Shari'ah consultant the preparation of a study on Waqf.

On 8-9 Rabi' I, 1427 A.H., corresponding to 6-7 April 2006 A.D., a joint meeting of the Shari'ah Standards Committees (1) and (2) was held in Makkah Al-Mukarramah, and discussed the study. The meeting requested the consultant to introduce necessary amendments in the light of the discussions and observations of the joint committee members.

On 19 Shawwal 1427 A.H., corresponding to 10 November 2006 A.D., the Shari'ah Standards Committee (2) held a meeting in Manama (Kingdom of Bahrain) in which it discussed the draft of the standard and requested the consultant to introduce necessary amendments in the light of the discussions and observations of the meeting.

In its meeting No. (17) held in Makkah Al-Mukarramah on 26 Shawwal – 1 Dhul-Qa'dah 1427 A.H., corresponding to 18-23 November 2006 A.D., the Shari'ah Board discussed the changes in the Standard which had been made by the joint meeting of Shari'ah Standards Committees (1) and (2), and introduced changes that it deemed necessary.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 18 Safar 1428 A.H., corresponding to 8 March 2007 A.D. More than 30 participants attended the session as representatives of central banks, Institutions, and accounting firms. The session was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (19) held in Makkah Al-Mukarramah on 26 Sha'ban – 1 Ramadan 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the amendments that had been suggested in the public hearing, introduced changes that it deemed necessary and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for considering Waqf (in principle) as a permissible and recommendable practice (Mandub) is the Quranic Verses which instruct people to do good and spend on charitable causes, and also the Hadith (Prophetic tradition) which indicates: *"When a person dies his rightful deeds will stop except in three respects: An ongoing charity "Sadaqah Jariyah..."*. Waqf is considered to be the ongoing charity referred to in the Hadith, because the beneficiary does not own the Waqf asset, and accordingly, cannot dispose of it.

  Moreover, there is the Hadith about the piece of land in Khybar which Umar donated as Waqf, when the Prophet (peace be upon him) advised him to do so.

  Again, permissibility of Waqf is supported by the practice of the Sahabah (Prophet's Companions) like Uthman and Abu Talhah, in addition to Ijma' (consensus of Fuqaha). Waqf for charitable purposes can also be justified through Qiyas (analogical deduction) in comparison to Waqf for mosques.

  Enforceability of the Waqf when it is indicated by a donor in his will, stems from the fact that according to Shari'ah a will should be executed, and its alteration or cancelation is strictly prohibited.
- Family Waqf (*Waqf ahli* or *Dhurri*) is permissible on the basis of the Hadith about Umar's Waqf, and because family Waqf is, in fact, a charitable Waqf since it will finally become so.
- Acceptance of the Waqf is not a condition for its validity when the beneficiary is not specified, because acceptance cannot be expected in this case. In case of a specific beneficiary, acceptance can be obtained from him even if implicitly when he keeps silent. The ruling that when the beneficiary rejects the Waqf his rights in the Waqf shall be dropped, whereas the Waqf should still remain valid, is based on the viewpoint of

the Hanafi School of fiqh. The justification here is that the beneficiary can drop his own rights in the Waqf, but he cannot nullify the Waqf itself.

- Waqf inception can be subject to any form of disposition which traditionally indicates it, because traditions are usually recognizable, when they do not contradict with Shari'ah rulings.
- Permissibility of temporary Waqf is based on the viewpoints of the Maliki and the Imami Schools of Fiqh, in addition to what has been reported about the viewpoint of Abu Yusuf of the Hanafi School. Such viewpoint is based on the fact that a temporary Waqf can also fulfill its charitable objectives and result in two benefits: one of them is the benefit generated from Waqf throughout its specified period, and the other is the benefit to the Waqif since he may need his property in the future. Moreover, permissibility of temporary Waqf could encourage Waqf practicing, and, hence, contribute to fulfillment of the present need for charitable institutions.
- Permissibility of declaring Waqf as effective starting from a future date can be viewed in terms of analogy between Waqf and *Wasiyyah* (will).
- The ruling that the Waqif should have full legal competence is based on the fact that Waqf in its very essence is a donation (*Tabarru'*), and therefore, the Waqif should have full legal competence.
- Prohibition of Waqf by a person who is legally restricted for irrationality, aims at safeguarding his creditors, his own self, and his dependants. There is no harm, however, when the irrational person declares the Waqf for himself. As regards the Waqf by a person who is suffering a fatal illness, it should be subject to the rulings applicable to the will of such person.
- Permissibility of retreating from Waqf, unless it is a mosque, is the Hadith that has been narrated by Abdullah Ibn Umar and Umar's Hadith, as well as Qiyas (analogical deduction) to 'Ariyah (a lent thing).
- The basis of the ruling that Waqf should not be for an impermissible purpose while it can be for non-charitable purposes, is that Waqf is a donation (*Tabarru'*), and therefore, the only Shari'ah condition to be observed in it is permissibility of the purpose for which the donation is made. This viewpoint belongs to the Maliki School, whereas the Hanafi School is of the opinion that the Waqf purpose should be charitable.

- The ruling that Waqf can be made for a person who is nonexistent at the time of establishing the Waqf, is based on the Hadiths narrated about Waqf for progeny, and on the fact that Waqf is an ongoing charity and therefore it should include those who will exist in the future.
- Waqf is said to have a legal personality and financial liability which are quite independent from those of its superintendent, because Waqf can give and take commitments. When, for instance, the Waqf superintendent borrows money for the Waqf, the debt obligation does not fall on him but rather on the Waqf itself. Similarly, when the beneficiary fails to fulfill his obligation towards the Waqf, he becomes indebted to the Waqf, rather than to the Waqf superintendent. Therefore, in this case, the Waqf superintendent has no right to relief the debtor from the debt.
- The ruling that Waqf donation should not exceed one third of the donor's wealth, is based on the analogy between Waqf and *Wasiyyah* (will), where part of the wealth should be left to the inheritors of the deceased (the obligatory entitlement as per Shari'ah). This has been explicitly referred to in the Egyptian Law of Awqaf.
- Permissibility of making Waqf in the form of moveable property, regardless of its nature and even if such property is not survivable, is based on the ruling practice during the era of the Prophet (peace and blessings be upon him) and the orthodox caliphs with respect to making Waqfs for mosques. The majority of Fiqh scholars also support this viewpoint; whereas the Hanafi scholars hold that Waqf of moveable property is permissible only when it is the normal practice.
- Money can be donated as a Waqf because this is the original form of Waqf, as emphasized by Muhammad Ibn Abdullah Al-Ansari the companion of Imam Zafar and supported by Ibn Taymiyyah. Shares and Sukuk come under this type of Waqf.
- A usufruct can be donated as Waqf, because it is wealth, and hence it should be subject to the general rules of Waqf. The fact that a usufruct is temporary does not affect this ruling since Waqf can also be temporary as has been indicated earlier.
- The ruling that permissible conditions of the Waqif shall be observed (including the ten conditions), is based on the Hadith which states:

*"Muslims are bound to the conditions they make"*. In the last part of it, this Hadith implies that the donor's condition which has to be observed should not be in contradiction with the Shari'ah *"…except a condition that permits what has been prohibited or prohibits what has been permitted (by Shari'ah)."*

- The basis for appointing a superintendent for the Waqf is the Hadith which indicates that: *"There is no misdemeanor (Junah) on the one who is in charge of it"*, and because interest necessitates the presence of someone who takes care of the investments of the Waqf assets, collection of the Waqf's income and distributing it among beneficiaries.
- The Waqf superintendent has to observe the conditions of the Waqif because Waqf is a donation (*Tabarru'*), and therefore, it can be subject to conditions according to Shari'ah. As regards observation of the rules of Shari'ah, the reason is obvious.
- The basis for depriving the Waqf superintendent the right of leasing the Waqf to himself or his son (without resorting to legal authorities) is the fear from favoritism which is part of human nature, and therefore prohibition of such leasing arrangement would minimize the chance for neglecting the interest of the Waqf.
- The ruling that a Waqf property shall not be lent is based on the fact that lending the property will reduce the chances for its investment.
- Borrowing for the Waqf is restricted to the case of acute need, and not allowed for spending on the beneficiaries, because borrowing is meant to safeguard the Waqf against the harm of being useless, whereas refraining from payment to beneficiaries when there is no Waqf income does not involve such harm.
- Permissibility of combining Waqf resources is based on the fact that it could lead to the benefit of the Waqf, and that all Waqf properties are devoted for the Sake of Allah, Glory be to Him. However, appropriate allocation to the different beneficiaries of the combined Waqf assets should be duly observed so as not to cause harm to such beneficiaries. The General Council of Fatwa of Kuwait issued a Fatwa (Shari'ah opinion) permitting transference of the excess income of a mosque to other mosques.
- The condition pertaining to the need for judiciary supervision on the Waqf is based on the desire to ensure the achievement of the interests of the

stakeholders, and perform the role of *Hisbah* (a Shari'ah regulatory body). The first person who arranged judiciary supervision on the Waqf was Tawbah Ibn Namir, the judge of Egypt in the early Islamic era.

- The ruling that Waqf assets should not be leased for less than the normal rent of similar assets (while minor injustice could be accepted) is based on the desire to avoid favoritism and waste of Waqf income. This viewpoint enjoys unanimous agreement of Muslim Fiqh scholars. The viewpoint regarding termination of the contract when the normal rent of similar property increases and the Waqf tenant refuses rent increment belongs to the Hanafi School, contrary to the Maliki and Shafi'i Schools who hold that the contract should not be terminated if the lease contract is for a specific period.
- Permissibility of the forms of Waqf leasing which have been indicated in Fiqh references is based on the desire to preserve the interests of the Waqf as well as the interests of all its tenants, without causing injustice to any party or neglecting the interest of the Waqf property.
- Permissibility of application of modern financing techniques which have been developed by Institutions rests on the fact that such forms are in conformity with the usual forms of land leasing and cultivation. Such modern forms could even generate more income than the traditional ones, and achieve the goals of preservation and security of the Waqf assets.
- Permissibility of making a reserve fund for maintenance and renovation of the Waqf is based on the desire to preserve the Waqf assets and their ability to generate income, as has been emphasized by a number of Fiqh scholars.
- *Istibdal* (exchange of the Waqf asset) is permissible because it achieves the interest of the Waqf, through its development and maximization of its income.

# Appendix (C)
# Definitions

**Waqf**

Making a property invulnerable to any disposition, and donating its income for charitable causes. The term Waqf is also used to describe the property donated in this manner.

**Waqf Ahli (Family Waqf)**

The income of the donated assets or usufructs goes in this case to the Waqif himself, his children, a certain number of people, or a specific entity, for a specific period.

**Waqf Khayri (Charitable Waqf)**

The income of the donated assets or usufructs goes to charitable purposes without specifying a certain entity or a specific group of people as beneficiaries. The Waqf could be eternal or temporary.

**Waqf Assets**

The property used for generating income, while it cannot be disposed of.

**Hikr or Tahkir**

A lease contract according to which the Waqf land is kept in the hands of the tenant to build on it or cultivate it as long as he pays the normal rent for such property. *Hikr* or *Tahkir* can also take place through utilization of the Waqf land by leasing it for a specific purpose without specifying the period, and thus, the tenant obtains the right to stay, subject to a valid contract. A third form of *Hikr* or *Tahkir* can take place implicitly when the land is leased for a specific period, and then the tenant build on it or cultivate it after obtaining the permission for that. In this latter case, when the lease period expires, and the tenant wishes to stay and pay the rent equivalent to that of similar property, he can be allowed to do so, in order not to cause harm to

him. *Hikr* or *Tahkir* is an alternative to *Istibdal* (exchange of the Waqf land), when the latter is not possible. These two methods constitute a financial right which cannot be inherited.

**Irsad or Takhsis (Allocation)**

*Irsad* refers to the case when the government authorities allocate a publicly owned piece of land for public utilities such as schools, hospitals and charitable activities. This is not considered as Waqf because, in this case, the land is allocated by someone who does not own it.

**Haq Al-Qrar (Right to Stay)**

Preference right to build on or cultivate the Waqf land. A certain type of this contractual arrangement is sometimes known as *Kadak*, and is applicable to leasing of shops and factories.

## Shari'ah Standard No. (34)

# Hiring of Persons

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to indicate the Shari'ah rulings on hiring of persons in its two distinct forms which include: hiring in the sense of obtaining the services of a private employee (*Ajir Khas*), as well as hiring in the sense of obtaining the services of a shared employee (*Ajir Mushtarak*). The service could also be either a defined task, or a future service which needs to be specified through detailed terms of reference. The standard also covers the relevant controls that Islamic financial institutions (Institution/Institutions)[1] should observe when the institution is the employee and when it is the employer.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers hiring of the service/work of persons between the institution and other institutions or individuals. The standard covers the cases when the institution is the employee and when it is the employer. However, the standard does not cover other contracts such as Mudarabah, investment agency, Musaqat, Muzara'ah, Mugharasah, and Istisna'a.

## 2. Definition of the Term "Hiring of Persons"

It refers to the contract through which a service/work of a natural or a legal person is obtained against a specific amount of pay. The service thus obtained could be specific or a future one that needs to be specified through detailed terms of reference, such as educational, health and consultancy services.

## 3. Pledge to Hire a Service

3/1 There is no Shari'ah prohibition against having a framework agreement to regulate the process of hiring between the institution and the client. Such agreement may comprise the general conditions which govern the relationship between the two parties, whereas there should be a separate hiring contract for each operation, signed by both parties. Under such framework agreement the two parties may also perform operations through exchange offer and acceptance with due reference to the general conditions stipulated in the agreement.

3/2 The institution has the right to ask the client who pledges to hire its services to pay a specific amount to be retained by the institution as a guarantee for the seriousness of the client in executing his pledge and honoring any commitments that may result from it. In case of withdrawal from the part of the client the deduction from this guarantee amount should not exceed the actual harm caused to the

institution. The guarantee amount can either be kept as a deposit with the institution without being disposed of, or invested on behalf of the client through Islamic Mudarabah or investment agency, or frozen in a current account owned by the client and guaranteed by the institution. The institution and the client may also agree at the time of signing the contract to consider the guarantee amount as a prepaid installment of the cost payable by the client. [see Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek, item 2/3]

**4. Concluding a Contract for Hiring of Persons**

4/1 A contract for hiring of persons can take place in any form that normally indicates it. It can be concluded verbally, in writing or through modern means of communication.

4/2 The two parties of the contract (the employer and the employee) should be legally competent (capable of awarding and accepting agency), otherwise the contract cannot be concluded.

4/3 A private employee, who works for and under the supervision of a single employer, has no right to work, at the same time, for anyone else, except on permission of his former employer. Unlike a private employee a shared employee who works for more than one person and who is not supposed to work for a specific person at a specific time, is not subject to such restriction.

4/4 The private employee should be informed about the hiring period and the type of work he is supposed to do in general, while the shared employee should be informed about the work, its type, and specifications. The specific period within which the work has to be done could also be added, and in that case the employee has to do the work within that specific period. When no specific period for doing the work is referred to in the contract, resort should be to normal practice.

4/5 A private employee is not responsible for damage, unless it is due to his own transgression, negligence, or breach of a stipulated condition.

4/6 A shared employee is absolutely responsible for damage, unless it is caused by an evitable factor. This, however, does not hold true in the case of an investment agent who is permitted to utilize the money. Unlike the shared employee who has to guarantee what he is paid to work on, the investment agent does not guarantee, except in case of transgression or negligence.

4/7 The contract for hiring of persons is a binding contract, which none of the two parties can terminate or amend without the consent of the other, except in case of contract breaching, or due to an emergent excuse, or because of inevitable circumstances.

4/8 For a private employee, the beginning of the hiring period should be specified. The hiring period should start at the time of signing the contract, except when the two parties agree on a specific date for its beginning. Hiring in the latter case is known as (deferred hiring), or hiring that has to be executed in the future.

4/9 When a private employee fails to report to work on the date specified in the hiring contract he shall be entitled to no pay for the period between the specified and actual dates of work commencement (the pay for the absence period should be deducted from his total pay). The employer in this case shall have the right to terminate the contract, unless the two parties agree on a compensatory period at the end of the contract period.

4/10 For a shared employee, a certain period for performing the work may be specified. When the shared employee fails to do the work during that period, the employer has the right to terminate the contract or a new period can be agreed upon.

4/11 There is no Shari'ah prohibition for any of the two types of employees (private and shared) to receive 'Arboun (Earnest Money) at the time of signing the contract. If the hiring contract is implemented, the amount of earnest money should become a prepaid part of the employee's pay, otherwise the earnest money should go to the employee. However, when the contract is not executed the employee

is preferably supposed to take from such earnest money only the portion which compensates the actual harm caused to him.

## 5. Subject Matter of Hiring Contract

The subject matter of the hiring contract is the service/work and the pay.

### 5/1 Rulings pertaining to the service/work

5/1/1 The service/work of the employee which constitutes a subject matter of the contract should be well known, accomplishable and permissible in Shari'ah.

5/1/2 It is permissible to determine service in terms of a specific work to be done or a specific period of service, or in terms of both. If the employee is able to do all the work within the specified period, he becomes entitled to the whole pay. If he is able to do only part of it during the period, his entitlement to the pay will depend on two probable outcomes. If the part of the work he has done during the period is in fact useless and cannot be benefited from the employee shall become entitled to no pay. If the accomplished part of the work is useful and can be benefited from, and the employer is unwilling to extend the period, the employee shall become entitled to the amount normally paid for similar work (*Ajr al-Mithl*).

5/1/3 When a person is hired for doing a specific service/work, the employer has no right to hire out the service/work of such person to a sub-employer, unless the contract permits sub-hiring, or this has been agreed upon by the two parties. If the hired service/work is specifically defined and has to be delivered in the future, the employer in this case has the right to hire out to someone else an identical service/work (Parallel hiring). [see Shari'ah Standard No. (17) on Investment Sukuk, item 5/2/10]

5/1/4 The employer should stick to utilizing the work/service of the hired person as per the permissible conditions that have been agreed upon.

5/1/5 When the hiring contract relates to a specific service, the employee (the institution) should own the service and have the ability to deliver it. Hence, it is impermissible for the institution to sign a contract with the client before it possesses the service and becomes in a position to perform actual or constructive delivery.

5/1/6 Hiring can be for performing a future service that is well described and specified to the extent which leaves no room for ambiguity and dispute. In that case the employer does not have to own the required service before signing the contract. Consequently, an agreement may be reached for performing the service at a specific time in the future, with due consideration to the ability of the employee to own the service and become able to deliver it on time, by himself or through someone else. The pay for the service here should not necessarily be made in advance, unless the contract is a Salam or Salaf contract. If the employee happens to deliver a service that does not conform to what has been agreed upon, the employer has the right to reject it and insist on having a service that conforms to specifications.

**5/2 Rulings pertaining to the pay**

5/2/1 The pay, whether in cash, or in-kind or in the form of a service, should be well known to the extent that leaves no room for dispute. It can be either fixed or variable according to a method which is well known to the two parties.

5/2/2 The pay can be determined for the work as a whole so that the employee becomes entitled to it after doing all the work, or it can be determined in installments and the employee becomes entitled to each installment at the relevant stage of the work done. The pay can also be determined on the basis of a specific period, after which the employee becomes entitled to it, or such period can be divided into sub-periods and the pay determined accordingly. Furthermore, the pay can be determined on the basis of both the work and the period,

and the employee becomes entitled to it when he performs the work within the specified period. [see item 5/2/9]

5/2/3 The pay becomes obligatory when the two parties sign the contract, and payable on delivery of the service/work or making it available (when the employee puts himself at the disposal of the employer even if the employer has not yet assigned a task to him). After signing the contract, there is no Shari'ah prohibition against forwarding the pay as a lump sum amount, or in installments.

5/2/4 The pay can be variable, yet the amount of pay for the first period should be known. Following the first period, it is permissible to use an accurate indicator for predetermination of the pay for the successive periods. However, such indicator should be known to both parties and mutually agreed upon, for avoidance of dispute. This indicator which replaces the specifically determined pay for the period should have an upper and a lower limit.

5/2/5 It is permissible, on the consent of the two parties, to amend the pay of future periods (the periods in which benefiting from the service has not yet taken place), whereas the unpaid amounts of pay that relate to past periods become a debt obligation owed by the employer, and hence it is impermissible to stipulate a condition for increasing such amounts (rescheduling).

5/2/6 The pay can be determined as a percentage of the output (e.g., 10%) or a part of the thing to be made.

5/2/7 It is permissible to stipulate in the contract that in case of default by the employer in the settlement of any installment, or when he refrains from doing so without a reasonable excuse and after a sufficient period of notification; all other installments shall become due and eligible for premature settlement. However, the employee in this case does not own the prepaid installments finally until he completes the work of the whole hiring period. [see Shari'ah Standard No. (8) on Murabahah, item 5/1]

5/2/8 It is impermissible to make a condition which leads to any increment in the pay agreed upon, in case of default by the employer. Nevertheless, the contract may include a pledge by the employer to donate, in case of default, a percentage of the pay for charitable purposes. Such donation should entirely go to charitable purposes, under the supervision of the Shari'ah Board of the institution.

5/2/9 It is permissible to agree upon more than one rate of pay, as when the two parties agree that if the work is done within a certain period the pay will be this much, and if it is done in another (shorter) period the pay will increase to that much. Similarly, two different rates of pay can also be linked to two different places, types, or specializations, of the work to be done.

**6. Guarantees for Provision of the Pay and the Service**

6/1 The employee has the right to obtain the permissible guarantees in their different forms so as to document his eligibility for receiving the pay. Likewise, the employer has also the right to obtain such guarantees for receiving indemnity in case of any transgression or negligence or breach of the contract from the part of the employee. The ruling here is, in fact, similar to that on documentation and collateralization (Rahn), suretyship (Kafalah) transfer of right (*Hawalat al-Haqq*) and set-off (Maqassah). [see Shari'ah Standard No. (5) on Guarantees, item 2/3]

6/2 It is permissible to state in the contract that the pay has to be made in advance, deferred, or in installments. In case of premature termination of a contract in which the pay has already been made in advance, the two parties should resort to settlement. When the employee accepts any period of delay for a pay that has to be settled in advance, such acceptance should be considered as a respite which the employee has willingly granted to the employer, and hence it can by no means be considered as a right of the latter. Due attention shall be given here to item 5/2/2.

## 7. Commitments of the Employee and the Employer

### 7/1 Commitments of the employee

7/1/1 The private employee has to render his service to the employer and observe the period of hiring during which he should not be absent, except on permission of the employer, or to perform a recognizable duty. Similarly, the shared employee has to perform the work as agreed upon, and within the stipulated period, if any.

7/1/2 In principle, the employee is supposed to do the work by himself since he has been hired to perform a specific work required from him, unless the contract stipulates otherwise. This, however, does not hold true in case of hiring someone to do a future service/ work that has been specifically defined. In this latter case, what needs to be catered for is observation of all the specifications mentioned in the contract.

7/1/3 In hiring of persons, it is permissible to stipulate a penalty code indicating a specific amount which the employee should pay to the employer in case of delay in performing the work/service within the specified period. The amount to be thus paid has to be determined with due consideration to normal practice as well as justice.

### 7/2 Commitments of the employer

7/2/1 The employer shall observe the following:

a) Payment of the pay in advance, on deferred payment basis, or in installments as agreed upon. In the absence of agreement on a specific form of payment, the due pay should be paid after rendering the complete service to the employer, or on expiry of the hiring period in case of private employment. When a due pay is delayed by the employer in spite of notification the employee has the right to stop work or prevent the employer from utilizing the service that has already been done.

b) Provision of facilities/requirements to the employee, if the work to be done so requires, or when provision of such facilities and requirements is stipulated in the contract.

## 8. Emergencies, Termination, Expiry and Renewal of Hiring Contracts

### 8/1 Emergencies of hiring

8/1/1 A private or shared hiring contract which relates to the employee in person as per normal practice, shall be terminated on the death of the employee, or when the employee loses his entire legal competence, or when - due to injury or sickness - he becomes unable to work anymore or for a period which is normally considered to be too long for the employer to tolerate. Such contract shall also be terminated when the employee-institution encounters liquidation, bankruptcy, or freezing of activities.

8/1/2 When the employee refrains from delivery of the service as required, and fails to present the suitable alternative as agreed upon, the employer has the right to terminate the contract and demand indemnification for the actual harm caused to him by the act of the employee.

### 8/2 Termination, expiry and renewal of hiring contracts

8/2/1 In specific hiring, when the service/work becomes completely useless the contract becomes null and void; whereas when it is partially useless the employer has the right to terminate the contract. If, instead, the service/work that has become useless pertains to hiring on the basis of future delivery of a well defined service, the contract shall remain valid, and the employee, in this case, has to deliver a similar service.

8/2/2 The hiring contract can be terminated on the consent of its two parties, yet none of them has the independent right of its termination, except for a contingent excuse or *force majeure* situation. The employer has the right to terminate the contract on the existence of a defect that makes the service useless. The

contract can also be terminated on the basis of a conditional option (*Khiyar al-Shart*), by the party who has stipulated such option, and within its specified period.

8/2/3 The employee has the right to stipulate termination of the contract when the employer fails to make or delay payment of the pay agreed upon, or when the employer does not pay one installment or more of such pay (*Khiyar al-Naqd*).

8/2/3 On the consent of the two parties, the hiring contract can be terminated before its effectiveness.

8/2/3 Hiring comes to an end at the end of the contract period, yet it remains when it is needed for a reasonable excuse or for avoidance of harm. In case of continuation, hiring shall be for a pay to be agreed upon between the two parties, otherwise the normal pay for similar services should be applied.

8/2/6 The hiring contract can be renewed for another period, whether renewal is to be declared before expiry of the original contract, or to take place spontaneously. For spontaneous renewal, a condition is to be stated in the contract indicating that the contract shall spontaneously become renewed on the commencement of a new period, if none of the two parties notifies the other about his disinterest in renewal.

## 9. Date of Issuance of the Standard

This Standard was issued on 28 Jumada II, 1429 A.H., corresponding to 2 July 2008 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Hiring of Persons in its meeting No. (21) held on 24–28 Jumada II, 1429 A.H., corresponding to 28 June – 2 July 2008 A.D., in Dar Al-Taqwa Hotel, in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (14) held on 21-23 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D., the Shari'ah Board decided to issue a Shari'ah standard on Hiring of Persons (usufructs of services).

On 29 Jumada I, 1426 A.H., corresponding to 6 July 2005 A.D., the Secretariat General decided to commission a Shari'ah consultant to prepare a study on Hiring of Persons (usufructs of services).

A joint committee composed from Shari'ah Committees (1) and (2) held a meeting in the Kingdom of Saudi Arabia, on 7 Jumada I, 1427 A.H. corresponding to 3 June 2006 A.D. The joint committee discussed and cleared the study, and asked the consultant to prepare the draft of the standard.

In a further meeting of the joint committee, held on Thursday 21 Sha'ban 1427 A.H., corresponding to 14 September 2006 A.D., in the Kingdom of Bahrain, the draft of the standard was discussed and the consultant was requested to introduce necessary amendments in the light of the discussions and observations of the meeting.

In its meeting No. (19) held in Makkah Al-Mukarramah on 26–30 Sha'ban 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the draft of the standard and introduced the changes that it deemed necessary.

In its meeting No. (20) held in the Kingdom of Bahrain, on 4-8 Safar 1429 A.H., corresponding to 11-15 February 2008 A.D., the Shari'ah Board discussed once again the draft standard and introduced further changes.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 8 Jumada II, 1429 A.H., corresponding to 12 June 2008 A.D. More than 30 participants attended the session as representatives of central banks, institutions, and accounting firms. The session was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (21) held in Al-Madinah Al-Munawwarah, on 24–28 Jumada II, 1429 A.H., corresponding to 28 June – 2 July 2008 A.D., the Shari'ah Board discussed the draft standard, introduced the changes that it deemed necessary and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Hiring of persons is permissible according to Qur`an, Sunnah (Prophetic Traditions) and Ijma' (consensus of Fuqaha). In Qur`an this is emphasized in the Verse stating: ***{"Then if they give suck to the children for you, give them their due payment"}***.(2)

  As far as Sunnah is concerned, permissibility of hiring of persons can be derived, for instance, from the Hadith of the Prophet (peace be upon him) in which he said: *"The most eligible of whatsoever you have got a pay for, is the Book of Allah"*.(3) This in addition to many other Hadiths. In this regard, Al-Bukhari presented a whole chapter on Ijarah (hiring) which comprises 22 sections, and so did Abu Dawud, as well as other Sunnah scholars who referred to several Hadiths on the subject within other chapters.

  Similarly, Ijma' (consensus of Fuqaha) on permissibility of hiring of persons is said to have been reached since the time of the Sahabah (companions of the Prophet, peace be upon him), as well as the time of their successors and the founding leaders of the schools of Fiqh. In this respect Al-Kasani said: "As regards Ijma' of the Ummah (Muslim Nation) it had been reached before the existence of the deaf……."(4)

- Permissibility of a pledge which is binding to only one party is supported by a number of Shari'ah proofs which support honoring of contracts, pledges and promises, in addition to what has been emphasized by some Shari'ah scholars. On this regard, the International Islamic Fiqh Academy issued its

(2) [Al-Talaq (Divorce): 6]; and see: *"Jami' Al-Bayan"*, by Al-Tabari, verified by Mahmoud Shakir, Dar Ibn Hazm, [28: 181].
(3) *"Sahih Al-Bukhari"* with *"Fath Al-Bari"* [4: 452–453].
(4) *"Bada`i' Al-Sana`i'"*, Muassasat Al-Tarikh Al-Arabi, Beirut, 1421 A.H. [4: 16].

resolution No. 40-41 (2/5 & 3/5) on Enforceability of Pledge in Murabahah.[5] The rulings stated in that resolution also hold true in the case of pledge in hiring and other similar dispositions.

- Permissibility for the institution to receive an amount from the party who pledges to hire its services (seriousness margin), is based on need and interest. A similar Fatwa (Shari'ah opinion) has been issued in this regard by the Unified Shari'ah Supervisory Board of Al Baraka Group.[6] That Fatwa is relevant to the case of hiring.
- Enforceability of the hiring contract is derived from the verses and Hadiths which instruct people to honor contracts, as when Allah, the Almighty, says: ***{"O you who believe! Fulfill (your) obligations..."}***.[7] besides the general consensus among fiqh scholars on enforceability of hiring,[8] since it is a contract which facilitates ownership through exchange of two objects.
- The ruling that the period of hiring should be specified stems from the fact that non-specification could result in prohibited Gharar (uncertainty) and Jahalah (ignorance) which lead to dispute. Prohibition of sales which involve Gharar (uncertainty) has been emphasized by well verified Hadiths.[9] Therefore hiring of persons shall not involve Gharar, because, in essence, it is a sale of service/work.
- Permissibility of hiring of persons for doing deferred services is based on the practice of the Prophet (peace be upon him) when he and Abu Bakr hired a man from Bani Al-Dail to serve them as a guide, after three days.[10] Moreover, hiring is a time-based contract and therefore its object can be delivered in the future.
- Permissibility of taking 'Arboun (Earnest Money) is derived from what Omar did in the presence of Sahabah (companions of the Prophet, peace

(5) The Journal of the Academy, Issue No. (5), Vol. (2), (pp. 754 and 965).
(6) Fatwa No. (9/10) of the Unified Shari'ah Board of Al Baraka.
(7) [Al-Ma'idah (The Table): 1].
(8) *"Al-Fatawa Al-Hindiyyah"* [4: 410]; *"Al-Sharh Al-Kabir"* [2: 4]; *"Al-Rawdah"* [5: 173]; and *"Al-Mughni"* with *"Al-Sharh Al-Kabir"* [6: 20].
(9) *"Sahih Muslim"* [5: 3]; and *"Sunan Abu Dawud"* (H: 3376).
(10) *"Sahih Al-Bukhari"* with *"Al-Fath"* [4: 443], Al-Matba'ah Al-Salafiyyah.

be upon him), and adopted by Ahmad. On this regard, The Islamic Fiqh Academy of Makkah Al-Mukarramah has also issued its resolution No. 72 (3/8).

- Sub-hiring is permissible because when the employer owns the service/ work he becomes able to transfer it to someone else.
- The ruling that a hiring contract can be conditional is based on the Hadith of the Prophet (peace be upon him) which indicates: *"Muslims are at their conditions, except a condition that permits what has been prohibited or prohibit what has been permitted."*(11)
- The ruling that hiring for a specific service is impermissible before owning and possessing the service, is reached by analogy to prohibition of selling things that one does not own, and the Hadith which has been narrated by Hakim Ibn Hizam stating: *"Don't sell what you do not have"*.(12)
- Permissibility of signing a hiring contract for a service to be delivered in the future, is judged by analogy to Salam, and because that does not lead to dispute. According to the Shafi'i and Hanbali scholars the pay should not necessarily be made in advance.
- A private employee should not guarantee what he works on, except in case of transgression, negligence, or breach of a condition. This is actually the general principle in trust-based contracts; in addition to that, the contract comprises an interest for the employee since he will receive the pay. In case of transgression, negligence, or breach of condition the act results in harm, and hence the employee has to indemnify the employer, as per the directives of the Prophet (peace be upon him) who said: *"No harm, and no reciprocal harm"*.(13)
- The ruling that a shared employee has to guarantee what he works on, is based on what has been reported about some of the Sahabah (companions of the Prophet – peace be upon him) who emphasized that this has to be so,

(11) Related by Al-Bukhari: *"Fath Al-Bari"*, *"Kitab Al-Ijarah"* [4: 451]; and *"Abu Dawud"* with *"'Awn Al-Ma'bud"* [9: 516].

(12) Related by Abu Dawud in his *"Sunan"* (H: 3530); Al-Nasa`i in his *"Sunan"* [2: 225]; Ibn Majah in his *"Sunan"* (H: 2187), and Ahmad in his *"Musnad"* [3: 42].

(13) Related by Malik in *"Al-Muwatta'"*, *"Kitab Al-Aqdiyah"* [1: 464]; Ahmad in his *"Musnad"* [1: 313] and [5: 327]; and Ibn Majah in his *"Sunan"* [2: 784].

because the shared employee will be doing what he has been paid to do in the absence of the owner, besides the fact that the employee in this case is working for many employers rather than for a particular employer.(14)

- The hired service shall be permissible because what is prohibited by Shari'ah cannot be an object of a Shari'ah-recognizable contract. Moreover, impermissible hiring entails provision of support to wrongdoing and misbehavior; whereas Allah, the Most High, says: ***{"Help you one another in Al-Birr and Al-Taqwa (virtue, righteousness and piety, but do not help one another in sin and transgression"}***.(15)
- The pay for future hiring periods can be adjusted on mutual consent of the two parties, because such adjustment constitutes contract renewal for a coming period. No pay has yet become payable to the employee for that future period so that it can become a debt owed the employer, and consequently lead to prohibited rescheduling of debt. When, instead, such adjustment is done for an unsettled amount of pay which belongs to past periods, so as to extend the repayment period against an increase in the amount to be paid, adjustment in this case will lead to Riba (usury). The 11th Seminar of Al Baraka has already issued a Fatwa in this connection.(16)
- The ruling that the pay can be composed of two parts is based on Tradi (mutual consent), in addition to the fact that such arrangement neither violates the contract rulings nor does it encounter a Shari'ah prohibition.
- The pay can be in the form of a common share, because the pay in this form can be known, and will not lead to dispute or Gharar (uncertainty).
- Permissibility of stipulating in the contract that all outstanding installments of the pay shall become due in case of default by the employer in the settlement of any installment is based on Tradi (mutual consent), besides the fact that such a condition neither violates the contract nor does it encounter Shari'ah prohibition. The Prophet (peace be upon him) said: *"Muslims are*

(14) *"Bada`i' Al-Sana`i'"* [4: 210]; *"Hashiyat Al-Dusuqi"* [4: 23]; *"Mughni Al-Muhtaj"* [2: 351]; and *"Al-Mughni"* with "*Al-Sharh Al-Kabir"* [6: 115].

(15) [Al-Ma'dah (The Table): 2].

(16) The Book on Resolutions and Recommendations of Al Baraka Seminar (11/2).

*bound by the conditions the make*".[17] In this regard the International Islamic Fiqh Academy has also issued its resolution No. 64 (2/7).[18]

- Impermissibility of stipulating a condition for increasing pay overdues is based on the fact that any increment in such amounts (against extension of settlement period) is Riba (usury). In this connection, The International Islamic Fiqh Academy issued its resolution No. 133 (7/14).[19]
- Permissibility of applying two rates of pay (so that the employer would become entitled to the higher rate when he performs the work in the shorter period and vice versa) stems from the fact that such arrangement does not lead to Gharar (uncertainty) or Jahalah (ignorance). In addition to that, such arrangement had been Traditionally resorted to, and approved by a number of Fiqh scholars.[20]
- Permissibility of seeking payment guarantees, is similar to permissibility of Kafalah (suretyship) and *Tawthiqat* (documentations) in Islamic jurisprudence, besides the fact that request for guarantees here does not violate the rulings of the contract but rather confirms them, since guarantees are suitable for debt contracts.
- The contract becomes null and void when the service is completely or partially useless, because the outcome of the contract has not been accomplished, and the contract has not achieved its objectives. In addition to all that, the pay is supposed to be made against the benefit. In this respect, the International Islamic Fiqh Academy issued its Resolution No. 13 (1/3).[21] If, instead, the contract relates to a specifically defined service which has to be delivered in the future, the contract does not become null and void because the service in question will still remain as a debt, and the employee should be asked to provide a service that has the same specifications.
- The ruling that hiring will come to an end on expiry of the contract period or on the consent of the two parties, is based on the fact that a hiring contract

(17) Reference has been referred to earlier.
(18) The Journal of the Academy, No. (6), (P. 193) and No. (7), Vol. (2), (P. 9).
(19) The Journal of the Academy, No. (14), Vol.(4), (P. 687).
(20) See: *"Al-Fatawa Al-Hindiyyah"* [4: 445] and *"Al-Mughni"* by Ibn Qudamah [5: 442].
(21) See: the Journal of the Academy, No. (2), Vol. (2), (P. 527) and No. (3), Vol. (1), (P. 77).

is a time-based contract and therefore, it expires at the end of the period. Similarly, a hiring contract is a consensual contract which starts and ends on the consent of the two parties.

- Permissibility of spontaneous renewal of the contract when it is stipulated as a condition or when agreed upon between the two parties, stems from the fact that such condition does not violate the rulings of the contract. The Prophet (peace be upon him) said: *"Muslims are bound by the conditions the make"*.(22)
- The basis for the commitments of the employee and the employer is that such commitments constitute essential requisites of the contract for hiring of persons. Moreover, such commitments are based on the agreement of the two parties. Both of these two justifications are unanimously accepted by Shari'ah scholars.(23)
- The ruling that a hiring contract which relates to the employee in person becomes null and void on the death, loss of legal competency or persistent sickness of the employee, is based on the fact that the object of contracting will, thus, become no longer existent. Consequently, there will also be no pay since the pay is to be made in exchange of the benefit. In addition to all that, this ruling conforms to normal practice.
- The ruling that a contract which relates to a future service does not become null and void on the death of the employee, is based on the fact that in this case the service, as a debt, is considered as existent.
- The pay shall become due even if the employer could not benefit from the employee who had put himself at his disposal. This ruling is based on the fact that the employee is entitled to the pay since he has been able to fulfill the condition of putting himself at the disposal of the employer, while the employer has no excuse for not benefiting from the services.
- Permissibility of terminating the hiring contract in case of contingencies is based on observation of need and necessity of avoiding hardship, in addi-

(22) Reference has been referred to earlier.

(23) See: *"Bada`i' Al-Sana`i'"* [4 :210]; *"Tabyin Al-Haqa`iq"* [5: 124]; Al-Dusuqi in *"Al-Sharh Al-Kabir"* [4: 23]; *"Mughni Al-Muhtaj"* [2: 351; and *"Al-Mughni"* with *"Al-Sharh Al-Kabir"* [6:115].

tion to normal practice. A Fatwa in this regard has been issued by the Board of Fatwa and Shari'ah Supervision of the Kuwait Finance House.[24]

- Permissibility for the employee to state a condition for termination of the contract when the pay is delayed is based on the fact that such condition is fair, and does not violate the rulings of the contract. The Prophet (peace be upon him) said: *"Muslims are at their conditions"*.[25]

(24) Fatwa No. (232) and No. (252).

(25) Reference has been referred to earlier.

## Shari'ah Standard No. (35)

# Zakah

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This standard aims to identify the Zakah base for Islamic financial Institutions (Institution/Institutions),[1] and indicate the different types of zakatable assets and the liabilities (debts of the Institution) and allocations that have to be deducted from them. The standard also aims to illustrate the payable Zakah rates, and indicate the specific heads of Zakah disbursements.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers identification of the Zakah base for Institutions (including Islamic insurance companies) as well as the subsidiary and the mother company of the Institution (the company). This will be done through identification of the items of financial statements that should or should not be included in calculation of the Zakah base, and the liabilities or allocations that should or should not be deducted from Zakatable assets. The standard also covers payable Zakah rates, disbursement of Zakah funds on the eight categories of Zakah recipients, and the rulings pertaining to disbursement.

## 2. Procedural Rulings

### 2/1 Methods of calculation of Zakah base

There are two methods for calculation of Zakah base: the first is the method of net assets, and the second is the method of net investment assets. The two methods have different bases of assessment, yet if such difference is well recognized the final outcome will be the same. This standard is based on the net assets method.

**Net Assets Method**

2/1/1 Calculation of Zakah base by using the net assets method is done as follows:

Zakah base = Zakatable assets – (liabilities payable during the financial year as at the date of the balance sheet + all installments of liabilities of the financial year which will become due during the coming financial period + rights of the holders of non-restricted investment accounts + minority rights +sovereign rights +waqf rights + charitable rights + rights of non-profit-earning organizations that have no specific owner).

Zakatable assets include: cash and the like, receivables (minus) doubtful debts, assets prepared for trading (such as goods, financial papers and real estate), and financing assets (Mudarabah, Musharakah, Salam, Istisna'a…..). Deductions from financial assets include fixed assets relating to them as well as deductible allocations as shown in item 7.

2/1/2 Assets prepared for trade are to be assessed in terms of their expected cash value (selling market value) at the time when Zakah is due.

2/1/3 In determination of zakatable assets in agriculture and livestock other than articles of trade, application of the ratios and rates specified by Shari'ah should be observed.

**2/2 Direct payment of Zakah by the institution**

2/2/1 The institution or the company is committed to pay Zakah under the following cases:

a) Enactment of an enforceable Zakah law.

b) Stipulation of commitment to pay Zakah in the articles of association.

c) Issuance of a Zakah commitment resolution by the general assembly.

2/2/2 When the Institution accepts agency for payment of Zakah on behalf of all or some of its equity holders or the holders of investment accounts, funds should be available - or submitted by the principals of such agency - for payment of Zakah on their behalf.

2/2/3 There should be coordination between the mother Company and its subsidiaries with regard to payment of Zakah so as to avoid double payment.

2/2/4 In case of establishing a Zakah fund, or preparing Zakah accounts, clearance by the Shari'ah Board of the institution or the company should be obtained. Clearance by the Shari'ah

Board is particularly required for disbursement of the Zakah funds, when performed directly by the institution/company, or through an accredited Zakah agency. Moreover, a comprehensive report on Zakah disbursements should be presented to the Shari'ah Board on annual basis.

2/2/5 In the absence of any of the conditions indicated in item (2/2/1) above, payment of Zakah shall become the responsibility of shareholders and holders of the investment accounts. In this case the Institution or the company has to indicate the amount of Zakah payable per share or per a given balance of an investment account.

**2/3 Zakah-related financial statements**

2/3/1 The Balance sheet

Due to the fact that Zakah relates to ownership of zakatable assets, what matters to the Institutions in Zakah calculation is the financial data included in the balance sheet of the institution (the budget), which comprises assets, liabilities, and their related allocations.

2/3/2 Income statement

Income statement (profit and loss account) does not form a basis for Zakah calculation, yet it is referred to for knowing the income or profit of the income-earning fixed assets. In order to pay Zakah the Institution should not necessarily be making profits. Incurring losses by the Institution does not prevent Zakah from becoming due. The Institution is still committed to pay Zakah, except when its liabilities (debtors) absorb all its assets.

**3. General Rulings**

3/1 Shari'ah definition of Zakah, status (Hukm) of Zakah in Shari'ah, and Zakatable funds

3/1/1 Zakah is a right which becomes due in certain types of wealth, and disbursable to specific categories of recipients. It is an in rem duty when its conditions are satisfied.

3/1/2 Zakah is obligatory on gold, silver, currencies, trade articles, livestock (camels, cows and goats), agricultural produce, minerals and *Rikaz* (treasures).

3/1/3 Zakah is not obligatory on wages, salaries and income from free occupations at the time of receiving such income; whereas it is obligatory on that portion of such income which remains unexpended for a whole year.

3/1/4 Zakah is not obligatory on fixed assets which generate income and which are not acquired for trade, such as leased assets. Nevertheless, at the end of the year, Zakah is obligatory on the remaining portion of the income generated by these assets.

3/1/5 Zakah is not obligatory on public wealth (public sector) or the insurance funds of public institutions.

3/1/6 Zakah is not obligatory on the charitable Waqf (*al-Waqf al-Khayri*). As regards the family Waqf (*al-Waqf al-Ahli*) the beneficiaries should pay Zakah, at the end of the year, from that portion of the Waqf income which remains unexpended.

3/1/7 The above ruling which relates to exemption of charitable Waqf from Zakah is also applicable to trust funds as well *Irsad* (allocation) of public funds and properties for (non-profiteering) educational, charitable, and social Institutions, which have no specific owner, even if such institutions make profits.

## 3/2 Conditions for Zakah obligation

3/2/1 Full ownership

Full ownership materializes when nobody else has a right in the asset in question, the owner can dispose of the asset the way he likes, and the owner of the asset is the sole owner of the income generated from the asset. In this case, no matter if the asset is

allocated for any specific purpose other than settlement of debts (for instance, no matter if it is allocated for implementation of investment projects).

3/2/2 *Nisab* (Zakatable wealth stratum)

The *Nisab* for gold regardless of its form is 85 grams of pure gold or its equivalent in currency (paper or coins), and the same *Nisab* is also applicable to articles of trade after valuation, as well as to extracted minerals. For silver, the *Nisab* is 595 grams of pure silver. The *Nisab* which is widely recognized as applicable to articles of trade is that of gold. *Nisab* for Zakah on livestock is shown at the end of this standard.

3/2/4 Al-Hawl (Zakah year)

The Zakah year for cash and commercial assets as well as livestock is a lunar year (354 days). In case of adopting the solar year for cash and commercial assets, the Zakah rate becomes 2.577%.(2) As regards agricultural products no consideration is to be given to the Hawl (Zakah year) because what matters is harvesting. Similarly what should be considered for minerals and Rikaz (treasures) is their extraction.

**3/3 Applicable Zakah rate**

The rate of Zakah applicable to gold, silver, currencies and articles of trade is 2.5% - with due consideration to item 3/2/3 above - , whereas the rate applicable to agricultural produce is one tenth (10%) for the produce of non-irrigated lands, half of the tenth (5%) for the produce of irrigated lands, and three quarters of the tenth (7.5%) for the produce of partially irrigated lands. Zakah rates applicable to livestock are shown at the end of this standard.

**4. Fixed Assets**

**4/1 Operational fixed assets**

Zakah is not obligatory on operational fixed assets such as the premises of the institution and its equipments; or on intangible assets such

(2) In a leap year the rate is 2.5775

as patent rights, trademarks and computer software. Zakah is also not obligatory on moveable assets acquired for operation (other than those prepared for trade) such as spare parts and tools used for further production, even when such assets are kept in the warehouses.

**4/2 Income-generating fixed assets**

There is no Zakah on fixed assets which generate income like *Mustghallat* (leased assets), if such assets are not acquired for trade. Nevertheless, Zakah is obligatory, at the end of the year, on the unexpended portion of the income generated by such assets, by adding that portion of income to the other zakatable assets and applying the Zakah rate.

Income-earning fixed assets appear in the financial statements under the following items:

4/2/1 Mustaghallat (leased assets such as real estate properties, transportation vehicles..etc.). At the end of the year, the unexpended rental of these assets is to be subjected to Zakah by adding it to other zakatable assets.

4/2/2 Real estate investments: At the end of the year, the unexpended income of these assets is to be subjected to Zakah by adding it to other zakatable assets.

4/2/3 Capital projects under implementation (which are not for trading)

If a project of this type happens to generate income at some of its stages of implementation, Zakah is obligatory on the unexpended part of that income, after adding it to zakatable assets at the end of the year. If such projects are being implemented for trading purposes. [see item (5/2/6/3)]

4/2/4 Investments in shares with the aim of retaining them (*Nama'*)

If it is possible to know through the company what is the exact amount of Zakatable assets (cash, articles of trade and repayable debts) per share, Zakah can be levied on that amount, otherwise Zakah is to be levied on the portion of zakatable assets per share,

which has to be reached through estimation. If the company has no zakatable assets, Zakah is obligatory on the remaining part of the net income at the end of the year.

As far as shares owned for non-trading purposes are concerned, no allocation for deterioration in the value of share investments should be made from the zakatable assets. Regarding shares acquired for trading purposes, the ruling on articles of trade (item 5/2) should be applied.

4/2/5 Investment in the shares of subsidiaries

In, accounting, a subsidiary is the entity in which the mother company owns 50% of the shares. The process of Zakah payment in this case starts with calculating the Zakah of the subsidiary independently, and then the mother company pays its share of Zakah in proportion to its shareholding in the subsidiary. The remaining part of the Zakah of the subsidiary is to be paid by the other parties (minority rights). Such arrangement holds true when the subsidiary does not pay its Zakah directly.(3)

## 5. Zakatable Assets

### 5/1 Liquid or easy-to-liquidate current assets

Such assets which include cash assets and assets which can be converted into cash (quasi cash), are shown in the financial statements under the following items:

5/1/1 Cash in hand: Zakah has to be paid from these funds. If such funds are in foreign currency Zakah should be paid from the equivalent amount in local currency as per the prevailing exchange rate on the date when Zakah is due.

5/1/2 Gold and silver assets in any form: Zakah on such assets is to be assessed on the basis of their net weight or cash value.

(3) From a Shari'ah point of view, the same ruling is applicable when the mother institution owns less than 50% of the shares of the subsidiary.

5/1/3 Bank balances: bank balances constitute the following items in the financial statements:

5/1/3/1 Current accounts

Institutions and companies should pay Zakah from their current accounts with other Institutions, because such accounts constitute debts that will certainly be settled. Current accounts include those with the central bank as well as those with other banks. When the Institution obtains interest in such accounts (though it is prohibited) it should pay Zakah from the principal amounts and donate the whole amount of the interest for charitable purposes. For the banks or the Institutions which receive such deposits current accounts constitute liabilities. [see item 6/3/1]

5/1/3/2 Investment accounts

a) The owners of these accounts should pay Zakah from the investment balances as well as the profits, whether such accounts represent short or long term deposits, and even if drawing from the account is restricted by the investment Institution or the owner. If these accounts are invested through permissible modes, what really matters is their share in the investment assets, rather than their share in the invested amounts. Consequently due consideration has to be given to the nature of the assets representing the invested amounts.

As for the institutions in which the accounts are invested, an account of this type represents a trust (Amanah) rather than a liability, and therefore these Institutions should pay Zakah only on their share of the profits or their commissions, as part of their cash assets.

b) When the investment accounts earn interests (though prohibited) Zakah is payable from the principal, while the entire amount of interest should be donated for charitable purposes. As for the banks in which these interest bearing accounts are deposited, the principal amounts (excluding interest) represent liabilities. [see item 6/3/2]

5/1/4 Bonds, Sukuk and funds

5/1/4/1 Bonds and treasury bills (which represent debts and involve interest – though prohibited): Zakah from the principal of the bond (cost of the bond) should be paid, whereas the entire amount of interest should be donated for charitable purposes. As regards the issuing banks, the nominal value of these bonds and bills represent a liability. [see item 6/3/2]

5/1/4/2 Investment Sukuk of different types: Their owners should pay Zakah on the basis of the underlying assets of these Sukuk, and as indicated in this Standard. As for the Institutions which manage the assets or keep the investment Sukuk, the Sukuk represent a trust (Amanah) rather than a liability, and therefore these Institutions should pay Zakah only on their share of the profits or their commissions, as part of their cash assets.

5/1/4/3 Investment Funds in their different forms: Zakah has to be paid on the basis of the underlying assets of the fund, and as indicated in this Standard.

5/1/5 Amounts retained for documentation of the deal

5/1/5/1 *Hamish Jiddiyyah* (security deposit): This refers to the advance amount which the client pays in order to confirm his binding pledge. Such amount is supposed to cover any harm caused by recoiling of the client from completion of the deal: Zakah on such amount

shall be paid by the client. If the amount is deposited in a current account it shall become subject to the rulings shown in item 5/7/3/1 and if it is deposited in an investment account it shall become subject to the rulings indicated in item. [5/1/3/2]

5/1/5/2 The initial security for entering bids as well as implementation security: are to be ducted from the zakatable assets of the Institution which receives them, while the owner of such amount has to pay Zakah it annually as part of his assets, unless he has not been enabled to invest it before refund. When several years elapse before refund, Zakah for one year has to be paid. If such amounts are deposited in an investment account it shall become subject to the rulings stipulated in item. [5/1/3/2]

5/1/5/3 Cash security charged to individuals and Institutions for obtaining certain services such as telephone and electricity services, or security paid on renting shops and equipments: Zakah should be paid by the owner of such amount on refund, and for one year, unless he has been enabled to invest the amount before refund. If the owner of the amount has been enabled to invest it before refund Zakah has to be paid subject to the rulings stated in item. [5/1/5/2]

5/1/5/4 'Arboun (Earnest Money): To be deducted from the zakatable assets of the buyer, while the seller should pay Zakah from it as part of his Zakatable assets, since he will get the amount if the contract is concluded or not.

**5/2 Commodity current assets (Articles of Trade)**

5/2/1 Articles of trade include anything offered for sale such as real estate and moveable assets, whether the good is being sold in

its current state or after manufacturing, and when it is acquired through buying or otherwise. To be subject to Zakah payment such goods should not necessarily be obtained through buying, the mere intention to offer them for sale is quite sufficient.

5/2/2 Articles of trade should be valued at selling market price in the place where they exist, and according to the method of their sale (retail, or wholesale, or if both whichever the predominant). Articles of trade should not be valued at cost or market price whichever the less. However, when other methods of valuation are extremely difficult, valuation at cost can be used for Zakah purposes. When there is a price change during the period between the date of accrual and date of payment of Zakah, the price at the date of Zakah accrual should be adopted.

5/2/3 When the articles of trade are subject to another type of Zakah treatment (e.g., when the articles of trade are livestock or agricultural produce) they should become subject to Zakah on articles of trade only.

5/2/4 In principle, Zakah on articles of trade is to be paid in cash, yet in case of trade recession it can be paid in kind (from the same articles of trade), provided that the interest of Zakah recipients could, thus, be achieved.

5/2/5 Zakah has to be paid on the goods earmarked for the buyer after concluding the contract, even if he has not yet possessed them.

5/2/6 Applications relating to commodity current assets in the items of financial statements

5/2/6/1 Commodity stocks prepared for Trade, raw materials in their different forms, and goods for sale in their original form or after being manufactured by adding them to other materials: To be valued for Zakah purposes at selling market price.

If a good of this type is defective it shall be valued at its selling market price and as per the method of its sale (retail, or wholesale, or if both whichever the predominant). If the good in question is a slow-moving item it can be valued for Zakah at its market price and in its current form. When an allocation is made for such goods it should not be deducted from zakatable assets.

5/2/6/2 Goods in process: To be valued for Zakah at their current market price on the day of Zakah accrual, and if it is not possible to know their market value, they could be valued at cost.

5/2/6/3 Works under implementation (constructions): To be valued for Zakah in their current state on the day of Zakah accrual.

5/2/6/4 Industrial accessories (spare parts) used in production equipment: are not part of Zakatable assets.

5/2/6/5 Goods in transit: To be valued for Zakah at market price in the place where they are found.

5/2/6/6 Goods to be sold by others on commission (by agency): To be valued for Zakah at market price in the place where they are found.

5/2/6/7 Goods imported through documentary credits covered by the Institution, including the expenses of opening the credit and the amounts retained by intermediary banks: Zakah should be paid on the amounts retained for the credit, and not the expenses. When the goods are owned Zakah has to be paid from them on the basis of their market value.

5/2/6/8 Goods prepared for export through documentary credits to the benefit of the Institution: The amounts retained

for the credit, are neither subject to Zakah nor are they deductable from zakatable assets, since they have not yet been possessed. However, Zakah has to be paid on the goods that are still held by the Institution as part of its finished goods or goods in process.

5/2/7 Intangible rights prepared for trade such as copy right, patent right, trademarks, and computer software: should be subject to Zakah on articles of trade.

5/2/8 End of the year stock of raw materials (primary materials) which are normally used as ingredients and remain as components of the goods manufactured for trade: Should be valued for Zakah at their market value before entering the process of manufacturing. No Zakah is payable on supporting materials which do not represent ingredients of or remain as components of the manufactured goods, such as fuel and cleaning materials.

5/2/9 Finished goods and goods in process being manufactured for trade: are subject to the same rate applicable to Zakah on articles of trade. Finished goods and goods in process should be valued in their current state and at market price.

5/2/10 Rapping and packing materials: are not to be included in valuation of goods for Zakah if such materials are not prepared for trade separately. Nevertheless, if such materials increase the value of the goods they should be included.

**5/3 Receivables of the institution or the company**

5/3/1 If the debt owed to the Institution is a cash amount the Institution should pay Zakah on it annually - whether such debt is due or not - since the Institution will certainly receive it. As for bad debts (non-repayable debts) and doubtful debts the Institution does not have to pay Zakah except for one year after collection of such debts, and as per the rulings indicated in item 6/2.

5/3/2 The institution can postpone Zakah on its outstanding debts until full or partial collection. On collection, the Institution has to pay Zakah for the whole past period. When a specific debt is partially doubtful, and an allocation is made for doubtful debts, the doubtful part of the debt can be deducted from Zakatable assets, if the total amount of such debt has initially been included in the these assets.

5/3/3 When the debt owed to the institution by another party comprises interest that has arisen from the process of lending and borrowing or from rescheduling of the debt; the Institution should pay Zakah on the principal only and donate the whole amount of interest for charitable purposes. It should, however, be noted that interest bearing deposits and loans as well as discounting of receipt papers are strictly prohibited dealings which should be avoided.

5/3/4 Applications relating to Receivables in the items of financial statements

5/3/4/1 Debtors: Zakah shall be paid on the amounts payable to the Institution against goods or services sold on debt. In this respect, due consideration should be given to the above-mentioned items.

5/3/4/2 Loans, overdraft accounts, and debt bonds including discounted bonds (zero coupon) and accepted bills (discounted bills): Zakah is payable on the value paid for purchasing the bond, whereas interest – though prohibited – should become subject to the rulings indicated in item 5/3/4.

5/3/4/3 Receipt papers (bills and promissory notes): Zakah shall be paid on the principal of the debt (amount of the paper), including the increment added to the price, if the paper relates to a commodity sold on debt. It shall be noted here that the case will remain the same whether

the debt represented by the paper is due or not, since no difficulty is going to be encountered in its collection. If the paper comprises interest the rulings indicted in item 5/3/4 regarding interest should be observed.

5/3/4/4 Amounts retained from contracts: Such guarantee amounts are held by the clients to ensure that the Institution is going to honor its commitments. If the Institution has not been enabled to invest these retention amounts it should not pay Zakah on them. However, on receipt of the amounts the Institution has to pay Zakah on them for only one year.

5/3/4/5 Advance payments on signing contracts: No Zakah shall be paid on them, since they are no longer owned by the Institution.

5/3/4/6 Prepaid expenses: No Zakah is payable on such amounts which represent expenses of forthcoming financial periods, since they are no longer owned by the Institution.

5/3/4/7 Accrued income: It represents income of the current period which has not yet been received, and it shall be subject to Zakah on debts as indicated in item 5/3/1.

5/3/4/8 Legal deposit: It refers to the amount retained by a bank on request of the concerned authorities for the sake of awarding license to the Institution. The Institution cannot withdraw or dispose of such amount except on permission of the concerned authorities. If the institution has not been enabled to invest the retained amount it shall pay Zakah on it for only one year at the time of refund. If such deposit involves interest (though prohibited) the rulings indicated in item 5/3/4 should be applied.

5/3/4/9 Murabahah debtors: It indicates the amounts owed by purchasers. Zakah in this case is payable on total price including profits, as indicated in item 5/3/1.

5/3/4/10 Debtors of Salam goods purchased by the Institution and not yet received: the Institution should pay Zakah on Salam capital if the goods have been purchased for trading purposes. When the goods are purchased for operating or income generating purposes the rulings indicated in item 4/1 and 4/2 should be applied. As regards the Salam capital received by the seller of the goods, such income is subject to Zakah as part of the seller's cash assets.

5/3/4/11 Debtors of Istisna'a goods sold by the institution: This item represents the balance of amounts due to the Institution as per delivery dates of the Istisna'a commodity. Such amounts are part of Zakatable assets, and Zakah has to be paid on them under the category of current assets, because they constitute cash amounts.

5/3/4/12 Debtors of Istisna'a goods purchased by the institution: When such goods are purchased for the sake of trading, the debt relating to them (the price which the Institution is committed to pay to the seller) should be included in zakatable assets, and subjected to Zakah as per item 5/3/1.

5/3/4/13 Investment in shares for the sake of trading: Should become subject to the Zakah rate applicable to articles for trade. Valuation has to be at market price, yet in the absence of any market for such shares, valuation can be made by experts.

5/3/5 Debtors in an insurance portfolio

As indicated in the Shari'ah standard on Islamic Insurance the contributions of policyholders constitute a fund which has an independent financial liability, and the contributor is supposed to have given the premium as a donation. Consequently, the insurance fund is not committed to pay back any excess amounts to policyholders [items 2 and 5/5 of the Shari'ah Standard No.

(26) on Islamic Insurance]. In view of this no Zakah is payable by the insurance portfolio.

## 5/4 Zakah on agricultural produce and fruits

5/4/1 The *Nisab* for agricultural produce and fruits is 653 kilograms. No consideration should be given to the *Hawl* (Zakah year) because what matters here is harvesting. The applicable Zakah rate is one tenth (10%) for the produce of non-irrigated lands, half of the tenth (5%) for the produce of irrigated lands, and three quarters of the tenth (7.5%) for the produce of partially irrigated lands.

5/4/2 In calculation of the *Nisab* different types of the same kind of produce can be added together, such as the different types of the same kind of grain or fruit, whereas different kinds of produce or fruits cannot be added together. Each kind of produce or fruit should have its separate *Nisab*. It makes no difference when the agricultural produce or fruits owned by the same Institution or company are in different geographical locations.

5/4/3 *Khars* (estimation by experts) can be adopted when the agricultural products or fruits are ripe. One fourth or one third can be deducted and left to the owner and the rest becomes subject to Zakah on the basis of *Khars* after the produce is dried. Zakah can also be paid in terms of value.

5/4/4 Works under implementation (constructions) relating to agriculture are not part of Zakatable assets.

5/4/5 Production requirements such as fertilizers and insecticides are not part of zakatable assets, and should not be deducted from the Zakah base unless they have been obtained through debt.

5/4/6 Rapping and packing materials are not part of zakatable assets.

5/4/7 Expenses relating to irrigation, land development, irrigation channels and soil woks shall not be deducted from zakatable assets.

5/4/8 Cost of delivery to recipients shall be deducted from zakatable assets.

5/4/9 Zakah on the produce of a rented agricultural land should be paid by the tenant. In case of Muzara'ah or Musaqat, Zakah shall be paid by the two parties proportionately.

5/4/10 Subsidies and concessions related to agriculture: Cash subsidies shall be included in the Zakah base as part of liquid assets subject to item 5/3/1, whereas free-of-charge land and equipment should not.

**5/5 Zakah on minerals**

5/5/1 Minerals here include all stuffs of this kind extracted from the earth or the sea whether in liquid, solid or gaseous form.

5/5/2 The *Nisab* for minerals is what has reached in value 85 kilograms of gold. *Nisab* is to be assessed for quantities extracted continuously. If extraction is suspended for an abnormal period assessment of *Nisab* shall start at the time when extraction is resumed again. The Zakah rate applicable to minerals is 2.5%. If the extracted minerals are owned by the state no Zakah shall be paid on them, otherwise minerals are the property of their extractor, and he should pay Zakah on them. [see Shari'ah Standard No. (22) on Concession Contracts]

5/5/3 Pearl, coral and fish extracted from the sea for trade should become subject to the Zakah rate applicable to articles of trade.

**5/6 Zakah on livestock**

*Nisabs* and Zakah rates for livestock (camels, cows and goats) are shown at the end of this standard. Livestock that reaches the *Nisab* is subject to Zakah, whether owned for milk or progeny. The animals shall become subject to the Zakah rate on livestock, only if they are fed through free grazing, most of the year. If the animals are owned for trade they shall become subject to the Zakah rate on articles of trade.

5/6/1 It makes no difference if the animals which belong to the same owner are found in the same place or different places. Mixed ownership can also be recognized so that the animals owned by more than one person are treated as if they are owned by a single person, when such animals share the same facilities.

5/6/2 Animals owned for trade should become subject to the Zakah rate on articles of trade. Valuation has to be at selling market price.

5/6/3 Working animals, such as animals used in land plowing, irrigation and carrying are not part of zakatable assets.

5/6/4 Animals other than camels, cows and goats are not subject to Zakah payment, unless they are owned for trade. If such animals are used for production rather than trade they should not be included in zakatable assets.

5/6/5 When animal products such as milk and wool are owned for trade they should become subject to Zakah on articles of trade.

5/6/6 Zakah is not payable on horses, mules, donkeys and all other animals used for work or adornment, unless owned for trade.

5/6/7 Zakah is not obligatory on chickens acquired for production, which should be treated in the same way as Mustaghallat (productive assets such as leased properties). [see item 4/2]

5/6/8 Chickens, milk and stocks of animals are subject to Zakah on articles of trade when they are owned for trade purposes.

## 6. Liabilities

### 6/1 Classification of liabilities

Liabilities in financial statements comprise items which are not debts owed by the Institution in the strict sense of Shari'ah. Such items include for instance the capital of the company, the reserves and the profits. The debts included under the item of liabilities comprise the following:

6/1/1 Non-current (long term) liabilities which refer to debts that become due after one year. Such debts usually arise from purchase of fixed assets on debt, in addition to other long term entitlements.

6/1/2 Current (short term) liabilities which refer to debts that become due within one year.

**6/2 Debts owed by the institution**

6/2/1 If the debts owed by the Institution have arisen from obtaining current zakatable assets for the purpose of trade they should be deducted from the Zakah base.

6/2/2 If the debts owed by the Institution have arisen from obtaining non-zakatable fixed assets, they should not be deducted from the Zakah base.

6/2/3 When it is difficult to know the amount of debt that has arisen from acquiring zakatable assets, the ratio of zakatable assets to total assets should be used for assessment of such debt which has to be deducted from the Zakah base. If, for instance, zakatable assets constitute 40% of total assets, 40% of total debts should be deducted from the Zakah base.

6/2/4 If the debt owed by the Institution has arisen from a Shari'ah-banned practice such as borrowing with interest, unpaid interests should not be deducted from zakatable assets, because impermissible commitments cannot lead to a Shari'ah-recognizable debt.

**6/3 Applications relating to current liabilities in the items of financial statements**

6/3/1 Current accounts: The balances of current accounts should be deducted from the zakatable assets of the Institutions with which such accounts are deposited. Similarly, the principal as well as the profits of investment accounts should be deducted from the zakatable assets of the Institutions entrusted with

investing these accounts to the benefit of their holders. In the case of investment accounts the share of the Mudarib or agency fees earned by the Institution shall be excluded from the deductable amount.

6/3/2 Creditors: This item refers to the amounts payable to the creditors of the institution during the Zakah year. Such amounts which usually arise from obtaining goods, equipment, or services on debt should be deducted from zakatable assets.

6/3/3 Creditors of sold goods of Salam: It refers to those who purchased goods from the Institution through Salam and have not yet received them. The goods constitute a debt, because they have not yet been delivered, and therefore, the amount of Salam capital should be deducted from the zakatable assets.

6/3/4 Creditors of sold goods of Istisna'a: The goods constitute a debt because the Institution has entered in a commitment to make them, and it is yet to do so. Hence, such goods shall become subject to the rulings indicated in item 6/3/6.

6/3/5 Creditors of purchased goods of Istisna'a: This indicates the debt commitment of the Institution when it purchases goods through Istisna'a. The balance of this item should be deducted from Zakatable assets.

6/3/6 Payment papers: It includes bills and order bonds issued to importers of deferred goods and services, or bills and order bonds issued for interest free borrowing; if such papers will fall due in the next Zakah year. Such assets should be deducted from zakatable assets.

6/3/7 Short term loans and overdraft accounts shall be subject to the rulings indicated in item 6/3/2.

6/3/8 Accrued expenses: It is the expenses which relate to the current period and is to be paid during the next period. Such expenses should be deducted from zakatable assets.

6/3/9 Prepaid income: If such income relates to services which have not yet been provided no Zakah has to be paid on the exact portion of it which relates to the undelivered services; because such income is not finally owned, and the Ijarah (hiring) contract for provision of the services could be terminated on occurrence of an excuse or a *force majeure* situation. Consequently prepaid income for undelivered services should be deducted from zakatable assets.

Nevertheless, cash amounts of earnest money forwarded on conclusion of written or verbal exchange-based (Mu'awadah) contracts are considered to be owned by the Institution or the company, and Zakah has to be paid on them even if the goods in question have not been delivered. That is to say such amounts should not be deducted from zakatable assets.

6/3/10 Due taxes: Tax amounts that relate to the current period, but has to be paid in the next period should be deducted from zakatable assets.

6/3/11 Security amounts paid by clients to guarantee fulfillments of their commitments and settlement of periodical bills should be deducted from zakatable assets.

6/3/12 Minority rights which refer to other shareholders' equity in the subsidiary, and which appear in the consolidated financial statements should become subject to the rulings indicated in item 4/2/5.

## 7. Provisions

### 7/1 Definition of provisions

Provisions represent the amounts retained from revenues at the end of the financial period so as to cater for probable shortage of assets, or to meet imprecisely determined or unforeseen commitments of the Institution. Since provisions are estimates of probable loss amounts and unspecified commitments, they have to be totally or partially returned back to the profit and loss account (income statement), if

the debt is collected or the commitment is fulfilled, or if the provision amount is more than it should have been.

**7/2 Classification of provisions**

Regarding provisions, the following should be observed:

7/2/1 Provisions relating to fixed assets: Such provisions are nondeductible from Zakah assets, since fixed assets are not part of the Zakah base.

7/2/2 Provisions relating to current assets: Since Zakah is calculable on the basis of market value, provisions relating to current assets are not considered as part of liabilities to be deducted from zakatable assets. If, for any reason, current assets are valued for Zakah calculation at book value which happens to be more than exchange value, the difference between book value and market value pertinent to provisions should be deducted from Zakatable assets.

7/2/3 Provisions relating to liabilities: Liability provisions which aim to cover imprecisely determined commitments of the company such as provisions for: end of service benefits, staff leaves, taxation, and indemnities, shall be reasonable so as not to become secret reserves. Whenever exaggeration in such provisions is discovered, the excess amount should be removed.

7/2/4 In the cases when the provision is deductable from assets interest should not be deducted if it happens to be involved in it. Deduction from assets in this case should include only the Shari'ah-recognizable commitment. It should, however, be noted that interest bearing deposits and loans are strictly prohibited by Shari'ah. [see item 6/2/3]

**7/3 Applications relating to provisions**

7/3/1 Provision for redemption of pre-operating expenses: It is the cumulative amount of the redeemed part of pre-operating expenses. This provision is not deductable from zakatable assets.

7/3/2 Provision for deterioration in the value of investments in shares purchased for acquisition: This provision is meant to cater for price decline in financial markets, or book value, below cost; in case of valuation at cost or market value whichever the less. Such provision is not deductable from zakatable assets.

7/3/3 Provision for perishable or slow moving goods: In case of slow moving goods the provision is to cover probable declines in value due to expiry, obsolescence of type, or slow marketing. This provision is not deductable from zakatable assets.

7/3/4 Provision for probable declines in the prices of goods or financial papers: This provision is usually made to cater for declines which actually take place, and it is not deductable from Zakatable assets.

7/3/5 Provision for leaves: It is the amount deducted from revenues so as to cater for the commitment of the institution to compensate staff for leave entitlements. This provision is not deductable from Zakatable assets.

7/3/6 Provision for end of service and retirement benefits or pension salary of staff: It refers to the amounts deducted from revenues for meeting payment of such obligations. Such amounts are not deductable from Zakatable assets because they are allocated for disbursement, but not yet disbursed. They can be deducted only when they are actually paid or when they become due for payment during the current year, but not yet settled.

7/3/7 Provision for indemnity: It refers to the estimated amounts deducted from revenues in order to cater for a confirmed commitment relating to an initial legal verdict (before appeal) stipulating the payment of a specific amount as indemnity to a certain party. Such provision is estimated according to the amounts mentioned in the verdict, and it should not be deducted from Zakatable assets until it becomes due for payment by virtue of a final verdict.

7/3/8 Provision for maintenance: It is an amount allocated for spending, but not yet spent. It is not deductable from Zakatable assets.

7/3/9 Provision for insurance of fixed assets: This provision refers to the amounts charged to the revenues of the company to substitute the premiums that will be paid to insurance companies. This provision is estimated as per the amounts of its components. It should not be deducted from Zakatable assets because it comprises amounts that have been allocated for spending, but still owned by the company.

7/3/10 Provision for decrease in the price of currencies: It is the amount charged to the revenues of the company to cater for probable decline of the prices of foreign currencies against the price of the currency used in the financial statements of the company. It is assessed on the basis of the difference between the two prices (purchase price and market price). Such provision is not deductable from zakatable assets, because what matters is the prevailing exchange price at the time of valuation of Zakatable assets.

7/3/11 Provision for taxes: It refers to the estimated amounts deducted from the revenues of the company for settlement of the unpaid taxes of the current year. Such provision is assessed according to size of activity during the current financial period, besides the tax level in the previous financial periods. This provision is not deductable from Zakatable assets.

## 8. Reserves

### 8/1 Definition of reserves

Reserves are amounts deducted from profits by virtue of law (statutory reserves), or as required by articles of association of the Institution, or on the basis of a decision by the general assembly (voluntary reserves). Reserves provide necessary funds for many purposes such as future expansion, facing probable losses, distribution of profits in the years when no profits are realized, and distribution of the accumulated amounts of the reserves when they are no longer needed.

**8/2 Nature and Shari'ah status (Hukm) of reserves**

8/2/1 Both types of reserves (statutory and voluntary) are not deductable from zakatable assets, because in Shari'ah they are not considered to constitute debt obligations owed by the company, although it is referred to under liabilities. Since reserves are owned by the company they should be subject to Zakah as part of Zakatable assets, in case of applying the net assets method of Zakah assessment.

8/2/2 In spite of the fact that the capital account and the issuance premium provide sources of funding for the company they are not considered to be part of its debt obligations, even if capital is usually referred to under liabilities. Therefore, capital account and issuance premium are not deductable from Zakatable assets.

**8/3 Applications relating to reserves**

8/3/1 Revaluation reserve (capital reserves): It results from revaluation of fixed assets at current market value, and since fixed assets are not subject to Zakah, such reserve is not deductable from Zakatable assets.

8/3/2 Income reserve: It refers to that part of distributable profit which is retained by an administrative decision in provision for future need. It is not a debt obligation owed by the Institution, and therefore should not be deducted from Zakatable assets.

8/3/3 Reserve of profits earned from share purchasing operation (institution's treasury shares): This reserve results from the act of the Institution when it purchases and sells its own shares. It is not deductable from Zakatable assets, since it is part of the profits.

8/3/4 Reserve of profits declared for distribution: It refers to the profit declared by the board of directors, but the decision for its distribution has not yet been taken.

8/3/5 Reserve of retained profits: This reserve comprises the profits earmarked for transference to forthcoming years. It constitutes one type of income reserves, and is not deductable from Zakatable assets.

## 9. Eight Heads of Zakah Disbursement

The heads of Zakah disbursement are the eight categories specified by the Verse which states: ***{"As-Sadaqat (here it means Zakat) are only for the Fuqara' (poor), and Al-Masakin (the poor) and those employed to collect (the funds); and for to attract the hearts of those who have been inclined (towards Islam); and to free the captives; and for those in debt; and for Allah's Cause (i.e., for Mujahidun - those fighting in the holy wars), and for the wayfarer (a traveller who is cut off from everything); a duty imposed by Allah. And Allah is All-Knower, All-Wise."}***[4] Shari'ah Supervisory Boards of the institutions may specify the meaning and appropriate way of application, for each one of these categories.

## 10. Rulings Relating to Zakah Disbursement

10/1 The Zakah payer (institution) cannot discharge of his Zakah commitment by relieving his debtors from their debt obligations. This, however, does not mean that Zakah recipients cannot repay their debts out of the Zakah amounts which they receive from their creditors, provided that such arrangement does not involve collusion or a pre-stated condition.

10/2 In principle, Zakah is to be paid as soon as it is due, yet it can be delayed - for not more than one year – due to shortage of funds, or if its distribution is made according to a certain time schedule, or for any other obvious interest.

10/3 Institutions should establish a special fund or account for Zakah.

10/4 In principle, Zakah should be spent on its eight heads, yet if need arises Zakah funds can be utilized in investment projects.

(4) [Al-Tawbah (Repentance): 60]

However, such projects should, at the end, be owned by the Zakah recipients, or put under the supervision of the competent Shari'ah body entrusted with collection and distribution of Zakah. Nevertheless, investment of Zakah funds should be after fulfilling the urgent needs of Zakah recipients, and on availability of sufficient safeguards against losses.

10/5 Zakah does not cease to be valid by prescription.

10/6 Zakah can be paid before its due time, subject to specific conditions on which Shari'ah boards should be consulted.

10/7 Zakah can permissibly be paid in terms of the equivalent value of the subject commodity.

10/8 Zakah should not necessarily cover all the eight heads of its disbursement. It can permissibly be confined to some of them.

10/9 Zakah funds can be transferred from place of payment to another place due to an obvious interest to be judged by the Shari'ah boards of the institutions.

## 11. *Nisab* and Zakah Rate for Livestock (An'am)

11/1 *Nisab* and Zakah rate on camels

| From | To | Obligatory Zakah Rate |
|---|---|---|
| 1 | 4 | Nothing |
| 5 | 9 | 1 goat |
| 10 | 14 | 2 goats |
| 15 | 19 | 3 goats |
| 20 | 24 | 4 goats |
| 25 | 35 | Bint Makhad camel (at the second year of age) |
| 36 | 45 | Bint Labun camel (at the third year of age) |
| 46 | 60 | Hiqqah camel (at the fourth year of age) |
| 61 | 75 | Jaza'ah camel (at the fifth year of age) |
| 76 | 90 | 2 Bint Labun |
| 91 | 120 | 2 Hiqqah |
| 121 | 129 | 3 Bint Labun |
| 130 | 139 | 1 Hiqqah + 2 Bint Labun |
| 140 | 149 | 2 Hiqqah + 1 Bint Labun |
| 150 | 159 | 3 Hiqqah |
| 160 | 169 | 4 Bint Labun |
| 170 | 179 | 1 Hiqqah + 3 Bint Labun |
| 180 | 189 | 2 Hiqqah + 2 Bint Labun |
| 190 | 199 | 3 Hiqqah +1 Bint Labun |
| 200 | 209 | 4 Hiqqah or 5 Bint Labun |
| 210 | 219 | 1 Hiqqah + 4 Bint Labun |
| 220 | 229 | 2 Hiqqah + 3 Bint Labun |
| 230 | 239 | 3 Hiqqah + 2 Bint Labun |
| 240 | 249 | 4 Hiqqah + 1 Bint Labun |

For more than 249, one Hiqqah for every 50 camels and one Bint-labun for every 40 camels.

11/2 *Nisab* and Zakah rate on cows

| From | To | Obligatory Zakah Rate |
|---|---|---|
| 1 | 29 | Nothing |
| 30 | 39 | Tabee'a or Tabee'ah (at 2nd year of age) |
| 40 | 59 | Musinnah (at 3rd year of age) |
| 60 | 69 | 2 Tabee'a or 2 Tabee'ah |
| 70 | 79 | Musinnah + Tabee'a or Tabee'ah |
| 80 | 89 | 2 Musinnah |
| 90 | 99 | 3 Tabee'a or 3 Tabee'ah |
| 100 | 109 | Musinnah + 2 Tabbee'a or 2 Tabee'ah |
| 110 | 119 | 2 Musinnah + Tabee'a or Tabee'ah |
| 120 | 129 | 3 Musinnah or 4 Tabee'a or 4 Tabee'ah |
| For more than 129, one Tabee'a or one Tabee'ah for every 30 cows and one Musinnah for every 40 cows. | | |

11/3 *Nisab* and Zakah rates on goats

| From | To | Obligatory Zakah Rate |
|---|---|---|
| 1 | 39 | Nothing |
| 40 | 120 | 1 goat |
| 121 | 200 | 2 goats |
| 201 | 399 | 3 goats |
| 400 | 499 | 4 goats |
| For more than 499, one goat for every 100 goats. | | |

## 12. Date of Issuance of the Standard

This Standard was issued on 30 Dhul-Qa'dah 1429 A.H., corresponding to 28 November 2008 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the draft of the Standard on Zakah in its meeting No. (22) held in the Kingdom of Bahrain on 28–30 Dhul-Qa'dah 1429 A.H., corresponding to 26-28 November 2008 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (13) held on 26-30 Sha'ban 1425 A.H., corresponding to 10-15 October 2004 A.D., in Makkah Al-Mukarramah, The Shari'ah Board decided to issue a Shari'ah standard on Zakah.

On 1 Ramadan 1425 A.H., corresponding to 16 October 2004 A.D., the Secretariat General decided to commission a Shari'ah consultant to prepare a study on Zakah.

A joint committee composed from Shari'ah Committees (1) and (2) was held on Thursday 8 Rabi' I, 1427 A.H., corresponding to 6 April 2006 A.D., in Makkah Al-Mukarramah. In that meeting the committee discussed the study, cleared it, and asked the consultant to introduce necessary changes in the light of the observations and suggestions made in the meeting.

In its meeting No. (17) held in Makkah Al-Mukarramah, on 26 Shawwal – 1 Dhul-Qa'dah 1427 A.H., corresponding to 18-23 November 2006 A.D., the Shari'ah Board discussed the amendments made by the joint committee and introduced the changes that it deemed necessary.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 18 Safar 1428 A.H., corresponding to 8 March 2008 A.D. More than 30 participants attended the session as representatives of central banks, institutions, and accounting firms. The session was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (18) held on 12–16 Jumada II, 1428 A.H., corresponding to 27 June – 1 July 2007 A.D., in Al-Madinah Al-Munawwarah, the

Shari'ah Board discussed the amendments proposed by the public hearing, and introduced the changes that it deemed necessary.

In its meeting No. (20) held in the Kingdom of Bahrain, on 4-8 Safar 1429 A.H., corresponding to 11-15 February 2008 A.D., the Shari'ah Board discussed the changes introduced by the joint meeting of Shari'ah Committees (1) and (2), and introduced necessary changes.

In its meeting No. (22) held in the Kingdom of Bahrain, on 28-30 Dhul-Qa'dah 1429 A.H., corresponding to 26-28 November 2008 A.D., the Shari'ah Board adopted the Standard after discussing it and introducing necessary changes.

# Appendix (B)
# The Shari'ah Basis for the Standard

It is impossible to imagine a debt arising from commodities purchased through Salam, because the capital (price) has to be paid in advance. The Salam buyer has to pay Zakah on the Salam capital which he receives.

# Appendix (C)
# Definitions[5]

**Method of Net Investment Assets**

Paid-up Capital + Reserves + Provisions which have not been deducted from assets + Retained Profits + Net Income + Liabilities which are not payable during the current financial period as at the date of the Balance Sheet + Total installments of the coming financial period + net fixed assets and additional investments which are not for trade such as real estate for leasing + carried forward losses.

(5) For easy reference, most of the terms have been defined in the text of the rulings indicated in this standard.

Shari'ah Standard No. (36)

# Impact of Contingent Incidents on Commitments

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to illustrate the contingent incidents which come suddenly upon commitments and cause deviation from stipulated results.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the contingent incidents encountered in honoring the commitments that stem from application of Islamic modes of financing and investment by Islamic financial institutions (Institution/Institutions).[1] It also covers the effects of such incidents on commitments.

The Standard, however, does not cover defects of will or the conducts that result from mutual consent of the two parties.

## 2. Definition of Contingent Incidents

Contingent incidents in this standard refer to those incidents which occur suddenly and cause significant influence on commitments that are properly stipulated. Therefore, contingent incidents are different from defects of will, which exist since the time of signing the contract, although their impact occurs later on. Contingent incidents are also different from termination of commitments on mutual consent of the two parties or as per the desire of any of them; when a party is entitled to such right by virtue of the contract.

## 3. Types of Contingent Incidents

From the standpoint of its influence, a contingent incident can be either of the type that necessitates amendments in the contract, or the type which constitutes an external reason for termination of the contract.

## 4. Contingencies Leading to Amendment of the Contract

The impact of such contingencies is confined to necessitating amendments in the contract rather than leading to its complete termination. Practical examples of such contingencies include the following among others:

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

4/1 Levy of custom duties or taxes after signing the contract. Such incident affects the commitment of the party who has to bear the new obligations by virtue of law or as per the stipulations of the contract.

4/2 Change in the prices of the commodities used in implementation of a contract in a way that subjects the contractor to serious harm. Actual harm in this case can be removed through reconciliation, arbitration or legal arrangements.

4/3 Prevention of importation of the goods to be delivered in fulfillment of a Murabahah or Ijarah contract. The actual harm caused to the client or the Institution can, in this case, be removed by resort to reconciliation, arbitration or law.

4/4 Change in laws leading to more financial commitments to be borne by one of the two parties. Determination of the party who shall bear the additional burden can be reached by resort to law or as per the stipulations of the contract.

## 5. Contingencies Which Constitute External Reasons for Termination of the Contract

This type of contingencies leads to termination of commitments without intervention of any of the two parties. Bearing of the consequences in this case is to be assigned to the competent party, as when an owner has to bear the consequences relating to what he owns. Examples of such contingencies include, among others:

### 5/1 When delivery becomes impossible or useless

In this case the fulfillment of the commitment becomes impossible or of no use; as when the commitment to supply the requirements of a conference could not be fulfilled before holding the conference. In such case the commitment shall become null and void if:

5/1/1 Failure to honor the commitment is absolutely inevitable.

5/1/2 Failure to honor the commitment originates from objective rather than personal reasons.

5/1/3 Failure to honor the commitment is caused by an external party.

**5/2 Total or partial damage of the object of commitment**

If the object of commitment is damaged before being delivered to the committing party, the loss should be borne by the committed party. Similarly, when the commitment object is completely damaged due to an act of the committing party, that party should bear the loss. In case of partial damage of the object of commitment before actual or legal delivery to the committing party, and if the damage is caused by a heavenly factor (Sabab Samawi) which the committed partly can by no means avoid, the committing party should have the right of option.

**5/3 Entitlement to the object of commitment**

If the object of commitment turned out to be owned by someone else other the committed party, the committing party becomes entitled to compensation. If the object of commitment is partly owned by someone else the commitment in that part becomes null and void, and the committing party shall have the right of option with regard to accepting or declining the remaining part of the commitment object. The committing party may choose to accept the remaining part as part of his compensation or he may terminate the contract due to fragmentation of delivery.

**5/4 Termination of commitment due to excuses**

When the emergence of an incidental excuse in Ijarah leads to abnormal harm, the harmed party has the right to terminate the contract. The party who encounters the incident may also terminate the contract if his excuse is obvious. If acceptability of the excuse is doubtful the issue may be resolved by mutual agreement, or resort to law. [see Shari'ah Standard No. (9) on Ijarah or Ijarah Muntahiah Bittamleek; and Shari'ah Standard No. (34) on Hiring of Persons]

**5/5 Jawa`ih (calamities)**

The term Jawa`ih refers to any incident (other than human acts) which cannot be avoided even if known. The effects of such incidents are – originally - noticeable in selling of fruits and other agricultural products, where the occurrence of an incident of this type leads to discounting the

price in proportion to the damage in the product. An example of this can also be seen in the "Ijarah Muntahia Bittamleek Contract". In this case the amount of rent in excess of the normal rent of similar property is dropped when ownership cannot be transferred to the lessor for a reason which the lessee cannot stop. [see Shari'ah Standard No. (9) on Ijarah or Ijarah Muntahia Bittamleek, item 8/8]

## 6. Date of Issuance of the Standard

This Standard was issued on 17 Rabi' I, 1430 A.H., corresponding to 15 March 2009 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Impact of Contingent Incidents on Commitments in its meeting No. (23) held in the Kingdom of Bahrain on Thursday – Saturday 15-17 Rabi' I, 1430 A.H., corresponding to 12-13 March 2009 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (14) held on 21–23 Rabi' I, 1426 A.H., corresponding to 30 April - 2 May 2005 A.D., in Dubai (U. A. E.), the Shari'ah Board decided to issue a Shari'ah Standard on Impact of Contingent Incidents on Commitments.

On 29 Jumada I, 1426 A.H., corresponding to 6 July 2005 A.D., the Shari'ah Standards Committee decided to commission a consultant to prepare a study on Impact of Contingent Incidents on Commitments.

The study was discussed in a joint meeting of the Shari'ah Standards Committees (1) and (2), held in Makkah Al-Mukarramah on 8–9 Rabi' I, 1427 A.H., corresponding to 6-7 April 2006 A.D. The Joint Committee then advised the consultant to introduce the necessary changes in the Standard, in the light of the discussions and observations of the meeting.

The revised draft of the Standard was discussed in another joint meeting of the Shari'ah Standards Committees (1) and (2), held in the Kingdom of Bahrain, on Thursday 21 Sha'ban 1427 A.H., corresponding to 14 September 2006 A.D. The consultant was again advised to introduce changes in the Standard as per the discussions and observations of the meeting.

In its meeting No. (20) held in the Kingdom of Bahrain, on 4-8 Safar 1429 A.H., corresponding to 11-15 February 2008 A.D., the Shari'ah Board discussed the Changes in the Standard which had been made by the joint meeting of Shari'ah Standards Committees (1) and (2), and introduced changes that it deemed necessary.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 24 Safar 1430 A.H., corresponding to 19 February 2009 A.D.

More than 30 participants attended the session as representatives of central banks, Institutions, and accounting firms. The session was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (23) held in the Kingdom of Bahrain on Thursday – Saturday 15-17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D., the Shari'ah Board discussed the amendments that had been suggested in the public hearing, introduced changes that it deemed necessary and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Permissibility of amending the commitment to absorb the impacts of contingent incidents is based on the fact that in such cases Muslims should strive for appropriate disposition without rushing to termination of the commitment. This rule is adopted by the various schools of Fiqh with regard to external incidents which take place without the intervention of any of the two parties.
- The ruling that the commitment shall become null and void if its fulfillment has become useless is based on the fact that implementation of a useless commitment is an act of futility, while there is no room for futility in Shari'ah legislation as indicated by Al-Shatibi and others.
- The basis for the ruling that commitment shall become ineffective when the object of the contract turns out to be owned by someone else other than the committed party, is that unlawful seizure is unrecognizable as a basis of ownership. The Prophet (peace be upon him) is reported to have said: *"An extorter is indebted with what he takes until he returns it back"*.(2)
- The basis for the rulings relating to Jawa`ih (calamities) is the Hadith(3) (Prophetic tradition) which states: *"The Prophet (peace be upon him) has forbidden Bay' al-Sinin (sale of agricultural produce for many years to come), and permitted value discounts on calamities"*. Therefore, rulings can be derived from this Hadith for similar cases when the object of the contract is lost due to an inevitable incident.

(2) Related by Ahmad in his *"Musnad"*; *"Ashab Al-Sunan"*; and Al-Hakim in his *"Mustadrak"*, quoting Samrah, and *"Al-Fath Al-Kabir"* [2: 232].

(3) This Hadith has been related by Muslim, Abu Dawud and Al-Nasa`i: *"Majma' Al-Zawa`id"* [1: 703].

# Appendix (C)
# Definitions

**Contingencies Relating to Legal Competence**

Incidental change in personal traits which leads to loss of competence and induce mal-disposition.

**Defects of Will**

Hidden matters which coincide with the inception of the contract and entail amendments of rights and duties when they occur.

**Al-Jawa`ih**

Catastrophes which hit the produce and damage it partially or totally, such as storms and the like.

**Contingent Incidents (*force majeure*)**

Abnormal incidents which justify procedures that are not allowed under normal circumstances. Examples of such incidents include wars, internal unrest, and natural catastrophes.(4) Describing such incidents as "heavenly" is to indicate the inability of human beings to avoid them. Examples of such incidents include, for instance, insanity forgetfulness and unconsciousness,

**Heavenly Incidents**

Incidents which human beings cannot avoid. It includes also the strict directives of Shari'ah in which the slaves of Allah, the Almighty, have no room for choice.(5)

(4) *"Mu'jam Mustalahat Al-Shari'ah Wa Al-Qanun"*, Dr. Abdul-Wahid Karam (P. 676).
(5) *"Mu'jam Mustalahat Usul Al-Fiqh"*, Dr. Qutb Mustafa Sano (P. 305).

**Istihqaq (Entitlement)**

Occurrence of the fact that someone else has the full right of total or partial ownership on the sold property.[6] It can also be defined as existence of other verifiable claims of right on the property which one party pledged to deliver to the other.[7]

(6) *"Al-Khiyar Wa Atharuh Fi Al-'Uqud"* (P. 478).
(7) *"Mu'jam Mustalahat Al-Shari'ah Wa Al-Qanun"* (P. 37).

## Shari'ah Standard No. (37)

# Credit Agreement

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to indicate the various types of credit facilities and their most important applications as well as the returns and commissions which result from them. The Standard also covers the Shari'ah rulings pertaining to credit facilities so as to be observed by Islamic financial institutions (Institution/Institutions).(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers credit facilities and the returns and commissions arising from them, whether such facilities are practiced between the Institution and its clients or between the institution and other institutions.

## 2. Definition of Credit Facilities

2/1 The term credit refers to the financial transaction according to which one of the two parties becomes indebted to the other. Indebtedness in such transactions can arise at the beginning of the transaction, and this is known as direct cash credit such as loans and discounting of commercial papers. Instead, indebtedness could be only probable at the end of the transaction, and that is incidental credit, such as bank suretyship, letters of guarantee, bills of acceptance, and letters of documentary credit. The term "credit facilities" is used to denote credit in both cases. The concepts of credit and credit facilities are more comprehensive than the concept of financing which relates to the case of actual deferment of one of the two transacted objects.

**2/2 According to this standard, credit facilities in institutions can be divided into the following types:**

2/2/1 Cash facilities: This type includes the transactions in which the Institution presents funds, whether in the form of cash - as is the case in *Qard Hasan* (benevolent loan), Musharakah and Mudarabah; or in the form of an asset or usufruct - as is the case in Murabahah and lease financing. It should be noticed here that Musharakah and Mudarabah do not result in a debt owed by the client except in case of transgression or negligence.

2/2/2 Incidental facilities: This type includes the transactions which result in an incidental commitment owed by the Institution such as suretyship and letters of guarantee.

**2/3 Transactions that entail instant delivery of the transacted objects are not considered as part of credit facilities.**

**2/4 The decision of granting credit facilities:**

It refers to the approval of the Institution to enter into a credit facility with a specific client. The approved facility will be subject to a specific financial limit that can be used during a specific period of validity and subject to a certain date of maturity. The credit facility would also comprise specific conditions relating to guarantees, method of repayment and regulatory requirements. The decision of granting the facility is usually issued in the form of a letter addressed from the Institution to the client, indicating that the letter does not constitute any commitment from the part of the Institution unless transactions are actually commenced. Similar to letters of granting facilities, letters for renewal or extension of the period of already approved facilities also carry the same conditions.

**2/5 Using credit facilities**

It refers to commencement of the client to utilize the facility by submitting a request for a letter of guarantee or a letter of credit, or making a pledge to purchase a commodity or hire an asset through the Institution.

**3. Types of Credit Facilities**

**3/1 Types of traditional credit facilities used by banks:**

3/1/1 Loans

Loans refer to facilities payable on a specific date agreed upon between the traditional financial Institution and the client. Loans can be extended directly to the client, or through participation with other traditional financial Institutions, or through acquisition of bonds issued by the client.

3/1/2 Overdraft

Overdraft is a facility which the traditional financial institution puts at the disposal of the client to draw from it on need, up to a specific limit and within a given period.

3/1/3 Discounted papers

Discounted papers comprise commercial papers and bonds to order discounted in the traditional financial institution.

3/1/4 Issued credit cards

In this traditional form of credit facility, the indebtedness which can arise from using the credit card is determined for each client within a certain limit, and he can repay it in installments along with the interest.

3/1/5 Documentary credits

Documentary credits are among the facilities which traditional financial Institutions extend to their clients. In this case the Institution assumes the commitment to pay to beneficiaries the value of the credits opened for its client, whether the value of such credits is due on sight of the documents or on a date thereafter.

3/1/6 Bank acceptances

This type of facilities which traditional financial Institutions offer to their clients entails a commitment from the Institution, for the benefit of a client or for its own benefit, to pay to beneficiaries the value of the accepted papers when they are due.

3/1/7 Bank guarantees

Traditional financial Institutions offer this type of facility to their clients. In such facility the bank, upon request of its client, undertakes to pay to a third party the amounts indicated in the guarantees, on request and within a specific period.

3/1/8 Foreign exchange operations

Foreign exchange operations constitute a traditional facility offered to clients in deferred contracts of buying and selling foreign currency.

## 3/2 Types of Islamic credit facilities used by institutions

### 3/2/1 Murabahah and Musawamah

Murabahah and Musawamah are two types of sale transactions which constitute methods of financing used by Islamic financial institutions to cater for client needs for owning moveable as well as immovable assets. Contrary to Musawamah, in Murabahah the cost incurred by the Institution for obtaining the good must be indicated. [see Shari'ah Standard No. (8) on Murabahah]

### 3/2/2 Mudarabah

Mudarabah is a method of financing which institutions use for financing various economic activities. According to this method the institution enters the deal as the partner who subscribes the funds (Rab al-Mal) while the other partner (Mudarib) subscribes the work and performs the managerial duties. The two parties agree, within the contract, on a specific method for profit sharing, while the entire loss has to be borne by Rab al-Mal, unless it is due to transgression or negligence of the Mudarib. [see Shari'ah Standard No. (21) on Financial Papers: Shares and Bonds]

### 3/2/3 Permanent Musharakah and diminishing Musharakah

Musharakah is a method of financing in which the institution joins the client as a shareholder in the capital of a certain project or operation. In this case the two parties share the profits and losses according to a predetermined method specified in the contract.

### 3/2/4 Operational-cum-financing Ijarah

It is a method used for financing clients' needs for usufructs and assets. According to this method the institution purchases the assets and rents them to clients for specific periods, against periodical amounts of rent stipulated in the contract. [see Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek]

3/2/5 Istisna'a

Istisna'a is a method through which the institutions provide finance to their clients. In this case the institution assumes the commitment of manufacturing the equipment or the good, or constructing the buildings or the different types of capital assets according to the specifications agreed upon. The institution which provides finance in this manner has the right to sign a Parallel Istisna'a contract with another party to manufacture the asset in question.

3/2/6 Salam

Salam is a method of financing which institutions use for extending finance to owners of farms and merchants who want to spend on their business as well as on their personal needs. Under this mode of financing the Institution has the right to arrange Salam with another party through a parallel Salam contract.

3/2/7 Other financing operations

Finance can also be extended to clients through other financing operations which include among others: *Qard Hasan*, customer overdraft balances, letters of guarantee and letters of credit.

**4. Shari'ah Status of Offering Credit Facilities**

The decision to offer a credit facility and the facility agreement are considered as means of mutual understanding and exchange of non-binding promises for entering into transactions. The Shari'ah status of actual utilization of the facilities depends on the type of contract to be used.

**5. Shari'ah Rulings on Credit Facilities**

5/1 It is impermissible to use any of the traditional facilities mentioned in item 3/1 if it involves interest or would lead to an interest-bearing loan as is the case in guarantees and uncovered credits, or it would result in deferment of one of the two transacted objects as is the case in currency exchange contracts. [see Shari'ah Standard No.

(14) on Documentary Credit; Shari'ah Standard No. (2) on Debit, Charge and Credit Cards; and Shari'ah Standard No. (1) on Trading in Currencies]

5/2 The institution is not committed to pay any compensation to the client on rejection of his application to utilize the approved facilities, whereas the client also is free to use the facilities within the specified period or not. When the client refrains from using the facilities, he is not committed to pay any compensation to the Institution.

**5/3 Returns and commission on credit facilities**

5/3/1 First type: Commissions and returns which arise before contracting

5/3/1/1 Commission for credit study

The institution is permitted to take commission for the credit study it prepares internally or through an external party, so as to know the credit worthiness of the client and his ability to honor his commitments within the period agreed upon. Entitlement of the Institution to such commission is due to fact that the client has benefited from the study regardless of whether the study has led to acceptance or rejection of his request. The study shall become the property of the client who has the right to take it.

5/3/1/2 Commission for offering credit facilities

This commission refers to the amount which the Institution charges against allocating and specifying the limit of the facility. The institution usually charges such commission whether the deal is finalized or not. However, it is impermissible for the Institution to obtain commission for offering credit facilities, because the mere indication of willingness to enter into a lending and borrowing transaction does not justify remuneration. [see item 2/4/2 of Shari'ah Standard No. (8) on Murabahah]

5/3/1/3 Commission for renewal or extension of credit facilities

This type of commission should be treated in the same way like commission for offering credit facilities. [see item 5/3/1/2 above and Shari'ah Standard No. (8) on Murabahah]

5/3/1/4 Cost of preparing the contracts and forms pertaining to the transaction

5/3/1/4/1 The cost of preparing the contracts to be signed between the Institution and the client should be shared between the two parties, unless the contract indicates otherwise. Such charge should be fair and commensurate with the actual work load so as not to comprise an implicit fee for commitment or for offering the credit facility.

5/3/1/4/2 When Murabahah (or any other mode of financing) is used through syndicated financing the arranging Institution has the right to charge arrangement fees which has to be borne by the participants of the syndication. [see items 2/4/3 and 2/4/4 of Shari'ah Standard No. (8) on Murabahah]

5/3/1/5 Cost of the feasibility study of the project

The institution has the right to charge the cost of the feasibility study it prepares, when the client requests such a study for his own interest, and the cost of the study is agreed upon beforehand. [see item 2/4/5 of Shari'ah Standard No. (8) on Murabahah]

5/3/1/6 *Hamish Jiddiyyah* (security deposit)

The institution may charge the seriousness margin which refers to an amount of earnest money forwarded by the client at the stage of offering his binding pledge in Murabahah. In case of retreatment of the client

from concluding the contract the amount of actual harm caused to the institution shall be deducted from the seriousness margin. [see item 7/8/2 of Shari'ah Standard No. (5) on Guarantees]

5/3/2 Second type: Commissions and returns which arise on signing of the contract

5/3/2/1 Commitment fee

The institution should not charge the commitment fee which relates to traditional facilities of interest-bearing loans, whether in the case of direct loans or the indebted-current (overdraft) loans. Such fee which traditional institutions charge to the client even if he has not used the facility, is also known as the "loan fee", or the "indebted-current facility fee", or the "financing fee". [see item 2/4/1 of Shari'ah Standard No. (8) on Murabahah]

5/3/2/2 'Arboun (Earnest Money)

It is permissible for the institution to charge such earnest money which constitutes part of the price paid in advance in sale and lease contracts. Such amount is owned by the seller or the landlord when the buyer or the tenant uses his right of terminating the contract. [see item 7/8/3 of Shari'ah Standard No. (5) on Guarantees]

5/3/2/3 Guarantee return

The institution should not obtain any returns on the guarantee relating to documentary credits, letters of guarantee, and bank suretyship, except actual expenses, whereas it can obtain returns for agency in documentary credits. [see item 7 of Shari'ah Standard No. (5) on Guarantees; and item 3/3 of Shari'ah Standard No. (14) on Documentary Credit]

5/3/2/4 Return on debt rescheduling

5/3/2/4/1 The institution should not obtain returns against extending the date of repayment of debts in all credit facilities. It should charge only the actual expenses of the rescheduling transaction. [see item 5/7 of Shari'ah Standard No. (8) on Murabahah; Shari'ah Standard No. (3) on Procrastinating Debtor, and item 3/3/1 of Shari'ah Standard No. (14) on Documentary Credit]

5/3/2/4/2 Renewal and extension of facilities should be done by entering into new contracts, rather than by extending the duration of the ongoing ones.

## 6. Obtaining Guarantees on Credit Facilities

The institution has the right to use permissible forms of guarantee in order to ascertain the fulfillment of the commitments of its client. [see item 3/4/1 of Shari'ah Standard No. (14) on Documentary Credits, and item 4/1/1 of Shari'ah Standard No. (5) on Guarantees]

## 7. Date of Issuance of the Standard

This Standard was issued on 17 Rabi' I, 1430 A.H., corresponding to 15 March 2009 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Credit Agreement in its meeting No. (23), held in the Kingdom of Bahrain, on Thursday – Saturday 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (14) held on 21–23 Rabi' I, 1426 A.H., corresponding to 30 April – 2 May 2005 A.D., in Dubai (U. A. E.), the Shari'ah Board decided to issue a Shari'ah Standard on Credit Agreement.

On 24 Jumada I, 1427 A.H., corresponding to 20 June 2006 A.D., the Secretariat General decided to commission a consultant to prepare a study on Credit Agreement.

The study was discussed in a joint meeting of the Shari'ah Standards Committees (1) and (2), held in the Kingdom of Bahrain, on 19 Shawwal 1427 A.H., corresponding to 10 November 2006 A.D. The Joint Committee then advised the consultant to introduce the necessary changes in the Standard, in the light of the discussions and observations of the meeting.

The revised draft of the Standard was discussed in another joint meeting of the Shari'ah Standards Committees (1) and (2), held in the Kingdom of Bahrain, on 15 Jumada I, 1428 A.H., corresponding to 31 May 2007 A.D. The consultant was again advised to introduce changes in the standard as per the discussions and observations of the meeting.

The draft of the standard was discussed once again in a joint meeting of the Shari'ah Standards Committees (1) and (2), held in the State of Kuwait, on 21 Jumada I, 1428 A.H., corresponding to 7 June 2007 A.D. Further changes were introduced in the document in the light of the discussions and observations of the meeting.

In its meeting No. (19) held in Makkah Al-Mukarramah, on 26-30 Sha'ban 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the changes in the standard which had been made by the consultant and introduced changes that it deemed necessary.

In its meeting No. (20), held in the Kingdom of Bahrain, on 4-8 Safar 1429 A.H., correponding to 11-15 February 2008 A.D., the Shari'ah Board discussed the changes introduced by the joint meeting of the Shari'ah Standard Committees (1) and (2), and introduced the changes which it deemed necessary.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 34 Safar 1430 A.H., corresponding to 19 February 2009 A.D. More than 30 participants attended the session as representatives of central banks, institutions, and accounting firms. Shari'ah scholars, university teachers and other interested parties also attended the session. Several observations were made and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (23) held in the Kingdom of Bahrain, on Thursday – Saturday 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D., the Shari'ah Board discussed the amendments that had been suggested in the public hearing, introduced changes which it deemed necessary and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Shari'ah Basis for Charging a Fee for Preparation of the Credit Study**

The credit study is a detailed study on the financial and credit position of the client so as to facilitate assessment of his credit worthiness and ability to honor commitments. According to Shari'ah, this task as such can constitute a remunerable service apart from the financing contract. The institution can even stipulate a condition that the study should be prepared by a third party. Charging the client for the credit study is also justified by the fact that the benefit from the study is shared between the financier and the financed party, rather than confined to the former only. The fee for the study should not necessarily be equal to the actual cost of its preparation, since it is a service which can be performed independently within the contract. Therefore, the credit agreement fee is considered as a fee payable for the effort exerted in preparation of the study as an independent service, irrespective of its results.

In this regard, the Shari'ah Board of Aayan Company for Leasing and Finance issued a Fatwa (Fatawa Aayan: 189), indicating permissibility of charging such fees. The text of that Fatwa runs as follows:

> "When the clients of Aayan Company wish to sign with Aayan Company permissible investment or financing contracts through Mudarabah, Musharakah or any other mode of financing, and if Aayan Company, for that purpose, needs to conduct a study on the financial status of these clients and their legal eligibility for concluding such contracts, it is permissible for Aayan Company to sign special contracts with these clients so that Aayan Company prepares the required study. For preparation of the study, Aayan Company may charge a fee to be paid by the clients on the basis of

the special contracts which should be completely separate from the financing and legal contracts pertaining to the deals in question. The prepared study should become the property of the client once he pays the cost of its preparation, and therefore Aayan Company should not deprive him the right of obtaining it. Aayan Company should handover the study to the client so that he can be able to use it in his deals with Aayan Company or with any other party".

# Appendix (C)
# Definitions

**Financing**

Financing takes place only when one of the two objects of the transaction is deferred such as loan, discounting of bills, simple credit, Murabahah, Salam and Istisna'a. Financing may not take place in suretyships, letters of guarantee, letters of documentary credits and bank acceptances. Therefore, the term financing is more special than the term credit. That is to say, any financing is credit, but any credit does not always lead to financing.

**Indebted-Current**

This is one of the traditional forms of extending loans to customers. In this case the customer (borrower) is given access to draw from an account opened for this purpose (the indebted-current account) up to a certain maximum limit which constitutes the amount of the loan, and within a specific period. A maximum date will also be specified for repayment of the drawn amounts. Such account is usually made subject to the following terms:

- The customer has to pay interest on the amounts he draws actually.
- The customer should pay a commitment fee calculable as a percentage of the total amount of the loan. Such amount is paid in addition to interest and is considered as Riba (usury).

The indebted-current account differs from the direct loan in that interest in the case of the former is paid at the end of the transaction's period. In the indebted-current account also interest is calculable on the basis of the amounts that have been actually used by the customer (the debit balance).

**Facility Limits**

The maximum limit of the facility is the total amount of the facility that has been approved by the institution. Such amount is extended through a specific mode of financing (Murabahah, Ijarah, letter of guarantee, documentary

credit ….etc.). It constitutes the maximum exposure limit for the institution with regard to the specific client.

**Credit Policy**

Credit policy refers to the precautionary measures adopted by the Institution with the aim of safeguarding its funds in the light of rules and regulations and in view of the resolutions of its Shari'ah Supervisory Board and the prevailing principles and traditions in the field of its activities.

**Credit Study**

The credit study is the process of identifying the credit worthiness of the client and his ability to honor his commitments within the specified period. It also aims to assess the suitability of the type, size and currency of the requested financing to the activity to be financed, and to what extent the financing is commensurate with the resources and capabilities of the client in general. Moreover, the credit study indicates - subject to the nature of financing operations - the suitable guarantees to be requested from the client, whether for the debts and entitlements stemming from the operations or against transgression and negligence from his part. The final result of the study presents a clear recommendation on whether the client is to be offered the facility subject to certain conditions, or his application should be rejected on the basis of specific reasons.

The credit study covers the financial standing, cash flow, activity results, income, and expenses of the client. It also covers other various aspects such as past experience of the institution with the same client, image of the client, and his ability to manage his activity and stand any difficulties he may encounter while practicing such activity.

**Facility Agreement**

This agreement is signed between the client who applies for the facility and the institution when the decision to offer the facility is issued. The agreement indicates the type and amount of the facility as well as the guarantees and profit margin, or profit sharing ratio in case of Musharakah in Islamic transactions. Such agreement is not considered to be binding for the client before entering into the actual contracts.

## Shari'ah Standard No. (38)

# Online Financial Dealings

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to indicate the Shari'ah rulings relating to conclusion of contracts and financial dealings online, and illustrate what the Institution/ Institutions[1] should observe in this respect.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers the Shari'ah rulings relating to conclusion of financial contracts online, either by launching commercial websites, or by provision of online access services. The standard aims to indicate the various aspects pertaining to this subject such as the Shari'ah status of the contracts concluded in this manner, determination of the time of contract inception, permissible procedures of possession after signing the contract, and Shari'ah rulings relating to protection of online financial dealings.

## 2. Launching Commercial Websites for Contractual Dealings

2/1 It is permissible in Shari'ah to launch commercial websites, provided that such sites do not involve any impermissible act, such as promotion of impermissible goods and services, or using impermissible means to promote pemissible goods and services.

2/2 It is permissible in Shari'ah to conclude online contracts, provided that the contracts thus concluded between the institution and its clients observe the general rules of financial transactions as prescribed by the Shari'ah, regarding for instance, opening of the accounts, performing remittances and signing commercial contracts.

## 3. Provision of Online Access Services

3/1 Shari'ah permits institutions to provide online access services to users on the basis of subscription contracts or any other similar arrangement, and against a specific fee.

3/2 The contract for provision of online access service by the institution is a shared-hiring contract "*Ijarah Mushtarakah*" signed between the institution and the beneficiary. Therefore, it should become subject to the conditions and rulings of the contract for hiring of persons in general, and those of the contract for hiring of a shared employee in

particular. [see Shari'ah Standard No. (34) on Hiring of Persons and Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek]

3/3 The institution which provides such service should take all necessary precautions and measures to prevent impermissible use of the internet by the beneficiaries to whom the Institution provides the access service.

**4. Contract Signing Session (*Majlis al-'Aqd*) for Concluding Online Financial Contracts**

4/1 When the contract is concluded through audio or audiovisual communication between the two parties, it should become subject to the same Shari'ah rulings on contracts signed in the presence of the two parties. Consequently it should satisfy the rulings relating to this type of contracts which include, for instance: simultaneous presence of the two parties (*Itihad al-Majlis*), non-existence of any indication of disinterest from any of the two parties, succession of offer and acceptance (as per normal practice), and all the other rulings.

4/1/1 The contract signing session in this case is the time of communication between the two parties if the conversation relates to the contract. If the conversation is over or disconnected, or the two parties shifted to another subject, the contract signing session is considered to have stopped (unless disconnection of the conversation is for a reasonably short while).

4/2 When the contract is concluded through written communication, by e-mail, or through access to site, it shall become subject to the rulings applicable to contracts signed in the absence of the two parties, because such deal is similar to message contracting.

4/2/1 The contract signing session in the case indicated in item 4/2 above starts from the moment of communicating the offer to the concerned party up to issuance of acceptance. The contract signing session may also be discontinued when the offering party retreats from his offer before an acceptance decision is made by the other party.

4/2/2 When the offering party specifies a certain period for validity of his offer, the time allowed for acceptance should cover the whole period. The offering party has no right to withdraw from his offer during that period.

4/3 When the contract is concluded through online bidding the highest bidder should not retreat from his bid until the bidding process is over. The highest bidder should also not retreat from his offer after finalization of the bidding process if the seller had made a condition that the offer should remain binding for a certain period, or if the normal practice necessitates validity of the offer for such period.

**5. Expressing Offer and Acceptance in Online Financial Contracts**

5/1 Expression of offer and acceptance in online contracts can be in any form that indicates the consent of the two parties to conclude the contract.

5/2 When the offering party sends through website or e-mail a message containing all the rights and commitments pertaining to the contract in question without retaining the right of withdrawal if the message is accepted, that message is considered as an offer.

5/3 When the offering party sends the electronic message through website or e-mail without indicating all the rights and commitments relating to the contract in question, or when he stipulates a condition that he should have the right of withdrawal even if the message is accepted, the message is considered to be an announcement or an invitation for contracting rather than an offer. In this case a process of offer and acceptance has to be done.

5/4 When the contract is concluded through website, clicking on the acceptance icon is considered as acceptance in the strict Shari'ah sense if the system in the website does not require confirmation of acceptance. If the system in the website requires confirmation of acceptance in any way, acceptance does not take place without making such confirmation.

5/4/1 The Institution which provides its services on website should include in the system a step for acceptance confirmation as a precautionary measure against dealers' mistakes.

## 6. Time of Commencement of an Online Contract

Irrespective of the method of contracting, an online contract is considered to be valid since the time when the other party accepts the offer and whether the offering party has come to know that or not.

## 7. Possession (Qabd) in Online Financial Contracts

7/1 Regarding online contracts, possession in the strict Shari'ah sense takes place through all accepted methods of actual and constructive possession. [see Shari'ah Standard No. (18) on Possession (Qabd), items 3 and 5]

7/2 If the sold commodity is computer software or the like, possession in the strict Shari'ah sense takes place when the purchaser, after signing the contract, downloads the software or the data or any good of this type from the website to his personal computer.

7/3 When the sold commodity is a currency, gold, silver or any other commodity in which instant exchange (Taqabud) is required, instant exchange of the two objects of the contract should be ascertained during the contract's signing session.

## 8. Protection of Online Financial Dealings

### 8/1 Protection of commercial sites and dealers data against being trespassed

8/1/1 Commercial websites are considered as private properties of their owners, and therefore their trespassing could necessitate compensation.

8/1/2 The institution should use all possible measures of website protection, so as to safeguard its own rights as well as the rights of its clients.

8/1/3 Trespassing of dealers' online data is impermissible. It is strictly prohibited to sell such data or transmit it to others without the permission of its owners.

8/1/4 Verification of trespassing of commercial sites and data stealing should be done by referring to the prevailing traditions and regulating rules which do not encounter the rules and principles of Shari'ah.

8/1/5 The compensation due in case of trespassing should comprise direct financial loss as well as actual loss of earnings. Expert advice for assessment of compensation can also be sought when need arises.

8/1/6 Compensation shall become due only when it is claimed, whereas claiming compensation does not have a specific time limit after the incident of trespassing is known. In this regard relevant rules and regulations should be observed provided that they do not contradict with the rules and principles of Shari'ah.

8/1/7 In case of stealing money or confidential data from a protected website the responsibility should rest with the person who committed the theft directly. If it is not possible, for a permissible reason, to charge the person who committed the act of theft directly, the responsibility should rest with the one who facilitated the act. The owner of the site is by no means chargeable for such act, if he has taken all possible measures to protect his site, and unless he has pledged to shoulder such responsibility under all circumstances.

**8/2 Verification of dealers' identities**

8/2/1 In order to safeguard its own interests, the Institution should take all possible precautions and measures to verify the identities of its website dealers, and make sure that they are legally competent for concluding valid contracts.

8/2/2 It is acceptable in Shari'ah to adopt the electronic signature as a means of verifying the identities of dealers, provided that such means is adoptable by virtue of the prevailing rules and regulations.

8/2/3 When forgery or an error is committed with regard to the personality or characteristics of one of the two parties, the other party has the right to terminate the contract.

8/2/4 For verification of forgery or error recourse should be to the general rules of evidence.

**8/3 Protection of dealers from adhesion contracts (*'Uqud al-Iz'an*)**

8/3/1 It can be noticed that in a big part of the online contracts the offer is addressed to the public in general and the contract has uniform details. In such contracts also the offering party alone has the right of stipulating the terms and conditions of the contract, while the other party does not have the right to change such terms and conditions. A contract of this type is considered as an "adhesion contract" when it relates to a commodity or usufruct that nobody can do without, and the offering party assumes actual and legal monopoly or face only meager degree of competition in its supplying.

8/3/2 According to Shari'ah, online adhesion contracts should be subject to state control so as to protect dealers by endorsement of what is equitable and elimination of what is inequitable in these contracts, before launching them to dealers.

8/3/3 If the price in the online adhesion contract is fair, and the terms and conditions of the contract do not entail any injustice for the adhering party, the contract is considered to be permissible and binding to its two parties.

8/3/4 If the price in the online adhesion contract is unfair (comprises excessive injustice), or the contract includes an unjust condition for the adhering party, the latter has the right to resort to law for nullification of the contract or amending its conditions for the sake of relieving him from the consequent injustice.

8/4 If the online contract is concluded on the basis of describing the sold object, or depending on the fact that the buyer has previously seen the object, or on presentation of a model resembling the object,

whereas at the time of delivery the sold object is found to be different, the buyer should have the choice between concluding the contract, terminating it, or negotiating with the seller appropriate means of settlement.

## 9. Date of Issuance of the Standard

This Standard was issued 17 Rabi' I, 1430 A.H., corresponding to 15 March 2009 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Online Financial Dealings in its meeting No. (23) held in the Kingdom of Bahrain, on Thursday – Saturday 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (16) held in Al-Madinah Al-Munawwarah, on 7-12 Jumada I, 1427 A.H., corresponding to 3-8 June 2006 A.D., the Shari'ah Board decided to issue a Shari'ah standard on Online Financial Dealings.

On 12 Rajab 1427 A.H., corresponding to 6 August 2005 A.D., the Secretariat General decided to commission a Shari'ah consultant to prepare a study on Online Financial Dealings.

A joint committee composed from Shari'ah Committees (1) and (2) held a meeting in the Kingdom of Bahrain, on 18 Safar 1428 A.H., coresponding to 8 March 2006 A.D. The joint committee discussed the study, and asked the consultant to introduce necessary changes in the light of the discussions and observations of the meeting.

In a further meeting of the joint committee, held in the Kingdom of Bahrain on 24 Rabi' II, 1428 A.H., coresponding to 11 May 2007 A.D., the draft of the standard was discussed and the consulted was requested to introduce necessary amendments in the light of the discussions and observations of the meeting.

In its meeting No. (19) held in Makkah Al-Mukarramah, on 26–30 Sha'ban 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the amendments made by the joint committee meeting and introduced the changes which it deemed necessary.

In its meeting No. (20) held in the Kingdom of Bahrain, on 4–8 Safar 1429 A.H., corresponding to 11–15 February 2008 A.D., the Shari'ah Board discussed once again the draft standard and introduced further changes.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 24 Safar 1430 A.H., coresponding to 19 February 2009 A.D. More than 30 participants attended the session as representatives of central banks, institutions, and accounting firms. The session was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (23) held in the Kingdom of Bahrain, on Thursday – Saturday 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D., the Shari'ah Board discussed the amendments suggested by the public hearing, introduced the changes that it deemed necessary and adopted the standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for permissibility of launching commercial websites if such sites are free from impermissible practices is the fact that in principle, transactions in any form are allowed, unless they lead to commitment of an impermissible act. Moreover, launching of such sites serves the interests of a large number of people in this era, and thus, conforms to the underlying mission of Shari'ah.
- Permissibility of concluding online financial contracts is due to the fact that such contracts do not involve any impermissible aspect. They carry no difference from traditional contracts except in that the means used for their conclusion is different. If, in principle, contracts as such are allowed as long as they observe the rules of transactions in Shari'ah, it is only natural that the means whereby these contracts are concluded become allowed as long as they conform to permissible rules of contracting.
- Concluding online contracts through audio or audiovisual communication between the two parties is classified under the category of contracts concluded in the presence of the two parties, because in such online contracts both parties are in fact present at the same time, although not in the same place. Therefore, simultaneous presence of the two parties in terms of time, which constitutes the prerequisite meant by coincidence of presence,(2) is fulfilled at the time of exchanging offer and acceptance. In this connection the International Islamic Fiqh Academy issued a resolution about the Shari'ah ruling on concluding contracts through the modern means of communication. The text of the resolution is as follows: "If any two parties enter into a contract at the same time while they are in different places – this includes contracting through

(2) See: *"Fath Al-Qadir"* [3: 190–192]; *"Hashiyat Al-Dusuqi 'Ala Al-Sharh Al-Kabir"* [3: 5]; *"Mughni Al-Muhtaj"* [2: 5]; *"Al-Mughni"* [3: 481]; and see *"Al-Madkhal Al-Fiqhi Al-'Am"* [1: 348].

telephone and wireless devices – contracting between these two parties is considered as contracting between two present parties".[3] Needless to say, there is no difference between contracting through a telephone call, and contracting through online voice communication.

- When the contract is concluded through written communication, by e-mail, or through access to site, it shall be classified as a contract signed in the absence of the two parties. This ruling is based on the fact that exchange of offer and acceptance in this case takes place without simultaneous presence of the two parties. In this regard the Al Baraka Seminar on Islamic Economics issued a resolution stating that "According to Shari'ah, when an online contract is signed between two parties who are not in the same place, it is considered as a contract between two absent parties if neither of the two parties can hear the voice of the other. Consequently such contract should become subject to the Shari'ah rulings on message contracting".[4]
- The ruling that the offering party does not have the right to retreat from his offer within the period specified by the seller for validity of the offer is based on the viewpoint of some Maliki scholars who believe that if an offer is announced to be valid for a specific period it should remain valid throughout that period. This viewpoint has been emphasized by Al-Hattab quoting Abu Bakar Al-Arabi.[5] In this regard also The International Islamic Fiqh Academy issued a resolution emphasizing the following: "When the offering party issues a term-offer through these devices, he is committed to keep his offer during the specified period. He does not have the right to retreat from it."[6]
- When the offering party sends the electronic message through website or e-mail without indicating all the rights and commitments relating to the contract in question, or when he stipulates a condition that he should have the right of withdrawal even if the message is accepted, the

(3) Resolution No. 52 (3/6).

(4) The 19th Al Baraka Seminar on Islamic Economics, held in Makkah Al-Mukarramah, on 6–7 Ramadan 1420 A.H., corresponding to 2-3 December 2000 A.D.

(5) See: *"Mawahib Al-Jalil"* by Al-Hattab [4: 241]. This viewpoint has been adopted by a number of civil laws, and is known as "Term Offer". See article (98) of the Jordanian Civil Law and article (93) of the Syrian Civil Law.

(6) Resolution No. 52 (3/6).

message is not considered as an offer, because from a Shari'ah point of view an offer should be categorically obvious and cannot bear any other meaning.(7)

- The ruling that irrespective of the method of contracting an online contract is considered to be valid since the time when the other party accepts the offer and whether the offering party has come to know that or not, is based on the fact that Shari'ah scholars define contract as "the concordance of two wills". Therefore as soon as the accepting party declares his consent concordance between the two wills takes place and the contract becomes valid.(8) A resolution issued in this regard by the International Islamic Fiqh Academy states: "When a contract is to be signed, through a written message or a messenger, between two absent parties who are not in the same place and neither of them can see or hear the other - a case which includes contracting through telex, fax and PC screens - the validity of such contract starts as soon as the concerned party receives and accepts the offer".(9)
- The ruling that possession in the strict Shari'ah sense takes place when the purchaser, after signing the contract, downloads the computer software or the data or any other good of this type from the website to his pc, is based on the fact that possession takes place actually and constructively when the sold object is released and disposition is facilitated for the buyer. Possession of objects differs according to the type of the object in question and how its possession is normally perceived. In this respect a resolution has been issued by the International Islamic Fiqh Academy regarding possession and its forms, especially the recent ones.(10)
- Prohibition of trespassing commercial websites and data theft is derived from prohibition of all forms of encroaching upon rights of others because Allah, the Almighty, says: ***{"...but transgress not the limits. Truly, Allah likes not the transgressors."}***.(11) Moreover, websites have financial worth, and are considered as private rights of their owners. Trespassing of such

(7) See: *"Fath Al-Qadir"* [3: 190-92]; *"Hashiyat Al-Dusuqi 'Ala Al-Sharh Al-Kabir"* [3: 5]; *"Mughni Al-Muhtaj"* [2: 5]; and *"Al-Mughni"* [3: 481].

(8) See: *"Bada`i' Al-Sana`i'"* [6: 2994] and *"Hashiyat Ibn 'Abidin"* [7: 26].

(9) Resolution No. 52 (3/6).

(10) Resolution No. 53 (4/6).

(11) [Al-Baqarah (The Cow):190].

sites may result in financial harm for their owners. In this regard the International Islamic Fiqh Academy issued a resolution emphasizing prohibition of transgression against trade name, trade address, trademark and all other similar rights.(12)

- Acceptability of adopting the electronic signature as a means of verifying the identities of dealers if such means is recognizable by the prevailing rules and regulations is based on the need to avoid the harm that could arise from online forgery in the dealers' identities. In addition to that, adopting electronic signature does not constitute an impermissible practice. In fact Shari'ah encourages the use of technological means to preserve peoples' wealth, because preservation of wealth constitutes one of the main five aims (*Maqasid*) of Shari'ah.
- The ruling that when forgery or an error is committed with regard to the personality or characteristics of one of the two parties, the other party has the right to terminate the contract is based on the fact that such an incident can influence the consent of the deceived party. According to Shari'ah the consent of the two parties is the fundamental prerequisite of contracting. This fact has been emphasized by the majority of Shari'ah scholars.(13)
- The ruling that the state has to assume control upon online adhesion contracts - which are characterized with launching of public offers, uniform details, imposed terms and conditions, provision of indispensible commodities or usufructs and monopoly of supply - is based on the general texts of Shari'ah which instruct people to avoid harm and achieve justice.
- If a contract is concluded on the basis of describing the object sold, or depending on the fact that the buyer has previously seen the object, or on presentation of a model resembling the object; whereas at the time of delivery the sold object is found to be different, the buyer should have the option of terminating the contract for false description. This ruling is based on the need for preservation of the rights of the two parties of the contract, as has been emphasized by the majority of Fiqh scholars.

(12) Resolution No. (5), 5th Session 1408 A.H. – 1988 A.D.

(13) See: *"Al-Mawsu'ah Al-Fiqhiyyah"*, the term *Rida*, Vol. (22).

# Appendix (C)
# Definitions

**Internet**

A cross-border devise of communication between computer networks.

**Website**

Information stored in the form of pages, while each page contains a set of certain type of information formed up by a page designer by using special symbols. For browsing of the pages, software of internet browser is requested, so as to resolve the symbols and issue orders for page display.

**Internet Service Provider**

The service provider is the party (institution) which provides lines of internet access to beneficiaries on the basis of subscription contracts or any other arrangement, against a specific fee.

**Electronic Signature**

The electronic signature is data in the form of letters, figures, symbols, signs or any other form, embodied in or attached to or liked with an information message through electronic, digital, phonic or any other format. The electronic signature has a style which allows specification of the distinct identity of the signatory, so that the signature can be verified and the content of the message is approved.

**Electronic Message**

The data and information published or exchanged through electronic devices such as internet, telex, fax and other similar means.

Shari'ah Standard No. (39)

# Mortgage and Its Contemporary Applications

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This standard aims to indicate Shari'ah rulings on mortgage and its contemporary applications in Islamic financial institutions (Institution/Institutions).[1]

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This standard covers mortgages requested by the Institution with the aim of documenting the debts and commitments owed to it by other individuals and Institutions. It is also covers the mortgages presented by the Institution to other parties in order to document the debts and commitments it owes to them. Furthermore, the standard covers the mortgages which the Institution, in its capacity as a notary or agent, keeps for the benefit of other parties.

## 2. Definition of Mortgage

To mortgage means to make a financial asset or so tied to a debt so that the asset or its value is used for repayment of the debt in case of default.

## 3. Shari'ah Rulings on Mortgage

3/1 Mortgage is permissible in Qur`an, Sunnah (Prophetic tradition) and Ijma' (consensus of Fuqaha).

3/1/1 The mortgage contract is binding for the mortgagor once it is concluded, and the mortgagor does not have the right to revoke it from his own side, whereas the mortgagee has the right to do so.

3/1/2 Possession of the mortgaged asset takes place on the basis of the same requirements for possession of a sold property. It could be actual possession by putting a hand on the property, which is known as seizure mortgage; or possession could be legal through registration and documentation, which is known as security or formal mortgage. Both types of mortgages are subject to the same rulings.

3/1/3 The mortgagee has the right to appoint an agent to possess the mortgage on his behalf. The agent, thus appointed, should have

the same rights of disposition which the principal has. The mortgage can also be put in the hands of the mortgagee or in the hands of a third party known as the notary, to be agreed upon between the two parties. When the mortgage is kept by a notary neither of the two parties has the right to transfer it to any other location.

3/1/4 The mortgagee has the right to stipulate a condition that the mortgagor should appoint him or his representative as an agent who can sell the mortgaged asset and repay the debt out of its value in case of default, without resorting to judiciary. The mortgagor does not have the right to retreat from such agency once agreed upon.

3/1/5 The death of the mortgagor or the mortgagee has no effect on the validity of the mortgage contract. The respective inheritors shall substitute the dead party.

3/1/6 The mortgage contract is no longer valid when the mortgaged asset perishes unless a compensation for it is obtained (through solidarity insurance, for instance). The mortgage contract can also cease to be valid for other reasons such as termination of the contract by the mortgagee, settlement of or relief from the debt, or relinquishment of the mortgage right. Furthermore, the validity of the mortgage contract can also expire as a result of transfer of the ownership of the mortgaged asset (through sale, gift or will) on permission of the mortgagee; unless the new owner accepts to keep the mortgage contract. [see item 3/2/6]

3/1/7 The mortgagee has the right to keep the whole mortgaged asset for any part of the debt, unless he accepts partial releasing of the mortgage. On repayment of the debt the mortgagee has no right to keep the mortgaged asset as a collateral for a new debt for which the asset is not mortgaged, except when the two parties agree to keep the mortgaged asset as a collateral for any debt between them within a specific period.

## 3/2 Rulings relating to the mortgaged asset

3/2/1 The mortgaged asset should be a Shari'ah-permissible property. It should also be well specified (through pointing, naming or description) and can possibly be delivered.

3/2/2 In principle, the mortgaged object should be a tangible asset, yet it can be a debt, a cash amount, a fungible asset or a consumable commodity. Perishable objects can also be mortgaged as they can be sold and replaced by their value. Moreover, a mortgaged object can be a share of common property which can be identified and sold separately.

3/2/3 The same asset can be mortgaged to more than one mortgagee. If all mortgages are of the same rank the consent of all the parties has to be sought, and the mortgage right in the asset is to be shared among them in proportion to their respective debts. If the mortgages are ranked in such a way that a succeeding mortgagee should get his debt repaid only when his precedent mortgagee does, the consent of the succeeding mortgagee alone has to be sought.

3/2/4 The mortgaged asset is a trust in the hands of the mortgagee, the notary or the agent and is still owned by the mortgagor as long as it is mortgaged. Therefore when the mortgaged asset perishes in the hands of the mortgagee, the notary or the agent, for a reason other than transgression or negligence, no responsibility shall rest with him, and the debt shall still remain valid. If the perish of the mortgaged asset is due to transgression or negligence of the mortgagee, the agent or the notary he shall be held responsible for compensation at the value of the asset on the date of its perish, whereas the debt shall remain valid. In this case the two parties have the right to perform clearance arrangements between the debt amount and the value of the perished mortgage asset.

3/2/5 The mortgagor can mortgage an asset that is owed to him by the mortgagee, whether the asset is kept by the mortgagee

as a trust (such as deposited or lent assets and investment accounts); or as a guaranteed asset (such as current accounts and assets retained after nullification of contracts). In the latter case the status of the mortgagee will consequently change from keeping the asset on guarantee basis to keeping it on the basis of trust.

3/2/6 The mortgagor can mortgage a borrowed asset (borrowed mortgage), or a rented asset (rented mortgage), on permission of the owner in both cases. If a borrowed or rented mortgage is used for repayment of the defaulted debt, the owner of the asset should have the right of recourse on the mortgagor for compensation; in kind if the mortgaged asset is a fungible asset, or in value if otherwise. When a borrowed or rented mortgage asset perishes in the hands of the mortgagor, the mortgagor has to compensate the owner of the borrowed asset, whereas for the rented asset compensation is deserved only if the perish of the mortgaged asset is due to transgression or negligence of the mortgagor.

3/2/7 In a sale contract the seller has the right to stipulate a condition that the buyer, after actual or constructive possession of the good, should mortgage it to him against the deferred price.

3/2/8 Appreciation in the value of the mortgaged asset as well as its income is considered to be mortgaged along with the principal, unless the two parties agree otherwise.

3/2/9 The mortgagor can benefit from the mortgaged asset on permission of the mortgagee, whereas the mortgagee has no right at all to enjoy free of charge benefit from the mortgaged asset with or without the permission of the mortgagor. However, on permission of the mortgagor the mortgagee can utilize the mortgaged asset against the normal pay for similar assets. [see items 3/3/ and 4/3]

3/2/10 The mortgagor should bear all actual expenses relating to reparation of the mortgaged asset and its preservation against

decay. When the mortgagee pays such expenses with or without the permission of the mortgagor he has the right of recourse on the mortgagor for compensation or he may obtain compensation in terms of an equivalent period of benefiting from the mortgaged assets. The mortgagee should bear all the expenses relating to safekeeping, documentation and selling of the mortgaged asset, except when the two parties agree that the mortgagor should bear such expenses.

3/2/11 With due consideration to item (5), it is permissible to mortgage debt, whether such debt is owed by the mortgagee or anyone else.

3/2/12 Possession of a mortgaged debt takes place by possession of the debt's document or by attestation of the debt at the time of its mortgaging. When a debt is mortgaged, the mortgagee becomes more entitled to it than anyone else.

**3/3 Rulings relating to the debt for which the mortgage is signed**

3/3/1 The debt for which the mortgage is signed should be a permissible debt such as sale income, guarantee against damage, Salam commodity, Istisna'a commodity or an owed usufruct. Concluding a valid mortgage contract need not necessarily be preceded by establishing the debt. The mortgage contract can be signed before or at the same time of signing the debt contract. The debt for which the mortgage is signed should not be a impermissible debt (such as a usurious loan); or a non-debt deal (such as a specific price, the usufruct of a specific asset, and a spot sale commodity that is still in the hands of the seller).

3/3/2 It is impermissible to stipulate mortgage as a condition in trust-based contracts such as agency, deposit, Musharakah, Mudarabah and leasing contracts. If mortgage in such contracts is to be confined to indemnity in case of transgression, negligence or breach of the contract, then it is permissible. [see Shari'ah Standard No. (5) on Guarantees, item 2/2/1]

### 3/4 Execution of the mortgage

3/4/1 With due consideration to item 3/1/4, the mortgagee has the right to claim the sale of the mortgaged asset in case of default. After repayment of the mortgagee's debt the remaining value of the mortgaged asset should be given to the mortgagor by virtue of the mortgage contract. If the sale value of the mortgaged asset happened to be less than the due debt, the difference shall be subject to Shari'ah rulings on normal debt, and the mortgagee should have the right of recourse on the mortgagor for settlement of such difference.

3/4/2 The mortgagee does not have the right to stipulate a condition that he should own the asset in case of default. Nevertheless, there is no prohibition for the mortgagee to purchase the mortgaged asset from the mortgagor at market value, and take the portion of the value to which he is entitled.

3/5/3 When the mortgagor is bankrupt, the mortgagee should have the priority over other debtors, for getting his debt repaid from the sale value of the mortgaged asset. If the sale value of the mortgaged asset is less than the mortgagee's debt, he becomes in the same standing with other debtors with regard to the excess indebtedness.

## 4. Mortgage of Financial Papers and Sukuk

4/1 It is permissible to mortgage the financial papers and Sukuk which can be issued and transacted according to Shari'ah, such as Islamic Sukuk and shares of Islamic financial Institutions. The shares of the companies whose original activities are permissible can also be added to this category. [see Shari'ah Standard No. (21) on Financial Paper: Shares and Bonds, item 3/4]

4/2 It is permissible to mortgage usufruct-based Sukuk which represent common shares in the usufructs of specific assets, or assets in the form of a specific indebtedness. This should be taken with due consideration to Shari'ah Standard No. (17) on Investment Sukuk, item 5/1/5/2.

4/3 It is impermissible to mortgage the financial papers and Sukuk that should not be issued or transacted according to Shari'ah, such as interest-based bonds, preference shares and enjoyment shares [see Shari'ah Standard No. (21) on Financial Paper: Shares and Bonds, items 2/6 and 2/7]. Such financial papers include also traditional investment certificates, certificates of traditional investment deposits and shares of the companies that pursue impermissible activities like manufacturing of alcohols, swine trade and dealing in Riba [see Shari'ah Standard No. (21) on Financial Paper: Shares and Bonds, item 2/1 and Shari'ah Standard No. (14) on Documentary Credit, items 3/4/1 and 3/4/2]. Among these financial papers also are shares of traditional financial Institutions, shares of traditional financial companies, shares of traditional insurance companies and shares of companies which originally pursue permissible activities, yet Riba-based and other prohibited dealings constitute a predominant part of their activities.

## 5. Mortgage of Current Accounts and Cash Securities

When a current account is mortgaged for the benefit of the same institution with which it is opened, the institution should not use the account unless an agreement is reached between the two parties to transfer the account to an investment account, and thus, make it subject to the rulings on Mudarabah instead of the rulings on loan. This is so because the institution, as a mortgagee, has to avoid making free of charge benefit from the mortgaged account. On transference of the account to an investment account, the account holder becomes entitled to his profit share as the owner of the capital (Rab al-Mal), while the institution becomes entitled to its profit share as the worker (Mudarib).

## 6. Mortgage of Investment Units and Investment Accounts

6/1 The Institution can accept mortgage in the form of investment units in Islamic investment funds. In this case the Institution as a mortgagee can suspend the right of the client to get back or draw from the account, absolutely or in proportion to the amount of the debt, whichever is more suitable.

6/2 The income and growth earned by the units or the account are considered to be mortgaged along with the principal. This should hold true whether the contractual relationship between the client and the Institution or the fund is Mudarabah or investment agency, unless the two parties agree on other arrangement.

**7. Mortgage of What Will Be Owned**

It is permissible to mortgage an income which is still to be owned if the principal (income earning asset) is specified. The contract in this case is valid whether such income is to be mortgaged along with the principal or independently.

**8. Insurance of the Mortgaged Asset**

The mortgagee has the right at the time of signing the contract to request from the mortgagor to arrange Islamic insurance for the mortgaged asset whenever it is possible. When the mortgagor accepts to do so the compensation to be received on the damage of the mortgaged asset shall replace it. If the compensation is received in the form of a cash amount such amount shall be mortgaged along with its returns by depositing it in a frozen investment account owned by the mortgagor. [see Shari'ah Standard No. (5) on Guarantees, item 4/8]

**9. Zakah on the Mortgaged Asset**

9/1 The owner of the mortgaged asset should pay Zakah if it is payable on the asset and its income or on its income only. The fact that the owner cannot dispose of the mortgaged asset does not relief him from payment of Zakah.

9/2 Zakah is payable on all cash mortgages such as current accounts, cash securities, units of investment funds, frozen investment accounts, Sukuk, Salam debts, and Istisna'a debts, subject to stipulations of Shari'ah Standard No. (35) on Zakah, items 5/1, 5/2 and 5/3.

**10. Date of Issuance of the Standard**

This Standard was issued on 17 Rabi' I, 1430 A.H., corresponding to 15 March 2009 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the standard on Mortgage and its Contemporary Applications in its meeting No. (23) held in the Kingdom of Bahrain, on Thursday – Saturday 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (16) held in Al-Madinah Al-Munawwarah on 7-12 Jumada I, 1427 A.H., corresponding to 3-8 June 2006 A.D., the Shari'ah Board decided to issue a Shari'ah standard on Mortgage and Its Contemporary Applications.

On 12 Rajab 1427 A.H., corresponding to 6 August 2005 A.D., the Secretariat General decided to commission a Shari'ah consultant to prepare a study on Mortgage and Its Contemporary Applications.

A joint committee composed from Shari'ah Standards Committees (1) and (2) held a meeting in the Kingdom of Bahrain, on 24 Rabi' II, 1428 A.H., corresponding to 11 May 2007 A.D., the joint committee discussed the study, and asked the consultant to introduce necessary changes in the light of the discussions and observations of the meeting.

In a further meeting of the joint committee, held in the State of Kuwait on 21 Jumada I, 1428 A.H., corresponding to 7 June 2007 A.D., the draft of the standard was discussed and necessary amendments were introduced in the light of the discussions and observations of the meeting.

In its meeting No. (22) held in the Kingdom of Bahrain, on 28–30 Dhul-Qa'dah 1430 A.H., corresponding to 26-28 November 2008 A.D., the Shari'ah Board discussed the amendments made by the joint meetings of the Shari'ah Standards Committees (1) and (2) and introduced the changes which it deemed necessary.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 24 Safar 1430 A.H., corresponding to 19 February 2009 A.D. More than 30 participants attended the session as representatives of central

banks, institutions, and accounting firms. The session was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the session, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (23) held in the Kingdom of Bahrain, on Thursday – Saturday 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D., the Shari'ah Board discussed the amendments introduced by the public hearing, introduced the changes that it deemed necessary and adopted the standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Shari'ah Rulings on Mortgage (item 3)**

- Mortgage is permissible when the debt transaction takes place while the two parties are on travel because Allah, the Almighty, says: ***{"I And if you are on a journey and cannot find a scribe, then let there be a pledge taken (mortgaging)..."}***.(2) Mortgage is also permissible when the contracting parties are not on travel, because Anas is reported to have said: *"The Prophet (peace be upon Him) mortgaged his armor plate to a Jew in Al-Madinah and took some barley from him to his family"*. In this regard Ibn Al-Mundhir said: "I do not know anyone, except Mujahid, who held a different interpretation for the Verse: ***{"...if you are on a journey ...etc"}***. Traveling (adds Ibn Al-Mundhir) is referred to in the Verse as the predominant case where mortgage is needed, since traveling parties would most probably be in lack of a scribe. Hence the verse, although it mentions traveling, it does not stipulate it as a condition for concluding mortgage contracts. Mortgage is also not obligatory, a fact which - to my knowledge - has encountered no dispute. The emphasis on mortgage in the Verse indicates guidance rather than obligation, because Allah, the Almighty, says: ***{"and if one of you deposits a thing on trust with another"}***.(3)
- According to the Hanbali,(4) Hanafi(5) and Shafi'i scholars mortgage is valid and binding when it is stipulated as a condition in a sale contract. The Hanbali(6) scholars believe that it is one of the conditions that serve

(2) [Al-Baqarah (The Cow): 283].
(3) Muhammad Ibn Abdul-Wahhab, *"Mukhtasar Al-Insaf Wa Al-Sharh Al-Kabir"* [1: 506], Matabi' Al-Riyadh, Riyadh, First Edition, Abdul-Aziz Ibn Zayd Al-Rumi et al (eds.). Electronic Copy, Al-Jami' Al-Kabir Program.
(4) Ala` Al-Din (Al-Mardawi), *"Al-Insaf"*, op. cit, [11: 206–207].
(5) Ala` Al-Din Al-Samarqandi, *"Tuhfat Al-Fuqaha`"*, op. cit, [2: 70].
(6) Ministry of Awqaf – Kuwait, *"Al-Mawsu'ah Al-Fiqhiyyah"*, the letter Ba, Bay' Wa Shurut, item 28.

the interest of the contract, whereas the Hanafi scholars consider it as one of the conditions that suit and conform to the contract, since it entails contract documentation.(7) In elaborating their standpoint the Hanafi scholars indicate: "In Shari'ah, mortgage as well as price suretyship serve the purpose of debt documentation. Stipulating mortgage as a condition in the contract is just like stipulating a condition that relates to quality of the price, hence it is an explicit condition for what the contract implicitly aims at".(8) Mortgage is one of the conditions needed when the deal is to be concluded with someone who insists on them. If a condition of this type is not fulfilled the concerned party will have the right of option. One of the cases that justify having the right of option, according to the Hanafi scholars, is "Refraining from honoring a valid condition like the mortgage condition or suretyship for an outstanding debt".(9)

- Keeping the mortgaged asset in the hands of a notary is permissible. According to the Shafi'i scholars it is permissible "because the right belongs to the two parties, so they can agree on that".(10)
- According to the Hanbali School when the seller stipulates a condition that he shall keep the sold object until he receives the price, his condition is considered to be valid and observable. To the Hanbali scholars, such type of condition is neither part of the contract's necessities nor does it serve the contract's interest, yet it does not run counter to the contract's objectives. Nonetheless, such condition (as perceived by the Hanbali scholars) entails some benefit for the seller or the buyer.(11)
- The seller does not have the right to stipulate a condition that he shall retain the ownership of the sold commodity until he receives the price which is deferred for a certain period.(12) The seller does not have such right be-

(7) Mustafa Ahmad Al-Zarqa, *"Al-Madkhal Al-Fiqhi Al-'Am"*, published 1968, [1: 477-478].
(8) Ala` Al-Din Al-Samarqandi, *"Tuhfat Al-Fuqaha`"*, op. cit, [2: 70].
(9) Muhammad Al-Hajjar, *"Fath Al-'Allam Bi-Sharh Murshid Al-Anam Fi Al-Fiqh 'Ala Madhab Al-Sadah Al-Shafi'yyah"* [5: 19], Dar Ibn Hazm, Beirut, First Edition, 1418 A.H.
(10) Ibrahim Ibn Ali Ibn Yusuf Al-Shirazi Abu Ishaq, *"Al-Muhadhdhab Fi Fiqh Al-Imam Al-Shafi'i"* [1: 310], Dar Al-Fikr, Beirut. Electronic copy: Al-Jami' Al-Kabir Program.
(11) Ministry of Awqaf – Kuwait, *"Al-Mawsu'ah Al-Fiqhiyyah"*, the letter Ba, Bay' Wa Shurut, item 28.
(12) Ministry of Awqaf – Kuwait, *"Al-Mawsu'ah Al-Fiqhiyyah"*, the letter Ba, Bay', *"Ahkam Mushtarakah Bayn Al-Mabi' Wa Al-Thaman"*, item 60/D.

cause he has willingly relinquished his right in spot payment of the price; therefore, he has no right to cancel the right of the other party (to get the sold commodity).(13) This viewpoint is adopted by the Hanbali School.(14)

**Rulings Relating to the Mortgaged Asset (item 3/2)**

- The mortgaged asset should be a Shari'ah-permissible property because the underlying objective is to sell this asset for settlement of the debt in case of default. Therefore if the mortgaged asset is an impermissible property of the mortgagor, it cannot be sold. In this regard the Hanafi scholars indicate that "Mortgage is for settlement of debt, and a Muslim cannot repay debts or get debts repaid to him in terms of Shari'ah-banned objects such as alcohol and swine".(15) In *"Al-Insaf"* the Hanbali viewpoint is indicated as follows: "It is permissible to mortgage any asset that can be sold".(16)
- The mortgaged asset can be a debt,(17) a cash amount,(18) a common pro-

(13) Ala` Al-Din Al-Samarqandi, *"Tuhfat Al-Fuqaha`"*, op. cit, [2: 56].
(14) Ala` Al-Din (Al-Mardawi), *"Al-Insaf"*, op. cit, [11: 491]
(15) Ala` Al-Din Al-Samarqandi, *"Tuhfat Al-Fuqaha`"*, op. cit, [3: 53-54]
(16) Muhammad Ibn Abdul-Wahhab, *"Mukhtasar Al-Insaf Wa Al-Sharh Al-Kabir"* [1: 511], Al-Riyadh Press, Riyadh, First Edition, Abdul-Aziz Ibn Zayd Al-Rumi et al (eds.).
(17) In *"Al-Insaf"* Mortgage is defined as "documentation of a debt by an asset so that the debt can be repaid from the sale value of the asset when repayment from other sources is not possible". Al-Zarkashi said: "Mortgage is documentation of a debt by an asset or a debt". This viewpoint of Al-Zarkashi is reported by Ala` Al-Din (Al-Mardawi) in *"Al-Insaf"* printed with *"Al-Muqni'"*; *"Al-Sharh Al-Kabir"* and *"Al-Insaf"* [12: 359], Hujar Press, First Edition, 1995.
(18) According to the Shafi'i scholars "It is permissible to lend cash so as to be mortgaged. When the debt is due, if the debtor made repayment the case is obvious, otherwise the cash can be used for purchasing the asset required for settlement, or the same cash amount can be paid for settlement of the debt if it is a cash debt", Muhammad Al-Hajjar, *"Fath Al-'Allam"*, op. cit, [5: 27]. Permissibility of selling the mortgaged asset and mortgaging its value instead of it has also been indicated by the Hanbali scholars in several cases as when they state that "It is permissible to mortgage perishable objects for an outstanding debt, so that the sale income of such objects can be mortgaged", Shamsul-Din (Ibn Qudamah), *"Al-Sharh Al-Kabir"*, op. cit, [12: 368]. The Maliki scholars state that "It is impermissible to mortgage dinars, or dirhams or filses, or food stuffs in the form of mixed ingredients or what is measured in terms of volume and weight, without imprinting a mark on it so that the mortgagee would not be able to use the mortgaged object and return back a similar one", Abu Abdullah Muhammad Ibn Muhammad (Al-Maghribi), *"Mawahib Al-Jalil Li-Sharh Mukhtasar Khalil"*, Dar Al-Fikr, Second Edition, 1978, [5: 5].

perty,[19] a borrowed asset or a rented[20] asset.

- The mortgage is a trust in the hands of the mortgagee and is owned by the mortgagor. The mortgagor should bear all the expenses relating to maintenance of the proper state of the mortgage object including all necessary outlays such as feeding, clothing, safekeeping, veterinary services and the likes. In this regard, the Prophet (peace be upon him) is

(19) The Shafiee scholars emphasized permissibility of mortgaging the asset that can permissibly be sold (even if common property, that can be sold), Muhammad Al-Hajjar, *"Fath Al-'Allam"*, op. cit, [5: 25]. The Hanafi scholars emphasize prohibition of mortgaging "common property……., because delivery cannot take place", Ala` Al-Din Al-Samarqandi, *"Tuhfat Al-Fuqaha`"*, op. cit, [3: 54]. It has been stated in *"Al-Sharh Al-Kabir"* : "Mortgage of common property is permissible as emphasized by Ibn Abu Layla, Al-Nakh'i, Malik, Al-Awza'i, Al-Aniri, Al-Shfiee and Abu Thur. According to Ashab Al-Ra'y, it is impermissible except when a partner mortgage his share to his counter partner, or the two partners together mortgage their common property to one person, or one person mortgages his asset to two person so that they can possess it together", Shamsul-Deen (Ibn Qudamah), *"Al-Sharh Al-Kabir"*, op. cit, [12: 369–370].

(20) Ibn Al-Mundhir said: All our precedent scholars from whom we learnt unanimously agreed that when someone borrows an object from someone else so as to mortgage it for obtaining a specific amount of money from a specific person for a specific period, his act is permissible. Ibn Al-Mundhir has also reported a unanimous agreement among Fiqh scholars that if the person (in the preceding example) borrowed the object according to the above stated conditions, but he mortgaged something else, his act is impermissible. If such person mortgaged the borrowed object for a debt amount that exceeds what he had stated when borrowing the object, the mortgage becomes null and void either for the whole amount of the debt as emphasized by Al-Shafiee, or for the excess part only, on the basis of deal fragmentation. According to Al-Qadhi when the object to be mortgaged is borrowed without restrictions, the process of borrowing is permissible and the borrower can mortgage the borrowed object for any amount. This viewpoint is one of two viewpoints supported by Al-Shafi'i. The other viewpoint emphasized by Al-Shafiee is that mortgage of a borrowed asset is impermissible without knowledge of the amount, nature and maturity of the debt to be mortgaged for. When the borrowed mortgage asset perishes the guarantee resets with the mortgagor, since a borrowed property has to be guaranteed by the borrower. There is also the case when the person from whom the mortgaged asset is borrowed releases the mortgaged asset without resorting to the mortgagor, and whether he should resort to the mortgagor in this case or not. Fiqh scholars are divided between two standpoints concerning this issue, as they do with regard to the case of someone who repays the debt of someone else without his permission, Shamsul-Deen (Ibn Qudamah), *"Al-Sharh Al-Kabir"*, [5: 148]. Electronic copy: Al-Jammi' Al-Kabir Program. As indicated in *"Al-Insaf"*, It is permissible to borrow or rent something so as to mortgage it, on permission of the owner in both cases", Ala` Al-Din (Al-Mardawi), *"Al-Insaf"*, op. cit, [5: 148-149]. Electronic copy: Al-Jami' Al-Kabir Program.

reported to have said: *"The one who mortgages the asset should get its benefits and bear its expenses."* Since the mortgaged asset belongs to the mortgagor he should, therefore, bear its expenses as if it is still in his hands.(21) According to the Hanafi School "expenses of a mortgaged asset are of two types: the first type includes all the expenses which relate to maintenance of the proper state of the asset and its preservation against decay, and such expenses should be borne by the mortgagor. The second type comprises expenses such as those relating to safekeeping of the asset, or returning it back to mortgagor, or returning back part of it which has been damaged by an accident; and such expenses have to be borne by the mortgagee". Furthermore, the Hanafi scholars indicate: "When the mortgagee without the permission of the competent authority bears the expenses that should have been borne by the mortgagor, he is considered to have done so in donation, whereas when he does so on permission of the competent authority he has the right of recourse on the mortgagor for repayment. Similarly, the mortgagor is considered as a donor when he bears the expenses that should have been borne by the mortgagee without the permission of the concerned authority, and should have the right of recourse on the mortgagee when he does so, on permission of the competent authority".(22)

- The mortgagee does not have the right to make free of charge benefit from the mortgaged asset, because otherwise he will be committing Riba.

**Rulings Relating to the Debt for Which the Mortgage Is Signed (item 3/3)**

- The mortgage contract can be signed before, along with or after the debt contract. In this regard the Hanbali scholars indicate that "signing of the mortgage contract can be visualized in terms of three cases: it can take place after signing of the debt contract and in this case it is permissible as per the unanimous viewpoint of Fiqh scholars, because the debt is already

(21) Abdullah Ibn Qudamah Al-Maqdisi Abu Muhammad, *"Al-Kafi Fi Fiqh Al-Imam Al-Mubajjal Ahmad Ibn Hanbal"*, Al-Maktab Al-Islami – Beirut, [2: 146]. Electronic copy: Al-Jami' Al-Kabir Program.

(22) Ala` Al-Din Al-Samarqandi, *"Tuhfat Al-Fuqaha`"*, Ihya` Al-Turath Al-Islami – Qatar, [3: 59-61].

there and it needs documentation. The second case is when the mortgaged contract is signed at the same time of signing the debt contract, as when – for instance – one party says to the other: I sell to you this garment of mine for ten dinars payable after a month provided that you mortgage to me your slave Saad, and the other party responses: I agree to that. The mortgage contract in this second case is also valid, according to Al-Shafi'i and Ashab Al-Ra`y, because it is needed. The third case is when the mortgage contract is signed before the debt contract, as when - for instance – one party says to the other: I mortgage this slave of mine to you against lending me ten dinars. In this third case the mortgage contract is invalid according to the prevailing view point of the Hanbali School, while Al-Shafi'i considers it to be valid. The proponents of the validity of the contract in this case include also Abu Al-Khattab, Malik and Abu Hanifah. It is argued that the mortgage contract in this case is a documentation of a valid right and therefore it can precede it, similar to the case of guarantee. A further justification given by Fiqh scholars in this connection is that the mortgage contract in this case is signed for something which will take place in the future, and therefore it is similar to a darak guarantee (guarantee against occurrence of third party claim on the asset)".[23]

**Execution of the Mortgage (item 3/4)**

- Foreclosure: According to Hadith: *"Mortgage should not be foreclosed from its owner who should get its benefit and bear its expenses"*. The meaning of this Hadith is that the failure of the mortgagor to redeem his mortgaged asset does not make the mortgagee entitled to that asset. This was, in fact, the practice during the Pre-Islamic period (Jahiliyyah) when the mortgagee used to seize the mortgaged asset in case of default.[24]

**Contemporary Applications of Mortgage**

- Holding the documents which represent the ownership of the goods as a mortgage is permissible, because possession of the documents is

(23) Muwaffaq Al-Din (Ibn Qudamah), *"Al-Mughni"*, op. cit, [6: 444–445]. Darak guarantee is a "Guarantee given to the purchaser against the case when the purchased asset turns out to be owned by a third party". See: Muhammad Al-Hajjar, *"Fath Al-'Allam"*, op. cit, [5: 44].

(24) Mohammad Al-Hajjar, *"Fath Al-'Allam"*, op. cit, [5: 25].

considered as possession of the goods themselves. The possessor of the documents will become authorized to dispose of the goods like an owner.

- It is permissible to mortgage shares because shares represent a common share of Shari'ah-permissible assets (cash, tangible assets, usufructs, rights and debts – item 3/1 of Shari'ah Standard on Financial Papers). As shown in item (7) above, some of the Fiqh scholars indicate that mortgaging of common property is permissible.
- It is permissible to mortgage Sukuk because, similar to shares, they represent common shares in Shari'ah-permissible assets (cash, debts, usufructs, tangible assets). The only difference between shares and Sukuk is that Sukuk can be a common share of only one type of these assets (cash, or debts or usufructs or tangible assets), [see Shari'ah Standard on Investment Sukuk]. As we have seen previously Fiqh scholars indicate that it is permissible to mortgage common property as well as cash, tangible assets and debts. Although there is no Shari'ah or Fiqh text that permits or prohibits mortgaging of usufructs, yet I can see no Shari'ah restriction against it, if such usufructs are Shari'ah-acceptable and their mortgaging could achieve the Shari'ah objective of "Preservation of rights and documentation of debts, through sale of the mortgaged asset and repayment of the debt in case of default". Achievement of such objective appears to be possible through mortgaging of the Sukuk issued against usufructs of assets (in hand and with debtors). [see Shari'ah Standard on Investment Sukuk, 5/1/5/2]
- Permissibility of freezing the balances of current accounts and the like as mortgages is based on the fact that this is similar to mortgaging of assets which are previously held under the guarantee of the mortgagee (assets in the hands of the mortgagee), which is permissible.(25)

(25) According to the majority of Fiqh scholars (except the Shafi'i School) the account in this case becomes kept by the institution on trust basis, rather than on guarantee basis. As can be understood from what has been stated by Imam Ahmad, the mortgage becomes binding once the contract is signed. The Hanbali scholars elaborate on this issue by stating: "When someone mortgages an asset which is already in the hands of the mortgagee, whether the mortgagee has obtained such asset through borrowing, on trust basis, or forcibly …etc, the mortgage is valid, because the asset is owned by the mortgagor and can be possessed, hence, it can be mortgaged, as if it is in =

- It is permissible for the Institution to retain investment accounts and investment units as mortgage because this is considered as mortgaging of common property which is permissible as has been indicted earlier in this standard. Permissibility of such mortgages can also be based on the fact that an investment account or unit usually comprises cash, or assets, or debts, or most often a mixture of all that. As we have seen earlier mortgaging of any of these items is permissible. Furthermore, mortgaging of investment accounts and units can be seen as similar to mortgages that comprise a forgivable degree of gharar, due to the changing nature of real assets as a com-

= the hands of the owner. Therefore what can be understood from this statement by Imam Ahmad is that the mortgage here becomes binding by virtue of the same contract with no need for any further act (i.e., what changes is the ruling only). According to Al-Qadi and his companions as well as Al-Shafi'i the mortgage does not become valid without the elapse of sufficient time for possession", Shamsul-Din (Ibn Qudamah), *"Al-Sharh Al-Kabir"*, op. cit, [12: 406]. The author of *"Al-Insaf"* has also discussed this issue and added mortgaging of an asset held by the mortgagee on the basis of a nullified contract (Ala` Al-Din Al-Mardawi, Electronic copy: Al-Jami' Al-Kabir Program). An important point to be noted here is what has been quoted in *"Mukhtasar Al-Insaf"* and *"Al-Sharh Al-Kabir"* on the discussion about the status of the mortgagee who is already holding the asset on guarantee basis. The quoted statement comprises the following: "When someone mortgages an asset which is already seized or borrowed by the mortgagee, the mortgage is valid and the guarantee of the mortgagee is cancelled according to Malik and Abu Hanifah. Al-Shafiee said that the guarantee should not be cancelled and the mortgage is valid because there is no contradiction between the two. According to Al-Shafiee even in the mortgage arrangement the mortgagee is committed to guarantee in case of transgression. To me, the mortgagee has the right to hold the asset as a mortgage and he is no longer to be seen as a transgressor, yet the assertion that there is no contradiction between holding the asset as a mortgage on the one hand, and holding it through borrowing or seizure on the other, is objectionable, because a borrower or someone who takes the asset by force has to guarantee the asset whereas a mortgagee is supposed to keep the asset on trust basis rather than under guarantee. Moreover, on mortgaging the asset there will remain no reason which justifies continuation of the guarantee. If the mortgagee is to be held responsible later on for transgression against the mortgaged asset, that will be for his transgression rather than for his status as a borrower or someone who has taken the asset by force", Muhammad Ibn Abdul-Wahhab, *"Mukhtasar Al-Insaf Wa Al-Sharh Al-Kabir"*, [1: 508] – Electronic copy: Al-Jami' Al-Kabir Program. The Shafiee scholars [Muhammad Al-Hajjar, *"Fath Al-'Allam"*, op. cit, [5: 29] indicate: "The mortgaged asset is a trust in the hand of the mortgagee except in eight cases: (I) An extorted asset changed to a mortgage in the hands of the extorter, =

ponent of such accounts and units. As we have seen before, such mortgages are permissible according to the Maliki scholars who argue that "since the mortgagee has the right to lend his money without documentation, it is only logical that he can accept documentation with some Gharar. In the final analysis something is better than nothing".(26) Moreover, it can be argued that the unknown aspects of the transaction are later on going to be known.

**Contemporary Applications of Debt Mortgaging**

- It is permissible to issue documentary credit for a client on guarantee of a debt owed to this client by a third party, and documented by a letter of credit, a guarantee, a receipt, a commercial paper, a bond, or Islamic Sukuk, because it is permissible to mortgage debt as we have seen earlier.
- It is permissible to issue documentary credit to a client against another documentary credit (Back-to-back credit and transferable credit), be-

= (II) A mortgaged asset changed to an extorted asset, (III) A borrowed asset changed to a mortgage, (IV) An asset offered for sale changed to a mortgage, (V) An asset sold through a false contract changed to a mortgage, (VI) A sold asset changed to a mortgage after termination of the contract by the buyer, and (VII) An amount payable by the husband on divorce changed to a mortgage before being received by the wife. The justification for guarantee in these cases is the presence of the reason which necessitates it. That is to say relaxation of guarantee because of mortgage is overruled by a Shari'ah requisite for guarantee because of borrowing or seizure; contrary to the case of on-trust deposit (Wadi'ah) where there is a Shari'ah prohibition against guarantee. Regarding the same issue of mortgaging an asset that is already in the hands of the mortgagee, the following has also been stated by Fiqh scholars "when the mortgaged asset is already in the hands of the mortgagee such as a borrowed or an extorted asset, the mortgage is valid and the guarantee is cancelled according to Malik and Abu Hanifah. Al-Shafiee argues that the guarantee should not be cancelled and the mortgage is valid because there is no contradiction between the two. According to Al-Shafi'i even in the mortgage arrangement the mortgagee is committed to guarantee in case of transgression, and therefore the mortgage is valid along with the guarantee."; Shamsul-Din (Ibn Qudamah), *"Al-Sharh Al-Kabir"*, op. Cit, [12: 407]. Ibn Qudamah then discussed the proposition advocated by Al-Shafi'i that there is no contradiction between holding the asset as a mortgage on the one hand, or holding it through borrowing or seizure on the other. Ibn Qudamah emphasized that a borrower or someone who takes the asset by force has to guarantee the asset whereas a mortgagee is supposed to keep the asset on trust basis rather than under guarantee. See: *"Al-Mawsu'ah Al-Fiqhiyyah Al-Kuwaytiyyah"*, the term Al-Rahn, item (9).

(26) See: *"Al-Mawsu'ah Al-Fiqhiyyah Al-Kuwaytiyyah"*, the term Al-Rahn, item (9).

cause a documentary credit results in a debt owed by the bank to the client, and such debt can be mortgaged for obtaining a new debt.

**Insurance of the Mortgaged Asset**

- Insurance of the mortgaged asset is permissible because if such asset is damaged the compensation received can be used for replacing the mortgage; and thus continuation of the vital role of mortgage in preservation of rights, documentation of debts and facilitation of debt repayment and collection is ensured.

Shari'ah Standard No. (40)

# Distribution of Profit in Mudarabah-Based Investment Accounts

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to indicate the controls and rulings on distribution of profits of investment accounts in Islamic financial institutions (Institution/Institutions).(1) In this regard the standard covers three major aspects including: realization of profit, entitlement to profit and profit distribution.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers investment accounts managed on the basis of Mudarabah and the principles and conditions of realization and entitlement to profit. The Standard also covers how profits are to be distributed between the institution as a Mudarib and the holders of investment accounts as Arbab al-Mal, and to discuss the procedural aspects of profit realization such as determination of the expenses to be charged to investment accounts and the allocations and reserves to be deducted from the profits. The standard does not cover the accounts managed on the basis of investment agency because such accounts require a separate standard.

## 2. Investment Accounts (Demand Deposits)

### 2/1 Definition and types of investment accounts

These are the amounts which the institution receives from investors on the basis of participatory Mudarabah (al-Mudarabah al-Mushtarakah). The holders of such accounts delegate the institution to invest their funds through Mudarabah. Investment accounts can be divided into two types. The first type is investment accounts that are managed on the basis of unrestricted Mudarabah where the Mudarib is delegated to invest the Mudarabah funds in any field of investment he deems suitable. The second type is investment accounts which are managed on the basis of restricted Mudarabah, where the Mudarib has to invest the Mudarabah funds in a specific type of investment to be determined by Rab al-Mal (owner of the capital). The relationship between the holders of these accounts and the institution is the typical relationship between the Mudarib (the work provider) and Rab al-Mal.

2/1/1 Unrestricted investment accounts

These are the amounts received from investors who authorize the institution to invest their funds on the basis of Mudarabah without restricting the investment of such funds to a specific project or investment program. The holders of the accounts and the institution share the profit, if any, according to the ratio specified for each of them either in the Mudarabah contract or in the application for opening the account. The holders of the accounts bear all the losses in proportion to their respective shares in the capital, except losses arising from transgression, negligence or breach of the contract, which have to be borne by the institution.

2/1/2 Restricted investment accounts

These are the amounts whose owners authorize the institution to invest them on the basis of Mudarabah in a specific project or investment program(2). The holder of the account and the institution share the profit, if any, according to the ratio specified for each of them either in the Mudarabah contract or in the application for opening the account. The holder of the account bears all the losses in proportion to his share in the capital, except losses arising from transgression, negligence or breach of contract, which have to be borne by the institution.

2/1/3 Equality in investment opportunities

In principle, equality in investment opportunities should be ensured between shareholders' funds and the funds of the holders of the investment accounts in participatory Mudarabah. In case a different policy is to be adopted, the institution should disclose that before disposition, with due consideration to the relevant regulatory restrictions and the conditions of opening the accounts.

(2) Restricted investment accounts can be managed on the basis of investment agency.

**2/2 The difference between an investment account and a current account and its likes**

2/2/1 The current accounts are the amounts which the institution receives from clients who are not seeking investment. Such amounts represent loans which the institution has to guarantee their repayment on demand without any increment. The institution has the right to dispose of such amounts and invest them for its own benefit and under its own responsibility, preferably after indicating this in the application for opening the account.(3) As regards investment accounts, these are the amounts deposited with the institution on trust basis, and hence the institution is not committed to guarantee their repayment, except in case of transgression, negligence or breach of the contract.

2/2/2 The institution should guarantee full repayment of the amounts of the current accounts to their holders, whereas it should not assume the commitment to pay any fixed or variable increment on the principal amounts of such accounts, because such payment constitutes usurious interest. The institution is not committed to guarantee investment accounts. It is only committed to distribute their profit or loss among their holders as per the ratios agreed upon.

2/2/3 Saving accounts which carry no authorization for investing them to the benefit of their holders shall become subject to the rulings on current accounts, whereas those which carry such authorization shall become subject to the rulings on investment accounts.

2/2/4 The institution may charge fees (commissions) for the services of opening investment accounts. Such fee has to be a lump

(3) For more rulings on current accounts as regards, for instance, charging fees for keeping such accounts or distribution of prizes to them see Shari'ah Standard No. (19) on Loan (Qard).

sum amount which should preferably not exceed the average actual cost, and should be charged once at the time of opening the account.

2/2/5 In case of depositing coins or paper money by handing them over to the cashier the institution may charge a fee for transportation, storage and counting of the deposited amounts. This, however, does not include amounts transferred to the account of the institution.

2/2/6 In transference of money between accounts constructive possession is sufficient, whether for the same currency or different currencies, because the process involves exchange and transference. [see Shari'ah Standard No. (1) on Trading in Currencies]

2/2/7 The funds which the institution fails to transfer to owners because of change of address shall be kept in a suspended account for the specified period before being added to the charity account. If the addresses of the owners of such funds came to be known later on the funds should be paid out to them from the charity account. In this regard, a clause should be added to the conditions for opening the accounts indicating that the holders of the accounts agree to donate for charitable purposes any amounts which could not be transferred to them within a specific period due to change of address.

2/2/8 In principle, the institution should resort, through exchange of correspondence, to holders of the accounts when there is any change in the conditions or profit sharing ratios. However, due to the difficulty and cost involved in such process the institution may send notifications, or advertise the new changes in its website so that the implicit acceptance of the concerned parties is obtained if no protest is received from them within a specific period. The changes in question, which shall become effective starting from the beginning of the next period, should be incorporated in the conditions of the

accounts, with due reference to the procedure followed for their adoption.

2/2/9 It is permissible to stipulate the authoritative status of the documents and financial statements of the institution, unless such documents and statements are proved to be wrong by the accountholder. If dispute arises the two parties should resort to experts, arbitration or law.

2/2/10 The cost of proving the accusation shall be borne by the accountholder when he files the claim against the institution.

## 3. Realization of Profit

Realization of distributable profits should be subject to the following:

### 3/1 Safety of the capital

3/1/1 Realization of profit in investment accounts does not take place before protecting the capital. Any amount of profit distributed before ensuring such protection is considered as an advance payment, rather than realized profit [see item 5/3]. The profit authorized for investment at the end of the investment period is considered as part of the capital in the next period.

3/1/2 Actual and constructive liquidation

Realization of profit in investment accounts does not take place before the following steps:

3/1/2/1 Liquidation of Mudarabah assets, which can be either actual liquidation where all the assets are converted into cash and all debts are collected, or it can be constructive liquidation where, in addition to cash amounts, noncash assets are valued by experts, along with valuation of all debts with regard to possibilities of collection and appropriate allocations for bad debts.

3/1/2/2 Covering of the following expenses:

a) Expenses relating to utilization of the balances of the investment accounts by charging each operation with the direct expenses incurred in its execution.

b) The share of the balances of the investment accounts from shared expenses, excluding expenses relating to the institution's own activities.

Investment accounts should also not be charged with the expenses of the tasks which have to be performed by the Mudarib. Such expenses include the expenses of the investment departments and the bodies which endorse their decisions as well as the expenses of the follow-up and accounting departments. It is also permissible to specify a ceiling for the expenses above which all the expenses are to be borne by the Mudarib.

3/1/2/3 Deduction of the allocations and reserves relating to the investment, from investment income so as to arrive at distributable profit. In this case, allocations for bad debts and reserve for rate of returns have to be deducted from gross profit, whereas reserve for investment risks has to be deducted after deduction of the Mudarib's share.

**3/2 In realization of the profit the following should be observed**

3/2/1 When loss is incurred in one Mudarabah operation it can be covered from the profits of other operations, and if it exceeds the profits it should be covered from capital. What should really matter is the final result of liquidation at the end of the financial period specified by the institution. The loss of a certain financial period should not be covered from the profits of another period, except in the case of covering losses from reserves.

3/2/2 Due to the fact that unrestricted investment accounts of continuous participatory Mudarabah lack coincidence in the beginning and end of the process of depositing funds in the accounts, the profit from the operations which extend to succeeding periods has to be distributed over the whole period of such operations in proportion to the duration of each operation.

## 4. Entitlement to Profit

4/1 The method of profit distribution should be well known so that no room is left for uncertainty and dispute. Distribution of profits should also be in terms of ratios, and not at all by specifying a lump sum amount or a percentage of the capital for any party, or any other method that could lead to avoidance of sharing of the profit between the two parties.

4/2 Specification of profit ratios for the two parties should not be postponed beyond the time of signing the contract. When the two parties do not specify such ratios at the time of signing the contract normal practice can be sought - if any - as when, for instance, profit is normally shared on equal basis. If there is no normal practice to resort to the Mudarabah contract becomes null and void, the Mudarib is entitled to the wage normally paid for similar work, and the whole profit goes to Rab al-Mal.

4/3 The institution can specify different ratios for distribution of profits between itself and different categories of holders of investment accounts, or it can specify a unified ratio for all. The ratios for distribution of profits among the holders of the investment accounts can also be unified or varying on the basis of certain weights.

4/4 When one of the two parties stipulates a lump sum amount for himself the Mudarabah contract becomes null and void. This restriction, however, does not include the case when the two parties agree that if the profit exceeds certain limit or index the excess amount should be taken by one of them. If the profit is at that limit/index or below it shall be shared as agreed upon between the two parties.

4/5 It is impermissible to earmark the profit of a specific type or portion of the capital or the assets into which capital is converted, for one of the two parties. It is also impermissible to allocate the profit of a certain financial period or a specific transaction for one party, and the profit of another financial period or a specific transaction for the other.

4/6 The method agreed upon for distribution of profit can be fixed for the whole period, or variable according to specific sub-periods of partial liquidation.

4/7 When the Mudarib mixes the Mudarabah funds with his own funds, he becomes a partner by subscribing his funds and a Mudarib for the Mudarabah funds of the other party. In this case the profit has to be divided between the two amounts of capital, so that the Mudarib can get the profit of his work as well as the profit of his funds as a partner. The profit share of the Mudarib as a partner shall become subject to the same treatment of the shares of the holders of investment accounts. [see item 4/3]

4/8 In principle, the profit belongs to the institution and the holder of the account, yet the two parties can agree on allocation of a certain part of the profit to the benefit of a third party. [see Shari'ah Standard No. (13) on Mudarabah, item 8]

4/9 It is permissible for the accountholder to exit from the Mudarabah with all his funds or part of them. Such exit represents the desire of the accountholder to redeem his share in the Mudarabah assets without withdrawing the total amount deposited in his account or part of it. It is permissible for the institution in this case to specify the amount relating to the exit so that it can earn no profit, or less than the profit it would have earned in the absence of exit. Such arrangement constitutes exit on the basis of supply and demand, rather than deprivation from profit.

4/10 The ratios of the amounts deposited in the investment accounts which the institution retains for liquidity purposes – may be stated in the conditions of the accounts - has to be treated as follows:

4/10/1 The case could be that the bank never invests such amounts because they are withheld in the accounts of the central bank or the bank's treasury for the sake of meeting requests for withdrawal from investment accounts, hence there is no return for which a ruling can be indicated here.

4/10/2 Or the case may be that the bank utilizes such funds in short term or easy-to-liquidate investments so as to cater for applications for withdrawal from investment accounts - although the bank sometimes stipulates in the conditions of the accounts that such funds are allocated for liquidity purposes. In this case it is permissible for the bank to invest such funds without obtaining the consent of the holders of the accounts, because the bank is authorized for any disposition that serves the interest of the two parties of the unrestricted Mudarabah contract. When a return is earned from such investment it should be added to the investment base. The holders of the account will be entitled to a share in this profit in their capacity as Arbab al-Mal, and the bank is entitled to its share as a Mudarib, subject to the ratios agreed upon. If, instead, a loss is incurred from investment of the amounts, without any transgression or negligence from the side of the bank, it should be borne by the holders of the accounts in their capacity as Arbab al-Mal.

## 5. Distribution of Profit

### 5/1 Application of scoring method of profit distribution:

With due consideration to items 4/3 and 4/4, the scoring method for distribution of profit among the participants of general investment accounts can be used. Such method takes into account the amount contributed by each investor and the period of its stay in the investment (currency unit x time unit). Each account is given a certain number of scores depending on its amount and the period of stay of that amount in the investment even if depositing and withdrawal have repeatedly been done and the amount varied from time to time. The holders of the accounts are considered to have implicitly exchanged mutual relief from commitment (Mubara`ah) for any aspects that practically cannot be catered for.

5/2 There is no prohibition against setting an expected rate of return which is not considered to be binding if not achieved, even if it is

reached through a feasibility study. However, final distribution of profits should be based on realization of profit after actual or constructive liquidation, rather than on such expected rate of return.

5/3 It is permissible to pay advance amounts to the holders of the accounts before actual or constructive liquidations so that final settlement can be made later on. After actual or constructive liquidation the institution is committed to make necessary additions to, or deductions from, the advanced amounts so that each holder of an investment account receives his exact share of the profit.

5/4 Mutual relief from commitments (Mubara`ah) in case of exit should be stipulated in the contracts of the Mudarabah-based investment accounts. The stipulation should indicate that the exiting party reliefs the holders of the accounts (the depositors) from commitment towards his rights in any undistributed or non-apparent profit, as well as his rights in the remaining part of the reserves for investment risks and rate of return, and the remaining part of allocations for debts. Similarly, the stipulation should state that the holders of the accounts relief the exiting party from commitment towards any losses that have not yet become apparent. The stipulation should also indicate that on liquidation of the investment base the remaining parts of the above mentioned reserves and allocations shall be devoted to charitable purposes.

5/5 Institutions should liquidate Mudarabah and distribute the realized profit between the Mudarib and the holders of the investment accounts according to the conditions of the Mudarabah contract.

5/6 When the shareholders in their capacity as the Mudarib, decide - after liquidation of the Mudarabah and preparation of the profit and loss account - to relinquish part of their profit share to the benefit of the accountholders, the institution should disclose that.

## 6. Other Rulings on Investment Accounts

The rulings which have not been stipulated in this Standard can be seen in Shari'ah Standard No. (13) on Mudarabah.

## 7. Date of Issuance of the Standard

This Standard was issued on 26 Jumada II, 1430 A.H., corresponding to 19 June 2009 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Investment accounts and Profit Distribution on its meeting No. (24), held in Al-Madinah Al-Munawwarah, on 25–26 Jumada II, 1430 A.H., corresponding to 18-19 June 2009 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (10) held on 2–7 Rabi' I, 1424 A.H., corresponding to 3-8 May 2003 A.D., in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia, the Shari'ah Board decided to issue a Shari'ah Standard on bank deposits and distribution of profits .

On 7 Dhul-Hajjah 1424 A.H., corresponding to 29 January 2004 A.D., the Shari'ah Standards Committee (1) decided to commission a Shari'ah consultant to prepare a study on bank deposits and distribution of profits.

In its meeting No. (16) held on 8–9 Jumada I, 1426 A.H., corresponding to 15-16 June 2005 A.D., in the Kingdom Of Bahrain, the Shari'ah Standards Committee (1) discussed the draft of the Standard and introduced necessary changes.

In its meeting No. (17) held on 8–9 Sha'ban 1426 A.H., corresponding to 8-9 September 2005 A.D., in the Kingdom of Bahrain, the Shari'ah Standard Committee (1) discussed the draft of the Standard and introduced necessary changes.

In its meeting No. (15) held on 22 Sha'ban 1426 A.H., corresponding to 30 September 2005 A.D., in Makkah Al-Mukarramah, the Shari'ah Board discussed the draft of the Standard, and decided, in the light of the discussions and observations of the meeting, to send the draft of the Standard to Shari'ah Standards Committee (1) for study.

In a meeting held in the Kingdom of Bahrain, on 1 Safar 1427 A.H., corresponding to 1 March 2006 A.D., the Shari'ah Standards Committees (1) and (2) discussed the draft of the Standard and introduced necessary changes in the light of the observations of the meeting.

In its meeting No. (17) held in Makkah Al-Mukarramah, on 26 Shawwal 1427 A.H., corresponding to 18 November 2006 A.D., the Shari'ah Board discussed the amendments suggested by the Shari'ah Standards Committees (1) and (2) and introduced necessary changes.

In its meeting No. (22) held in the Kingdom of Bahrain, on 28–30 Dhul-Qa'dah 1430 A.H., corresponding to 26-28 November 2008 A.D., the Shari'ah Board discussed the draft of the Standard and introduced necessary changes.

The Secretarial General of AAOIFI held a public hearing in the Kingdom of Bahrain on 6 Rabi' II, 1430 A.H., corresponding to 2 April 2009 A.D. More than 30 participants attended the public hearing as representatives of central banks, institutions, and accounting firms. The public hearing was also attended by Shari'ah scholars, university teachers and other interested parties. Several observations were made in the public hearing, and duly responded to by the members of the Shari'ah Standards Committees (1) and (2).

In its meeting No. (23) held in the Kingdom of Bahrain, on 15–17 Rabi' I, 1430 A.H., corresponding to 12-15 March 2009 A.D., the Shari'ah Board discussed the draft of the Standard and introduced necessary changes.

In its meeting No. (24) held in Al-Madinah Al-Munawwarah, on 25–26 Jumada II, 1430 A.H., corresponding to 18-19 June 2009 A.D., the Shari'ah Board discussed the draft of the Standard, introduced necessary changes and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The current account is considered as a loan because the bank has to guarantee its repayment on demand. In this regard the International Islamic Fiqh Academy issued its resolution No. 86 (9/3) which stipulates that "Demand deposits (current accounts) whether in Islamic or traditional banks are loans in the strict Shari'ah sense. The receiving bank holds such deposits under guarantee and is committed by Shari'ah to repay them on demand. The fact that the receiving bank is solvent does not affect this ruling"

**Rulings and Conditions relating to Profit**

- Profit has to be known because it constitutes the object of contracting, and therefore ignorance about it nullifies the contract.
- It is impermissible in Mudarabah to specify the return for any of the two parties in terms of a lump sum amount or a certain percentage of the capital, because such specification eliminates profit sharing which constitutes a fundamental aspect of the Mudarabah contract. By such specification, the very essence of partnership will be lost when, for instance, the profit earned is just equal to the lump sum amount or percentage of the capital earmarked for one party.
- Permissibility of applying the scoring method of profit distribution is based on the fact that the funds of the participants in the same investment base have all contributed to achievement of the return as per their respective amounts and periods of stay in the accounts. The scoring method is the most equitable method of accounting in hand that can be used for assigning profit shares commensurate to the amounts and their periods of stay in the accounts. However, entering into investment on such basis necessitates mutual relief from commitments (Mubara'ah) among investors with regard to any part of entitlement that could not be catered

for through this method. It is a well established principle in Figh literature that much more exemptions can be allowed in partnership-based dealings (*Musharakat*) than in exchange-based dealings (Mu'awadah) and that division (Qismah) through approximation of shares is based on mutual consent.

- Charging the Mudarabah expenses in the way shown in the Standard takes into consideration what should be done by the Mudarib for the sake of carrying out his investment decisions on receipt of the funds, and his commitment to do the work which entails having the bodies required for that purpose. A resolution to this effect has also been issued by the Al Baraka Seminar (4/1).
- Impermissibility of charging interest for loans is based on the fact that such charge constitutes Riba. In this regard the international Islamic Fiqh Academy issued its resolution No. (10/2) stipulating that "whether such increment is charged for postponement of a defaulted debt, or as an interest on the loan stipulated since the time of signing the contract, both increments are forms of Shari'ah-prohibited Riba".
- Impermissibility of postponing specification of profit ratios for the two Mudarabah parties until the profit is earned is based on the fact that such postponement leads to Jahalah (ignorance) which could lead to dispute. On the contrary, agreement between the two parties - at time of distribution - on changing the ratios agreed upon or donating part of the profit is a right that the two parties may permissibly exercise.
- Impermissibility of final distribution of the profit between the stakeholders of the company before deduction of expenses, allocations and reserves is the Shari'ah principle that no profit is to be sought before preservation of the capital.
- Permissibility of distributing the profit on the basis of constructive liquidation and after ensuring the safety of the capital is based on acceptance of valuation in Shari'ah(4) in several applications including Zakah

(4) See the Forth Resolution of the Muslim World League in its 15th Session, held in Makkah Al-Mukarramah, on 21–26/10/1422 A.H.; Resolution No. 30(5/4) of the International Islamic Fiqh Academy; and Fatwa No. (2/8) of the 8th Seminar of the Al Baraka, Fatawa Al Baraka, (P. 134).

as well as theft incidents. In this context, the Prophet (peace be upon him) is reported to have said: *"When someone liberates a slave he owns with other parties, he should pay partners from his money, and if he has no money, the slave has to be equitably valued for him".* (5)

- The Shari'ah basis for the ruling that no profit has to be sought in Mudarabah before preservation of the capital is the Hadith of the Prophet (peace be upon him) who said: *"A prayer performer is just like a merchant who obtains profit only after preserving his capital. Similarly a prayer performer cannot get his Nafilah (voluntary prayer) accepted before he performs Faridah (obligatory prayer)".*(6) This Hadith indicates that profit sharing is inacceptable before preservation of the capital. This is so because profit is an increment which cannot be obtained before obtaining the principal.
- The Mudarabah contract becomes null and void when the two parties refrain from specifying profit sharing ratios and fail to find any established normal practice of profit sharing applicable to their case. This ruling is based on the fact that ignorance about profit, which constitutes the contracting object, must nullify the contract.
- Profit sharing ratios can be commensurate to shareholding ratios or not, because profit is deserved for contribution of funds, work or guarantee. When any of these three aspects is fulfilled there is no Shari'ah prohibition for the partners to specify profit sharing ratios on mutual consent. This viewpoint is adopted in the Hanbali School.(7)
- The Shari'ah basis for impermissibility of agreement between the two parties on charging the whole loss to one of them or using disproportionate ratios for loss distribution is the statement of Ali Ibn Abu Talib who is reported to have said: "Profit is to be distributed as per the agreement of

(5) *"Sahih Muslim"* [2: 1140].

(6) Related by Al-Bayhaqi in *"Al-Sunan"* quoting Ali Ibn Abu Talib. Al-Bayhaqi mentioned that the chain of transmission of this Hadith includes a weak narrator: *"Al-Mawsu'ah Al-Fiqhiyyah"* [38: 74].

(7) *"Al-Hidayah Sharh Al-Bidayah"* by Al-Mirghinani, [3: 3-8], Al-Maktabah Al-Islamiyyah; *"Bada`i' Al-Sana`i'"* by Al-Kasani, [6: 62-63]; and *"Al-Mubdi'"* by Ibn Muslih [5: 4], Al-Maktab Al-Islami, Beirut, 1400 A.H.

the two parties, whereas loss should be borne according to the ratios of contribution to the capital".[8] A condition which stipulates that the loss of one party should be borne by the other party is invalid because it is oppressive and would lead to reaping of unlawful gain by one party at the expense of the other.

- It is permissible for the two parties to stipulate a condition that when profit exceeds certain limit or index the whole additional amount should be taken by one of them, because such condition is permissible according to Shari'ah if it happens to be stipulated.
- It is impermissible to agree on earmarking the profit of a specific portion of the capital for one party and the profit of the remaining portion for the other, because such arrangement could jeopardize the process of profit sharing and lead to oppression.
- Permissibility of agreement between the two parties to change profit sharing ratios at any time, stems from the fact that the two parties are the sole owners of the profit, and agreement between them to change its distribution ratios does not entail a Shari'ah-prohibited act, such as discarding away the principle of profit sharing.[9]
- Permissibility of agreement on fixed or variable ratios of profit distribution is based on the validity of such agreement since it has been the result of mutual consent. The only restriction is that such agreement should observe the Shari'ah ruling that neither of the two parties should be deprived from his share in the profit.
- Regarding constructive liquidation a resolution has been issued by the Islamic Fiqh Academy of Makkah Al-Mukarramah.[10]

---

(8) Related by Ibn Abu Shaybah in his *"Musannaf"* [4: 268], Maktabat Al-Rushd Press, Riyadh.

(9) See the proceedings of the 10th Al Baraka Seminar – Fatwa No. (8) and the 4th Al Baraka Seminar - Fatwa No. (5). This viewpoint is also supported by a Fatwa issued by the Shari'ah Board of the Faisal Islamic bank of Sudan (P. 107) and published in the Manual of Shari'ah Fatawa of the Center of Islamic Economic of the International Islamic Bank , (P. 53).

(10) The 4th Resolution of the 16th Session, held by the Islamic Fiqh Academy of the Muslim World League. This viewpoint has also been adopted by the 8th Al Baraka Seminar (Fatwa No. 2).

# Appendix (C)
# Definitions

**Deposit (Wadi'ah)**

Funds given to someone for safekeeping

**Bank Deposit**

Funds which individuals and institutions entrust the bank to keep, provided that the bank assumes the commitment to repay such funds or their equivalent to depositors or any other specific person, on demand or subject to the conditions agreed upon.

**Demand Deposit (Current Deposit)**

Demand deposit is the means whereby a current account is established. The current account can be defined as: The funds deposited by their owners with the bank so as to be ready for withdrawal on need. The bank assumes the responsibility of immediate repayment of such funds on demand, and without any type of prior notification.

**Savings Deposit (Savings Account)**

Small cash deposits which individuals cut from their incomes and pay to the bank so as to open saving accounts for them. The owners of such accounts have the right to withdraw the whole or part of the balances of their accounts at any time.

## Shari'ah Standard No. (41)

# Islamic Reinsurance

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to illustrate the rules and principles of Shari'ah that govern Islamic reinsurance and indicate the controls which Islamic insurance and reinsurance companies as well as Islamic financial institutions (Institution/Institutions)[1] should observe in dealing with traditional insurance and reinsurance companies. The overall objective of the standard is to facilitate transference of risks and increasing of insurance capacity.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers Islamic reinsurance and participation with traditional insurance or reinsurance companies. The Standard does not cover Islamic insurance which has already been covered in a separate standard.

## 2. Definition of Reinsurance

2/1 Islamic Reinsurance refers to the agreement among insurance companies, on behalf of the insurance funds under their management, to devise a mechanism for the avoidance of part of the risks which the insurance funds may encounter. On the basis of such agreement a reinsurance fund which has a distinct legal personality and independent financial liability is formed up through making contributions out of the insurance funds paid by the insurance clients on the basis of donation. The reinsurance fund, thus formed, assumes the task of covering part of the risks encountered by the insurance funds.

2/2 Reinsurance, as described above, constitutes the Islamic alternative for the reinsurance provided by traditional reinsurance companies, which is based on exchange of the reinsurance premiums and compensation, rather than on donation commitments.

## 3. Shari'ah Status of Reinsurance

3/1 Shari'ah status of Islamic reinsurance:

3/1/1 It is permissible to reinsure with Islamic reinsurance companies.

3/2 Shari'ah status of reinsurance with traditional reinsurance companies:

It is impermissible for Islamic insurance companies to reinsure with traditional reinsurance companies, except when such reinsurance is sought as a transitional arrangement stemming from public need which amounts to necessity.

## 4. Key Methods of Reinsurance

With regard to the scope of commitment of the reinsurer, reinsurance can take place through one of the following two forms:

4/1 Selective reinsurance: In this case the insurance company presents the individual risk which constitutes the subject matter of reinsurance to the reinsurer along with a summary of all the information related to it, so that the reinsurer can study the information and decide whether to accept the risk or not. The reinsurance company (insurer) becomes committed to what it accepts.

4/2 Comprehensive reinsurance (reinsurance agreement): In this case the reinsurance company assumes the commitment to accept all the risks which fall within the scope of the agreement signed with the insurance company.

## 5. Key Forms of Reinsurance Requests

5/1 Risk sharing reinsurance: The insurance company in this case seeks reinsurance for a percentage of the insurance policies it issues (50% or 25%), whether such coverage is within or in excess of its own insurance capacity.

5/2 Excess risk reinsurance (beyond risk tolerance): The insurance company keeps all the insurance policies which it can easily tolerate their risks and seeks reinsurance for those which involve risks that it cannot tolerate.

5/3 Loss reinsurance: According to this type of reinsurance the reinsurance company assumes the responsibility of bearing the losses beyond the specific limit agreed upon. This form of reinsurance is widely used in the insurances which involve big amounts. The insurance company bears, for instance, the first 20 thousand dollars of compensation for the accident, while the reinsurance company bears the rest.

## 6. Controls on Reinsurance with Traditional Reinsurance Companies

In reinsuring with traditional reinsurance companies, Islamic insurance companies should observe the following controls:

6/1 Islamic insurance companies should reinsure first with Islamic reinsurance companies, to the largest possible extent.

6/2 Islamic insurance companies should not keep any cash reserves for ongoing risks, that belong to traditional reinsurance companies and on which interest has to be paid. Nevertheless, an agreement can be reached between the Islamic insurance company and the traditional reinsurance company in order to specify a certain portion of the premiums payable to the traditional reinsurance company to be retained by the Islamic insurance company. The Islamic insurance company can invest retained funds through Mudarabah or investment agency, where the Islamic insurance company assumes the role of the Mudarib and the traditional reinsurance company assumes the role of Rab al-Mal. When profit is distributed as per the ratios agreed upon, the share of the traditional reinsurance company is to be added to its account with the Islamic insurance company, whereas the share of the profit earned by the Islamic insurance company for performing the investment as an independent personality is to be added to the account of the participants.

6/3 The periods of the reinsurance agreements sought by Islamic insurance companies from traditional reinsurance companies should be commensurate to the actual need.

6/4 Before signing agreements with traditional reinsurance companies, Islamic insurance companies should seek the approval of their Shari'ah Supervisory Boards.

6/5 Islamic insurance companies should stick to the minimum size of reinsurance with traditional reinsurance companies, and Shari'ah Boards should undertake follow-up in this connection.

**7. Shari'ah Status of Compensations and Commissions Presented to Islamic Insurance Companies by Traditional Reinsurance Companies**

7/1 It is permissible for Islamic insurance companies to receive the amounts of the insurance coverage from traditional reinsurance companies.

7/2 It is impermissible for an Islamic insurance company to receive reinsurance commission from a traditional reinsurance company. Nevertheless, the Islamic insurance company has the right to seek premium discounts from the traditional reinsurance company.

7/3 Islamic insurance companies should not accept any redistributions of insurance surplus forwarded by traditional reinsurance companies. Nonetheless, Islamic insurance companies can request premium discounts from traditional reinsurance companies.

## 8. Shari'ah Controls on Practicing Islamic Reinsurance by Islamic Reinsurance Companies

8/1 Islamic reinsurance companies should observe the Shari'ah controls on the activities of Islamic insurance companies indicted in Shari'ah Standard No. (26) on Islamic Insurance, with due consideration to the fact that the participants in this case are the insurance companies.

8/2 Formation of a Shari'ah Supervisory Board to supervise the process of establishing the Islamic reinsurance company, verify its contracts and documents, overview its applications and submit Shari'ah reports on its activities.

8/3 It is permissible for the Islamic reinsurance company to provide reinsurance services to traditional insurance companies, subject to the following conditions:

1. The contract to be used should be the Islamic reinsurance contract.
2. There should be no linkage.
3. Reinsurance should not involve a Shari'ah prohibited object.

## 9. Financial Gains Received from Islamic Reinsurance Companies

All financial gains which Islamic insurance companies receive from Islamic reinsurance companies are considered as lawful gains and should be credited to the account of policyholders (the participant companies of the reinsurance scheme), as part of revenues.

## 10. Date of Issuance of the Standard

This Standard was issued on 2 Dhul-Qa'dah 1430 A.H., corresponding to 21 October 2009 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the draft of the Standard on Islamic Reinsurance in its 25th meeting held during the period of 2-4 Dhul-Qa'dah 1430 A.H., corresponding to 21-23 October 2009 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

In its meeting No. (16) held in Al-Madinah Al-Munawarah, during the period of 7-12 Jumada I, 1427 A.H., corresponding to 3-8 June 2006 A.D, the Shari'ah Board decided to issue a Shari'ah Standard on Islamic Reinsurance.

On 12 Rajab 1427 A.H., corresponding to 6 August 2005 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Islamic Reinsurance and Participation with Traditional Companies.

In a joint meeting held in the Kingdom of Bahrain, on 18 Safar 1428 A.H., corresponding to 8 March 2007 A.D., the Shari'ah Standards Committees (1) and (2) discussed the study, approved it and required the consultant to prepare the exposure draft of the Standard.

In a further joint meeting held in Manama, the Kingdom of Bahrain, on 15 Jumada I, 1428 A.H., corresponding to 31 May 2007 A.D., the Shari'ah Standards Committees (1) and (2) discussed the draft of the Standard and necessary amendments were made in the light of the discussions and observations of the meeting.

In its meeting No. (19) held in Makkah Al-Mukarramah, during the period of 26-30 Sha'ban 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the draft of the Standard and made the amendments which it deemed necessary.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 8 Jumada II, 1429 A.H., corresponding to 12 June 2008 A.D. The public hearing was attended by more than thirty participants

representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in this field. The members of the Shari'ah Standards Committees (1) and (2) duly responded to several comments and observations that were made in the public hearing.

In its meeting No. (25) held in the Kingdom of Bahrain, during the period of 2-4 Dhul-Qa'dah 1430 A.H., corresponding to 21-23 October 2009 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated the necessary amendments that it deemed appropriate, and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Impermissibility of commercial reinsurance is based on the fact that the idea of commercial reinsurance depends on the idea of commercial insurance and involves Shari'ah-prohibited Gharar. As related by Muslim, Ashab al-Sunan and others, quoting Abu Hurayrah, the Prophet (peace be upon him) prohibited *Bay' al-Gharar*(2) (aleatory sale). Gharar, as defined by several Fiqh scholars, indicates uncertainty about the outcomes, or the consequences, or end result of something.(3) According to some contemporary Fiqh scholars Gharar is similar to or part of betting or gambling.(4) A number of resolutions on prohibition of Gharar have also been issued by Islamic Fiqh Academies including the Resolution of the Islamic Fiqh Academy -Makkah Al-Mukarramah in its 1398 A.H. Session, endorsing the Resolution of the Supreme Council of the Ulema of the Kingdom of Saudi Arabia in its 10th Session held in Riyadh on 4 Rabi' II, 1397 A.H., and Resolution No. (9) 9/1 of the International Islamic Fiqh Academy.
- Permissibility of cooperative insurance stems from the fact that cooperative insurance companies are based on cooperation and donation rather than on exchange-based dealings. It is a well-known as Fiqh axiom that Gharar does not affect donation-based contracts. Permissibility of cooperative insurance can also be derived from several Verses of the Glorious Qur`an

(2) *"Sahih Muslim"*, *Kitab Al-Buyu'* [3: 115]; *"Sunan Abu Dawud"* [2: 22]), (H: 3376); *"Sunan Al-Nasa`i"* [2: 21]; *"Sunan Ibn Majah"* [2: 73]; *"Sunan Al-Tirmizi"* [3: 532]; *"Sunan Al-Darami"* [2: 16]); *"Al-Muwatta`"* [2: 66]); *"Musnad Ahmad"* [1: 201, 2: 367 and 397]; *"Sunan Al-Bayhaqi"* [5: 22]; and *"Musnnaf Ibn Abu Shaybah"* [8: 19], Part 2.

(3) See: *"Sharh Al-'Inayah Ma'a Fath Al-Qadir"* [5: 192]; *"Tabyin Al-Haqa`iq"* [4: 46]; *"Al-Taj Wa Al-Iklil"* [4: 36]; *"Fath Al-'Aziz Bi Hamish Al-Majmu'"* [8: 127]; *"Matalib Uli Al-Nuha"* [3: 25]; *"Al-Qawa'id Al-Nuraniyyah"*, (P. 166); and *"Nazariyyat Al-'Aqd"*, (P. 224). See also Sheikh Siddiq Al-Darir: His valuable book on *"Al-Gharar Wa Atharuhu Fi Al-Uqud"*, Salih Kamil Lil-Rasa`il Al-Jami'iyyah, (P. 54).

(4) See: Dr. Hussein Hamid: *"Al-Gharar"*, (P. 72).

and Prophetic Hadiths which instruct people to cooperate. In this regard, a number of resolutions have been issued by the Islamic Research Academy of Al-Azhar in addition to the Resolution of the Islamic Fiqh Academy -Makkah Al-Mukarramah and Resolution No. (9) 9/1 of the International Islamic Fiqh Academy which states: "Indeed, the contract which respects the origins of Islamic dealings is the cooperative insurance contract which is based on donation and cooperation…" Moreover, permissibility of cooperative insurance contract has never encountered dispute from any contemporary Fiqh scholar.(5)

In addition to what has been stated above, the underlying reasons for permissibility of solidarity reinsurance and impermissibility of commercial reinsurance can be summarized in the following essential differences between the two systems:

a) The commercial reinsurance company is an exchange-based financial contract which aims to make profit out of the reinsurance itself, and therefore should become subject to the rulings on exchange-based financial contracts which can be affected by Gharar. In the contrary, in solidarity reinsurance the contract is based on donation and cooperation and thus cannot be affected by Gharar when the contract involves it.

b) The company in the Islamic reinsurance contract is an agent of the reinsurance account, whereas in commercial reinsurance the company is a principal party who signs the contract in his own name.

c) The company in commercial reinsurance owns the reinsurance premiums against commitment to pay the reinsurance amount, while in Islamic reinsurance the company does not own the contributions, which are owned by the reinsurance account.

d) In Islamic reinsurance the remaining part of the contributions and the returns on it -after expenses and compensations- go to the account of the policyholders (such amounts represent the surplus distributed among participants), whereas this cannot be imagined in commercial

(5) A Fatwa issued by the Shari'ah Board of the Al Rajhi Banking Company for Investment, Fatwa No. (40).

reinsurance, because the contributions are owned by the company by virtue of the contract and through actual possession. The contributions in the case of commercial reinsurance are even considered as revenue and profit.

e) In Islamic reinsurance the returns earned from investment of the principal amount of the contributions go to the account of the policyholder after deduction of the Mudarib's share by the company, whereas in commercial reinsurance such returns go to the company.

f) Islamic reinsurance aims to achieve cooperation among the participating companies rather than profit, whereas commercial reinsurance aims to achieve profit from the reinsurance process itself.

g) In Islamic reinsurance the company makes profits by investment of its funds in addition to its share in the Mudarabah, as it assumes the role of the Mudarib and the reinsurance account assumes the role of Rab al-Mal.

h) In Islamic reinsurance companies the participant and the reinsurance client are in fact the same person even if legally considered as separate personalities, while in commercial reinsurance companies they are completely different.

i) An Islamic reinsurance company observes the rules of the Islamic Shari'ah and the Fatwas issued by its Shari'ah Supervisory Board, whereas the case is not so for commercial reinsurance companies.

j) When the allocations deducted from the solidarity reinsurance fund remain unpaid until the time of liquidation they are spent on charitable purposes and are not given to the participants, whereas in commercial reinsurance companies such funds go to participants.

- The Islamic reinsurance contract is considered as a binding donation contract, because it is analogous to Munahadah (contribution of travelers to a pool of food victuals) or to pledge of donation. Both of the Islamic Fiqh Academy of the Muslim World League and the International Islamic Fiqh Academy stipulated in their resolutions referred to earlier that Islamic reinsurance is based on donation.

The fact that the Islamic reinsurance contract is binding can also be derived from what has been emphasized by Imam Malik about donation. According to Imam Malik a gift in general becomes valid before possession, and this was also said to have been the viewpoint of Ali and Ibn Masood. The Hanbali scholars hold that a gift is binding even if it is not possessed, except in things that are measured in terms of volume and weight.(6) Ibn Rushd (the grandson) said: "Scholars were in disagreement regarding possession…Malik said: "The contract is valid on acceptance, and possession of the gift should be enforced quite like the case in sale…"(7)

Ali and Ibn Mas'ud are reported to have said: *"Gift is permissible if it is known, whether it is possessed or not"*. It is also reported that Abu Bakar and Omar considered the gift to be binding only when it is possessed.(8) Therefore, Malik seems to have taken all these viewpoints into consideration. He derived from the viewpoint of Ali, Ibn Masood and the others that the contract as such is binding, whereas he took the viewpoint of Abu Bakar and Omar to mean that possession is a necessary condition for completion of the contract so as to leave no room for the Dhari'ah (excuse) mentioned by Umar.(9)

The fact that a pledge of donation is binding can also be derived from the Hadith of the Prophet (peace be upon him) who said: *"The person who retreats from a gift that he offers is like the dog which licks up its vomit"*.(10)

- The ruling that the company, which assumes the role of the agent in Islamic reinsurance, should not guarantee is based on the unanimous agreement among Fiqh scholars that an agent should not guarantee except in case of transgression, negligence or breach of the contract.
- The necessity of mentioning the nine principles of Islamic reinsurance in the articles of association of the company stems from the need for reinforcing the donative nature of the contract and laying the Shari'ah foundation

(6) *"Bidayat Al-Mujtahid"* [2: 53]); *"Al-Mughni"* by Ibn Qudamah [5: 64]). See also: *"Bada`i' Al-Sana`i'"* [8: 3960]; and *"Al-Ghayah Al-Quswa"* [2: 655].
(7) *"Bidayat Al-Mujtahid"* [2: 534].
(8) See: *"Al-Muwatta'"* [2: 46]; and *"Nasb Al-Rayah"* [4: 12].
(9) "Bidayat Al-Mujtahid" [2/53]).
(10) *"Sahih Al-Bukhari"* [5: 19]; and *"Sahih Muslim"* (H: 1622).

for this important aspect of the company. In the absence of emphasis on these principles which distinguish Islamic reinsurance from commercial reinsurance, Islamic reinsurance may become an exchange-based reinsurance contract, and hence becomes vulnerable to nullification by Gharar, as has been indicated earlier. For illustration of these distinguishing principles of Islamic reinsurance, several Fatwas have been issued including: Fatwa No. (12/11) issued by the 12th Al Baraka Seminar on Islamic Economics, and Fatwa No. (42/3) issued by the Shari'ah Supervisory Board of Al Rajhi Company, as well as the Fatwas of the Shari'ah Supervisory Board of Faisal Islamic Bank, Islamic Insurance company –Jordan-(11) and Islamic Insurance Company of Qatar.

- The basic elements and conditions of the Islamic reinsurance contract are derived from its nature as a contract which is binding to the two parties in addition to the special nature of the insurance contract with regard to the subject matter of insurance.
- The reinsurer and the client should honor their commitments because the reinsurance contract is binding to both parties. According to Shari'ah, the two parties should honor what they agree upon as long as it does not contradict with the rules and principles of Islamic Shari'ah. This can be derived from the Quranic Verses and Hadiths which instruct people to observe commitments and conditions they agree upon, including the Verse: ***{"O you who believe! Fulfill (your) obligations"}***(12) and the Hadith of the Prophet (peace be upon him) who said: *"Muslims are at their conditions"*.(13)
- The basis of the ruling that the reinsurance company may assume the responsibility of managing the reinsurance account against a fee or free of charge is the nature of the agency (Wakalah) contract which Fiqh scholars unanimously declare as permissible with or without remuneration. This point of view is supported by the 12th Al Baraka Seminar on Islamic

(11) See: *"Fatawa Al-Ta`min"*, Dallah Al Baraka Group, reviewed by Dr. Abd Al-Sattar Abu Guddah and Dr. Ezz Al-Din Mohammad Khojah, (pp. 99-108).

(12) [Al-Ma`dah (The table):1].

(13) Related by Al-Bukhari with dogmatizing comments from his side: *"Fath Al-Bari"* [4: 251]; *"Al-Tirmidhi"* - with *"Tuhfat Al-Ahwazi"* [4: 584] and he said a good and authentic Hadith.

Economics (Fatwa No. 12/11), the Islamic Fiqh Academy of the Muslim World League (Fatwa No. 961) and the Supreme Council of Ulama of the Kingdom of Saudi Arabia (Fatwa No. 51).

- Permissibility for the company to invest the funds of the reinsurance account is based on the Mudarabah contract which Fiqh scholars unanimously declare as permissible. Such contract entails prior specification of profit sharing ratios so that the reinsurance account can get its share of the profit as indicated by a number of Fatwas including: Fatwa of the Shari'ah Supervisory Board of Faisal Islamic Bank,(14) Fatwa No. 12/11 of the 12th Seminar of Al Baraka and Shari'ah Standard No. (13) on Mudarabah.
- Necessity of observing conditions in general, including commitment of the company to present Qard Hasan (benevolent loan) to the reinsurance account, is based on the commitment to honor pledges that are binding to only one party of the contract. Honoring such pledges is emphasized by a number of distinguished Fiqh scholars, and is well supported by Shari'ah Texts and Traditions. One of these texts is the Verse: ***{"O you who believe! Fulfill (your) obligations"}***, which is taken to mean any Shari'ah-acceptable commitment. Several Hadiths have also indicated enforceability of honoring contracts, pledges and promises.(15) In this respect also Fiqh Academies and Shari'ah Supervisory Boards have issued resolutions including: Resolution No. (40-41) 2-3/5(16) of the International Islamic Fiqh Academy, and the Fatwa of the Shari'ah Supervisory Board of the Islamic Insurance Company –Jordan.(17)
- The ruling that the participant should bear the burden of proving, is based on application of the general rules of evidence which state that evidence is to be provided by the alleger. This rule is supported by explicit indications from the Qur`an and the Sunnah and the viewpoints of knowledgeable Fiqh scholars. A Fatwa in this regard has also been issued by the consolidated Shari'ah Supervisory Board of Al Baraka (Fatwa No. 14/6).

(14) See: The Book titled *"Al-Mudarabah Fi Kutub Al-Madhahib Al-Fiqhiyyah"*; and *"Al-Mawsu'ah Al-Kuwaytiyyah"*, the term Mudarabah.

(15) For more details see: *"Mabda` Al-Rida Fi Al-'Uqud"*, a comparative study [2: 1161] and its reliable references.

(16) See the Journal of the Academy, No. (5) 2/754-965.

(17) *"Fatawa Al-Ta`min"*, (P. 106).

- The basis of permissibility of the two types of reinsurance is the various evidences of permissibility of insurance and the Fatwas issued by the 2nd Seminar of Al Baraka (Fatwa No. 2/9), the 10th Seminar of Al Baraka (Fatwa No. 10/3/5), and the Fatwas of the Shari'ah Supervisory Boards of Dubai Islamic Bank, Faisal Islamic Bank, Kuwait Finance House, Qatar Islamic Bank and the Islamic Insurance Company.(18)
- The basis of the rulings relating to the Islamic insurance and reinsurance contract is the general principles of contracts in the Islamic Shari'ah such as forbiddance of cheating and fraud, and necessity of commitment to the time specified for implementation of contracts. In addition to these general principles, the insurance and reinsurance contracts are also based on specific rulings pertaining to insurance coverage indicated by the Resolutions and Fatwas issued by the Islamic Fiqh Academy of the Muslim World League, the Supreme Council of Ulema and the Shari'ah Supervisory Boards of Islamic banks and Islamic insurance companies.(19)
- The jurisdictions of the company are based on its articles of association, the documents which regulate the contract, the general principles of contracts and conditions, insurance practices and the Fatwas issued by Shari'ah Supervisory Boards.(20)
- The rulings that relate to regulation of the relationship between the company and the policyholders are based on the articles of association of the company which specify whether the contract is a fee-based agency or not, in addition to the Mudarabah contract regarding the reinsurance fund.
- The reinsurance coverage is based on the general texts affirming the Hadith which states: *"No harm and no reciprocal harm"*(21) and the general rules and principles of Islamic Fiqh which stipulate that coverage should be for the actual harms and not at all for making a wealth out of it. The reinsurance coverage is also governed by the donative nature of the Islamic reinsurance contract and the Fatwas issued by competent bodies such as

(18) *"Fatawa Al-Ta`min"*, (pp. 193 -206).
(19) Ibid.
(20) Ibid.
(21) This is a Hadith narrated by Malik in *"Al-Muwatta`"*, *Kitab Al-Aqdiyah*, (P. 464); *"Musnad Ahmad"* [1: 313 and 5: 527]; and Ibn Majah in his *"Hashiyah"* [2: 784].

Fatwa No. (3) of the 10th Seminar of Al Baraka and the Fatwas issued by the Shari'ah Supervisory Boards of Islamic banks and insurance companies.(22)

- The reinsurance surplus is based on the nature of the donation-based contract and what has been reported by Al-Bukhari about the practice of the Sahabah (companions of the Prophet, peace be upon him) in the case of Munahadah.(23)
- Permissibility of reinsurance with traditional reinsurance companies is based on the practical necessity arising from lack for Islamic reinsurance coverage and the dire public need which ranks up as necessity. Shari'ah recognition for necessity and dire public need is supported by a number of Texts in the Qur`an and the Sunnah. In this respect also a Fatwa has been issued by Faisal Islamic Bank of Sudan (Fatwa No. 5/3).

(22) *"Fatawa Al-Ta`min"*, (P. 153).

(23) Al-Bukhari stated in his *"Sahih"* with *"Fath Al-Bari"* [5: 12]), *Bab Al-Sharikah Fi Al-Ta'am Wa Al-Nihd Wa Al-'Urud* …because Muslims did not see any harm in Nihd, of which each of them used to eat a part, and he mentioned some Hadiths indicating what he had stated. In his Book *"Fath Al-Bari"* [5: 129], Ibn Hajar said: "Nihd is a practice in which all the people in companionship (on travel) provide the food. Each of them contributes the same quantity, yet some may consume more than others, even though, the remaining food is shared among them if they do not decide to keep it for another journey". This is exactly the reinsurance surplus, or quite similar to it.

# Appendix (C)
# Definitions

**Reinsurance**

The reinsurance contract is a contract according to which the insurance company transfers part of the risks of its insurance commitments to the reinsurance company. The insurance company, therefore, undertakes to pay to the reinsurance company part of the insurance premium paid by the participants, against commitment of the reinsurance company to bear part of the claims as per an agreement between the two parties. Islamic reinsurance has the distinctive characteristic of being based on the same principles of solidarity insurance, as indicated in Shari'ah Standard No. (26) on Islamic Insurance.

**Special Need**

Something that concerns a certain group of people, or the employees of a certain profession, as for instance the need for insurance for the employees in trade and industry sectors.

**Public Need**

Something that does not concern a certain group of people, or a certain country. Public need is the need that concerns everybody such as the need for Istisna'a.

**Reinsurance Commission**

A percentage amount of the contributions payable to the reinsurance company, paid to the Islamic insurance company for the efforts it exerts in mobilizing the reinsured insurance contracts.

**Reinsurance Profit Commission**

A percentage amount of the realized increase of revenues over expenses in the reinsurance agreement, paid to the Islamic insurance company as

a bonus for its excellent performance in managing the insurance operations in general, and the reinsured risks in particular.

**Risk-Sharing Reinsurance**

The process of sharing the insured risk between the Islamic insurance company and other insurance companies, either due to lack of sufficient insurance capacity for such risk, or because of regulatory requirements of risk sharing with regard to the magnitude of the risk in question.

**Financial Gains of Islamic Insurance Companies from Traditional Reinsurance Companies**

Reinsurance agreements between traditional reinsurance companies and Islamic insurance companies lead to the following financial gains to Islamic insurance companies:

- **Compensations for harms**; the reinsurance company bears a percentage of the risk cover -when the harm materializes- commensurate to the percentage of its share from insurance contributions.
- **Reinsurance commission**; which is a percentage amount of the contributions payable to the reinsurance company, paid to the Islamic insurance company for the efforts it exerts in mobilizing the reinsured insurance contracts.
- **Reinsurance profit commission**; which refers to a percentage amount of the realized increase of revenues (reinsurance contributions) over expenses in the reinsurance agreement (coverage), paid to the Islamic insurance company as a bonus for its excellent performance in managing the insurance operations in general and the reinsured risks in particular, and providing the best services to its customers. Such amount is paid in the form of an agreed upon percentage of the profits of the reinsurance company, as per the reinsurance agreement signed between the two companies. When the reinsurance company earns profits from the reinsurance contracts signed between the two companies, the reinsurance company pays the part of the profits agreed upon to the insurance company.

# Appendix (D)
# A Model Reinsurance Agreement Issued by Islamic Insurance Company – Jordan

1. The insurance company agrees with the reinsurance company on signing annual agreements with the aim of transferring part of the risk borne by the insurance company, to the reinsurance company.
2. The insurance company assumes beforehand commitment to transfer to the reinsurer the agreed upon part of the reinsured risk, and the reinsurer offers his acceptance. According to the conditions of the reinsurance agreements, the commitment of the reinsurer becomes valid since the time of signing the original insurance contract with the insurance client.
3. The insurance company assumes the commitment to pay the reinsurance contribution against the commitment of the reinsurer to pay its share of the claims, in addition to the commissions agreed upon for the contracts within the signed agreements. It can also be stipulated in the agreement that the insurance company shall obtain a share in the profits achieved by the reinsurer under the signed agreements.
4. The insurance company retains a percentage of the reinsurance contributions (40%) for fire agreements, general accidents and marine and health insurance, as a guarantee for honoring commitments from the side of the reinsurer. The amount thus retained is to be released after one year within the reinsurance agreement. During the period of its retention, the amount is to be invested with the Islamic Bank of Jordan through Shari'ah-acceptable modes of investment, and the reinsurer be given the part of the return agreed upon.
5. The return thus obtained by the reinsurer becomes part of his accounts, and is deductable from the commissions to be received from him, on the

basis of the fact that such amount is part of the cost of the reinsurance operation.

6. The reinsurer assumes the commitment to pay commission to the insurance company. Such commission is determined as a certain percentage of the reinsurance contributions. This amount does not represent a commission in the strict sense of the word. It is rather a contribution from the part of the reinsurer in the direct expenses borne by the insurance company, and which relate to the reinsured risks.
7. Such commissions enter into the accounts of policyholders as part of revenues in the account of the cooperative insurance fund.
8. The reinsurance agreement normally stipulates the right of the insurance company to obtain a specific percentage of the net profits achieved by the reinsurer under the reinsurance agreement.
9. Reinsurance profit commission is calculated at the end of the agreement period, and enters into the accounts of the policyholders as part of revenues.

Shari'ah Standard No. (42)

# Financial Rights and How They Are Exercised and Transferred

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to describe the rules relating to financial rights, how they are exercised and transferred and the mechanisms used to protect them as well as to highlight certain rights exercised in the transactions of Islamic financial institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard provides a description of financial rights, their types, rules, conditions, parameters, the way they are exercised and transferred and the mechanisms used to protect them. It also addresses the most important rights exercised in the transactions of financial institutions.

This Standard does not cover non-financial rights; *Khiyarat* (options to terminate a contract); e.g., *Khiyar al-Shart* (an option stipulated by the parties giving one or both of them the right to revoke the contract within a specified period of time) and *Khiyar al-Naqd* (an option giving the seller the right to revoke the contract for non-payment within a specified time etc.); or rights relating to Waqf (endowments), as they have already been covered in separate standards.

## 2. Definition of Financial Rights

A financial right is the prerogative of a (natural or artificial) person recognized by the Shari'ah to have rights and responsibilities and the legal capacity to enter into transactions.

## 3. Types of Financial Rights

Financial rights are of three types:

3/1 Personal rights (rights in personam): These are rights arising from the liability of another person, such as debts payable by a debtor.

3/2 Proprietary rights (rights in rem): These are rights attached to specific property conferring to the owner direct authority over it without interference from another person, whether such rights are primary or secondary.

3/2/1 Primary proprietary rights, such as rights arising from full and complete ownership, are independent rights that do not rely on the existence of any other right.

3/2/2 Secondary proprietary rights; these are proprietary rights that have no purpose of their own except to protect the fulfillment of personal rights, such as the rights of a creditor in security provided by an obligor.

3/2/3 The distinction between proprietary and personal rights: The owner of a proprietary right is able to directly enforce his right to specific property using permissible means. The owner of a personal right, on the other hand, cannot enforce his right by claiming any specific property.

3/3 Rights to intangible assets:

3/3/1 These are financial rights to intangible assets, whereby the owner is exclusively entitled to their output.

3/3/2 Types of rights to intangible assets: Rights to intangible assets are of many kinds, including rights to trade name, trading addresses, trademarks, commercial licenses; intellectual property, technical and industrial know-how, patents and copyrights.

3/3/3 Rules governing rights to intangible assets:

3/3/3/1 Rights to trade names, trading addresses, trademarks, copyrights, inventions and patents are the rights of their respective owners. These possess recognised monetary value in contemporary business and commercial custom. Since these rights are recognised and protected by the Shari'ah , it is not permissible to violate them.

3/3/3/2 Since rights to intangible assets are recognised as financial rights, it is permissible to dispose of or transfer them for consideration provided that such transactions are free of Gharar (ambiguity), deception and fraud.

3/3/3/3 Commercial license: A commercial license is a right given by the relevant authority to certain businesses to engage in specified activities. It is permissible for the license holder to dispose of it for or without consideration unless specifically prohibited by law.

3/4 Financial rights can be acquired by contract, stipulated conditions, inheritance or court order. Financial rights may be established by long-standing continuous use without objection or first use subject to fulfillment of all the Shari'ah conditions required for the acquisition of such rights.

**4. Rights Resulting from Ownership**

4/1 Ownership of an asset or usufruct gives the owner the right of complete disposition, either by a complete transfer or the transfer of usufruct only, for or without consideration, except what is prohibited by the Shari'ah.

4/2 Ownership of usufruct entitles the owner to use it (whether directly or indirectly through another person) subject to compliance with the terms stipulated by the owner of the asset and bearing liability for the asset in case of misuse, negligence or breach of condition.

4/3 Ownership of a license to use gives the licensee the right to personal use only which cannot be transferred to a third party.

**5. Easements**

5/1 Private easements are established rights attached to one real estate property over another, such as irrigation rights, watercourse rights, drainage rights and rights of passage.

5/2 Public easements are the rights of the general public to benefit from public utilities provided by the state and similar entities.

5/2/1 The right of an individual to a public easement is restricted to personal use only.

**6. Financial Rights Arising from Neighbourhood**

6/1 The rights of neighbourhood based on the ownership of different floors of a building prohibit each owner to act in a manner that will definitely or most likely cause harm to others.

6/2 Since the owners of different floors of a building co-ownership in the underlying land, the following apply:

6/2/1 If a lower storey collapses due to any fault of its owner, he is liable to reconstruct it so that the owners of the upper-storeys are not harmed.

6/2/2 If the owner of the lower storey is not responsible for the collapse, the courts have decisive authority to settle the matter in the best interests of both parties and to avert harm from them.

6/2/3 The owners have the right to enjoy use of common facilities and services.

**7. Right of Shuf'ah (Preemption)**

7/1 Definition of Shuf'a (preemption): Shuf'a is the right given to a neighbour or co-owner of real estate property to acquire a sold property from its buyer with or without their consent for the price at which it was sold.

7/1/1 The right of Shuf'ah exists only in relation to immovable property or movable property attached to it.

7/1/2 The right of Shuf'ah enjoyed by a neighbour is applicable only when the two properties share common easement rights.

7/2 Rules of Shuf'ah

7/2/1 The Shafi' (preemptor) takes the place of the buyer and, subject to circumstances being equal, enjoys the right to purchase the property on the same terms as contracted with the buyer, such as deferred payment. The Shafi' (preemptor) assumes all also the liabilities of the buyer such as the usual conveyancing costs.

7/2/2 If in a jointly owned property, there are more than one Shufa'a`(preemptors), each has the right of Shuf'ah proportionate to his share in the property.

7/2/3 Rights of Shuf'a are not extinguished upon the death of the Shafi' (preemptor) but are inherited by his heirs.

7/2/4 Rights of Shuf'ah must be claimed immediately upon becoming aware of the sale in accordance with custom or law, failing which they lapse.

7/2/5 The Shafi' (preemptor) is entitled to invalidate all the dispositions of the preempted property that were made prior to the exercise of the right of Shuf'ah , even if it has changed hands.

7/2/6 There is no right of Shuf'ah where ownership is transferred without a sale or a transaction having the effect of a sale. Therefore, there is no right of Shuf'ah where transfer is effected by inheritance, bequest or gift without consideration.

## 8. Right of Occupancy

Occupancy is a right based on the right of the tenant to retain his tenancy in property or commercial unit.

Occupancy has a number of forms:

8/1 The Shari'ah does not prohibit the owner and the tenant agreeing that the tenant will pay a lump sum of money over and above the periodic rental amount, on condition that it is considered part of the agreed rent for the entire lease period. If the lease is terminated early, the rules applicable to rental payments apply to this amount.

8/2 It is permitted by the Shari'ah for the owner and the tenant to agree during the lease period that the owner will pay an amount to the tenant in exchange of the tenant waiving his contractual right to the ownership of the usufruct for the remaining period on the basis that such payment compensates the tenant for waiver of his right to the usufruct that he purchased from the owner. However, if the lease period expires and the contract is not renewed, either expressly or by operation of a provision for automatic renewal, then it is not permitted to take payment for vacating the premises, and the owner has the right to take back his property after expiry of the term.

8/3 The Shari'ah permits an agreement between the incumbent tenant and a new tenant during the lease period to assign the lease for an amount exceeding the regular rental amount for release of occupancy subject to the requirements of the terms and conditions of the original lease

contract and applicable laws that are compliant with the rules of the Shari'ah.

In long-term lease contracts, contrary to contractual terms that are based on what is permitted by the laws of some jurisdictions, the Shari'ah does not permit the tenant to sub-lease or assign the property to another tenant in return for payment except with the agreement of the owner.

If the incumbent tenant agrees to hand over occupancy to a new tenant after the end of the lease period, the Shari'ah does not permit him to take any payment because the right of the incumbent tenant in the usufruct has expired.

**9. Right of Tahjir**

9/1 Tahjir means taking possession of a piece of land and marking it with certain recognised markers with the permission of the government.

9/2 Tahjir results in exclusivity and priority over others, but it does not on its own confer ownership.

9/3 A person who has carried out Tahjir on a piece of land is permitted to waive his entitlement in favour of another person for consideration, but he is not allowed to sell the land as he does not yet own it.

9/4 The right of Tahjir expires if the land is not utilised for three years, or as provided by applicable regulations.

**10. Transfer of Rights for Consideration**

10/1 It is not permissible to take consideration for transfer of put or call option rights, whether by means of sale or otherwise.

10/2 It is not permissible to take consideration for transfer or waiver of rights granted only to prevent harm, such as the right of Shuf'ah (preemption).

10/3 It is permissible to take consideration for transfer or waiver of easement rights, by means of sale or otherwise.

10/4 It is permissible to sell rights to use and rights arising from first use.

## 11. How Rights Are Exercised and Transferred

11/1 All financial rights are in principle disposable, and the owner of a financial right has the absolute right to exercise and transfer his right in accordance with the rules and principles of the Shari'ah and in particular, the following:

11/1/1 Rights should not be exercised in a manner abuse to others.

11/1/2 The public interest is given priority when it conflicts with the exercise of a private property right.

11/2 Subject to the provisions of this Standard, the constructive methods of disposal of rights include all types of contracts of exchange, donations, waivers, partnerships, and assignments of rights. [see Standard No. (7) on Hawalah]

## 12. Protection of Rights

12/1 Rights are to be protected from any violation.

12/2 In addition to the provisions of Shari'ah Standard No. (5) on Guarantees, the methods of protecting financial rights include:

a) Rights do not extinguished by passage of time but there can be a limitation period after which a claim cannot be made in court.

b) Right of lien: A creditor has the right to retain the debtor's property already in his possession until he receives payment of the due debt from the debtor. This may take several forms:

I. The right of the seller to retain the sold item until he receives the due price.

II. The right of a manufacturer or worker to retain the product of their work until they receive the payment due.

III. The right of the lessor to retain the lessee's property inside the leased asset until he receives the rent due, because the lessor has possession of the leased asset which contains the lessee's property.

IV. The right of a courier to retain the dispatched property until he receives his fees.

V. The right of a bailee to retain the bailed property until he receives his fee.

VI. The right of an agent to retain the property of the principal until he receives his agency fee.

c) If the buyer of an item becomes insolvent and the seller finds that specific item in the insolvency assets, the seller has a priority proprietary right to it if the applicable regulations of a jurisdiction allow it. Refer to Shari'ah Standard No. (43) on Insolvency.

## 13. Some Rules Governing Contemporary Applications of the Transfer and Exercise of Financial Rights

13/1 It is permitted for corporate bylaws to give existing shareholders priority over third parties to subscribe for shares upon a decision to increase the company's share capital. Each shareholder is entitled to subscribe in proportion to his respective share prior to the share issuance.

13/2 It is permissible to assign a right of priority referred to in item 13/1 to a third party without consideration, subject to the provisions of the law and the rules of company supervisory bodies.

## 14. Date of Issuance of the Standard

This Standard was issued on 4 Dhul-Qa'dah 1430 A.H., corresponding to 23 October 2009 A.D.

# Adoption of the Standard

The Shari'ah Board has adopted the Standard on Financial Rights and How they are Exercised and Transferred in its meeting No. (25) held during the period of 2-4 Dhul-Qa'dah 1430 A.H., corresponding to 21-23 October 2009 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 13 Shawwal 1425 A.H., corresponding to 25 November 2004 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Financial Rights and How They Are Exercised and Transferred.

In its meeting held on 4 Sha'ban 1426 A.H., corresponding to 8 September 2005 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on on Financial Rights and How They Are Exercised and Transferred and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its meeting No. (16) held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia, during the period of 7-12 Jumada I, 1427 A.H., corresponding to 3-9 June 2006 A.D. It became clear that the issue needed further study to deal with some Shari'ah aspects.

The General Secretariat commissioned a Shari'ah consultant to prepare a juristic study on Financial Rights and Their Disposition (to be presented) on 14 Jumada II, 1430 A.H., corresponding to 7 June 2009 A.D.

The General Secretariat held a public hearing, and all the comments made in the public hearing were listened to, and the members of the Shari'ah Board answered these comments and made commentary on them.

In its meeting No. (25) held in Bahrain during the period of 2-4 Dhul-Qa'dah 1430 A.H., corresponding to 21-23 October 2009 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated the necessary amendments that it deemed appropriate, and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for the recognition of financial rights is recognised jurisprudential evidences from the Qur`an, Sunnah, Ijma' and Qiyas that indicate the right of ownership.
- The basis for the rules governing rights to intangible assets is the Resolution of the International Islamic Fiqh Academy No. (43) 5/5 affirming, from established proofs, their existence and the rules governing them, which are the basis for the resolution.
- The basis for the distinction between proprietary rights and personal rights is the view of contemporary jurists that Islamic jurisprudence has recognised this distinction in all matters that require such distinction.(2)
- The basis for the recognition of rights, whether to tangible or intangible assets is the saying of the Prophet (peace be upon him): *"No harm and no reciprocal harm"*.(3)
- The basis for the right of Shuf'a enjoyed by a partner or a neighbour is the practice of the Prophet (peace be upon him). Jabir Ibn Abdullah (may Allah be pleased with him) narrated: *"Allah's Messenger (peace be upon him) ruled in favor of the right of Shuf'ah so long as the property is not divided"*.(4) Abu Salamah Ibn Abdul-Rahman narrated: *"The Prophet (peace be upon him) ruled in favor of the right of Shuf'ah in property that has not been divided among the partners. If boundaries have been assigned between them and the paths have been demarcated, then there is no right of Shuf'ah"*.(5) In the narration related by Muslim: *"The Prophet (peace be upon him) ruled in favor of the right of Shuf'ah in any undivided co-ownership, whether in a*

(2) See Mustafa Al-Zarqa: *"Al-Madkhal Ila Nazariyyat Al-Iltizam"*.
(3) The Hadith has been related by Malik in *"Al-Muwatta`"* (P. 464); *"Musnad Ahmad"* [1: 313], and *"Sunan Ibn Majah"* [2: 784].
(4) *"Sahih Al-Bukhari"*, (H: 2257).
(5) *"Al-Muwatta"*, (H: 1420).

*piece of land or an orchard. A co-owner is not allowed to sell his share unless permitted by the other co-owners. If the co-owner wants, he can buy it. If he wants, he can leave it. But if one co-owner sells it without permission of the other co-owners, then they have a greater right to it".*(6) Qatadah narrated that the Prophet (peace be upon him) said: *"The neighbour of the house has a greater right to the house".*(7) These two Hadiths are reconciled by ascribing the last Hadith to a neighbour who is also a co-owner or shares easement rights.

- The basis for the right to a share of water is Allah's Statement in the Qur`an: ***{"Here is a she-camel: It has a right to drink (water), and you have a right to drink (water), (each) on a day, known"}.***(8) There is also Allah's Statement in the Qur`an: "And inform them that the water is to be shared between them. Each one should drink in turn".(9) In Shari'ah, it means a turn to utilise water for land or trees or crops. Related Shari'ah terms are the right of Shirb, which is specifically for watering crops and trees; the right of Shafah, which is specifically the right of humans and animals to drink as well as using water for purposes like ablution, bathing, etc.(10) There is a special set of rules for water in the Shari'ah based upon the statement of the Prophet (peace be upon him): *"People share in three things: water, pasturage and fire".*(11)
- The basis for the right of Tahjir and the rights established by first use is the Sunnah. Ibn Qudamah states: "Anyone who carries out Tahjir of previously unappropriated land and begins to make it productive but did not complete it, he is more entitled to it than others, based upon the statement of the Prophet (peace be upon him): *"Anyone who first uses what no other Muslim has previously used is more entitled to it".* If he transfers it to someone else, then the second person is more entitled to it than others because the first owner of the right has granted it to him. If the owner of the right dies, it transfers to his heirs, based on the statement of the

(6) *"Sahih Muslim"* (H: 1608).
(7) *"Sahih al-Bukhari"* with *"Fath Al-Bari"* [12: 345].
(8) [Al-Shu'ara (The Poets): 155].
(9) [Al-Qamar (The Moon): 28].
(10) Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 188-192].
(11) *"Musnad Ahmad"* [5: 364].

Prophet (peace be upon him): *"The heirs of a deceased person inherit his estate"*. However, it is not permitted for the owner of a right of Tahjir to sell it because his entitlement is confined to his personal use like the right of Shuf'ah (preemption). [An alternative view is that] its sale could be considered valid because he is more entitled to it.(12) Al-Mardawi states: "Anyone carrying out Tahjir over previously unappropriated land will not own it…but he is more entitled to it than others, as well as his heirs after him and whomever he transfers it to, without any dispute. However, he cannot sell it, and this is the position of our School. It has also been said that he may sell it. Abu Khattab mentioned it as a possibility, and he referred to its permissibility as the correct position without any qualification in *"Al-Muharrar"*, *"Al-Ri'ayatayn"* and *"Al-Hawi Al-Saghir"*.(13)

- The basis for the prohibition of abusive exercise of rights is deduction from the Qur`an and Sunnah. There are many Verses in the Qur`an which indicate the obligation of justice, fairness and refraining from exercising one's rights in a way that harms others. Allah commands: ***{"Show forgiveness, enjoin what is good, and turn away from the foolish"}***.(14) As for the Sunnah, we find the following Hadith: *"May Allah bless the person who is lenient in selling and buying and when demanding his right"*.
- The basis for the invalidity of a condition stipulating that the seller retains ownership in a sale contract is that the transfer of ownership is a legal effect of the sale contract. Therefore, it is not permissible for a sale to take place without it. This has also been stressed in Resolution No. (51) 6/2 of the International Islamic Fiqh Academy held in Jeddah, which states: "The seller is not entitled to retain ownership of the sold item after the sale, but it is permissible for him to stipulate a condition on the buyer to retain possession of the item as security against deferred installments."
- The basis for the right of retention is the Qur`an and Sunnah. As for the Qur`an, it is stated by Allah: ***"And if you punish, then punish them with the like of that with which you were afflected. But if you endure patient-***

(12) Ibn Qudamah, *"Al-Kafi"* [2: 394].
(13) Al-Mardawi, *"Al-Insaf"* [6: 373 and 374].
(14) [Al-A'raf (The Heights):199].

***ly, verily, it is better for those who are patient"***.[15] The Glorious Verse indicates the permissibility of reciprocal treatment. Based on this, it is permissible for a person to retain his property unless he receives his own rights from others. As for the Sunnah, it was narrated that the Prophet (peace be upon him) said: *"The best amongst you is the one who is best in settlement of his obligations"*.[16]

- The basis for the impermissibility of taking consideration for sale or transfer of put or call options is Resolution No. (63) 7/1 of the International Islamic Fiqh Academy, which is based on recognised evidences.
- The basis for the impermissibility of selling the abstract rights mentioned in item 10 is the lack of monetary value [according to Shari'ah] as well as the presence of Gharar (uncertainty)and Jahalah (ambiguity).

(15) [Al-Nahal (The Bees): 126].
(16) *"Sunan Al-Nasai"*, printed with Suyuti's Commentary, (P. 318).

# Appendix (C)
# Definitions

**Right of Easement**

It is the established right over one piece of real estate for the benefit of another piece of real estate.

**Right of Irrigation (Shirb)**

Shirb literally means a share in water. The Shari'ah definition is a turn to irrigate land or trees or crops.

**Right of Watercourse (Majra)**

It is the right of an owner of land distant from a watercourse to bring it via the property of his neighbour to his land to irrigate it.

**Right of Drainage (Masil)**

It is the right of a person to get rid of excess water in his property via the property of another person. Watercourse is different from drainage in that watercourse is in order to bring water whereas drainage is to get rid of water not needed for the land.

**Right of Way Easement (Murur)**

It is the right of the owner of an interior piece of land (land surrounded by other persons' lands) to access his land by means of a road/path. It makes no difference if the road/path is public, not owned by anyone, or is privately owned by someone.

**Right of Ascendancy (Ta'alli)**

The right of ascendancy means one person's right to have his structure be physically located above the structure of another person. This happens in multi- storey buildings in which one person owns a unit in a lower storey and another owns a unit in the storey above it.

**Preemption**

Preemption in the terminology of jurists means the entitlement of the partner to buy what his partner has sold for the price at which he sold it.

**Intangible Rights**

Intangible right is the authority of a person over something that is abstract, e.g., ideas and inventions. The International Islamic Fiqh Academy, headquartered in Jeddah, issued its Resolution No. (43) 5/5 on the subject of intangible rights, which include; Trade Name, Title, Trademark, Authorship, and Invention. The Academy considered these to be rights particular to their respective owners which have established financial value. Consequently, these rights are recognized by the Shari'ah and they should not be violated.

**Right of Utilization (Intifa')**

The right of utilization is a juridical concept that refers to a person's temporary right over the asset of another person, who authorizes him to use it, exploit it, and dispose of its usufruct, but not the asset itself, during the period of utilization. The majority of jurists, including the Shafi'is, Malikis and Hanbalis, distinguish between the ownership of usufruct (Manfa'ah) and ownership of utilization (Intifa'). Granting ownership of utilization (Intifa') only allows a person to directly utilise [the asset]. Granting ownership of usufruct (Manfa'ah) is more general and comprehensive; it allows its owner to use the asset himself or to enable others to use it, either for compensation, as in a lease, or without compensation, as in gratuitous lending of the asset.

**Right of Exclusive Lease (Hikar)**

Hikar is the right to lease the land of an endowment for a long period of time. The Mustahkir (exclusive lessee) makes an advance payment to the endowment which is nearly equal to the price of the land that is used to develop it or for the maintenance of its premises. Another, insignificant, amount is arranged to be paid annually to the endowment by the Mustahkir (exclusive lessee) or by whosoever this right has been transferred to.

**Right of Priority in Subscribing to an Increase in a Company's Capital**

It is the stipulation that the existing shareholders will have the right of priority in subscribing to an increase in the company's capital by purchasing shares at their nominal value

**Vacating Houses or Shops**

It refers to the right to stay in a house or shop.

**Business License**

It is a right granted by the authorities to some traders to deal in specific activities.

**Right of Demarcation**

It means taking possession of a piece of land and marking it with markers or a wall. Demarcation confers privilege and precedence over others. It means that whosoever demarks land is more entitled to develop it; however, it does not confer ownership.

**Disposal**

Disposal is the competence approved by the Shari'ah , or custom, or law that enables the owner of rights to dispose of them. This disposal can either be by transferring his right to others for recompense; e.g., sale or barter, or without recompense; e.g., gift, will, or by relinquishment.

**Abusive Use of a Right**

It the use of a right in such a way that it is likely to cause serious extraordinary harm to another.

**Expiry**

It is the lapse of a right due to the passage of time. However, in the Shari'h, rights do not lapse due to the mere passage of time.

## Shari'ah Standard No. (43)

# Insolvency

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to describe the rules of insolvency and the circumstances that precede it, whether they are faced by the institutions, companies or individuals, both businessmen and non-businessmen, with whom financial institutions(1) deal.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the Shari'ah rules relating to the causes and consequences of insolvency, whether faced by an institution or its institutional or individual business and non-business customers. It also addresses the judicial declaration of insolvency over an institution and its consequences, and in particular, the sale of its assets, the distribution of the proceeds among the creditors and how insolvency is revoked.

It does not cover financial difficulties (as defined by Islamic jurisprudence), liquidity shortfalls or delays in payment that do not lead to a declaration of insolvency.

## 2. Definitions of Insolvency and the Declaration of Insolvency

Insolvency (Iflas): When the debt due of a person exceeds his assets.

Declaration of insolvency (Taflees): A judge's declaration that a debtor is insolvent, preventing him from disposing of his assets.

## 3. Shari'ah Ruling on Insolvency

3/1 A person whose debts exceed his assets has a moral obligation in Shari'ah to refrain from any action that may harm the creditors, even if he has not been declared insolvent.

3/2 The competent authorities should declare a person insolvent when his debts exceed his assets and sequester his assets if his creditors demand it, subject to the conditions mentioned in item 4/3.

3/3 When a debtor is declared insolvent, the declaration must be documented and certified as required by official procedures.

## 4. Stages of Insolvency

4/1 First stage: The creditors make a demand upon the debtor to pay the debt due to the creditors pro-rata and to refrain from making

donations, providing loans or disposing of or acquiring assets preferentially. The creditors can seek the assistance of concerned authorities in this regard.

4/2 Second stage: If the debtor refuses to pay what he owes to the creditors, the creditors are entitled to file a claim against him as a step towards seeking a declaration of insolvency. They can petition the competent authorities to seek to:

4/2/1 Prevent the debtor from making donations;

4/2/2 Prevent the debtor from providing loans;

4/2/3 Prevent the debtor from giving preferential treatment (for example to certain creditors or in the disposal or acquisition of assets);

4/2/4 Prevent the debtor from admitting financial liability to those who may be the subject of preferential treatment such as his blood relatives connected by up to four vertical steps (for example, a first cousin, who is connected vertically via the grandparents); and such as affiliates, subsidiaries and group entities of institutions;

4/2/5 Prevent the debtor from pre-paying debts that are not yet due;

4/2/6 Prevent the debtor from transferring any of his assets to some of the creditors or selling to or purchasing from them preferentially; and

4/2/7 Prevent the debtor from travel that causes harm to the creditors without appointing a surety to ensure his attendance if required, providing guarantors.

4/3 A declaration of insolvency requires:

4/3/1 An application made by creditors demanding that a debtor whose due debts exceed his assets be declared insolvent, subject to item 5/5; or

4/3/2 An application made by the debtor himself, except when the competent judicial authority considers his application to be fraudulent.

4/4 The creditors are not required to prove that they are the sole creditors. If another creditor appears before the distribution, he is entitled to a pro-rata share of the distribution. If a creditor appears after the distribution, the rule set out in item 8 shall apply subject to statutory procedures so long as they are not inconsistent with the rules and principles of Shari'ah.

4/5 The court has the sole authority to declare a person insolvent.

## 5. Consequences of Insolvency

Declaration of a debtor's insolvency gives rise to the following consequences:

5/1 An admission by a debtor, who has been declared insolvent, of any liability to another person relating to his sequestered assets has no legal effect, whether such admission relates to a debt incurred before or after the declaration of insolvency, unless the creditors accept that such debt was incurred before the declaration of insolvency.

5/2 The debts owed to creditors are attached to the existing property of the debtor at the time of sequestration as well as to any property that accrues to him without his dealing, such as gifts. All his property remains in his ownership until it is determined that such property be sold and that the proceeds be distributed among the creditors.

5/3 The debtor's acts of sale, gift or endowment subsequent to the declaration of insolvency have no legal effect, with the exception of acts relating to previous transactions, such as terminating a defective contract and exercising an option to terminate. Such lack of legal effect applies during the period of uncertainty that precedes the declaration of insolvency, as assessed by the competent authority.

5/4 After declaration of insolvency, all the debtor's subsequent acts of sale, purchase, admission (of liability) or guarantee, are attached to his future liability and not to the sequestered assets. He can be required to discharge such subsequent liabilities after revocation of the sequestration. Those whose rights attach to his liability are not entitled to share the sequestered assets with the creditors.

5/5/1 All of the debtor's undue debts become due despite the creditors of such undue debts having no present right to demand a declaration of his insolvency. The creditors of undue debts are entitled to share the sequestered assets with the creditors of due debts.

5/5/2 If the lessee becomes insolvent during the Ijarah term, the lessor shall be entitled, on a pro-rata basis along with other creditors, to the amount of rent corresponding to the period during which the usufruct was enjoyed. For the remaining period, the lessor shall have the option either to terminate the Ijarah contract or to carry on with it so that he has claims on the insolvency assets for the rent of the remaining period, while enabling the lessee to enjoy the usufruct unless the court considers continuity of the Ijarah to be in the interest of creditors, in which case the lessor shall receive the rent amount in full.

5/6 It is permissible, with the approval of the creditors, to agree to reduce undue debt that was accelerated by the declaration of insolvency and guarantors are liable to pay the reduced amount, rather than the amount originally guaranteed.

5/7 Undue debts owed to the insolvent debtor do not become due upon insolvency; all outstanding debts owed to the insolvent debtor before the declaration of insolvency (even if not yet due) are included in the insolvency assets (and are distributed to the creditors as and when they are paid).

5/8 After distribution, creditors have no legal right to demand any unpaid debt from the debtor. However, the debtor has a moral obligation in Shari'ah to pay all the debts in full.

**6. Right of Claw-Back of an Item Sold to the Debtor Prior to the Declaration of Insolvency (the Right of Claw-Back)**

The right of claw-back gives a creditor who sold an item to the insolvent debtor the right to demand return of the specific item if it is among the

sequestered assets or to have claims on these assets. This right shall be established for the seller who has not received any part of the selling price.

## 7. Sale of the Sequestered Assets and Allowances Made for the Insolvent Debtor

7/1 The concerned authorities will order the sale of the sequestered assets -other than the assets described below- whether they are in currencies different to the currency in which the insolvency is being administered, fungibles, stocks, commodities (goods or merchandise) or real estate. A reasonable period of time should be allowed before selling real estate assets, and assets should be sold in the order provided above. A survey of market prices should be conducted to ensure that a better price could not be achieved at auction. If the price offered is less than the value of the asset, the auction should be repeated to obtain the value of the asset. Otherwise, it should be sold at whatever price is achieved on the third auction. If possible, it is recommended to make the sale subject, for a reasonable period of time, to an option to reverse the sale.

7/2 Excluded from the sale are the insolvent debtor's tools of trade; whatever he needs to continue his business; a suitable home and basic expenses for him and his dependents. If his home exceeds his requirements, it should be sold and replaced by one that is suitable for him. The same applies mutatis mutandis to institutions.

7/3 The debtor is not required to earn or take out a loan if the proceeds of sale are not sufficient to pay off his debts.

## 8. Distribution of the Insolvent Debtor's Assets Among the Creditors

8/1 It is preferable to expedite the distribution but not with such excessive haste that it harms the insolvent debtor. It is not necessary to delay the distribution until all insolvency assets are sold. The proceeds may be distributed as and when they are received, which is required if the creditors demand it, taking into consideration the statutory procedures of insolvency provided that they do not conflict with the rules and principles of the Shari'ah are observed.

8/2 The judge should start the distribution with assets that are of the same denomination as the debt.

8/3 The following order should be observed during distribution:

8/3/1 Priority should be given to paying the fees of the administrators and their assistants who manage the process of sale and distribution.

8/3/2 Next in order should be secured creditors, as per the rules of granting security.

8/3/3 Non-employee contractors (such as tradesmen) and lessors of transport vehicles are entitled to declare a lien over any of the insolvent debtor's property in their possession in order to recover their full fees from the insolvency assets, and such property reverts to the insolvency assets once the fees are paid.

8/3/4 A person who finds a specific item of his property in the insolvency assets has a preferred claim over it. Such property may include safety deposits, portfolios, investment funds, the capital of Mudarabah or investment agency, and the share of a non-insolvent partner in a partnership managed by the institution declared insolvent and the insolvency assets in the case of an insolvent partner.

8/3/5 The rest should be distributed among the creditors, with each creditor receiving an amount pro-rata to his share of the total debt.

8/3/6 If a debt is discovered after the distribution, the new creditor should obtain his share from each of the existing creditors, either by mutual consent or through litigation.

**9. Rules Specific to Institutions**

9/1 The following items are included in the insolvency assets:

9/1/1 Current accounts held with the institution, because these are liabilities of the institution which must be borne by it alone and which should not be borne by the investment accountholders;

9/1/2 All debts outstanding against the institution.

9/2 Investment vehicles that are independent of an (insolvent) institution in their fund sources and revenues are not part of the insolvency assets. Such investment vehicles include restricted deposits, funds, portfolios and *Sukuk* assets that are not wholly or partially owned by the institution and in which the institution's responsibility is limited to managing on a paid agency or Mudarabah basis.

9/3 Any assets held by the institution as custodian, such as securities belonging to third parties and safety deposit boxes, are not part of the insolvency assets.

**10. Revoking the Declaration of Insolvency**

10/1 Upon distribution of the insolvent debtor's assets to the creditors, the declaration of insolvency is revoked by the court and announced according to the requirements of convention or statute.

10/2 After the declaration of insolvency is revoked, if an asset is discovered that came into the ownership of the insolvent debtor prior to the declaration of insolvency without reciprocal consideration, such as a gift, it is sequestered to be distributed among the creditors whose debts were outstanding before the declaration of insolvency. If statute restricts applications for a declaration of insolvency unless after expiry of a limitation period, the outstanding debt remains a liability of the debtor based on morality/religious credence.

10/3 If the insolvent debtor enters into a credit transaction after revocation of his declaration of insolvency and then owns property through new transactions, and is thereafter declared insolvent a second time, the creditors of the first insolvency are not entitled to a share of the assets of the second insolvency. If however, the new property came into his ownership without reciprocal consideration, such as a gift, the creditors of the first insolvency are entitled to a share of the assets of the second insolvency based on morality/religious credence.

## 11. Date of the Issuance of the Standard

This Standard was issued on 14 Jumada II, 1431 A.H., corresponding to 28 May 2010 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard of Insolvency in its meeting No. (27) held in the Kingdom of Bahrain during the period of 12-14 Jumada II, 1431 A.H., corresponding to 26-28 May 2010 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 14 Jumada II, 1430 A.H., corresponding to 7 June 2009 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Insolvency.

In its meeting held in Dubai, United Arab Emirates, on 20 Shawwal 1430 A.H., corresponding to 9 October 2009 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Insolvency and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its meeting No. (25) held in the Kingdom of Bahrain, during the period of 2-4 Dhul-Qa'dah 1430 A.H., corresponding to 21-23 October 2009 A.D. The amendments that were deemed appropriate were included.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 27 Safar 1431 A.H., corresponding to 11 February 2010 A.D. All the comments made in the public hearing were listened to, and a member of the Shari'ah Board answered these comments and made commentary on them.

In its 26th meeting held in the Kingdom of Bahrain, during the period of 24-26 Rabi' I, 1431 A.H., corresponding to 10-12 March 2010 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it considered suitable.

In its meeting No. (27) held in the Kingdom of Bahrain, during the period of 12-14 Jumada II, 1431 A.H., corresponding to 26-28 May 2010 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated

the necessary amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in the United Arab Emirates on 7 Sha'ban 1436 A.H., corresponding to 25 May 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for prohibiting a person overwhelmed by debts from disposals that harm the creditors is the Hadith, *"Allah will pay (the debts of) a person who takes the wealth of others with the intention of repaying it. But the one who takes it with the intention of destroying it, Allah will destroy him"*.
- The basis for the obligatory ruling of insolvency and interdiction against the one who has more debts than he can pay is the act of the Prophet (peace be upon him), who interdicted Mu'adh Ibn Jabal (may Allah be pleased with him) and sold his property for the debts against him and distributed it among his creditors.(2) This is the stance of the majority, who include Abu Yusuf and Muhammad. This is also the formal legal opinion of the Hanafis as against Abu Hanifah.
- The multiplicity of three stages is the Maliki opinion, and this is what the (modern) legal codes also uphold. In insolvency, it is essential to consult these rules and the ruling of the court.
- The basis for the requirement that the insolvency should be demanded by the owners of due debts is that there is no demand (warranted) for undue debt. Even if such a demand is made of the debtor, he does not have to pay it because the deferred period has a share in the price.
- The basis for the right of a debtor to request a declaration of his own insolvency is the Shafi'i opinion and the fact that it is in his interest to stabilize his financial situation. The Standard excludes fraudulent insolvency according to the satisfaction of the court.
- The basis for the requirement of a judicial ruling for insolvency is the act of the Prophet (peace be upon him) in the case of Mu'adh. Also, in-

(2) This has been related by Al-Bayhaqi by both *muttasil* (fully connected) and *mursal* (incomplete) chains of transmission, but the mursal narrations are more correct: *"Sunan Al-Bayhaqi"* [6: 48]; and *"Talkhis Al- Habir"* [3: 37], as in *"Al-Mawsu'ah"* [5: 301].

solvency needs consideration and Ijtihad; therefore, a judicial decision is required for it.

- The basis for non-enforcement of an insolvent's confession regarding the right of others to his property -except with the approval of the creditors- and the non-enforcement of his dispositions that transfer ownership is that they prevent harm to the creditors, as per the Hadith: *"No harm and no reciprocal harm"*.
- The basis for the attachment of new dispositions to the liability of the insolvent is that the right of the creditor is attached to the property existing at the time of insolvency. Thus there is no harm in the attachment of new dispositions to the liability of the debtor because his liability is fit for such a commitment.
- The basis for the view that gives the creditor the right to reclamation -a view accepted by the Malikis, Shafi'is, Hanbalis and some of the earliest scholars (the Salaf) as well as the majority of (modern legal) systems- is the Hadith related by Al-Bukhari and Muslim(3) that affirms the right to recourse for the seller when he finds the exact commodity with the insolvent buyer. He has the option to take it or to leave it and become a partner of the creditors in the distribution of the price. It is subject to the following conditions:
  a) The insolvent should be alive at the time of recourse. In the case of an institution or company, it should remain existent.
  b) The insolvent remains liable for all of the compensation due. If the seller has received part of it, he will be given an option regarding the remainder.
  c) The whole asset should remain in the ownership of the insolvent. If all or part of it has been destroyed, or if it has left his ownership through sale, or gift, or endowment, the right to reclamation will be cancelled regarding the remaining part except when the transaction involves multiple parties.
  d) The asset should not be in a condition where it is mingled with something from which it cannot be distinguished, nor can its characteristics have changed to the point that the original name for it no longer applies or that its value has been reduced.

(3) See: *"Fath Al-Bari"* [5: 66]; and *"Sahih Muslim"* [3: 1193].

e) The right of another person should not relate to it, e.g., when the insolvent has pledged it as security, except when the owner of the right (the mortgagee) renounces his right to the mortgage.

The right to reclamation is the cancellation of the sale. It can take place verbally or by a substitute means. It takes place immediately and does not need the decision of a judge, or the knowledge of the competent authority, or the ability to deliver.

Besides that, if the asset or its value or its feature decreased, or an inseparable increase occurred in it, like an increase in the weight of livestock, and he chose reclamation, he will only have that. But if the increase is separate, it would belong to the insolvent.

The right to reclaim land is not precluded by any building built on it by the insolvent nor by any trees he planted on it. The creditor will be given an option between having the insolvent remove the building and the trees, with the creditor bearing liability for any damage (to what is moved), or taking the building and trees and paying their price. In case of cultivated land, the crop will remain until harvest, free of any charge.

- The basis for the other view, which does not recognize the right to reclamation, is that the Hadith related by Al-Bukhari and Muslim contravenes the implication of a Shari'ah principle; i.e., the liability of the insolvent remains operative and the creditor's right regarding that liability remains stable. This group cited the Hadith: *"Anyone who died or went insolvent, and some of his creditors found exactly their property, they are on a par with the other creditors"*.(4)

  Mursal Hadiths are valid evidence according to those who take this view. They are Hanafis and some of the Salaf.(5)

- The basis for non-inclusion of all types of deposits of safekeeping in the insolvency assets is that they are not the property of the insolvent; inter-

(4) This has been related by Al-Daraqutni by a mursal chain of transmission. See also *"Al-Mawsu'ah Al-Fiqhiyyah"* [5: 311].

(5) See: *"Al-Mawsu'ah Al-Fiqhiyah"* [5: 311], for the documentation of the reference works of the madhhabs that affirm the right of reclamation and for the details related to the right of reclamation.

diction only occurs regarding his property, not the property of others entrusted to him.

- The basis for the requirement of a court ruling to rescind the interdiction of an insolvent is that it demands due consideration and Ijtihad, just as with a declaration of insolvency.

# Appendix (C)
# Definitions

**I'sar**

The present inability to discharge the financial obligations established in one's liability.

**Prudential or Precautionary or Preventive Interdiction**

Expedited and streamlined interdiction aiming at placing the debtor's assets under judicial supervision so that the creditor precludes the existence of a threat to his receipt of the full payment of his debt.

## Shari'ah Standard No. (44)

# Obtaining and Deploying Liquidity

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to define liquidity and the methods of obtaining, deploying and utilising it within Institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers what is meant by liquidity and the permissible means of obtaining and deploying it.

## 2. Definition of Liquidity and Liquidity Management

2/1 Liquidity refers to cash or that which can be easily converted to cash.

2/2 Liquidity management means achieving a balance between obtaining liquidity as swiftly and cheaply as possible and investing and deploying it effectively.

Liquidity is achieved in various ways depending on where it is being utilised. For example, in institutions it is the ability to cover withdrawals; in the money market it is the ability to swiftly convert securities into cash; and with Sukuk and investment funds, it is the ability to redeem or sell them in the secondary market.

## 3. Need to Utilise Liquidity in Institutions

Institutions need liquidity to meet numerous requirements, such as:

3/1 To distribute profits, which may rely on the liquidation of assets, see Shari'ah Standard No. (40) on Distribution of Profit in Mudarabah-Based Investment Accounts.

3/2 To discharge liabilities by selling inventory assets and converting them to cash to pay what is owed to creditors, to face contingent liabilities, or liquidate investment vehicles or the institution itself, and similarly to expand its activities, or to achieve capital adequacy or to improve its credit rating, see Shari'ah Standard No. (43) on Insolvency.

## 4. Obtaining and Deploying Liquidity

4/1 Obtaining and deploying liquidity through interest-bearing loans is prohibited by the Shari'ah, whether transacted directly or through

overdrafts or interest-bearing or commission-based facilities. Any liquidity support made available by supervisory or regulatory bodies (such as central banks) must be provided only through Shari'ah-compliant modes, such as Mudarabah and investment agency.

4/2 Permissible modes of obtaining liquidity include:

4/2/1 Selling commodities on a Salam (deferred delivery) basis, receiving payment up-front, and then purchasing the relevant commodities for delivery on the maturity date. It is permitted to secure a promise to sell (from a third party commodity broker) to mitigate the risk of fluctuation between the sale price and purchase price. [see Shari'ah Standard No. (10) on Salam and Parallel Salam]

4/2/2 Istisna'a concluding an Istisna'a-based sale contract stipulating advance payment -although advance payment is not obligatory- and concluding a parallel Istisna'a-based purchase contract stipulating deferred or installment payment. [see Shari'ah Standard No. (11) on Istisna'a and Parallel Istisna'a]

4/2/3 The institution selling some of its assets for immediate cash and then, if required, leasing the asset back on rent payable in arrears, taking into consideration what has been stated in Shari'ah Standard No. (9), item 5/8, on Ijarah and Ijarah Muntahiah Bittamleek.

4/2/4 Financing working capital to expand the institution's activities

This involves the institution inviting investors to participate in financing its working capital on a Mudarabah or Musharakah basis for a specified period of time determined by its liquidity requirements and with the ability to liquidate the Mudarabah or Musharakah at the end of such period. The investors enter into the Mudarabah or Musharakah by contributing their capital while the institution contributes its current assets, after valuation, as its share of the capital of the Musharakah or Mudarabah. The institution's fixed assets do not form part of

the Musharakah; rather, fixed assets are either lent or leased to the venture and rental payments are accounted as expenses of the Mudarabah or Musharakah.

4/2/5 Issuing investment Sukuk to expand the institution's activities

This involves issuing the types of investment Sukuk explained in Shari'ah Standard No. (17) on Investment Sukuk in order to obtain funds from Sukuk investors and undertake projects required of the institution. The institution may securitise some of its assets by selling them to Sukuk subscribers, managing the assets on their behalf and promising to purchase them at the market price or at a price to be agreed. If the institution is only the lessee and not the manager of the Sukuk assets, it may promise to purchase them at face value.

4/2/6 Tawarruq

This should be done in accordance with Shari'ah Standard No. (30) on Tawarruq.

4/2/7 Interest-free loan

An application of interest-free loans is outlined in Shari'ah Standard No. (26) on Islamic Insurance in item 10/8 regarding loans given by the Takaful operator to the Takaful fund.

**5. Liquidity Should Only Be Deployed Using Shari'ah-Compliant Modes, which include:**

5/1 Purchasing commodities in cash and selling them for deferred payment through Musawamah or Murabahah contracts.

5/2 Leases, lease contracts that end in ownership and forward leases, whether for tangible assets or services.

5/3 Purchasing commodities on a Salam basis (immediate payment for deferred delivery), then selling them after taking physical or constructive delivery, whether personally or by appointing the seller, in a separate contract, to sell the commodities to his customers.

5/4 Istisna'a and parallel Istisna'a, which involve the institution commissioning the manufacture of products or projects on an Istisna'a basis with immediate payment for deferred delivery upon completion and then selling the same manufactured products to a third party through a second Istisna'a contract for deferred price and delivery, without linking the two contracts, or procuring the sale by appointing the manufacturer as an agent, through a separate contract, to sell the manufactured product or project to his customers.

5/5 Musharakah and Mudarabah which involve the institution as the capital provider.

5/6 Investment agency, which involves the institution appointing another institution or those with whom it deals to act as its agents.

5/7 Subscription to purchase Shari'ah-compliant stocks, investment Sukuk or shares in investment funds.

5/8 International commodity trading in the financial markets in accordance with Shari'ah.

5/9 Currency trading in accordance with Shari'ah.

## 6. Date of the Issuance of the Standard

This Standard was issued on 14 Jumada II, 1431 A.H., corresponding to 28 May 2010 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard of Obtaining and Deploying Liquidity in its meeting No. (27) held in the Kingdom of Bahrain during the period of 12-14 Jumada II, 1431 A.H., corresponding to 26-28 May 2010 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 24 Dhul-Qa'dah 1428 A.H., corresponding to 3 December 2007 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Obtaining and Deploying Liquidity.

In its 25th meeting held in the Kingdom of Bahrain, during the period of 2-4 Dhul-Qa'dah 1430 A.H., corresponding to 21-23 October 2009 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Obtaining and Deploying Liquidity and made the necessary amendments.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 27 Safar 1431 A.H., corresponding to 11 February 2010 A.D. All the comments made in the public hearing were listened to, and a member of the Shari'ah Board answered these comments and made commentary on them.

In its meeting No. (26) held in the Kingdom of Bahrain, during the period of 24-26 Rabi' I, 1431 A.H., corresponding to 10-12 March 2010 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it considered suitable.

In its meeting No. (27) held in the Kingdom of Bahrain, during the period of 12-14 Jumada II, 1431 A.H., corresponding to 26-28 May 2010 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated the necessary amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in the United Arab Emirates, on 7 Sha'ban 1436 A.H., corresponding to 25 May 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for the definition of liquidity as referring to cash and whatever is easily converted into cash is that the traditional terminology for liquidity is Tandid (literally, to convert to cash), actually or by estimation. Actual Tandid means converting commodities into cash by selling them. Tandid by estimation means evaluating commodities in order to arrive at the expected monetary value that can be realized from them.
- The basis that profit distribution depends on the availability of liquidity is that there cannot be any profit except after the protection of the capital, and this protection is realized by liquidating the assets.
- The basis for the prohibition of procuring liquidity through interest-based loans is the prohibition of any type of Riba (usury). The supervisory bodies are the entities most responsible for overseeing that the institutions' liquidity is compliant with Shari'ah. This is because it is these bodies that have licensed the institutions to operate by Shari'ah-compliant procedures and prohibited them from that which violates the Shari'ah.
- The basis for the Shari'ah-compliant methods of obtaining liquidity is provided in the Shari'ah standard for each method.
- The basis for the Shari'ah-compliant methods of deploying liquidity is provided in the Shari'ah standard for each method.

# Appendix (C)
# Definitions

**Diversification of Liquidity**

The deployment of liquidity in various instruments; for example, purchasing short-term, medium-term and long-term Sukuk to protect investments from sharp fluctuations in the returns.

**Liquidity Preference**

It means to hold on to cash instead of deploying it. That is for the purpose of financing current purchases, or investing it in securities whose prices are expected to decline, or paying for contingent expenses.

**Liquidity Balance**

It means reconciling the need to obtain liquidity and the need to deploy it.

**Liquidity Surplus**

The availability of liquidity exceeding the institution's needs.

**Liquidity Deficit**

The need for liquidity in order to meet financial requirements.

**Good Liquidity**

It is based on two principles: The best price and the shortest period for obtaining it.

**Liquidity Risk**

It is the risk of having to sell commodities or securities at a loss in order to procure liquidity.

Shari'ah Standard No. (45)

# Protection of Capital and Investments

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims at explaining the most important ways of protecting capital and investments in Islamic financial Institutions.(1) It also aims to explain what is permissible according to the Shari'ah and what is not permissible as well as the Shari'ah basis for it.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the instruments and methods used to protect capital and investments from loss, decrease and destruction.

## 2. Definition of Capital and Investment Protection and the Difference Between Protection and Guarantee

Protection of capital and investments means using available methods to prevent loss, decrease or destruction. It is wider than a guarantee of invested capital, as a guarantee is an undertaking by a particular party to bear any loss, decrease or destruction of the capital. On the other hand, protection refers to the safeguarding of capital.

## 3. Shari'ah Ruling

3/1 Protecting capital by permissible means is desirable in Shari'ah as it serves the objectives of Shari'ah with regard to wealth.

3/2 It is compulsory for an investment manager, whether he is a Mudarib, an investment agent or a managing partner, in his fiduciary capacity, to exercise due diligence to protect the funds from loss, decrease or destruction. If he fails to do so using usual means of protection, he is liable (for loss), taking into consideration items 4/1 and 7/1.

3/3 It is permissible to use Shari'ah-compliant instruments and processes to protect investment from risks that it may be exposed to whether they are risks relating to a loss of capital, depreciation in value, inflation, or the fluctuation of exchange rates, etc.

3/4 The investment manager acts in a fiduciary capacity with regard to the funds. He is not liable for loss of capital except in case of his wilful misconduct, negligence or breach of contractual terms and conditions.

3/5 The efforts exerted by the investment manager to grow the capital must be suitable for the nature of the relevant investment. It is also incumbent on him to take professional measures that normally provide suitable protection for the funds. Otherwise, he will be deemed negligent.

3/6 It is not permissible to stipulate in an investment agreement that the investment manager is unconditionally liable for any loss of capital in cases other than willful misconduct, negligence and breach of contractual terms and conditions.

3/7 If a loss occurs caused by the Mudarib's wilful misconduct, negligence or breach of contract, the capital provider may hold the Mudarib liable for the loss of capital but not the loss of profit. However, if it is determined through actual or constructive liquidation that the investment accrued profit which was added to the capital and then suffered a loss due to the Mudarib's wilful misconduct, negligence or breach of contract, the Mudarib is liable to idemnify for loss of that profit as it has become a part of the capital. If destruction of the whole or a part of the capital is caused by the Mudarib's wilfil misconduct, negligence or breach of contract, the Mudarib is liable for the value of the capital.

**4. Shari'ah Compliant Means for Protecting Capital**

**4/1 Instruments and processes used to protect capital and investments must fulfill the following conditions:**

4/1/1 The investment partners should bear the risks and losses according to their respective shares in the capital.

4/1/2 The objective should not be to hold the investment manager liable in cases other than willful misconduct, negligence or breach of contract.

4/1/3 The means adopted for capital protection must not be a non-Shari'ah compliant contract and should not be a pretext to achieve an objective violating Shari'ah.

**4/2 Some permissible methods of protecting capital include:**

4/2/1 Takaful (Islamic insurance) for the investment to protect the capital or cover the risks of willful misconduct, negligence, breach of contract, procrastination, death or bankruptcy. Takaful coverage may be obtained either by the investors themselves or through the investment manager on their behalf.

4/2/2 Obtaining Takaful cover for the leased assets underlying the Sukuk or other instruments against the risk of destruction and for major maintenance.

4/2/3 An undertaking provided by Takaful institutions to guarantee exports and investments.

4/2/4 A voluntary undertaking by a third party acting in the public interest, such as the state, or relevant public interest authorities, such as a guardian, executor or father, to indemnify against a loss of capital without any right of recourse to the investment manager, such as a government pledge in respect of an investment project. In order for this undertaking to be valid, the third party should be administratively independent of the investment manager and there should be no direct or indirect ownership relationship of more than a half between the investment manager and the third party.

4/2/5 An undertaking by a third party to indemnify against a loss of capital resulting from the investment manager's wilful misconduct or negligence without receiving consideration for providing such a guarantee. However, the guarantor has the right of recourse to the investment manager.

4/2/6 Creating reserves to protect the capital through deductions from the investors' share of profits but not from the investment manager's share of profits due to him in his capacity as the Mudarib.

4/2/7 Diversifying the investment assets to achieve an appropriate return and minimize risks. This may include:

a) Combining real assets, such as real estate and commodities with financial assets (such as stocks and *Sukuk)* or combining assets denominated in two different currencies.

b) Dividing the capital into two parts by deploying the capital in Murabahah and Musharakah contracts, respectively.

The first part is used in Murabahah contracts with parties that have strong credit ratings in a way that the combination of the principal amount and the profit of Murabahah protect the initial capital and the second part is invested in Musharakah contracts.

c) Dividing the capital into two parts by deploying the capital in Ijarah and Musharakah contracts respectively.

The first part is used in Ijarah contracts with parties that have strong credit ratings in a way that the combination of the principal amount and the rental amount protect the initial capital and the second part is invested in Musharakah contracts.

d) Dividing the capital into two parts and deploying them in Murabahah and 'Arboun contracts respectively.

The first part is used in Murabahah contracts with parties that have strong credit ratings in a way that the combination of the principal amount and the profit of Murabahah protect the initial capital. The second part is used in 'Arboun contracts to purchase assets. If the value of the assets rises, the purchase contracts are completed and the assets are sold for a profit. If the value of the assets declines, the purchase contracts are not completed and the loss is limited to the amount of the 'Arboun, while the capital is protected by the Murabahah contracts. It is compulsory in this method to observe the Shari'ah rules relating to 'Arboun. This includes the requirement to reserve the assets sold under the 'Arboun contract from the time of contract conclusion until the settlement date and the impermissibility of trading in 'Arboun contracts. [see Shari'ah Standard No. (53) on 'Arboun]

4/2/8 Taking security and guarantees in Murabahah, Salam or Istisna'a contracts to ensure that debts are paid.

4/2/9 A sale with an option to terminate due to non-payment (*Khiyar al-Naqd*).

4/2/10 It is permissible to use other permissible instruments and processes with the consent of the investor to protect the capital from risks, whether those risks are related to the destruction of the original investment capital, depreciation in value, inflation or the fluctuation of exchange rates, etc.

4/2/11 If the investor has required the investment manager to adopt certain Shari'ah-compliant ways to protect the capital, the manager is obligated to do so. If he does not do so, he is liable for any resulting loss of capital, in accordance with item 4/4.

## 5. Shari'ah Non-Compliant Means for Protecting Capital

It is not permissible to protect the capital by Shari'ah-non-compliant means or means that result in violations of the Shari'ah, such as:

5/1 Stipulating that the investment manager is liable for loss of capital.

5/2 An undertaking by a third party to indemnify for loss of capital in the cases other than wilful misconduct or negligence of the investment manager with a right (of the third party) to have recourse to the investment manager.

5/3 A commitment by or obligating the investment manager to purchase the investment assets at their nominal price or at a price that was initially agreed upon.

5/4 An undertaking by a third party to guarantee the capital for a fee. This is a form of conventional insurance.

5/5 Protecting the capital by use of conventional hedging contracts such as futures, options and swaps.

## 6. Date of Issuance of the Standard

This Standard was issued on 24 Dhul-Qa'dah 1431 A.H., corresponding to 30 November 2010 A.D.

# Adoption of the Standard

The Shari'ah Board adopted this Standard in its meeting No. (28) held in the Kingdom of Bahrain during the period of 22-24 Dhul-Qa'dah 1431 A.H., corresponding to 27-29 May 2011 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 24 Dhul-Qa'dah 1428 A.H., corresponding to 20 December 2007 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Protection of Capital and Investments.

In its meeting held in Kuwait, on 20 Shawwal 1430 A.H., corresponding to 9 February 2009 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Protection of Capital and Investments and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its meeting No. (24) held in the Kingdom of Saudi Arabia, during the period of 25-27 Jumada II, 1430 A.H., corresponding to 18-20 June 2010 A.D. The amendments that were deemed appropriate were included.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 27 Safar 1431 A.H., corresponding to 11 February 2010 A.D. All the comments made in the public hearing were listened to, and a member of the Shari'ah Board answered these comments and made commentary on them.

In its meeting No. (26) held in the Kingdom of Bahrain, during the period of 24-26 Rabi' I, 1431 A.H., corresponding to 10-12 March 2010 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it considered suitable.

In its meeting No. (28) held in the Kingdom of Bahrain during the period of 22-24 Dhul-Qa'dah 1431 A.H., corresponding to 28-30 November 2010 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated

the necessary amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in Al-Madinah Al-Minawwarah, on 30 Sha'ban 1436 A.H., corresponding to 17 June 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for capital protection being a desirable objective is the Divine Command to adopt ways and means to protect wealth like having witnesses and documentation of the financial contracts and securing debt with mortgages and the like. Protection of wealth is one of the essential objectives that the Shari'ah has taken care of.
- The basis for the obligation of the manager to take due diligence to protect the investment is that his role regarding the investment is that of a fiduciary. This means that he should manage the investment in a way that serves the interest of the capital provider in his capacity of his fiduciary representative. He should thus use prudent means consistent with accepted standard practice to increase the funds.
- The basis for using permissible means to protect the investment is that all (financial) contracts are permissible by default unless proved otherwise. Furthermore, these instruments achieve the intent of the Shari'ah to safeguard wealth.
- The basis for the investment manager not being liable for the loss of the capital, except in cases of his wilful misconduct and negligence is the consensus of Muslim jurists.(2) That is because he takes the capital with the owner's permission and deals with it in the interest of the capital provider. He is thus the capital provider's representative in terms of possessing and managing the capital. This means that the loss or destruction of the capital in his possession is just like its loss or destruction while in the possession of its owner because he took it with his permission. Moreover, no person, including the manager is liable to anything without a specific command by Shari'ah.

(2) *"Al-Bahr Al-Ra'iq"* [6: 313]; *"Al-Bahjah Sharh Al-Tuhfah"* [2: 217]; *"Mayyarah 'Ala Al-'Asimiyyah"* [2: 131]; and *"Al-Mughni"* [7: 76].

- The basis for the impermissibility to stipulate an absolute guarantee to be provided by the manager, is that this condition strips partnership (Mudarabah and Musharakah) and agency contracts of their essential content, and turns them into a guaranteed loan contract. Moreover, these contracts are based upon trusteeship, and this condition violates their nature and implications; hence, it is void. Ibn Qudamah said, "The third type (i.e., of invalid conditions) is to stipulate what is not in the interest of the contract nor consistent with its nature and implications; e.g., stipulating that the partner is liable for the capital or for a share of the loss."(3) There is no disagreement among the jurists that this condition is void.(4)
- The basis for the opportunity cost not being compensated in the events of wilful misconduct or negligence is that it is non-existent wealth which has not been realised yet. However, realized profit after actual or constructive liquidation is treated like capital.

**Shari'ah-Compliant Means for Protecting Capital**

- The basis for stipulating equality among the partners in bearing loss is that partnership is based on equality between the partners. Stipulating that some partners should bear the loss more than others should violates the nature and implications of a partnership contract. Bearing the portion of loss that is supposed to be borne by another partner causes the latter partner to gain profit from that for which he has assumed no liability. The jurists agree that loss sharing in the partnership contract should be proportional to capital (contribution).(5)
- The basis for the permissibility to protect the capital with Takaful against any type of investment risks is that Takaful is an undertaking to make donations between the participants. It is not a contract to exchange counter-values (Mu'awadah). Its purpose is to achieve cooperation and solidarity among the participants. Hence, the Shari'ah prohibitions that apply to (conventional) commercial insurance do not apply to it.
- The basis for the permissibility of a third party's undertaking to bear the loss without the right of recourse to the manager is that, according to the

(3) *"Al-Mughni"* [5: 41].
(4) *"Al-Mabsut"* [15: 84]; *"Al-Bahjah Sharh Al-Tuhfah"* [2: 217]; *"Al-Hawi Al-Kabir"* [9: 113]; and *"Al-Mughni"* [7: 179].
(5) *"Bada'i' Al-Sana'i'"* [7: 517]; *"Hashiyat Al-Dusuqi"* [3: 353]; *"Tuhfat Al-Muhtaj"* [5: 292]; and *"A-Furu'"* [4: 403].

Shari'ah, this is an undertaking to make a voluntary donation. Therefore, it is permissible by the Shari'ah provided that the third party is independent from the manager so that his undertaking does not result in the manager becoming the guarantor.

- The basis for permissibility of deducting reserve amounts (from the profits) is that it is done with the consent of the relevant parties and is in the investors' interest as it strengthens the investment's financial situation. No deduction should be made from the manager's share because the liability for loss is borne by the capital providers, not by the manager.
- The basis for the permissibility of diversifying investment assets is that diversification achieves the interest of the investors. It does not fall under the prohibition of combining contracts in one contract because each contract is conducted independently of the other, whereby the manager divides the capital into parts and each part is invested independently in one type of contract or investment asset that differs from what the other portion of the capital is invested in. This is for the purpose of mitigating risks and diversifying returns. The parameters for each of these contracts may be sought by referring to the relevant Shari'ah Standard.
- The basis for the permissibility of obtaining securities and guarantees for deferred payment contracts is the Quranic Verse: ***{"And if you are on a journey and cannot find a scribe, then (you may resort to holding something as) mortgage, taken into possession"}***,(6) and ***{"...who produces it is (the reward of) a camel load; I guarantee it"}***.(7)
- The basis for the liability of the manager to bear the loss if he violates the Shari'ah-compliant conditions stipulated by the capital provider is the Quranic Verse: ***{"O you who believe! Fulfil (your) obligations"}***.(8)
- Fulfilling contractual obligations requires the fulfilment of the conditions stipulated in them. The Prophet (peace be upon him) said, *"Muslims are*

(6) [Al-Baqarah (The Cow): 283].
(7) [Yusuf (The Prophet Joseph): 72].
(8) [Al-Ma`idah (The Table): 1].

*bound by their conditions (stipulated in contracts and undertakings)"*.[9] Breaching these conditions amounts to negligence from the manager. Hence, it is compulsory upon him to bear any loss arising from this breach.

**Shari'ah Non-Compliant Means for Protecting Capital**

- The basis for the prohibition of a third party's undertaking to bear the loss with the right of recourse to the manager is that this condition results in making the manager liable for the loss, which is prohibited by the Shari'ah.
- The basis for prohibiting the manager from undertaking to buy the investment assets at their face value or at a value initially agreed upon is that this condition results in the manager undertaking to bear the partial or complete loss of the assets' value, which is a forbidden condition as aforementioned.
- The basis for the prohibition of a third party's guarantee for a fee received in exchange for the guarantee is that it firstly entails excessive ambiguity because the extent of the loss is unknown at the inception of the contract, and because giving a guarantee in exchange for a fee, is prohibited by the Shari'ah.
- See Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets for the basis of the prohibition of trading in options, futures and swaps.[10]

(9) Related by Al-Tirmidhi from the Hadith of Amr Ibn 'Awf, may Allah be pleased with him, in *"Kitab Al-Ahkam"*, Chapter on *"Ma Dhukira 'An Rasuli Allah, peace be upon him, Fi Al-Sulh"*, No. (1272); it is related also by Abu Dawud from the Hadith of Abu Hurayrah, may Allah be pleased with him, in *"Kitab Al-Aqdiyah"*, Chapter on *"Bab Fi Al-Sulh"*, No. (3120); also it is related by Al-Darqutni from the Hadith of 'A`ishah, may Allah be pleased with her, with the addition of "…that which is consistent with the truth", [2: 3]. It is an authentic Hadith when all its chains of transmission are taken into consideration; *"Taghliq Al-Ta'liq"* [3: 280]; and *"Fath Al-Bari"* [4: 451].

(10) See Resolution No. (63) 1/7 of the International Islamic Fiqh Academy regarding Financial Markets.

# Appendix (C)
# Definitions

**Wilful Misconduct by the Manager**

Wilful misconduct by the manager that renders him liable is to do what he is not allowed to according to the dictates of the Shari'ah, or the contract, or customary practice.

**Negligence by the Manager**

Negligence by the manager that renders him liable is to fail to do what it is required of him by the Shari'ah, or the contract, or customary practice.

Shari'ah Standard No. (46)

# Al-Wakalah Bi Al-Istithmar (Investment Agency)

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to explain the rules of Investment Agency applicable to Islamic financial institutions,(1) the conditions for its validity, its types, its implications and its contemporary applications.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers Investment Agency in various fields, or parts thereof, and the powers and responsibilities of the principal and the investment agent. It does not cover Agency in general or the acts of Uncommissioned Agent (Fodooli) as they are covered by Shari'ah Standard No. (23) on Agency and the Acts of an Uncommissioned Agent (Fodooli).

## 2. Definition of Investment Agency and Its Permissibility

2/1 Investment Agency means appointing another person to invest and grow one's wealth, with or without a fee.

2/2 Investment Agency is permissible subject to the relevant Shari'ah rules.

## 3. Investment Agency: Integral Parts (Arkan) and Its Key Types

3/1 The integral parts (Arkan) of a valid investment agency are offer and acceptance, the subject matter of the contract, and the two contracting parties (the principal and the agent). [see Shari'ah Standard No. (23) for the conditions that are required for a valid agency and the rules relating to the acts of the uncommissioned agent (Fodooli)]

3/2 It is permissible to make the appointment of an agent contingent agency upon the fulfillment of certain conditions or to cause to take effect on a specified future date. It is also permissible to stipulate conditions/restrictions that are compliant with Shari'ah. For further details, see Shari'ah Standard No. (23).

3/3 It is permissible for the investment agency to be restricted to a particular kind of investment, or a specific place or be subject to other restrictions. It is also permissible that it be unrestricted, in which case it would still be restricted by customary practice and that the agent acts in the principal's best interests.

3/4 It is not permissible for any one of the parties to unilaterally amend the restrictions in the agency contract. [see Shari'ah Standard No. (23) for the types of agency]

## 4. Characteristics of Investment Agency

4/1 Investment agency contracts, whether remunerated or unremunerated, are binding on institutions because they are invariably fixed term contracts in which both parties agree not to terminate within a specified period.

4/2 Where the parties agreed to terminate for a specified period, it is permissible for the contract to stipulate the right of one of the parties to terminate the contract unilaterally in specific circumstances.

4/3 When the term of an agency expires, the agent is required not to enter into new investment activities, but may not liquidate ongoing existing investments.

## 5. Agency Fee

5/1 If the agency is remunerated, the agent's fee should either be a fixed amount or a percentage of the amount invested. It is also permissible to link the fee to an established index/benchmark that is known to both parties and is referred to before every investment period after the fee of the first period has been determined. It should, however, be capped and floored (by assigning it maximum and minimum limits).

5/2 If the fee was not specified in the contract and the agent customarily charges a fee as is normal practice in institutions then the agent will be entitled to a fee which is prevalent in the relevant markets. This also applies when the agent does not complete the task required after starting and realizing returns that are beneficial to the principal.

5/3 The principal is required to pay the investment agent's fees in accordance with stipulated time and manner.

5/4 It is permissible to stipulate that the agent, in addition to his fee, is entitled to all or part of any amount over and above the expected profit as a performance incentive.

## 6. Amount, Term and Profit of the Investment

6/1 The amount and term of the investment should be determined, irrespective of whether the amount is paid as a lump sum or in installments.

6/2 The principal is responsible for any expenses related to the investment such as transportation, storage, taxes, maintenance and insurance. It is not permissible to require the agent to pay them from the agent's own funds, or to defer any reimbursement due to the agent where he has paid them on behalf of the principal or to make such reimbursement subject to the yield of the investment. And the investment agent is liable, as a legal entity, for any expenses related to its employees or equipment.

6/3 The agent may start investment activity before receiving the funds (from the principal), and with the principal's permission, by:

6/3/1 Incurring a debt on behalf of the principal by purchasing on credit;

6/3/2 Advancing a loan to the principal by purchasing something on his behalf.

6/4 Any loan advanced by the agent is construed as an interest free loan which may not bring any benefit to the agent as creditor. The agent is entitled to its fee and performance incentive, without consideration to the loan advanced.

6/5 The profit in its entirety is the right of the principal unless it is stipulated that the agent shall be entitled to all or part of any excess above the expected profit as a performance incentive in addition to its fixed fee.

6/6 It is permissible for the agent, with the principal's consent, to set aside a portion of the profit to create a profit equalisation reserve for the benefit of the principal.

6/7 Upon liquidation, the balance of the profit equalisation reserve is returned to the principal without affecting the agent's entitlement to the fixed fee or performance incentive for the period in which the reserve was set aside.

## 7. Liability of an Investment Agent

7/1 The agent acts in a fiduciary capacity in relation to the investment and therefore is not liable for any loss in cases other than willful misconduct, negligence, or breach of contract unless the breach happens to be advantageous to the principal such as selling an asset for a price higher than the price required by the principal. In situations where the agent is held liable for loss of capital, such liability is limited to the capital amount and the agent is not liable for loss of expected profit whether the capital was invested immediately or delayed or not invested at all.

7/2 If the investment results in profit or capital gain in case of a breach that is advantageous to the principal, then such profit or capital increase belongs to the principal without affecting the agent's right to its performance incentive.

## 8. Rights and Obligations of the Contracts Executed by the Agent

The results of the contract (like transfer of ownership and entitlement to the fee) belong to the principal. However, the rights and obligations (like pursuit of payment or delivery including litigation) belong to the agent.

## 9. Appointment of a Sub-Agent

9/1 The investment agent is not permitted to appoint a sub-agent for the prescribed investment activities except for activities outside its area of expertise, or what is normally outside the capacity of the agent or its employees or where the principal grants the agent permission to subcontract.

9/2 The sub-agent appointed by the agent with the consent of the principal cannot be dismissed by the agent but can only be dismissed by the principal. However, if the principal authorizes the agent to appoint any sub-agent at his will, the agent is entitled to dismiss the sub-agent.

## 10. Restrictions Stipulated in Investment Agency

10/1 The investment agent must adhere to a restriction requiring it to consult the principal before any investment and if any breach by the agent results in loss, the agent shall bear it.

10/2 If the Investment Agency is restricted to activities that yield a minimum specified profit margin and the agent does not find such an investment, then it should seek the principal's consent before investment. If it invests in lower-yielding transactions, it is liable to compensate the principal for the difference between the profit earned and the average profit prevalent in the market (if it is less than the stipulated amount/percentage). It is not liable for the minimum profit margin specified for the investment by the principal. [see Shari'ah Standard No. (23) on Agency and the Acts of an Uncommissioned Agent (Fodooli), item 6/3/2]

## 11. Rules of Investment Agency

If the agent co-mingles his own funds with the principal's funds or with the funds that he manages, he may not then purchase, for his own account any assets from the assets owned by the co-mingled funds without giving notice on each occasion. This is to establish the transfer of ownership and liability for the asset from the co-mingled funds to the agent's account. This requirement is impracticable in relation to investment accounts (and therefore this requirement may be waived). [see items 7/1/2 and 7/1/3]

See also Shari'ah Standard No. (23) on Agency and the Acts of an Uncommissioned Agent (Fodooli).

## 12. Contemporary Applications of Investment Agency

12/1 Co-mingling the funds of an unrestricted agency with Mudarabah funds or with the agent's funds.

12/1/1 It is permissible to co-mingle funds on the basis of Investment Agency with funds from Mudarabah investment accounts. Such funds are treated as if they were extra funds provided by a capital provider in a Mudarabah investment or shareholder funds when they are co-mingled with funds in Mudarabah investment accounts. Allocation of profits is calculated by the standard prorated method (usually daily weighted

average method) for funds invested in Mudarabah which takes into account each investor's amount and the tenor of the investment. All the profits of the invested funds in Murabahah belong to the principals and the agent is entitled to his fee and any performance incentive stipulated. The agent is not entitled to any profits generated from the Mudarabah accounts he invested.

12/2 Investment agency for the financing of working capital[2]

Investment agency can be used as a substitute for an overdraft. The amount provided to the client is regarded as the institution's undivided share in the working capital of the client. It is permissible for the client to use the withdrawn amount to settle the client's liabilities relating to his activities or his employees' salaries. The client is entitled to a fee for his service and profit from his portion of the working capital and losses occurring after the agency, if any, are borne by both parties on a pro-rata basis. If the client has any interest-bearing deposits or loans, the institution should stipulate that the client is solely responsible for them.

When the client does not require financing anymore, then the relationship may be terminated on the basis of Takharuj which means that either the joint account is distributed between them pro-rata or one party will purchase the share of the other at a price agreed upon at that time.

12/3 Appointing conventional banks by the institutions as their investment agents and vice versa

12/3/1 It is permissible for institutions to appoint a conventional bank as an investment agent, provided that the relevant contracts are compliant with Shari'ah approved by the institution's Shari'ah Supervisory Board, and that the conventional banks have among their activities Shari'ah-compliant modes of financing and investment with proper Shari'ah supervision

(2) As an alternative to an overdraft, its application requires precise accounting treatment.

and Shari'ah audit without violating the requirements of the regulatory authorities.

12/3/2 It is permissible for the institution to accept funds based on Wakalah from conventional banks and invest them in its activities which have been approved by its Shari'ah Supervisory Board, provided that the contract is free from conditions and restrictions that are prohibited by the Shari'ah.

12/4 Expiry of the investment agency term before collecting amounts receivable

If the agency expires and the receivables are yet to be collected, and the agency is not mutually renewed, the investment agent is required to collect the receivables and take necessary actions against the debtors or other counter-parties delaying their payments.

The agent is not entitled to any fee for such collection unless agreed otherwise. It is not permissible for the agent to use such funds received for his personal use or to re-invest them. The agent is not required to pay to the principal such receivables from his own personal funds, or to seek financing like Tawarruq for this purpose.

12/5 In the event of early termination of the agency either by mutual agreement, or by one party unilaterally exercising its right to terminate or by early settlement of the amounts due (from the obligors), it is permissible (if mutually agreed upon) to reduce the performance incentive stipulated for the agent, if any, in proportion to the tenor of the investment.

## 13. Date of Issuance of the Standard

This Standard was issued on 26 Jumada II, 1432 A.H., corresponding to 29 May 2011 A.D.

# Adoption of the Standard

The Shari'ah Board adopted this Standard in its 30th meeting held in the Kingdom of Bahrain during the period of 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 23 Muharram 1430 A.H., corresponding to 20 January 2009 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Investment Agency.

In its meeting held in Kuwait, on 6 Rabi' I, 1431 A.H., corresponding to 20 February 2010 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Investment Agency and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its 28th meeting held in the Kingdom of Bahrain, during the period of 12-14 Dhul-Qa'dah 1431 A.H., corresponding to 20-22 October 2010 A.D. The amendments that were deemed appropriate were included.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its 29th meeting held in Makkah Al-Mukarramah, during the period of 28-30 Rabi' I, 1432 A.H., corresponding to 3-5 March 2010 A.D. The amendments that were deemed appropriate were included.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 25 Jumada II, 1432 A.H., corresponding to 28 May 2011 A.D. All the comments made in the public hearing were listened to, and a representative of the Shari'ah Board answered these comments and made commentary on them.

In its meeting No. (30) held in the Kingdom of Bahrain, during the period of 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in Al-Madinah Al-Munawwarah, on 30 Sha'ban 1436 A.H., corresponding to 17 June 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for the differentiating between investment agency and agency in general is that the former is in order to increase wealth, and it is similar to Mudarabah and Musharakah in this respect. However, the difference between investment agency and Mudarabah and Musharakah is that Investment Agency is a form of Ijarah (hiring), while Mudarabah and Musharakah are forms of partnership. As for the general agency, it is an authorization to perform specific tasks such as payment etc. Even if the authorization is to engage in a sale/purchase, such as the authorization of the client in a Murabahah contract, its main purpose is to acquire ownership for the institution rather than investment on its behalf.
- The basis for the permissibility of investment agency is the Hadith stating: *"Engage in trade with the wealth of orphans so that it will not be consumed by Zakah"*(3) as well as numerous Verses of the Qur`an on seeking sustenance, striving and earning.
- The basis for the binding nature of the investment agency is that it is entered into for a specific period; i.e., there is an agreement between the counterparties that neither of them can unilaterally dissolve the contract except in certain circumstances specified in the contract.
- The basis for allocating for the investment agent any profit amount in excess of the expected profit is that it is a type of conditional gift and is an incentive.
- If the agency contract stipulates a certain percentage of profit and the agent invests in lower-yielding transactions, the agent is liable to compensate the principal for the difference between the profit earned and the average

(3) Related by Al-Tabrani in *"Al-Awsat"* and graded authentic (*sahih*) by Al-'Iraqi. Ibn Hajar graded it as good (*hasan*). *"Fayd Al-Qadir"* [1: 108]. It is found in *"Al-Muwatta`"* as a statement of Umar (may Allah be pleased with him).

profit prevalent in the market (if it is less than the stipulated amount/ percentage), because he is in breach of the conditions of the Agency. However, the agent is not liable for the specified percentage stipulated in the contract if it is higher than the prevalent market rate, because it will be tantamount to acquiring another's wealth by illegitimate means.(4)

- The basis for the permissibility of employing the agency's funds in the Mudarabah portfolio is that the authorization granted by the investment agency includes such employment when the agency is unrestricted.
- The basis for the principle that the agent, in a situation where the agency's funds are employed in a Mudarabah portfolio, is entitled to the agency commission and not to Mudarabah profit is that his contract with the institution is that of agency and not of Mudarabah. Even if the agent has employed the funds in a Mudarabah portfolio, the profit entitled to the institution is generated from the Mudarabah portfolio and not on the basis of agency.

(4) See *"Al-Mughni"*, vol. 5, (P. 135).

Shari'ah Standard No. (47)

# Rules for Calculating Profit in Financial Transactions

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to explain the rules and methods of calculation and distribution of profits in financing or investment activities of Institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers profit, its validity in Shari'ah and rules and methods of calculating and distributing it. It also explains who is entitled to profit earned from the financing and investment activities of the institutions. This Standard does not cover profit distribution in investment accounts because that is provided in a separate Standard.

## 2. Definition of Profit and Methods of Calculation

In the context of this Standard, Profit means the amount generated in excess of the original capital or of the cost in the operations of financing and investment activities. Calculation of profit refers to the methods used to determine the amount of profit in the institution's operations.

## 3. Permissible and Impermissible Profit

3/1 Permissible profit is that which results from a permissible transaction such as a sale, lease or partnership, in compliance with Shari'ah rules relating to contracts.

3/2 Impermissible profit is that which results from a prohibited transaction such as interest-based contracts, trade in forbidden commodities and/or invalid contracts.

## 4. Determining the Profit Rate in Transactions

4/1 There is no upper limit for profits, provided that the transaction is based on mutual consent, with due consideration for values of kindness, contentment and clemency.

4/2 In principle, it is impermissible for a regulator to cap profits. However, in monopoly situations, extraordinary circumstances and cases of clear public interest, it is permissible to fix the profit rate, provided it is not prejudicial.

## 5. Increasing the Profit Rate for Credit Sales over Cash Sales

It is permissible to increase the profit in credit sales as compared to cash sales, provided that it is incorporated into the price and that the amount of debt is not increased due to any late payment.

## 6. Determining Profit in Amounts or Percentages

6/1 The profit in a Murabahah contract may be stipulated as a fixed amount added to the cost price, or as a percentage of the cost price.

6/2 It is permissible to resort to a well-established benchmark/index mutually agreed upon between the parties in determining the profit during the undertaking stage (Wa'd) or when concluding the transaction. In all cases, the total price, the dates and amounts of the installments, if any, must be stipulated and must not vary with the movement of the benchmark/index. [see Shari'ah Standard No. (8) on Murabahah, item 4/6]

## 7. Setting Different Ratios or Rates for Profit Distribution in Mudarabah Financing

7/1 In Mudarabah financing it is permissible to set different profit ratios or rates as per the different tenors of the Mudarabah. The different rates may also be triggered upon the profit of either party reaching a specified hurdle rate. In all cases, no party to a Mudarabah contract may be totally deprived of profit. [see Shari'ah Standard No. (13) on Mudarabah, item 8/5]

7/2 It is permissible for the capital provider to stipulate that the mudarib does not employ the funds in investment activities where the expected profit rate falls below a specific percentage, taking into consideration that it is not permissible to either guarantee the capital, or the profit or both. [see Shari'ah Standard No. (46) on Investment Agency]

## 8. Profit Distribution in Shari'ah-Compliant Deferred Transactions

8/1 It is permissible to adopt customary accounting practices that are required by supervisory and/or regulatory bodies for calculating and distributing profit in deferred transactions across several financial

periods, provided they are in accordance with Shari'ah. Whenever possible, AAOIFI's Accounting Standards shall be adopted in this process.

8/2 When preparing their financial statements, institutions must avoid any methods of profit calculation or distribution that are misleading or deceptive.

9. **The Institution Must Disclose Its Method of Profit Calculation** and allow its clients to inquire about such methods. Likewise, it must disclose such methods when mentioning profit in its advertising campaigns and product marketing brochures in order to prevent any deception. In contracts, Institution must disclose the total price or the cost price and the profit, either as a lump sum or as a percentage of the cost price. Where profit rate is time-bound, it is impermissible to re-schedule debt obligations through increasing the profit and/or total amount by extending the duration.

10. **It Is Permissible to Adopt Shari'ah-Ccompliant Customary Accounting Practices to Calculate Profit** based on the length of the financing period such as a calculation method that determines profit for the entire period on the basis of an annualised percentage of the total amount of financing provided or a calculation method that determines profit on the basis of an annualised percentage of the amount of financing outstanding according to an amortised payment schedule, provided that it does so transparently and with full disclosure and that the total sale price is stated as a fixed amount.

11. **It Is Permissible for the Institution to Grant Its Client a Rebate for Early Payment** provided that this rebate was not stipulated in the contract, taking into consideration regulatory directives.

12. **Contractual Relationship Between the Institution and Its Client Is Not Affected by the Method Adopted in Booking Its Profits** in its internal records, as in separating the profit account from the expense account. Institutions should regularly upgrade their systems and computer software in order to be consistent with Shari'ah standards and rulings.

## 13. Date of Issuance of the Standard

This Standard was issued on 26 Jumada II, 1432 A.H., corresponding to 29 May 2011 A.D.

# Adoption of the Standard

The Shari'ah Board adopted this Standard in its meeting No. (30) held in the Kingdom of Bahrain during the period of 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 14 Rabi' I, 1429 A.H., corresponding to 20 April 2008 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Calculating Profit in Financial Transactions.

In its meeting held in Kuwait, on 24 Ramadan 1431 A.H., corresponding to 28 January 2010 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Calculating Profit in Financial Transactions and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its 28th meeting held in the Kingdom of Bahrain, during the period of 12-14 Dhul-Qa'dah 1431 A.H., corresponding to 20-22 October 2010 A.D. The amendments that were deemed appropriate were included.

The General Secretariat held a public hearing in the Kingdom of Bahrain, on 25 Jumada II, 1432 A.H., corresponding to 28 May 2011 A.D. All the comments made in the public hearing were listened to, and a representative of the Shari'ah Board answered these comments and made commentary on them.

In its meeting No. (30) held in the Kingdom of Bahrain, during the period of 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in Al-Madinah Al-Munawwarah, on 30 Sha'ban 1436 A.H., corresponding to 17 June 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for not stipulating a maximum profit limit is the Quranic Verse: ***{"...except it be a trade amongst you, by mutual consent"}***.(2) This ruling is also confirmed by Resolution No. (46) 5/8 of the Islamic Fiqh Academy, which states: "There is no fixed specific profit rate that traders are bound by."
- The basis for the permissibility of increased profit/price in a deferred/credit sale is the Quranic Verse: ***{"Allah has permitted sale"}***(3) as referring to the deferred sale in order for the comparison between it and interest, which also involves an increase, to be valid. Accounting Standard No. (20) has been issued on deferred sales.
- The basis for the permissibility of using different rates in Mudarabah transactions is because such a provision does not disrupt the sharing of profits by all parties.

(2) [Al-Nisa` (The Women): 29].
(3) [Al-Baqarah (The Cow): 275]

Shari'ah Standard No. (48)

# Options to Terminate Due to Breach of Trust (Trust-Based Options)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard covers the rules relating to options of buyers to revoke contracts where such options exist by operation of a Shari'ah rule as opposed to stipulation of the parties and which arise from the seller deceiving the buyer by statement or action or grossly overcharging him. It also covers the applications of such options to revoke in the activities of financial institutions.[1]

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the rules relating to options of buyers to revoke contracts that arise immediately upon the seller deceiving the buyer by statement or conduct or grossly overcharging him in specific circumstances. It does not cover *Khiyarat al-Tarawwi* (options to reconsider) or *Khiyarat al-Salamah* (options to revoke due to incomplete performance) as they have separate Shari'ah Standards dedicated to them.

## 2. *Khiyar Al-Taghrir* (Option to Revoke on Grounds of Deception)

### 2/1 Definition of *Khiyar al-Taghrir*

The option to revoke on grounds of verbal deception is the right of a buyer to revoke a contract due to deception by the seller or a colluding party, inaccurately describing the sale item so that the buyer purchases it at a price higher than the market price.

### 2/2 Examples of verbal deception (*Taghrir*)

a) Deliberate misinformation regarding the original cost price or expense incurred in a Murabahah (markup), *Tawliyah* (sale at cost) or *Hatitah* (sale below cost) sale. [see Shari'ah Standard No. (8) on Murabahah]

b) Increasing the bid in an auction sale phantom bidding which is known as Munajashah or Najsh.

c) Inaccurate statements to mislead the buyer into thinking that the sale item meets his requirements, or falsely claiming that it is no longer available elsewhere in the market.

d) Deceptively inaccurate announcements about a company's performance in order to entice the public to buy its shares.

**2/3 Causes**

2/3/1 The buyer has the option to revoke the contract in the event of being verbally deceived.

2/3/2 The buyer may return the item within a period customarily acceptable for revocation.

**2/4 Lapse of the option**

2/4/1 The option to revoke on grounds of verbal deception lapses if the item is destroyed or consumed by the buyer before the deception is discovered, or if an impediment arises preventing return, or if the buyer fails to return it despite being able to do so.

2/4/2 If this option lapses, the sell is entitled to the full price of the item and the buyer is not entitled to any refund.

2/4/3 The seller is liable for expenses relating to the return of the item to the place of sale.

**2/5 Transfer of the option**

*Khiyar al-Taghrir* does not transfer to the heirs of its holder upon death of the owner.

**3. *Khiyar Al-Tadlis* (Option to Revoke on Grounds of Deceptive Conduct)**

**3/1 Definition**

*Khiyar al-Tadlis* is the option of a buyer to revoke a contract on grounds of deceptive conduct by the seller or a colluding party. Such conduct would be to portray the sale item different than its actual condition, inducing the buyer to think that it is in a better condition.

**3/2 Prerequisites**

3/2/1 The deception must result from the seller's conduct or instructions. If caused by something that is beyond the seller's control or by unforeseen circumstances, the option is invalid.

3/2/2 The buyer must be unaware of the deception.

3/2/3 The deception must be continuing. If the seller engages in a deceptive conduct but the sale item's condition eventually improves (to a condition not less than the original specification) before the contract is revoked, the buyer has no right of revocation.

**3/3 Examples of deceptive conduct**

3/3/1 False branding of products using counterfeit labels to promote sales.

3/3/2 Painting an old car to hide its age and give the impression that it is new.

3/3/3 Adding lubricants or other substances so that the product appears in a better condition.

**3/4 Causes of *Khiyar al-Tadlis***

3/4/1 A buyer who is enticed by deceptive conduct may return the sale item or retain it.

3/4/2 The buyer may return the item within a period customarily acceptable for return.

3/4/3 The buyer is not entitled to compensation if he decides to retain the sale item.

**3/5 Lapse of the option**

The option to revoke on grounds of deceptive conduct lapses if the item is destroyed or consumed by the buyer after the deception is discovered, or if the buyer fails to return it despite being able to do so.

**3/6 Transfer of the option**

*Khiyar al-Tadlis* does not transfer upon death to the heirs of its owner.

**4. *Khiyar Al-Ghabn* (Option to Revoke on Grounds of Price Gouging)**

**4/1 Definition**

*Khiyar al-Ghabn* is a buyer's right to revoke a contract or accept it if it is discovered that the price paid exceeds the highest estimate given by experts in the market. The price gouging that triggers this

option is that which, according to the opinion of certified valuators, is deemed excessive in commercial custom.

**4/2 Prerequisite**

The buyer must be unaware of price gouging at the inception of the contract.

**4/3 Examples of price gouging**

4/3/1 Sale to a *Mustarsil*; i.e., a purchaser who does not negotiate the price because he trusts the seller not to overcharge him.

4/3/2 Collusion between brokers and sellers that leads to price spikes or increases of prices above fair market levels.

4/3/3 Exploiting the ignorance of exporters using deceptive statements in order to purchase items from them at a price lower than the prevalent price in the importer's country.

4/3/4 Acting as an intermediary between sellers and other market participants in order to sell items in the market for more than the prevalent price.

**4/4 Causes of *Khiyar al-Ghabn***

4/4/1 The party deceived by price gouging has the right to revoke the contract; he may also accept it without recourse to refund.

4/4/2 If the party deceived by price gouging accepts the contract, then he is not entitled to seek any compensation. It is permissible for the two parties (the party deceived by price gouging and the seller) to mutually agree upon an indemnification amount instead of revocation.

**4/5 *Khiyar al-Ghabn* lapses in the following situations**

a) Destruction or consumption of the sale item or the occurrence of any change or defect in it. The attachment of a third-party right over the sale item has the same legal effect as its consumption.

b) Inaction of the buyer during the period enabling him to revoke, and after discovering price gouging in the sale item.

c) Any disposal of the sale item, by the buyer, after discovering price gouging.

**4/6 Transfer of the option**

*Khiyar al-Ghabn* does not transfer upon death to the heirs of its owner.

**5. Date of Issuance of the Standard**

This Standard was issued on 26 Jumada II, 1432 A.H., corresponding to 29 May 2011 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Trust-Based Options in its meeting No. (30) held in the Kingdom of Bahrain during the period of 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 18 Jumada II, 1431 A.H., corresponding to 2 April 2010 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Trust-Based Options.

In its meeting held in Dubai, on 24 Ramadan 1431 A.H., corresponding to 3 September 2010 A.D., the Shari'ah Standards Committee discussed the draft of a Shari'ah Standard on Trust-Based Options and made necessary amendments.

The revised draft of the Shari'ah Standard was presented to the Shari'ah Board in its meeting No. (29) held in the Makkah Al-Mukarramah, during the period of 28-30 Rabi' I, 1432 A.H., corresponding to 3-5 March 2010 A.D. The amendments that were deemed appropriate were included.

The General Secretariat held a public hearing in the Kingdom of Bahrain on 25 Jumada II, 1432 A.H., corresponding to 28 May 2011 A.D. The public hearing was attended by a number of representatives from central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in this field. All the comments made in the public hearing were listened to, and; the members of the Shari'ah Standards Committee then answered or commented on them and decided to accept some of them.

In its meeting No. (3) held in the Kingdom of Bahrain, during the period of 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated the necessary amendments that it deemed appropriate, and adopted the Standard.

In its meeting held in the United Arab Emirates, on 7 Sha'ban 1436 A.H., corresponding to 25 May 2015 A.D., the Shari'ah Standards Review Committee reviewed this Standard. After deliberation, the committee approved necessary amendments, and the Standard was adopted in its current amended version.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Options to revoke sales on grounds of breach of trust are either permissible in Shari'ah by default or by stipulation in the contract.
- The basis for permissibility is that sale contracts should by default be free from defect.
- If then it is discovered that this was not the case and there was deception, verbally or by conduct or there was price gouging, the buyer has the right to revoke the contract.
- The basis for the permissibility for the option to revoke on the grounds of verbal deception because it contradicts the basic pillar of valid contracts in Shari'ah, which is mutual consent. That is because, without the verbal deception, the buyer would not have proceeded with the purchase. The same basis applies for deceptive conduct being a ground for revocation.
- The basis for the permissibility of revoking contracts on the grounds of price gouging with a trusting buyer is the Hadith stating: *"Overcharging a trusting buyer (Mustarsil) is forbidden"*.(2) A variant narration states: *"Overcharging a trusting buyer is Riba (usury)"*.(3)
- The basis for the lapsing of the option to revoke due to the disposal of the sale item by the buyer after having discovered the deception, verbally or by conduct, is that this disposal is equivalent to an explicit consent to waive this option.

(2) Related by Al-Tabarani (H: 3410)
(3) Related by Al-Bayhaqi (H: 10924 and 10925)

## Shari'ah Standard No. (49)

# Unilateral and Bilateral Promise

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to explain the concepts of unilateral promise/undertaking (promise) and bilateral promise/undertaking (bilateral promise); their various types and the enforceability of each type; the Shari'ah rules that govern them and the most important contemporary applications of each type in the activities of Islamic financial institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers promises (unilateral and bilateral) given by certain parties for the purpose of concluding a contract or effecting a disposal, and explains when such instruments are binding and when they are not, the jurisprudential rules that govern them, and the most important contemporary applications of each type in the activities of Islamic financial institutions.

## 2. Definitions of Unilateral and Bilateral Promises

2/1 For the purpose of this Standard, a unilateral promise is given when a party informs another of its resolute intention (undertaking) to act in the future in the interest of the other, with the other having the option to avail itself of the promise. The party undertaking the promise is called the 'promisor', the party receiving the promise is called the 'promisee' (the beneficiary of the promise) and the action is called the 'promised action'.

2/2 Bilateral promise in this Standard refers to the exchange of two back-to-back promises between two parties, each promising to perform an act in the future relating to the same subject matter.

## 3. Types of Promises and the Shari'ah Rules Applicable to Them

3/1 Promising to perform an act that impermissible by the Shari'ah is prohibited, and fulfilling such a promise is also prohibited. Examples of such promises are those intended to be a ruse to circumvent the prohibition of interest-bearing (Riba) transactions.

3/2 Any promise in a loan contract that procures benefit for the lender, over and above the repayment of the debt, is prohibited by the Shari'ah even if the promise is granted in a document separate from the loan contract.

3/3 Any promise in a sale contract made by the buyer or the seller that results in a repurchase contract ('Inah) is prohibited by the Shari'ah, whether the promise is part of the sale contract or is given prior or subsequent to it, such as purchasing an item on credit and promising to sell it back on spot for a lower price or selling an item on credit and promising to buy it back on spot for a lower price (reverse 'Inah). The same prohibition applies if the parties collude with a third party to act as an intermediary in the repurchase.

3/4 It is permissible to promise to perform an action or a financial transaction and it is then a religious obligation to fulfill it, meaning that breaking a promise without an excuse is a sin. However, a promise is not legally binding except when there is a real need for it to be enforced, such as when the promisor causes the promisee to incur a liability as a result of the promise. For example, if a person instructs a merchant to purchase a specific item and then resolutely promises the merchant that he will buy this item from him. If the merchant purchases the item solely in reliance on the promise, the promisor is legally bound to purchase the item from him, failing which the promisor is required to indemnify the promisee (merchant/seller) for any actual loss suffered such that if the merchant is unable to sell the item for a price that covers the cost of the item, the promisor is required to make up the difference between the cost of the item and the price obtained by the merchant for it. Actual loss does not include opportunity cost.

3/5 A legally binding promise, as explained in item 3/4 above, is enforceable only against the promisor and is not enforceable against the promisee who has the option either to demand performance from the promisor or to waive it.

3/6 Fulfilling a benevolent promise (such as a promise to make a gift or lend an item) is a religious obligation but is not binding legally, except if the promise is conditional upon the promisee performing an action that causes the promisee to incur a liability, in which case it is legally binding. For example, if the promisor says to the promisee: "If you

buy this item from me, I will give you a gift of another specified item", fulfilling such a promise is a religious obligation and is legally binding.

3/7 It is permissible for a party to promise to enter into a commutative contract in the future and for the promisee to promise the first party to enter into a separate commutative contract with a different subject matter from that of the first promise. For example, the first party says, "I promise to sell you this item", and the other party says, "I promise to lease to you such and such property", neither of the two promises is legally binding except if a promisor causes a promisee to incur a liability, in which case such promise is binding. [see item 3/5]

3/8 When a promise is made to enter into a contract in the future, such contract is not effected automatically. The contract must be entered into at the relevant time by the exchange of offer and acceptance. Where the promise is legally binding, if the offer is made by the promisee, the promisor is bound religiously and legally to accept it. And if the offer is made by the promisor, the promisee has the option to accept or reject it.

## 4. Types of Bilateral Promise and the Rules Applicable to Them

4/1 A bilateral promise to perform an act that is prohibited by the Shari'ah is itself prohibited such as a bilateral promise to enter into one or more contracts with the intention to circumvent the prohibition of interest (Riba); e.g., a bilateral promise to enter into a sale and repurchase ('Inah) contract and a bilateral promise to enter into a sale and a loan.

4/2 Fulfilling a bilateral promise to perform an act that is permitted but not binding under the Shari'ah is a religious obligation on both parties but is not legally binding except in situations where an actual commercial transaction is not possible without a binding bilateral promise owing either to legal requirements or to general commercial custom, and the objective is not merely to provide financing, such as:

4/2/1 Bilateral promises in international trade conducted by means of documentary credits.

4/2/2 Bilateral promises in supply agreements.

4/3 The binding bilateral promises referred to in item 4/2 are not future contracts, which means that the promised contract is not effected automatically upon the promised date. The contract must be entered into at the relevant time by exchanging notices of offer and acceptance. Since the bilateral promise is binding on both parties, if any party makes an offer, the other party is religiously and legally bound by it. If one party defaults in fulfilling the promise, the other party can obtain a court injunction requiring them to conclude the contract. If it is not possible to conclude the contract and the promisee needs to mitigate his loss by concluding the same contract with a third party but is not able to recover his cost by means of such contract, the defaulting party is liable to indemnify him for actual loss suffered (not to include opportunity cost) if the price obtained under the new contract (with the third party) is lower than price promised by the defaulting party.

4/4 It is permissible for the two parties to enter into a master agreement for future transactions where each party has the option whether or not to enter into the future transaction. If the parties enter into a transaction, then the terms and conditions agreed in the general framework (master agreement) apply. An agreement containing a general framework (a master agreement) is a bilateral promise that does not bind any of the parties to enter into those transactions. For example, an institution and a client wishing to enter into Murabahah transactions can agree on a general framework which explains the transaction process and the terms and conditions. A general framework (a master agreement) is not considered to be a concluded transaction and the client is not required upon signing the framework to enter into a Murabahah contract. Rather, each party has an option. When the parties enter into the Murabahah contract by exchanging notices of offer and acceptance, the contract becomes subject to all the terms and conditions agreed upon in the general framework (master agreement) which are expressly reconfirmed and incorporated in every contract. [see Shari'ah Standard No. (37) on Credit Agreement]

## 5. Permissible Applications of Promises and Bilateral Promises

5/1 The promise given by the client in the Murabahah transactions conducted by institutions is legally binding by virtue of item 3/5 of this Standard. [see Shari'ah Standard No. (8) on Murabahah]

5/2 The promise given by the institution in Ijarah Muntahia Bittamleek transactions to grant the leased asset to the lessee as a gift conditional on that he pays all the lease installments is legally binding as in item 3/6 of this Standard. [see Shari'ah Standard (9) on Ijarah Muntahia Bittamleek]

The promise given by the institution in diminishing Musharakah transactions that it will lease its share of the asset to the other co-owner is legally binding and the promise given by the client that he will buy units of the institution's share at stipulated intervals are legally binding by virtue of item 3/5 of this Standard. [see para 5 of Shari'ah Standard No. (12) on Sharikah (Musharakah) and Modern Corporations]

## 6. Impermissible Applications

It is impermissible to enter into back-to-back bilateral promises for the purpose of circumventing the prohibition by Shari'ah of certain transactions, such as back-to-back derivatives as in items 3/1 and 3/7 of this Standard. [see para 5 of Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets]

## 7. Date of Issuance of the Standard

This Standard was issued on 21 Safar 1434 A.H., corresponding to 4 January 2013 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the Standard on Unilateral and Bilateral Promise in its meeting No. (34), held in the Kingdom of Bahrain, during the period of 20-21 Safar 1434 A.H., corresponding to 3-4 January 2013 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 14 Jumada II, 1430 A.H., corresponding to 7 June 2009 A.D., the General Secretariat decided to commission a Shari'ah consultant to prepare a juristic study on Unilateral and Bilateral Promise.

In a joint meeting held in the Kingdom of Bahrain, on 18 Safar 1428 A.H., corresponding to 8 March 2007 A.D., the Shari'ah Standards committees (1) and (2) discussed the study, approved it and required the consultant to prepare the exposure draft of the Standard.

In a further joint meeting held in Manama, the Kingdom of Bahrain, on 15 Jumada I, 1428 A.H., corresponding to 31 May 2007 A.D., the Shari'ah Standards Committees (1) and (2) discussed the draft of the Standard and necessary amendments were made in the light of the discussions and observations of the meeting.

In its meeting No. (19) held in Makkah Al-Mukarramah, during the period of 26-30 Sha'ban 1428 A.H., corresponding to 8-12 September 2007 A.D., the Shari'ah Board discussed the draft of this Standard and made the amendments which it deemed necessary.

The General Secretariat held a public hearing in the Kingdom of Bahrain on 8 Jumada II, 1429 A.H., corresponding to 12 June 2008 A.D. The public hearing was attended by a number of representatives from central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in this field. The members of the Shari'ah Standards Committees (1) and (2) duly responded to several comments and observations that were made in the public hearing.

In its meeting No. (21) held in Al-Madinah Al-Munawwarah, during the period of 21-48 Jumada II, 1429 A.H., corresponding to 28 June -2 July

2008 A.D., the Shari'ah Board discussed the amendments proposed by the participants in the public hearing and incorporated the amendments that it considered suitable.

In its meeting No. (25) held in the Kingdom of Bahrain, during the period of 2-4 Dhul-Qa'dah 1430 A.H., corresponding to 21-23 October 2009 A.D., the Shari'ah Board discussed the draft of the Standard, incorporated the necessary amendments that it deemed appropriate, and adopted the Standard.

# Appendix (B)
# The Shari'ah Basis for the standard

The International Islamic Fiqh Academy resolved: "In situations where a sale contract cannot be concluded because the seller does not own the commodity and there is a public interest in obligating both parties to sign a contract in the future by virtue of law or otherwise, or according to international norms and customs, as in the case of opening letters of credit for importing goods, bilateral promise can be made binding to the two parties". [Resolution No. (157) 6/17 on Bilateral Promise and Collusion in Contracts (Islamic Fiqh Academy Magazine), Issue No. (17), Vol. 3, (P. 681)]

# Appendix (C)
# Definitions

**General Framework (Master Agreement)**

An agreement representing mutual understanding and the exchange of non-binding bilateral promises to enter into transactions.

Shari'ah Standard No. (50)

# Irrigation Partnership (Musaqat)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to explain the Shari'ah rules and requirements for Irrigation Partnership (Musaqat) and its applications in the activities of Islamic financial Institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the Shari'ah rules and requirements for Irrigation Partnership (Musaqat) and its applications in the activities of Islamic financial institutions. It does not cover other forms of agricultural partnership as they have separate Shari'ah standards dedicated to them.

## 2. Definition of Irrigation Partnership (Musaqat)

A contract between the owner of an orchard or its usufruct and a worker (irrigator) agreeing to share the produce according to specific ratios stipulated at the time of contract.

## 3. Permissibility and Description of the Contract

Irrigation Partnership (Musaqat) is a permissible contract that becomes binding on commencement of the work or if mutually agreed between the two parties not to terminate the contract before its expiry.

## 4. Elements of Irrigation Partnership

4/1 Offer and acceptance should be exchanged explicitly or implicitly by means of a recognised form of indication.

4/2 Each of the two parties should be legally competent.

4/3 The relevant trees should be identified, arable (productive), and in need of irrigation and plant husbandry.

## 5. Conditions of Validity (Prerequisites)

5/1 The contract should stipulate for each party a predetermined, defined, indivisible share of the produce.

5/2 The work should be restricted to the husbandry of the crop and trees. The owner may not (in this contract) demand any additional work from the worker (irrigator).

5/3 The contract is valid until the time of harvest or for a defined period in which the crop is normally enough for harvest.

**6. Duties of the Worker (Irrigator)**

6/1 The worker (irrigator) is obligated to care for the trees and crops as per agreement with the owner and customary requirements, including:

6/1/1 Carrying out plant husbandry by watering, pollinating, fertilising, weeding, maintaining and cleaning irrigation channels, pruning, controlling pests, harvesting and performing seasonal work that is usually required for each type of tree.

6/1/2 Not commissioning or subcontracting a third party to carry out his work without the permission of the owner. If he does so, the owner of the trees has the option to ratify the third party contract or reject it.

6/2 The worker (irrigator) may employ others to assist him to carry out part or all of the contracted work.

6/3 The worker (irrigator) acts in a fiduciary capacity and is not liable for any loss arising from other than wilful misconduct, negligence or breach of the terms of the contract. In such a case, he is liable to indemnify the owner against any actual loss caused, but remains entitled to his share of the crop.

**7. Duties of the Owner of the Trees**

The owner should facilitate for the worker (irrigator) full access to the trees (subject of contract), and remove any impediments which may hinder the work of the worker (irrigator).

**8. Joint Duties of the Worker (Irrigator) and the Owner of Trees**

8/1 After harvesting, the worker (irrigator) and the owner are obligated to take care of the crop, each in proportion to his share. Prior to harvesting, the worker (irrigator) is obligated to take care of the crop unless custom or a term of the contract dictates otherwise.

8/2 The worker (irrigator) and the owner are responsible for the expenses of the Irrigation Partnership in proportion to their shares, including any Takaful insurance, unless they agree otherwise.

8/3 The worker (irrigator) is solely responsible for performing the work customarily undertaken by workers (irrigators) in similar Irrigation Partnerships and such work does not entitle him to any increase in his share of the crop as he is already contractually obligated to carry it out. If he hires others to perform his work, their wage is his sole responsibility and should not be taken from the overall crop. The worker (irrigator) may hire, on the account of the Irrigation Partnership, others to perform work that is customarily beyond the scope of his duties.

8/4 If the worker (irrigator) refuses to complete the term of the Irrigation Partnership after commencing work or entering into the contract, the owner should demand performance from him. If the worker (irrigator) stops working before the crop materializes he is not entitled to any share. If he stops working after the crop materializes but before it is ready for harvest, a third party should be hired to complete the work and his wage should be deducted from the worker's (irrigator's) share after the crop is harvested and sold. If the worker's (irrigator's) share is not sufficient to pay the third party's wage, the worker (irrigator) must make up the difference. If the worker's (irrigator's) share of the crop is more than the third party's wage, he keeps the difference.

8/5 In an Irrigation Partnership (Musaqat) that is due to terminate when the crop materializes or is ready for harvest, if the owner does not enable the worker, and this occurs before the crop materializes, then the owner shall be requested to enable the worker (irrigator) to complete his work. If the owner does not enable the worker (irrigator), then the worker (irrigator) shall be entitled to a wage at the market rate for similar work. If this occurs after the crop materializes, the worker (irrigator) is entitled to his stipulated share of the crop.

## 9. Division of Produce

9/1 In principle, all recurring produce of the trees should be shared as part of the crop, such as fruits, palm leaves etc. unless the parties agree to restrict their sharing arrangement to just the fruits.

9/2 The worker (irrigator) is entitled to his share of the crop on an indivisible basis as soon as it materializes.

## 10. Contingencies in Irrigation Partnerships

10/1 If the crop does not materialize at all or is completely destroyed by a natural disaster, the worker (irrigator) is not entitled to anything. If the natural disaster destroys only part of the crop, the parties divide what remains according to their stipulated shares.

10/2 If the crop does not materialize during the stipulated term, the worker (irrigator) has the option either to stop working or to continue his work without a wage until the crop materializes and thereafter takes his share. If he stops working without a valid excuse, he foregoes his right to a share of the crop when it materializes. If he has a valid excuse, he is entitled to the portion of his share that corresponds to the period of time worked in proportion to the total time the crop took to materialize.

## 11. Trees Belonging to Third Parties and Usurped Trees

11/1 If it transpires that the trees belong to a third party, the crop will then belong to him (the third party). In this case, the worker (irrigator) is entitled to a wage or compensation from the other party (the usurping party) at the market rate for similar work but not exceeding (what would have been) his share of the crop.

11/2 If the worker (irrigator) enters into an Irrigation Partnership (Musaqat) with a party who, unbeknown to the worker (irrigator), has usurped the trees, then the produce, if any, will belong to the owner of the trees and the worker (irrigator) will be entitled to a wage at fair market rate. But if the worker (irrigator) knew that the trees were usurped, then he is not entitled to any remuneration.

## 12. Termination of Irrigation Partnership Contract (Musaqat)

The Irrigation Partnership (Musaqat) contract terminates upon the occurrence of any of the following:

12/1 Harvest and division of the crop, if the Irrigation Partnership was linked to the produce of a specific season.

12/2 Completion of the agreed term and division of the crop in accordance with Item 10/2.

12/3 Death of the worker (irrigator) or liquidation of the institution carrying out the work if the Irrigation Partnership (Musaqat) contract stipulates that the work is non-assignable. If there is no such stipulation, the successor has the option to complete the work on the same terms, either himself or by hiring workers (irrigators), in return for the deceased's (or liquidated institution's) share of the crop. If the successor chooses not to complete the work, the owner may complete the work himself or by hiring others and upon materialization of the crop, the successor of the worker (irrigator) is entitled to receive a wage at the market rate for similar work for the period of time worked by the deceased (or liquidated institution) but not exceeding his (or its) stipulated share of the crop.

12/4 Death of the trees that are the subject matter of the contract or inability of the trees to bear fruit.

12/5 Passing of a season without any fruit.

## 13. Revocation of Irrigation Partnership Contract (Musaqat)

13/1 Irrigation Partnership (Musaqat) contract is revocable by mutual consent of the two parties (Iqalah).

13/2 The owner can revoke the contract in the following situations:

13/2/1 When the worker (irrigator) is unable to perform the work, in which case the following apply:

13/2/1/1 If the worker (irrigator) is unable to work for a reason outside his control, such as an illness, he is entitled to receive a wage

at the market rate for similar work for the period of time worked.

13/2/1/2 If the worker (irrigator) is unable to work for a reason within his control, he is entitled to receive a wage at the market rate for similar work for the period of time worked. He is also liable to indemnify the owner for actual loss suffered, as determined by experts.

13/2/2 When the worker (irrigator) stops working and it is not possible to enforce him (to fulfil the terms of the contract).

13/3 The worker (irrigator) is entitled to revoke the contract if the owner refuses to allow him to work. [see item 8/5]

## 14. Zakat Due on Irrigation Partnership (Musaqat)

See Shari'ah Standard No. (35) on Zakat, item 5/4/9.

## 15. Some Applications of Irrigation Partnership (Musaqat) in Financial Institutions

15/1 The institution may enter into Irrigation Partnership (Musaqat) contracts with the owners of trees and then hire workers (irrigators) to carry out the work.

15/2 The institution can own trees and enter into Irrigation Partnership (Musaqat) contracts with other parties to carry out the work.

## 16. Date of Issuance of the Standard

This Shari'ah Standard was issued on 21 Safar, 1434 A.H., corresponding to 4 January 2013 A.D.

# Adoption of the Standard

The Shari'ah standard on Irrigation Partnership (Musaqat) was adopted by the Shari'ah Board in its meeting No. (34) held during the period of 20-21 Safar, 1434 A.H., corresponding to 3-4 January 2013 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 24 Dhul-Qa'dah 1431 A.H., corresponding to 30 November 2010 A.D., the Secretariat of AAOIFI decided to commission a Shari'ah consultant to prepare a juristic study on Irrigation Partnership (Musaqat).

In its meeting No. (30) held in the Kingdom of Bahrain, on 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011 A.D., the Shari'ah Board discussed the exposure draft of the standard and introduced the changes it deemed suitable.

In its meeting No. (31) held in the Kingdom of Bahrain, on 22-24 Dhul-Qa'dah 1432 A.H., corresponding to 20-21 October 2011 A.D., the Shari'ah Board also discussed the exposure draft of the standard and introduced the changes it deemed suitable.

In its meeting No. (32) held in Al-Madinah Al-Munawwarah, on 8-9 Rabi' II, 1433 A.H., corresponding to 1-2 March 2012 A.D., the Shari'ah Board continued its discussions on the draft exposure of the standard and introduced the changes it deemed suitable.

The Secretariat of AAOIFI held a public hearing in the Kingdom of Bahrain on 16 Jumada II, 1433 A.H., corresponding to 7 May 2012 A.D. The public hearing was attended by representatives of central banks, institutions, auditing firms, Shari'ah scholars, academics and others interested in this field. The members of the Shari'ah Board and the Shari'ah Standards Committee responded to a number of observations and comments raised by the participants.

In its meeting No. (33) held in Makkah Al-Mukarramah on 19-21 Shawwal 1433 A.H., corresponding to 6-8 September 2012 A.D., the Shari'ah Board

discussed the changes proposed at the public hearing and introduced the changes it deemed suitable to the draft exposure of the standard.

In its meeting No. (34) held in the Kingdom of Bahrain on 20-21 Safar 1434 A.H., corresponding to 3-4 November 2013 A.D., the Shari'ah Board discussed the exposure draft of the standard, introduced the changes that it deemed suitable and adopted the standard.

In its meeting No. (35) held in Al-Madinah Al-Munwwarah on 22-23 Shawwal 1434 A.H., corresponding to 29-30 September 2013 A.D., the Shari'ah Board continued its discussions on the exposure draft of the standard, and introduced the changes it deemed suitable, and adopted the standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Permissibility of Musaqat and Its Rationale**

- The basis for the permissibility of Musaqat is the Sunnah, Ijma' and common sense. From the Sunnah, there is the Hadith narrated by Ibn Umar that the Prophet Muhammad (peace be upon him) gave the land of Khaybar to its inhabitants to work on and cultivate in return for half of its yield (fruits and plants).(2)

  Based on Ijma', the companions (may Allah be pleased with them) practiced Musaqat in Khaybar until Umar (may Allah be pleased with him) evacuated them therefrom, without any objection from whosoever. Ijma' or consensus (by Four Schools of Fiqh) as to permissibility of Musaqat was cited by prominent scholars Al-Bisyawi, Ibn Hazm and Al-'Utabi, Muwaffaq Al-Din Ibn Qudamah, Shams Al-Din Ibn Qudamah and Al-Shamakhi, the author of *"Ghayat Al-Bayan"*, Ibn Muflih and Al-Buhuti.(3)

  On the basis of common sense, Musaqat fulfils the interest of both parties, and is associated with no harm.

  Its permissibility may also be deduced in analogy with Mudarabah.

- The basis for bindingness of Musaqat once it has been entered into or undertaken is the overarching Quranic Verse: ***{"O you who believe! Fulfil (your) obligations"}***.(4)

(2) Related by Al-Bukhari, Chapter on Muzara'ah for half of the produce, and so on. Also, related by Muslim, Chapter on Musaqat for part of the fruits and plants.

(3) See *"Al-Mukhtasar"*, Al-Bisyawi, (P. 291); *"Al-Jami'"*, Abu Al-Hasan, [49: 4]; *"Al-Muhalla"*, [8/230]; *"Al-Diya"*, [18: 245]; *"Al-Mughni"*, [5: 549-552]; *"Al-Sharh Al-Kabir"*, [5: 557]; *"Al-Idah"* [6: 233]; *"Al-Bahr Al-Ra`iq"* [8: 64]; *"Al-Mubdi'"* [5: 46]; and *"Kashf Al-Qina'"* [3: 533].

(4) [Al-Ma`idah (The Table): 1].

**Elements of Musaqat Contract**

- The basis for stipulating legal competency in a Musaqat contract is the Prophet's Hadith: *"The Pen has been lifted from writing the deeds of three: The one who is asleep until one wakes up, the child until he/she becomes pubescent and the insane until he/she becomes sane"*.(5)
- The basis for the necessity for identification of trees (subject matter of the contract), and the stipulation of the trees being arable (productive) in usual circumstances is avoidance of Gharar. Trees that are not arable (productive) do not fit the purpose of Musaqat.
- The basis for the stipulation of irrigation and cultivation of trees is that work is one of the requisite elements of the contract (Arkan), and Musaqat is invalid in the absence of one of its requisite elements.

**Prerequisites of Validity**

- The basis for specification of a predetermined, common share for both parties to the contract is the Hadith narrated by Ibn Omar that the Prophet (peace be upon him) gave the land of Khaybar to its inhabitants to work on and cultivate in return for half of its yield (fruits and plants). The specification of lump-sum compensation will divert the contract away from the features of Musaqat. The determination of a known compensation is meant to avert impermissible obscurity (Jahalah).
- The basis for the confinement of work to fruit growing and tree cultivation is that this what entails work in Musaqat; if another form of work is stipulated in the contract, such a stipulation shall contradict the very nature of the contract, as it only fulfils the interests of one party at the expense of the other.
- The basis for making the term of Musaqat equal to the period ending with the time the produce materializes or over a term enough for the produce to materialize is the rules of justice in Shari'ah so that the trees owner does not exclusively benefit from the produce while the worker receives nothing. The produce is what the contract is meant to achieve after all, and therefore it is impermissible that the worker is devoid of his/her rights by shortening the term of Musaqat.

(5) Related by Abu Dawud in the Chapter on an insane stealing or becoming liable to punishment.

**Obligations of the Worker (Irrigator)**

- The basis for the worker's obligation to undertake normal care of the trees and for the produce of fruits is that the people of Khaybar were entrusted with the work, without anyone else being sent by the Prophet (peace be upon him) to take up some of Musaqat works.
- The basis for the prohibition of sub-contracting in Musaqat without prior permission is that the trees are not the property of the worker (irrigator), nor the worker is authorized by the owner of trees to do so. And notwithstanding, the owner may not accept that the worker (irrigator) assigns the Musaqat contract to a third-party irrigator.
- The basis for the permissibility of using the services of hired hands or the like by the worker (irrigator) is the general condition cited by the Prophet (peace be upon him) to the people of Khaybar that "they may seek the services of hired hands, but only at their own expense". However, the worker's responsibility/liability shall not cease to exist.(6)
- The basis for the Musaqat worker acting in a fiduciary capacity (rather than a position of liability) is that he/she is an agent on behalf of the owner in preservation and care of trees and fruits.

**Obligations of Trees Owner**

- The basis for the necessity to enable unfettered disposal of the trees for the worker is to allow the worker to perform his duties as per the contract.

**Joint Obligations of the Worker and the Owner of Trees**

- The basis for the joint responsibility of the owner of trees and the worker for the preservation of fruits before harvesting is that the owner may take the fruits after harvesting, However, before harvesting, the worker alone shall be responsible for the trees and fruits because the owner has granted him unfettered access to the trees.
- The basis for the division of expenses between the owner and the worker (from their respective shares) is that it is more just (closer to justice) so that no harm is inflicted upon either party because of the other.
- The basis for obligating the worker to complete the work is that Musaqat is a contract that becomes binding upon commencement of work, so that

(6) Related by Muslim, Chapter on Musaqat for part of the fruits and plants. Also, related by Abu Dawud, Chapter on Musaqat.

neither party shall have the right to revoke it unilaterally. And the basis for the non-entitlement of the worker to any compensation in case he stopped the work before materialization of the produce is that he abandoned his obligation toward completion of work and is thus not entitled to receive a share of the produce before materialization. And if the produce materializes, then another hand may be hired to complete the work at the expense of the worker because in such a case the worker (Al-Musaqi) is entitled to receive a share and shall not be deprived of it, and he shall complete the work, and such an obligation shall not be considered fulfilled unless work is completely carried out. Otherwise, the wage of the hired hands shall be deducted from the share of the worker (Al-Musaqi).

- The basis for obligating the owner of trees, in case he prevented the worker from carrying out the work of Musaqat, to completely fulfil the contract is that the Musaqat contract becomes binding upon commencement of work or upon commitment of non-revocation (of the contract). And in the event that the owner revokes the contract before the produce materializes, the basis for obligating the owner to pay out the prevailing market wages is that the time and effort of the worker shall have to be compensated. And in the event that the owner revokes the contract after the produce materializes, then the worker is only entitled to his share in the produce (but not the prevailing market wages).

**Division of the Produce**

- The basis for the inclusivity of division of recurring produce is that the worker contributes with his work to the produce and thus shall not be deprived of his respective share. This roughly conforms to the standpoint of Ibadis and Malkis jurists, and coincides with the opinion of some of Hanifis. It has reported that Abu Said Al-Khudri opined that the worker deserves a share in the palm racemes and cotton straws, unless there is a customary practice ('Urf) or a condition (Shart) to the contrary. Abu Amr Al-Qurtubi also said: "Torn palm leaves and fibers and cords shall be shared by both parties according to their respective shares in the fruits", and this conforms to the law of equity. (7)

(7) *"Bayan Al-Shar"* [40: 292 and 296]; and *"Al-Kafi"* [2: 107].

- The basis for specification of the worker's share as a common share is the Hadith narrated by Rafi' on the authority of Hanzhalah Ibn Qays Al-Ansari who said: *"I asked Rafi' Ibn Khadij about paying the rental of a land in gold and silver. He answered: 'There is no objection to it, as people in the times of the Prophet (peace be upon him) used to pay rental for plants growing on water ravines/flumes/gullies and high points of streams and some sorts of plants. However, the Prophet (peace be upon him) prohibited such practices because the produce was not properly identified: Some of it used to grow and some used to perish, and people, at that time, were confined to this kind of rentals".*(8)
- The basis for the entitlement of the worker to his respective share upon materialization of the produce is that he has contributed to the materialization. It is the opinion of some of Shafis and the majority of Hanbalis, and it is also followed by Imamis.(9)

**Contingencies in Musaqat**

- The basis for non-entitlement of the worker to anything (reward or compensation) if the produce perished or destroyed by a natural disaster is that one of the effects of partnership entails that the subject-matter of division is the produce. Therefore, if the produce perished or destroyed, then there shall be no division. The same applies to the division of remaining produce in case of partial destruction due to a natural disaster.
- The basis for granting the worker the option, in case of non-materialization of the produce during the predetermined period of time, either to carry on his work gratis, or to stop working and lose his share in the produce, is as dictated by the rules of equity . The owner of trees benefits through keeping his trees, even if there is no produce. Any worker with an acceptable excuse is an exception, where he shall be entitled to his share for the worked period of time, as dictated by the rules of equity.

**Trees Belonging to Third Parties and Usurped Trees**

- The basis for the owner of trees being entitled to the fruits if it transpires that the trees belong to a third party is that in essence ownership of fruits shall

(8) Related by Muslim, Chapter on rental of lands, payment in gold and silver.

(9) *"Kashf Al-Qina"* [3: 538]; *"Al-Mughni"* [5: 576]; *"Al-Mubdi"* [5: 54]; *"Al-Rawdah"* [5: 160]; and *"Jami' Al-Maqasid"* [7: 376].

remain in the hands of the owner unless by virtue of a contract. However, the contract, in this case, is void. The basis for obligating the party who contracted with the worker to pay out the prevailing wage to the maximum of his stated share is that he worked on a commutative basis, and the contract was doubtful (not properly evidenced or documented); it is impractical to pay him the agreed compensation due to the ownership of the third party, who shall be entitled to the compensation; i.e., the prevailing wage, up to a maximum of his stated share because the contracting party did not commit to pay him more than his share, especially that no transgression was premeditated.

- The basis for entitlement of the owner of trees to take the fruits in case an usurper (Ghasib) of the trees contracted with someone else to carry out Musaqat works is that the fruits remain, in essence, owned by the owner unless by a contract to the contrary. And the contract here is void. The basis for obligating the usurper (Ghasib) to pay the worker who was unaware of usurpation is that it is tantamount to a paid work (work on a commutative basis) associated with a doubtful contract; it is impossible to pay him the agreed compensation because it belongs to someone else, who shall be entitled to the compensation; i.e., the prevailing wage. The worker shall be deprived of any payment if he is aware of usurpation because in such a case he becomes a transgressor, and he is among those referred to in the Hadith: *"Ill-gotten sapling shall have no right therein"*.(10)

**Termination of Musaqat Contract**

- The basis for termination of Musaqat contract upon completion of produce and division of the crop or passing of the agreed period of time or of a season without any fruit is the application of the contract that entered into by the two parties.
- The basis for termination of Musaqat contract upon the death of the worker or liquidation of the institution carrying out the work if Musaqat was subject to the condition of work commencement solely by him or the institution is that the condition was not met. The basis for granting the heirs (either through inheritance, in general, or by transfer of ownership, in particular)

(10) Related by Al-Bukhari, Chapter on wasteland rehabilitation. Also related by Malik, Chapter on building on wasteland.

the option either to carry on the work as per the set conditions or to stop it is that the heirs or the owners of the institution have had legally inherited this right. The basis for their entitlement to the prevailing wage is that their testator was entitled to the compensation by virtue of his efforts. So if he had died before the produce materialized, then he shall be entitled to the compensation. The basis for limiting the compensation, which is the prevailing wage, to a maximum of the testator's share in the produce is that the owner of trees did not commit to pay more than the worker's share. And if continuation of work by the heirs does not entitle them to more than the share of their testator in the produce, then how shall they deserve more without work?

- The basis for termination of Musaqat contract upon perishing of trees, subject matter of the contract, or inability of the trees to bear fruit is the Hadith stating: *"There should be neither harm nor malice"*, because the worker will be excessively harmed if he is obligated to work gratis (without compensation).

**Revocation of Musaqat Contract**

- The basis for revocation of Musaqat contract by mutual consent of the two parties is the Hadith of Prophet Mohammad (peace be upon him) stating: *"Anyone who consents to revoke the contract upon the request of a regretting counterparty, Allah shall forgive his regretful sins on the Day of Judgment"*.(11)
- The basis for obligation to pay the prevailing wage if the worker is unable to perform the work due to a reason out of his control is that the worker did exert an effort under a contract, therefore he shall be entitled to a compensation against that work, and that the work has not been performed in its entirety, and thus he is paid the prevailing market wage.
- The basis for liability of the worker to indemnify the owner for actual loss suffered for a reason within his control is that he caused such a loss, and therefore shall be liable.

(11) Related by Ibn Hibban, Chapter on Iqalah.

Shari'ah Standard No. (51)

# Options to Revoke Contracts Due to Incomplete Performance

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to explain the situations in which buyers have the option to revoke contracts due to reasons of defect, deal fragmentation and breach of description and how such options are exercised in the activities of Institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers options to revoke contracts due to reasons of defect, deal fragmentation and breach of description. It does not cover options to revoke arising from breach of trust (dishonest inducement, deception and overcharging) or options of due diligence (cooling-off options, and options to revoke due to non-payment) as they have separate Shari'ah standards dedicated to them.

## 2. Option to Revoke Due to Defect

### 2/1 Definition

It is the option of a buyer to revoke or continue with the contract arising from a hidden defect that the buyer did not notice at the time of contract.

### 2/2 Conditions applicable to options to revoke due to defect

An option to revoke due to defect is subject to the following conditions:

2/2/1 Appearance of a material defect in the subject matter of the contract.

A material defect is a defect that renders the item defective according to custom, makes it unfit for purpose or diminishes its value.

2/2/2 The defective item being incapable of repair except by incurring cost.

2/2/3 The buyer being unaware of the hidden defect at the time of contract, irrespective of the seller's awareness of the defect at the time of the contract.

2/2/4 The contract not containing a clause excluding the seller's liability for defect (*Bay' al-Bara`ah*- sale on the basis of as is

where is). It is prohibited for the seller to exclude liability due to defect in Ijarah and Istisna'a contracts.

2/2/5 The hidden defect not being caused by the buyer.

**2/3 Scope of the option to revoke due to defect**

Options to revoke due to defect exist in commutative financial contracts such as sales, money exchange, division of wealth, settlement of debt by payment in kind and gift conditional upon receipt of consideration (*Hibat al-Thawab*).

**2/4 Time limit**

Defective items should be returned, after taking delivery of the object of sale and discovering the defect therein, within the period of time customarily allowed for revocation on such grounds.

**2/5 Consequences of options to revoke due to defect**

The buyer has the option either to revoke the contract and return the item or continue with the contract. If the buyer chooses to return the item after taking delivery, revocation is effected by mutual consent or court order. If the buyer has not taken delivery, and he has been aware of the defect before taking delivery, he can unilaterally revoke the contract by giving notice to the seller and is entitled upon revocation to a refund of the whole price by mutual consent or court order.

**2/6 Conditions applicable to the return of sold items**

Return of the item is subject to the following conditions:

2/6/1 Return of the item not resulting in the fragmentation of a package deal to which the seller does not consent. And the buyer shall be entitled to compensation against inferiority due to the defect (Arsh).

2/6/2 The item not being damaged or destroyed in the possession of the buyer, in which case the buyer is entitled only to compensation for the defect and is not entitled to return the item unless the seller accepts return of the damaged item.

2/6/3 There being nothing added to the item attached to it but did not grow out of it, which necessities a price rebate, such as the erection of a building on land. Return of the item is not prevented, if the addition to the item is physically connected to it and grows out of it; or is physically separate from it whether it grows out of it, such as dividends on shares and rent from leased assets, or does not grow out of it.

2/6/4 In cases where return due to the defect is impossible (impractical), the buyer shall be entitled to compensation against inferiority caused by the defect.

**2/7 Impediments preventing the return of sold items**

The option to return the sold item is impeded by the non-fulfilment of any of the conditions provided in item 2/2.

**2/8 Abating (of the option)**

The option to revoke due to defect ceases (abates) in the following situations:

2/8/1 If the defect ceases before the buyer returns the item or payment of Arsh (compensation against inferiority due to the defect).

2/8/2 If the buyer expressly waives his option to revoke.

2/8/3 If the buyer expressly accepts the defective item.

2/8/4 If the buyer's conduct implicitly indicates that he has accepted the defective item, such as continuing to use the item, delaying return of the defective item longer than is customarily acceptable and without an excuse, exploiting or benefitting from the defective item or transferring ownership of the item after discovering the defect.

2/8/5 If the defective item is destroyed by the buyer.

## 3. Option to Revoke Owing to Deal Fragmentation

**3/1 Definition**

The option to revoke a contract owing to deal fragmentation is the option of the buyer to revoke a contract (a package deal) that no

longer includes everything that was contracted for, resulting in the package deal becoming fragmented.

**3/2 Conditions applicable to the option to revoke owing to deal fragmentation**

The option to revoke a contract owing to deal fragmentation is subject to the buyer not knowing that the deal would become fragmented.

**3/3 Types of deal fragmentation in which the option to revoke is granted**

3/3/1 When a person sells his own property along with the property of another person in one package without the consent of the other person or when a partner sells the partnership property in one package without the consent of the other partner.

3/3/2 When it transpires that part of the sold item(s) is the property of a third party.

3/3/3 When part of the sold item(s) is destroyed before delivery (actual or constructive).

3/3/4 When part of the sold item(s) in a Salam contract is not available on the delivery date. [see Shari'ah Standard No. (10) on Salam, item 5/8]

**3/4 Prerequisites**

Deal fragmentation entitles the buyer either to revoke the contract or accept what remains of the deal and pay the portion of the price corresponding to it. The buyer is not entitled to any compensation unless there is a defect in what remains of the sold item(s).

**4. Option to Revoke Due to Breach of Description**

**4/1 Definition**

The option to revoke due to breach of description is the option of a buyer to revoke the contract if the sold item does not meet a condition stipulated in the contract, explicitly or implicitly, such as a car having a specific color.

**4/2 Requirements of valid descriptions**

4/2/1 The description must be permissible by the Shari'ah.

4/2/2 The description must be specific and free from ambiguity (Gharar).

4/2/3 The description must relate to the purpose of the buyer or be the basis of an increase in price or of greater quality in the item, such as a requirement that a car be automatic.

4/2/4 The breach of description must occur at or before the time of delivery (actual or constructive) and must not be a subsequent occurrence.

**4/3 Consequences of the option to revoke for breach of description**

4/3/1 If the item fails to correspond to the minimum requirements of a description, the buyer is entitled to return the item or accept it for its full price without any entitlement to compensation.

4/3/2 If it is not possible to return the item, the buyer is entitled to a partial refund for the breach of description equal to the difference in price between an item that fulfills the description and one that does not.

**4/4 Timing and cessation of options to revoke due to breach of description**

The option to revoke for breach of description, like the option to revoke for defect, is granted immediately subject to custom and ceases in the circumstances in which the option to revoke due to defect ceases. [see item 2/7]

**4/5 Transfer**

The option to revoke for breach of description can transfer to all types of successors and assignees.

**5. Date of Issuance of the Standard**

The Shari'ah Board issued this standard on 21 Safar1434 A.H., corresponding to 4 January 2013 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the standard on Options to Revoke Contracts Due to Incomplete Performance in its meeting No. (34) held in the Kingdom of Bahrain on 20–21 Safar 1434 A.H., corresponding to 3–4 January 2013 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 14 Rabi' II, 1429 A.H., corresponding to 20 April 2008 A.D., the Secretariat of AAOIFI decided to commission a Shari'ah consultant to prepare a juristic study on Options to Revoke Contracts Due to Incomplete Performance.

In its meeting held on 29 Jumada II, 1431 A.H., corresponding to 12 June 2010 A.D., the Shari'ah Standards Committee, discussed the study and approved it and assigned to the Shari'ah researcher the preparation of the exposure draft of the standard.

In its meeting held in Dubai (United Arab Emirates) on 24 Ramadan 1431 A.H., corresponding to 3 September 2010 A.D., the Shari'ah Standards Committee discussed the exposure draft of the standard and made some changes in the light of the comments and remarks of the members.

In its meeting No. (32) held in Al-Madinah Al-Munawwarah, on 8–9 Rabi' II, 1433 A.H., corresponding to 1-2 March 2012 A.D., the Shari'ah Board discussed the exposure draft of the standard and introduced the changes it deemed suitable.

The Secretariat of AAOIFI held a public hearing in the Kingdom of Bahrain on 16 Jumada II, 1433 A.H., corresponding to 7 May 2012 A.D. The public hearing was attended by representatives of central banks, institutions, auditing firms, Shari'ah scholars, academics and others interested in this field. The members of the Shari'ah Board and the Shari'ah Standards Committee responded to a number of observations and comments raised by the participants.

In its meeting No. (33) held in Makkah Al-Mukarramah on 19-21 Shawwal 1433 A.H., corresponding to 6-8 September 2012 A.D., the

Shari'ah Board discussed the changes proposed at the public hearing and introduced the changes it deemed suitable to the draft exposure of the standard.

In its meeting No. (34) held in the Kingdom of Bahrain on 20-21 Safar 1434 A.H., corresponding to 3-4 November 2013 A.D., the Shari'ah Board discussed the exposure draft of the standard, introduced the changes that it deemed suitable and adopted the standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Option to Reconsider Due to Defect**

- The basis for permissibility of the option to reconsider due to defect is the Hadith narrated by 'A`ishah (may Allah be pleased with her) that a man purchased a young serf, and then set him to work, then he found him to be "flawed" or "defective", so he returned him back (to the seller) on the grounds of the defect. Thereupon, the Prophet (peace be upon him) said: *"No yield without risk taking" and in another narration: "No gain without risk taking"*.(2) Also, there is the Hadith on a sheep whose udder is tied up in order to look like a one full with milk. If the defect, lack of milk, is unveiled, then the buyer shall have the option either to keep it or to return it along with a Sa' of dates. All Schools of Fiqh (Madhahib) embraced this option, and that the key principle in the contracts of sale is freedom from defects.
- The basis for the stipulation of freedom from defects is what the companions (may Allah be pleased with them all) used to practice, and Othman (may Allah be pleased with him) issued a rule in favor of using this option in presence of the companions.(3)
- The basis for the effect of the option either to return the subject matter or keep the entire price –which is the standpoint of Hanafis and Shafis- is that the buyer has the right to return the subject-matter due to defect and the absence of intactness as generally dictated by the contract. The basis for non-entitlement to compensation (Arsh) in the case where the buyer keeps the subject-matter is that descriptions (features) are not considered to form part of the price in this case, and because the buyer did not consent that the sold item was transferred for a less than its stated price. The Han-

(2) Related by Abu Dawud and Al-Tirmidhi.

(3) Related by Malik in *"Al-Muwatta`"*; and Al-Bayhaqi in *"Al-Sunan Al-Kubra"* and he rendered it as an authenticate: *"Jami` Al-`Usul"* [2: 34].

balis were of the opinions that in case of return, the buyer shall have the right to request Arsh, corresponding to the inferiority caused by the defect.

**Option of Deal Fragmentation**

- The basis for permissibility of deal fragmentation is that it is a type of defect (some Fiqh references categorized it under the option to reconsider due to defect) and it becomes binding upon returning of a part of the object of sale.(4)
- The basis for the stipulation that the buyer shall not harbor prior knowledge about the deal coming into a point of defragmentation is that his knowledge is viewed as evidence to consent, and that the defect is not hidden or concealed.
- The basis for the effect of the option of defragmentation being either termination or holding into the remainder of his share in the price is that discounting an amount from the price for the whole deal in lieu of the missing part of the deal represents compensation, and no more than it, because the price (compensation) is for the two parts and is divided between them both.

**Option of Breach of Description**

- The permissibility of this option is the opinion of the majority of Fuqaha, while other Fuqaha categorized this option under option of deception (*Khiyar al-Tadlis*).
- The basis for the establishment of compensation due to incorrect description is that it is practically similar to the option of freedom from defect, in the case of objection to return the object of sale. And in the case where the buyer accepts to keep the object of sale, then he will possess it for the entire price -without application of Arsh- because what is missing here is a description, and descriptions do not have their corresponding part of the price in this instance.
- The basis for transferability of this option upon death to heirs, whether general or special, is that it falls in the category of physical asset ('Ayn) ownership.(5)

(4) *"Al-Fatawa Al-Hindiyyah"* [3: 83].
(5) *"Fath Al-Qadir"* [5: 1345]; and *"Al-Bahr Al-Ra`iq"* [6: 19].

Shari'ah Standard No. (52)

# Options to Reconsider (Cooling-Off Options, Either-Or Options, and Options to Revoke Due to Non-Payment)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to explain the Shari'ah rules relating to options to reconsider which contracting parties stipulate in their contracts (cooling-off options, either-or options, and options to revoke due to non-payment) and the application of such options in the activities of Institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers options to reconsider (cooling-off options, either-or options, and options to revoke due to non-payment) that are stipulated by the parties to grant them time to reconsider the transaction. It does not cover options to revoke contracts due to incomplete performance (defect, deal fragmentation and breach of condition or description) or options to revoke contracts due to breach of trust (dishonest inducement, deception and overcharging) as they have separate Shari'ah Standards dedicated to them.

## 2. Cooling-Off Options

### 2/1 Definition of cooling-off options

Cooling-off options give one or both of the parties or a third party the right either to continue with the contract or to revoke it within a stipulated period of time. It is effected by any phrase indicating that it is non-binding and revocable during the period of the option.

### 2/2 Conditions of validity

Cooling-off options are subject to the following conditions:

2/2/1 The option must be stipulated in the contract unless it is implied by a pre-existing custom or the parties agree to subsequently include it in the contract.

2/2/2 The option must have a stipulated time limit. The option is not valid if a time limit is not stipulated or if it is unspecified, such as a stipulation to refer to an expert without stating a time limit, or if the time limit is indeterminate, such as stipulating that the option will end when a certain index reaches a particular value. There is no minimum or maximum time limit except if

it is contrary to what is customarily acceptable in relation to the subject matter of the contract.

2/2/3 The stipulated cooling-off period must coincide with the beginning of the contract period.

2/2/4 If the contract relates to several items, it must specify those items to which the option relates, as provided in item 2/8/3.

2/2/5 The subject matter must remain in the condition it was initially in when it was sold, in accordance with item 2/6.

**2/3 Scope**

Cooling-off options apply to binding financial contracts, such as sale, lease, transfer of debt, guarantee, division of wealth and Waqf. They do not apply to non-binding contracts such as unpaid agency or contracts which require payment in advance, such as Salam or which require spot payment of both countervalues such as currency exchange.

**2/4 Consequences of cooling-off options**

2/4/1 The owner of the option has the right to confirm the contract or revoke it during the stipulated period. If he does not revoke it during this period, the option lapses and the contract become binding.

2/4/2 The owner of the option may test the sold item and does not thereby lose his right to revoke the contract except if he does so repetitively without need or conducts himself as the owner of the sold item in a manner that is contrary to the terms of the contract and/or custom.

2/4/3 Where there is a cooling-off option, the parties are not required to make payment or delivery (the sold item to the buyer and the price to the seller) unless they agree otherwise. One or both parties may voluntarily make payment or delivery and the option does not lapse as a result, except if the conduct of the parties towards the countervalues indicates the intention to give or take ownership. If one party makes payment or

delivery, the other is entitled to hold back, in which case the first party is entitled to demand return of what they have paid/ delivered.

2/4/4 The owner of the option may offer the item to which the option relates for sale to third parties, and the option does not lapse until the sale is completed.

**2/5 Effect of options to cool-off on ownership**

2/5/1 If the option to cool-off is owned by both parties or just the seller, there is no transfer of ownership in either countervalue and legal rights related to the subject matter remain solely with the seller to the exclusion of the buyer.

2/5/2 If the option is owned by just the buyer, ownership of the sold item transfers from the seller to the buyer and the buyer's conduct as the owner of the sold item serves as confirmation of the contract.

2/5/3 If an item sold under option is destroyed while in the possession of the seller, it is the seller's loss. If it is destroyed in the possession of the buyer while the buyer owns the option, he is liable to pay its price. If it is destroyed in the possession of the buyer owing to his negligence or violation while the seller owns the option and decides to revoke the contract, the buyer is liable to pay its cost. If it is destroyed in the possession of the buyer without there being any negligence or violation on his part, he has no liability.

**2/6 Rules relating to increase in the sold item during the option period**

2/6/1 Anything that is physically connected and grows out of the original, such as agricultural produce (crops) or animal produce (livestock) belongs to the buyer if the buyer owns the option and confirms the contract. And it belongs to the seller of the seller owns the option, whether he confirms the contract or revokes it.

2/6/2 Anything that is physically separate and does not grow out of the original, such as compensation for damage to the sold item caused by a third party during the option period, belongs to the buyer if he chooses to conclude the contract. If he chooses to revoke the contract, it belongs to the seller.

2/6/3 Anything that is separate but grows out of the original, such as dividends on shares and rent from leased assets belongs to the seller.

**2/7 Cessation and lapsing of cooling-off options**

2/7/1 When the option period expires, the contract becomes binding.

2/7/2 When the owner of the option exercises his option to revoke the contract, then the contract terminates. It is required for the other party to know of the revocation for the revocation to be valid. If the owner of the option concludes the contract, whether expressly or implicitly, the contract becomes binding.

2/7/3 If the sold item is destroyed before physical or constructive delivery, the contract terminates.

**2/8 Some applications of cooling-off options**

2/8/1 The institution, whether as a seller or buyer, stipulates an option to reconsider whether or not it is worth selling or buying an item.

2/8/2 The institution stipulates an option to reconsider when purchasing items from suppliers in order to offer them to its clients without obtaining a binding promise from them to purchase the items. If the clients do not wish to purchase the items, the institution returns the items to the seller.

2/8/3 The institution stipulates an option to reconsider in relation to the whole or a part of a single deal. If the various items being sold are different from each other, the items to which the option relates must be specified. If they are fungible, such as wheat or rice, the percentage to which the option relates must be specified.

2/8/4 It is not permissible to use cooling-off options as a ruse to synthesise the effect of a benefit enjoyed by the lender in exchange for a giving a loan, which can occur if the buyer pays for an item purchased under option, uses the item during the option period and then returns it before the option period expires to receive his money back.

2/8/5 It is not permissible to use cooling-off options to avoid price fluctuations during the option period.

## 3. Option to Revoke Due to Non-Payment

### 3/1 Definition of option to revoke for non-payment

Options to revoke due to non-payment are options stipulated by sellers or buyers to enable them to revoke contracts if the other party fails to make payment of price or rent on the due date. Such options are not valid unless they are expressly stipulated.

### 3/2 Scope of option to revoke for non-payment

Options to revoke for non-payment are permissible in contracts that do not require spot payment at time of contract. They are not permissible in Salam and currency exchange contracts.

### 3/3 Prerequisites

The seller is entitled to revoke the contract if the buyer does not pay the price within the specified period.

### 3/4 Transfer

Options to revoke due to non-payment lapse upon the death of the owner of the option (whether it is the seller or the buyer).

## 4. Either-Or Options

### 4/1 Definition

4/1/1 Either-or options entitle the buyer to conclude the contract to purchase one or more item out of several items specified by the contract during a stipulated period of time. Such options are created by stipulation of the parties.

4/1/2 It is not required for the items being sold to be fungible or for their prices to be equal. If their prices are different, the price of each item must be specified.

4/1/3 The agreed option period must be specified and there is no minimum or maximum time limit.

**4/2 Prerequisites**

4/2/1 Either-or options make ownership attached to one or more of several items to which the option relates but not to any item or items in particular. If the buyer takes delivery of all of them, he is liable to pay for one of them and holds the remaining items on trust. If one of them is destroyed or damaged in his possession, he must purchase it for its price. If all items are destroyed and their prices are different, the buyer is liable to pay the average price of the items for the number of items purchased. For example, if there are three items and he purchased one of them with an option to choose which one, he is liable to pay one third of the price of each item.

4/2/2 If the items to which the either-or option relates are destroyed by an act of the seller after the buyer has taken delivery, the buyer is not liable.

4/2/3 If the option period expires without the buyer choosing which item or items he wishes to confirm, he is legally obligated to do so unless the seller chooses to revoke the contract.

4/2/4 If the buyer treats one of the items in which he has an option as though he owns them, his conduct is deemed to be confirmation of the contract for those items.

**4/3 Transfer**

Either-or options transfer to the heirs of the owner of the option upon his death who in which case enjoy all the rights of the original owner of the option.

## 5. General Rules Relating to Option to Reconsider

5/1 It is not permissible to sell or transfer options to reconsider.

5/2 It is permissible to have two or more options to reconsider in one contract.

## 6. Date of Issuance of the Standard

The Shari'ah Board issued this standard on 23 Shawwal 1434 A.H., corresponding to 30 December 2013 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the standard on "Options to Reconsider" in its meeting No. (35) held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia, on 22-23 Shawwal 1434 A.H., corresponding to 29-30 September 2013 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 14 Rabi' II, 1429 A.H., corresponding to 20 April 2008 A.D., the Secretariat of AAOIFI decided to commission a Shari'ah consultant to prepare a juristic study on Options to Reconsider.

In its meeting held on 14 Safar 1430 A.H., corresponding to 9 February 2009 A.D., the Shari'ah Standards Committee, discussed the study, approved it, and assigned to the Shari'ah researcher the preparation of the exposure draft of the standard.

In its meeting held in Dubai, United Arab Emirates, on 24 Ramadan 1431 A.H., corresponding to 3 September 2010 A.D., the Shari'ah Standards Committee discussed the exposure draft of the standard and made some changes in the light of the comments and observations of the members.

In its 30th meeting held in the Kingdom of Bahrain, on 24-26 Jumada II, 1432 A.H., corresponding to 27-29 May 2011, the Shari'ah Board discussed the exposure draft of the standard and introduced the changes it deemed suitable.

In its meeting No. (31) held in the Kingdom of Bahrain, on 22-24 Dhul-Qa'dah 1432 A.H., corresponding to 20-22 October 2011 A.D., the Shari'ah Board continued its discussions on the exposure draft of the standard, and introduced the changes it deemed suitable.

The Secretariat of AAOIFI held a public hearing in the Kingdom of Bahrain on 6 Jumada II, 1434 A.H., corresponding to 16 April 2013 A.D. The public hearing was attended by representatives of central banks, institutions, auditing firms, Shari'ah scholars, academics and others interested in this field. The members of the Shari'ah Board and the Shari'ah

Standards Committee responded to a number of observations raised by the participants.

In its meeting No. (35) held in Al-Madinah Al-Munawwarah on 22-23 Shawwal 1434 A.H., corresponding to 29-30 November 2013 A.D., the Shari'ah Board discussed the changes proposed at the public hearing and introduced the changes it deemed suitable to the exposure draft of the standard, and adopted the standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

**Cooling-Off Option**

- The basis for cooling-off option is the Hadith narrated by Habban Bin Munqidh, attributed to the Prophet (peace be upon him), saying: *"If you are concluding a deal say: 'There shall be no Khalabah (misleading marketing or showcasing of products), then you shall have a 3-day option'"*.(2)
- The basis for consideration of all expressions that imply the cooling-off option is the opinion of the Four Schools of Fiqh (Madhahib).(3) Imam Al-Nawawi said: "This expression (as mentioned in the Hadith related by Ibn Hibban: *"There shall be no Khalabah..."* is neither considered to be a kind of literal worship, nor a Shari'ah ruling that a religiously accountable person shall be aware of it".(4)
- The basis for the stipulation of timing for cooling-off conditions is that an untimed option results in Jahalah (obscurity or ambiguity) which may lead to dispute. This is the opinion of the majority of Fuqaha.
- The basis for the stipulation of attaching the option to the contract is that detachment contradicts the prerequisites of the contract, which entails that it takes effect immediately.(5)
- The basis for the stipulation of attaching the option to a binding contract is that its usability comes into existence only when attached to such a contract. The basis for invalidity of the stipulation of such an option in contracts that entail taking possession (Qabd) is that it contravenes Qabd stipulated in Sarf and in Salam.

(2) It has been related by Ibn Hibban. It is a Hadith with acceptable authenticity.
(3) *"Al-Fatawa Al-Hindiyyah"* [3: 39]; *"Al-Mughni"* [3: 529]; and others.
(4) *"Al-Majmu'"* [9: 210].
(5) *"Al-Mughni"* [3: 502]; *"Bada`i' Al-Sana`i'"* [5: 300]; and *"Al-Majmu'"* by Al-Nawawi, [9: 191].

- The basis for permissibility (but not the obligability) of delivery of the two countervalues is that delivery serves both selection and reconsideration, which are literally the purpose of the option.
- The basis for the situation where the option does not abate upon offering it for sale is that such a practice is meant to probe the fairness of the price. However, it does abate in case of actual sale because this serves as a testimony to acceptance, as the disposal of the object underlying the option is considered to be as the disposal by owners.
- The basis for effecting ownership upon sale is that the price does not change if the two parties opted for continuity of ownership, and this conforms to the Hanafi School, as opposed to Hanbalis.

If the option is rested with one party, then the position of this standard is based on a variety of perspectives. [see applications in the Shari'ah Standard No. (8) on Murabahah]

**Option to Revoke Due to Non-Payment**

- The basis for permissibility is Qiyas (analogical deduction) to the cooling-off option and reports dating back to the time of the companions. It was taken up by Hanafis, Malikis and Hanbalis. The wisdom behind its permissibility is the need for the buyer to reconsider/re-evaluate his knowledge about prices and for the seller to ensure that the proper price is quoted in order to avoid procrastination by the buyer.
- The basis for impermissibility in contracts in which taking possession (Qabd) is a stipulation –such as Sarf and Salam- is that it is inconsistent with the stipulations of their validity.
- The basis for abating of the option upon the death of its owner is that it constitutes a readiness and willingness to act, and therefore is not transferable to heirs.

**Either-Or Option**

- The basis for permissibility of the either-or option is Qiyas (analogical deduction) to the cooling-off option; since it conforms to Shari'ah injunctions- i.e., the cooling-off option- so it was permissible based on it, and due to the need of the buyer to employ it in case of hesitancy as to selection of the most needful from amongst a number of objects. The majority of Fuqaha adopted it though with different views on definition and scope.

- The basis for all issues pertaining to ownership is the application of the rules relating to Daman (liability) and destruction (of objects of sales) and to treat both parties according to rules of equity in relation to the price that needs to be paid if the subject-matter of the option is destroyed.
- The basis for the transferability of the option to heirs is that a testator has an established ownership in the objects subject matter of the option, and as such heirs shall need to identify their selection.
- The basis for impermissibility of sale and tradability of either-or options is that such options are construed to be mere readiness and willingness (to contract), which cannot be transferred or traded.
- The basis for combination of two options or more is that such combination does not contradict their prerequisites -i.e., the effectuating of sale on an immediate basis.

## Shari'ah Standard No. (53)

# 'Arboun (Earnest Money)

# Contents

*IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL*

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to explain the Shari'ah rules relating to the payment of 'Arboun (Earnest Money) in sale contracts and its application in the activities of Institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the definition of 'Arboun (Earnest Money), the rules applicable to it and its applications in the activities of institutions in commutative financial transactions that do not require spot delivery of countervalues. It does not cover payments made prior to contract such as refundable security deposits, commissions or advance payments made subsequent to contracts that are not subject to options.

## 2. Definition of 'Arboun (Earnest Money)

2/1 Earnest money is paid by the buyer to the seller(2) at the time of contract on the basis that the buyer has the option to revoke the contract during an agreed period of time. If he confirms the contract, the earnest money is credited towards the price. If he does not confirm the contract or fails to pay the remaining price during the stipulated time, the seller is entitled to forfeit 'Arboun (Earnest Money).

2/2 An agreement to execute a contract in the future (an agreement to sell) is a promise and not a contract. If money is paid with the promise, it is not considered to be earnest money ('Arboun).

2/3 'Arboun (Earnest Money) can be paid in cash, in kind and with a usufruct.

## 3. Permissibility of Earnest Money

3/1 It is permissible to pay 'Arboun (Earnest Money) in commutative contracts that do not require spot payment of one or both countervalues whether the sale item is identified or is sold by description

(2) What applies to the buyer also applies to the lessee and the purchaser in an Istisna'a contract, and what applies to the seller also applies to the lessor and the seller in an istisna'a contract, etc.

for future delivery (*Ijarah Mawsufah Fi al-Dhimmah*), such as sales, Istisna'a contracts, leases of identified assets and of assets leased by description for a future date.

3/2 Payment of 'Arboun (Earnest Money) is not permissible in Salam and currency exchange contracts.

**4. Option Period Arising from 'Arboun (Earnest Money) Payment**

The option period arising from the payment of 'Arboun (Earnest Money) must be specified either by express stipulation of the parties, or by custom if there is an existing custom that specifies the option period.

**5. Lapsing of the Option Arising from 'Arboun (Earnest Money) Payment**

5/1 The buyer loses his right to revoke the contract if he informs the seller that he has confirmed the contract or disposes the sold item in a manner that indicates confirmation. The contract may stipulate conduct that indicates lapsing of the option and confirmation of the contract in order to avoid dispute. [see Shari'ah Standard No. (52) on Options to Reconsider]

5/2 If the option period expires without the buyer paying the remaining price to the seller and without the seller having agreed an extension, the contract is considered revoked and the buyer is not entitled to recover the 'Arboun (Earnest Money).

**6. Ownership and Liability for the Sold Item During the Option Period**

Prior to delivery, the seller is liable for any loss to the sale item. If it is destroyed or damaged before delivery to the buyer or delivery is not possible, the contract is void and the earnest money must be returned to the buyer. After delivery, the buyer is liable for the sale item. If it is destroyed or damaged after delivery to the buyer, the buyer's option is canceled and he is required to pay the balance (unpaid part of the price) to the seller.

**7. Delivery of the Sale Item During the Option Period**

The buyer may take delivery of the sale item during the option period, which does not on its own indicate confirmation of the contract unless the buyer's conduct indicates that he has accepted the sale item.

## 8. Increase in the Sold Item During the Option Period

8/1 Increase that is physically connected to the original is considered part of the original.

8/2 In principle, any growth in (increase to, and/or yield of) the sale item that is physically separate from it, which occurs during the option period whether prior to delivery or after delivery is considered part of the sale item. It is permissible for the party who is liable for the sale item to stipulate that any increase that is physically separate should belong to him, even if ultimate ownership of the sale item is not vested in him.

## 9. Disposal of the Sale Item Under 'Arboun (Earnest Money) Arrangement

9/1 If the sold item is identified, the seller is not entitled to dispose of it. If the seller does dispose of it by sale or lease or otherwise, his actions are subject to the rules relating to uncommissioned (Fodooli) disposals. If the buyer ratifies the seller's actions, he loses his option and is liable for the remainder of the price to the first seller. The first seller's disposal becomes binding and the first buyer is entitled to receive the sale price. If the first buyer does not ratify the seller's actions, the second disposal is void. [see Shari'ah Standard No. (23) on Agency and Acts of Uncommissioned Agent (Fodooli)]

9/2 If the sale is related to an identified item, the seller cannot deliver a different item even with same specifications, except with the consent of the buyer, in which case what the buyer has paid remains 'Arboun (Earnest Money).

9/3 If the buyer stipulates that he will offer the sale item to his clients during the option period and the seller accepts this, the buyer's right to revoke the contract remains valid during the option period, even after offering the item to his clients. The conclusion of a sale to one of his clients is deemed to be confirmation of the contract.

9/4 It is not permissible to negotiate/trade options arising from payments of 'Arboun (Earnest Money). [see Shari'ah Standard No. (20) on Sale of Commodities in Organized Markets]

## 10. Stipulating Refund of Earnest Money in the Contract

It is permissible for the buyer to stipulate a condition in the contract providing for a refund of earnest money in specific situations, such as the buyer's failure to obtain licenses from the relevant authorities.

## 11. Date of Issuance of the Standard

The Shari'ah Board issued this standard on 15 Muharram1435 A.H., corresponding to 8 November 2014 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the standard on 'Arboun (Earnest Money) in its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D.

# Appendix (A)
# Brief History of the Preparation of the Standard

On 19 Rabi' I, 1433 A.H., corresponding to 12 March 2012 A.D., the Secretariat of AAOIFI decided to commission a Shari'ah consultant to prepare a juristic study on 'Arboun (Earnest Money).

In its meeting No. (35) held in Al-Madinah Al-Munawwarah on 22-23 Shawwal 1434 A.H., corresponding to 29-30 September 2013 A.D., the Shari'ah Board discussed the exposure draft of the standard and introduced the changes it deemed suitable.

In its meeting No. (37) held in the Kingdom of Bahrain on 19-21 Jumada I, 1435 A.H., corresponding to 20-22 March 2013 A.D., the Shari'ah Board continued its discussions on the exposure draft of the standard, and introduced the changes it deemed suitable.

In its meeting No. (38) held in the Kingdom of Bahrain on 28 Sha'ban – 1 Ramadan 1435 A.H., corresponding to 26-28 June 2014 A.D., the Shari'ah Board continued its discussions on the exposure draft of the standard, and introduced the changes it deemed suitable.

The Secretariat of AAOIFI held a public hearing in the Kingdom of Saudi Arabia (Riyadh) on 28 Dhul-Hajjah 1435 A.H., corresponding to 22 October 2014 A.D. The public hearing was attended by representatives of central banks, institutions, auditing firms, Shari'ah scholars, academics and others interested in this field. The members of the Shari'ah Board and the Shari'ah Standards Committee responded to a number of observations raised by the participants.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the changes proposed at the public hearing and introduced the changes it deemed suitable to the exposure draft of the standard, and adopted the standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- The basis for permissibility of 'Arboun (Earnest Money) is a narration that Nafi' Ibn Abdul-Harith purchased a building in Mecca to be used as a prison from Safwan Ibn Umayyah, provided that if Umar (may Allah be pleased with him) approves the sale, then the sale is considered to be effected by him (Umar) and on his behalf (Umar's), and if not, then Safwan shall be paid 400 dinars.

  Also, there is a narration that Ibn Sirin said: "A man said to a lessor of ride camels: prepare your camels, so that if I did not leave with you on so and so day, you get 100 dirhams. Then he did not leave with him". And Shurayh said: "He who voluntarily makes it incumbent upon himself to do something (with a condition and without coercion), then he shall have to honor the condition". Hence, 'Arboun is similar, where a buyer pays part of the price and says: "If I did not confirm the sale, the 'Arboun is yours to keep". Payment of the 'Arboun either at time of contract or later at the time of relinquishing it is valid.

- The basis for impermissibly of 'Arboun in *Sarf* and Salam contracts is that 'Arboun is embedded with a cooling-off option (*Khiyar al-Shart*), which according to the majority of Fuqaha (of the Four Schools of Fiqh) is impermissible in Sarf contracts (currency exchange transactions). This rule was deduced from the Hadith: *"Gold for gold, silver for silver... like for like, equal for equal, and hand to hand. If these types differ, then sell them as you find proper, provided it is hand to hand"*.

  Ibn Umar (may Allah be pleased with both of them) is reported to have said: "O, Messenger of Allah, hold on that I may ask you a question: I sell camels in Baqi', so that I sell for dinars and receive dirhams, and I sell for dirhams and receive dinars. I take so and so of this and pay so and so of that? Then the Prophet (peace be upon him) said: *"No harm that you apply*

*the market rate unless you (you and the counterparty) leave the transaction session without settlement of dues"*. Therefore, this was an evidence on the requirement to take possession of both countervalues (Qabd) at the contracting session (*Majlis al-'Aqd*).

'Arboun is also impermissible in Salam contract, because in Salam, payment of the price (capital of Salam) shall be settled at the contracting session. The Prophet (peace be upon him) said: *"Whoever pays money in advance for dates (to be delivered later) should pay it for a known specified weight and measure (of the dates)…."*. This implies that unless the price is paid in full before the two parties leave the contracting session, the transaction is not deemed to be Salaf (or Salam).

- The basis for determination of a specific term for 'Arboun is to avoid Gharar that may result from an unknown term (Jahalah that involves 'Arboun term).
- The basis for the seller being liable for the object of sale before delivery and for the buyer being liable for it after delivery is the Shari'ah maxim: "Ownership (title) shall be established upon the conclusion of the contract, while liability is contingent upon delivery (Qabd)".
- The basis for attributing growth connected to the original is that it represents an integral part of it.
- The basis for attributing growth and yields, separate from the object of sale, to the object of sale is the saying of the Prophet (peace be upon him): *"Al-Kharaj Bi al-Daman"* (i.e., entitlement to revenue is based on bearing liability for the revenue-generating asset).

Shari'ah Standard No. (54)

# Revocation of Contracts by Exercise of a Cooling-Off Option

# Contents

***IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL***

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

# Preface

This Standard aims to define contract revocation and in particular, revocation by exercise of a cooling-off option (*Khiyar al-Shart*), to distinguish it from other types of contract termination that resemble it, to explain its causes and conditions, impediments to it and its application in the activities of Islamic financial institutions.(1)

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

# Statement of the Standard

## 1. Scope of the Standard

This Standard covers the stipulation of revocation of valid and binding contracts and the causes and consequences of and impediments to such revocation. It does not cover the expiry of contracts at the end of their contractual terms or nullification owing to the absence of a condition required by the Shari'ah.

## 2. Definition of Cooling-Off Options to Revoke

Revocation by exercise of a cooling-off option refers to the termination of a valid and binding contract by virtue of a stipulation in the contract giving one of the parties the option to revoke the contract.

## 3. Form of Cooling-Off Options to Revoke

A cooling-off option to revoke can be stipulated in the contract in any form that indicates it, and it is not required to use any specific word with the meaning of revocation.

## 4. Permissibility of Cooling-Off Options to Revoke

4/1 It is permissible for both parties to stipulate an option for one or both of them to revoke the contract in specific situations agreed in the contract, without violating Shari'ah rules.

4/2 Revocation by exercise of a cooling-off option is valid if its causes exist, its conditions are satisfied and there are no impediments. It is invalid if its causes do not exist, any of its conditions is not satisfied, if there is an impediment or it is contrary to Shari'ah.

## 5. Causes Triggering Revocation Rights

The cause that triggers the cooling-off option is the existence of one of the situations stipulated in the contract, the occurrence of which gives one or both parties a conditional right to revoke.

## 6. Conditions of Valid Revocation

The following conditions must be fulfilled for revocation to be valid:

6/1 Existence of the cause triggering the option to revoke at the time of the revocation.

6/2 Absence of any impediments.

6/3 Notification of the revocation given by the owner of the cooling-off option to the other party according to the requirements of custom.

6/4 Exercise of the cooling-off option to revoke by the owner of the option.

## 7. Impediments to Revocation

Revocation cannot take place in the following situations:

7/1 Destruction of the sale item caused by a natural disaster after delivery.

7/2 Destruction of the sale item caused by the buyer whether before or after delivery.

7/3 Conduct that transfers ownership and creates rights for third parties, such as selling or gifting the sale item resulting in ownership passing to a third party.

7/4 Expiry of the period specified in the contract for exercise of the cooling-off option.

## 8. Consequences of Revocation

Revocation nullifies the contract at the moment of revocation. Any growth in the sale item that is physically attached to it is considered part of it. Any growth in the sale item that is physically separate from it and occurs between the time of contract and revocation and before the buyer takes delivery belongs to the seller. If it occurs after deliver, it belongs to the buyer.

## 9. Waiver of Revocation Rights

If the owner of a cooling-off option chooses not to exercise his right to revoke and there is no specific recurring harm attributable to the cause

triggering the option, the buyer is deemed to have permanently waived the option. If the harm attributable to the cause triggering the option is recurring or continuous, the option is not waived. For example, if a leased asset breaks down and the buyer chooses not to revoke the contract and repairs the asset and then the asset breaks down again, the buyer is still entitled to exercise his option to revoke.

**10. Payment for Waiver of Revocation Rights**

10/1 It is not permissible to stipulate payment for waiver of revocation rights in a sale contract. In contracts that run for specified terms, such as leases (Ijarah), Istisna'a, debt transfer (*Hawalat al-Dayn*), share cropping (Muzara'ah), tree planting partnership (Mugharasah) and agency (Wakalah), it is permissible for one of the parties to waive their rights to the remaining period of the contract in return for a consideration agreed at the time of waiver.

10/2 Unforeseen circumstances resulting in non-exercise of a right to revoke are excluded from the above rule.

**11. Application of Cooling-Off Options to Revoke**

11/1 Cooling-off options to revoke may be stipulated in credit facility agreements to be triggered by events of default relating to solvency, potential insolvency before it occurs or breach of a restrictive covenant in the contract.

11/2 If the lessor stipulates in a lease contract that he is entitled to add a supplementary rental amount at the beginning of each lease period to cover the costs of maintenance, insurance and taxes levied on owners, and the lessee refuses to accept that, the lessor is entitled to revoke the contract. If the lessee has given a prior promise to purchase the leased asset, the lessor can exercise his rights under the promise and demand performance from the lessee provided that the supplementary rent for that lease period is not added to the purchase price.

11/3 A creditor is entitled to stipulate the right, after notifying the debtor, to accelerate all installments and the right to revoke the contract or

one of them in the event that the debtor fails to pay two or more instalments despite being solvent.

11/4 If the seller stipulates that the buyer provides security or surety or any other form of guarantee and the buyer fails to provide it, the seller is entitled to revoke the contract.

11/5 For other situations of revocation that apply in options to reconsider, options to revoke for incomplete performance and options to revoke for breach of trust, see the relevant Shari'ah Standards.

## 12. Date of Issuance of the Standard

The Shari'ah Board issued this standard on 15 Muharram 1435 A.H., corresponding to 8 November 2014 A.D.

# Adoption of the Standard

The Shari'ah Board adopted the standard on Revocation of Contracts by Exercise of a Cooling-Off Option in its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D,

# Appendix (A)
# Brief History of the Preparation of the Standard

On 1 Sha'ban 1431 A.H., corresponding to 13 July 2010 A.D., the Secretariat of AAOIFI decided to commission a Shari'ah consultant to prepare a juristic study on Revocation of Contracts by Exercise of a Cooling-Off Option.

In its meeting held on 9 May 2012 A.D., the Shari'ah Standards Committee discussed the study and the exposure draft of the standard and introduced the changes it deemed suitable in the light of the comments and observations of the members.

In its meeting No. (34) held in the Kingdom of Bahrain on 20-21 Safar 1434 A.H., corresponding to 3-4 January 2013 A.D., the Shari'ah Board discussed the exposure draft of the standard, and introduced the changes it deemed suitable.

In its meeting No. (35) held in Al-Madinah Al-Munwwarah on 22-23 Shawwal 1434 A.H., corresponding to 29-30 September 2013 A.D., the Shari'ah Board continued its discussions on the exposure draft of the standard, and introduced the changes it deemed suitable.

In its meeting No. (37) held in the Kingdom of Bahrain on 19-21 Jumada I, 1435 A.H., corresponding to 20-22 March 2013 A.D., the Shari'ah Board continued its discussions on the exposure draft of the standard, and introduced the changes it deemed suitable.

The Secretariat of AAOIFI held a public hearing in the Kingdom of Bahrain on 6 Jumada II, 1434 A.H., corresponding to 16 April 2013 A.D. The public hearing was attended by representatives of central banks, institutions, auditing firms, Shari'ah scholars, academics and others interested in this field. The members of the Shari'ah Board and the Shari'ah Standards Committee responded to a number of observations raised by the participants.

In its meeting No. (38) held in the Kingdom of Bahrain on 28 Sha'ban - 1 Ramadan 1435 A.H., corresponding to 26-28 June 2014 A.D., the Shari'ah Board discussed the changes proposed at the public hearing, and introduced the changes it deemed suitable to the exposure draft of the standard, and adopted the standard.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the exposure draft of the standard and introduced the changes it deemed suitable, and adopted the standard.

# Appendix (B)
# The Shari'ah Basis for the Standard

- Stipulation of cooling-off options apply only to binding contracts because nonbinding contracts are by their nature revocable by one or both parties.
- The validity of revocation by any form of language, that indicates it, is based on the general Shari'ah maxim: "Contracts are interpreted according to intent and inherent meaning of the parties and not by the words or forms used" (Maxims of Al-Majallah Al-'Adliyyah) and the statement of some jurists that the use of the technical word "Revocation" is designated by jurists and what is important is its meaning.(2)
- The existence of the cause triggering the option to revoke is required because revocation is contrary to the norm and rule that contracts are generally binding and that in principle consequences must flow necessarily from their causes, and that the cause must exist at the time of revocation.(3)
- The requirement that the other party be notified of revocation is based on the opinion of Abu Hanifah and Muhammad Ibn Al-Hasan, contrary to the opinion of the majority of jurists, because notification averts harm from the other party who, unaware of the revocation, may conduct themselves to their detriment.
- The four impediments to the exercise of cooling-off options are based variously on the following rationale: (I) Revocation would contradict the basic elements of the contract which have been validly established; or (II) revocation would contradict consent implied by conduct (implied terms have the same legal effect as express ones); or (III) revocation is impossible because the term of the contract has expired; or (IV) the subject matter of the option to revoke is deemed by law to have ceased to exist.

(2) *"Sharh Al-Minhaj Wa Hashiyat Al-Qalyubi"* [2: 195]
(3) *"Al-Furuq"* by Al-Qarafi [3: 269]; and *"Al-Qalyubi"* [2: 189]

- The basis for the ruling on the effect of revocation and that revocation nullifies the contract immediately, is the prevailing viewpoint of the Shafi'i and Hanbali schools. Revocation invalidates ownership in sale contracts. This ruling holds true for the asset sold (subject-matter of the contract), whereas increments in the asset sold (separate growth) from time of contracting until revocation and before delivery to buyer, belong to the seller who becomes the owner at or just prior to time of revocation.(4) When the buyer takes possession of the asset sold, any separate growth belongs to him.
- The basis for the rulings stated in item 9 regarding waiver of revocation right is the viewpoint which Al-Zarkashi has indicated in his book titled *"Al-Manthur Fi Al-Qawa'id"*.(5)
- The basis for impermissibility of stipulating compensation in the contract as a condition for waiver of revocation right, is based on analogy to Iqalah, which is considered as one form of contract revocation and has to be performed without any increase or decrease in considerations. Similarly, Shari'ah prohibits waiver of some rights (such as pre-emption and demarcation rights) against compensation.
- The basis for permissibility of stipulating, in the contract, compensation for waiver of the remaining periods of revocation right, in case of continuous contracts such as leasing, is the fact that the party who waives his right owns a benefit that makes him entitled to remuneration.
- The basis for applications of conditional revocation is the rulings indicated in the Shari'ah standard that relates to each application, because rulings on these applications are derived from these preceding standards.

(4) *"Ibn Abidin"* [4: 108] and *"Nihayat Al-Muhtaj"* [3: 434]
(5) *"Al-Manthur Fi Al-Qawa'id"* [2: 151]


# Overview: Publication Sponsor

## Islamic Financial Services in SABB Bank

Banks have become very important for all people and businesses all over the world. They are the backbone of any financial or economic system at both the local and international levels. Due to their importance, banks are highly regulated by most countries. This is because the country's economy depends totally on the activities of its banks. The stronger and more effective the banks are, the more likely it is that the economic and financial systems may be more stable and effective. All this explains why the countries normally pay much attention to monitoring and regulating systems for their banks and financial institutions as a means to maintain and increase the efficiency of their banking and financial operations.

The increasing number of economic and financial activities and transactions in the world in general and in the Islamic community in particular highlights the need for more Islamic banking services. This is why the Islamic banks, in a highly competing market, do their best to provide their customers with high-quality Islamic banking services that help them manage their financial transactions in a Shariah-compliant way.

The Saudi British Bank (SABB) is one of the banks that offer such Islamic banking services. In 2001, the Bank opened a new section, Amanah, to provide services and products compatible with Shariah standards under the supervision of an independent Shariah Committee. In 2012, the name of this section has been changed to "Islamic Financial Services".

SABB has a network consisting of 102 branches including 18 ladies' section branches. All SABB branches provide Islamic financial services. The bank provides Islamic financial services and solutions as well as treasury services for both personal and corporate customers.

**For Personal Customers:**

**1. Personal finance based on the concept of Tawarruq and Murabahah**

a) Tawarruq product (MAL)

MAL is a personal financing product based on Tawarruq. It is one of the sales types compatible with Shariah principles and approved by SABB Shari'ah Committee whereby the bank owns the metal purchased from the international metal market and then sells it to the customer at a fixed profit margin and the value thereof is payable over a maximum period of 5 years.

b) Murabahah product (SAHAM)

SAHAM is personal finance product based on Murabaha. It is one of the sales types compatible with Shariah principles and approved by Shariah Committee at SABB whereby the bank purchases Shariah compatible local shares from the Tadawul and then sells it to the customer at a fixed profit margin and the value thereof is payable over a maximum period of 5 years.

**2. Real estate finance**

Real Estate Finance is based on the concept of Ijarah with the promise to transfer ownership. It is a Shariah-compliant transaction whereby SABB purchases the house and then leases it to the customer with the promise to transfer ownership at monthly installment and finance period up to 25 years.

**For Personal and Corporate Customers:**

**1. Murabahah commodity investment account:**

Murabahah Commodity Investment Account is an alternative product for conventional fixed deposits product and it is an investment vehicle for customers wishing to gain attractive returns at low risks in short and medium terms.

**For Corporate Customers:**

**1. Islamic cash line**

Islamic Cash Line is a product approved by Shariah Committee at the Bank as the first alternative solution to the conventional overdraft. The product is structured by combining:

a) Murabahah liquidity/Tawarruq.
b) Mudarabah investment account.

**2. Tawarruq**

Tawarruq product provides companies with Shariah-compliant solutions for satisfying liquidity requirements for working capital or expansion projects. The product concept is based on the customer's purchase of metals owned by the bank on deferred payment including agreed profit margin. Upon ownership of the metals, the customer can authorizes SABB TSY to sell the goods on his behalf and receive the proceeds accordingly.

**3. Import documentary credits**

Import Documentary Credit is a Shariah-compliant product based on Murabahah concept, i.e., selling at cost price plus profit. The bank, upon the customer's request, opens a D/C and purchases the goods from origin. Upon the bank's taking constructive possession of the goods as per documents (arrival of documents) or physical possession (arrival of goods), it sells the goods to the customer at cost price plus profit.

**Treasury Services Include:**

**1. Islamic rate hedge against fluctuation of finance cost**

Hedging against fluctuations of finance is a treasury tool used to limit or minimize the effects of interest rate/profit margin fluctuation, allowing companies to manage their floating rates obligations against fixed rate through SABB Hedge SWAP.

**2. Promise to exchange**

Promise to Exchange is an alternative Islamic solution to conventional options, which provides protection against the risk of adverse exchange

rates movements in the future and allows the customer to make use of such movements.

To ensure their compliance with Shariah standards, all newly developed or proposed Islamic products are presented first to Shariah Committee. IFS department gathers and classifies all issues that the bank, its customers or employees seeks Shariah opinion thereon.

In addition to arranging the procedures for adopting Islamic products, IFS also monitors/supervises the practical application of products and ensure actual compliance with the Shariah resolutions and regulations by conducting periodic visits to the various departments of the bank that offer Islamic financial products.

The visit reports are then submitted periodically to the Shariah Committee for obtaining its directions and recommendations on the reported issues.


# SHARI'AH STANDARDS

The volume of Shari'ah Standards has become the most prominent compilation of contemporary Fiqh reasoning in the area of Fiqh al-Mua'amalt (Jurisprudence of Financial Transactions) around the globe. The standards cover a large array of Islamic financial contracts and products, including those pertaining to banking, Islamic insurance, investment banking, capital markets, financing, and so on.

These standards are widely popular in the global Islamic finance industry, and are deemed the most outstanding Shari'ah reference for that industry, including legislative bodies, regulatory authorities, and financial institutions, and other professional entities such as law firms, accounting and consultancy firms, in addition to universities, academic institutions and research centers and Fatwa issuing bodies.

Currently, AAOIFI standards are officially adopted by a number of central banks and financial authorities on a mandatory basis or as guidance. Hence, these standards are rightfully a major hallmark for the Islamic finance industry and one its principal accomplishments.

ISBN 978-603-8100-80-6