

# Study Centre

## Part 3: Instruments of Islamic Banking and Finance Tarek El Diwany

## Overview of this Course

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- Part 1: The Monetary System
- Part 2: Principles of Islamic Contract Law
- Part 3: Instruments of Islamic Banking and Finance

# A cash sale

**DEVELOPER**



**HOME BUYER**



immediate  
transfer of title



£100,000 cash price

# Instalment sale

**DEVELOPER**



immediate  
transfer of title

**HOME BUYER**



£150,000 in instalments over 10 yrs.

## Some common exchange contracts

- bay`mu`ajjal: a sale with instalment payments (the term bay` bithamin ajjil is widely used in Malaysia to denote this arrangement)
- `ijārah: hire/lease/rental/wages-time labour agreement (`ijārah muntahia bi-l-tamlīk is a lease followed by a purchase of the asset by the lessee)
- bay` al-ṣarf: currency exchange
- bay` al-salam: payment up-front with delivery deferred, used for fungibles
- istiṣnā`a: payment up-front with delivery deferred, used for non-fungibles, e.g. made-to-order capital equipment and property development (some modern scholars have allowed both payment and delivery to be deferred).

# Types of exchange

Classification	Examples
By timing of delivery	<p>Price (<i>thaman</i>) is delivered spot against delivery of object of sale (<i>mabī'</i>) spot (for example, a hand-to-hand sale).</p> <p>Price is delivered spot against delivery of object at forward date (for example, <i>bay' al-salam</i>).</p> <p>Price is delivered forward against object delivered forward (<i>bay' al-kāli' bi-l-kāli'</i>) which is generally prohibited by consensus.</p>
By method of price quotation	<p><i>Bay' al-musāwamah</i> (price quote without divulging the seller's input costs). Trust sales, for example <i>bay' al-murābahah</i> (cost-plus sale), <i>bay' al-wadī'ah</i> (sale below cost), <i>bay' al-tawliyah</i> (sale at-cost).</p>
By nature of countervalues	<p>Non-fungible for non-fungible, for example, the barter (<i>bay' al-muqāyadah</i>) of a horse for a cow. Non-fungible for fungible (such as a horse for money, <i>bay' al-muṭlaq</i>). Fungible for fungible (such as money for money, <i>bay' al-ṣarf</i>).</p>

# Murābahah

**DEVELOPER**



£100,000



immediate  
transfer of title

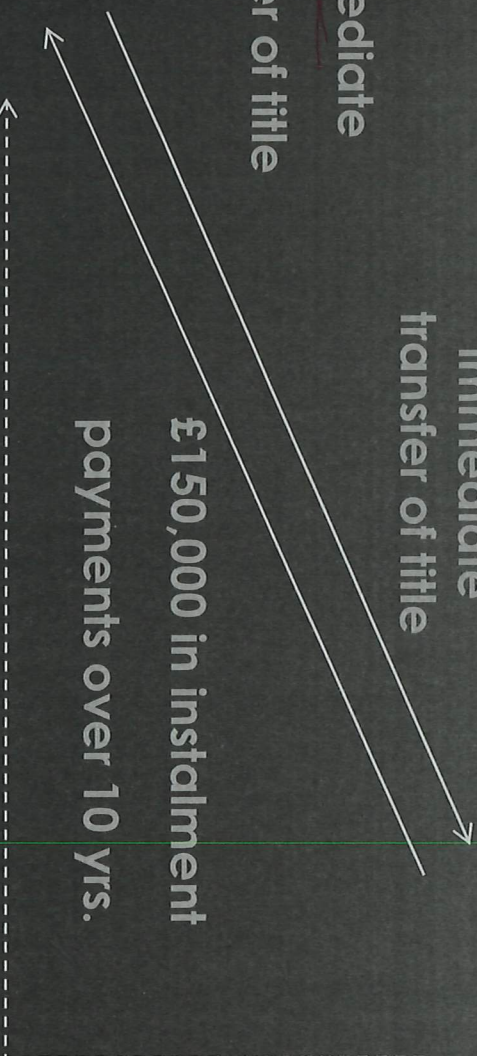
**FINANCE  
COMPANY**

**HOME BUYER**



immediate  
transfer of title

£150,000 in instalment  
payments over 10 yrs.



initial  
promise  
to buy

Ijārah

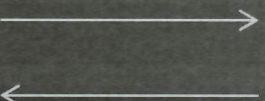
DEVELOPER



HOME BUYER



£100,000



immediate

transfer of title

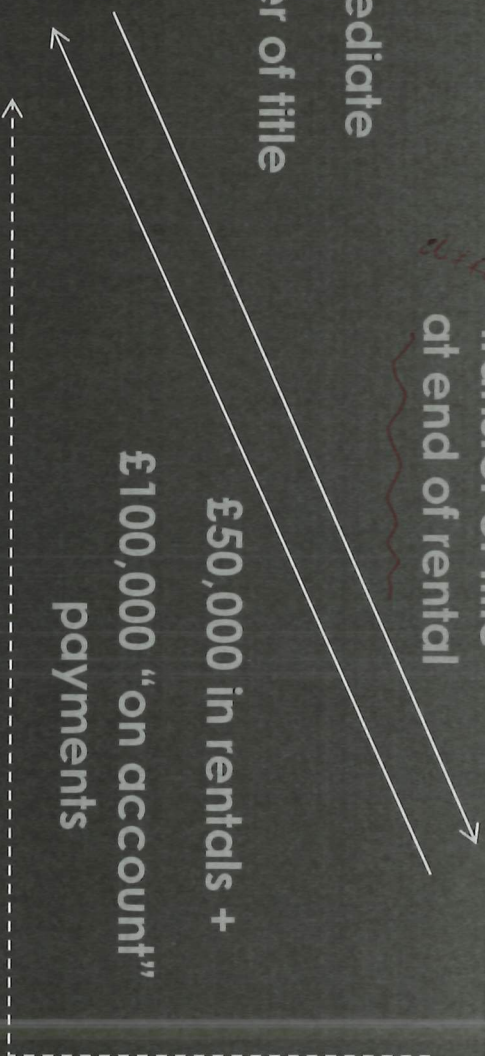
FINANCE  
COMPANY

transfer of title  
at end of rental

*distances to be marked*

£50,000 in rentals +  
£100,000 "on account"  
payments

promise  
to rent  
and then  
buy





# Diminishing partnership

*Set up Trust*

**FINANCE COMPANY**

£80,000

£20,000 now + £80,000

over 10 years

**HOME BUYER**

**PARTNERSHIP AGREEMENT**



Tenancy  
Rent LIBOR + margin, 10 yrs.



title transferred to Fin. Co. as trustee for partners

£100,000



**DEVELOPER**

Tawarruq

£150K

PAYABLE OVER 10 YEARS

BANK

CLIENT



COMMODITY  
DELIVERED NOW

# Tawarruq

£150k

PAYABLE OVER 10 YEARS

£100k

PAID NOW

BANK

CLIENT

DEALER



COMMODITY  
DELIVERED NOW



COMMODITY  
DELIVERED NOW

## Currency exchange ~ bay` al-ṣarf

- Four specific contract conditions:
  - spot exchange of countervalues at time of contract
  - where same genus is exchanged, quantities must be equivalent
  - option conditions and conditionality is prohibited
  - deferment of exchange prohibited
- AAOIFI Sharī'ah Standard No. 1 (Trading in Currencies) requires that:
  - no forward or futures market dealing in currency is permitted
  - possession can be actual or constructive
  - dealing shall not entail “evil consequences” to society

## Debt trading ~ bay` al-dayn

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- Debt may arise from sale, loan, fine, dowry
- Debt can be in the form of goods/services or money
- Sale of debt must be at face value because of ribā prohibition (but note Malaysian exception)
- Debt for debt sale generally prohibited
- Majority of scholars allow sale of debt to debtor at face value, or forgiveness of debt (as a gift)
- Sale of debt to third party allowed by some jurists under conditions (e.g. Malik requires spot payment in cash to avoid ribā)

## Bay' al-mu'ajjal

- Sale in which delivery of the object of sale is made immediately but payment is deferred to a future time. It is generally permitted in shari'ah and finds its legitimacy in Sūrah al-Baqarah where deferment is explicitly permitted.
- The price paid under a bay' mu'ajjal agreement may be more or less than the spot price but must be fixed at the time of contract conclusion. Once the price is fixed it cannot be increased in the event of late payment or default, but can be decreased at the option of the seller if so desired.
- Payment can be made as one lump sum or as a series of instalments, and the period of payment can be specified by reference to one or more particular dates or by reference to a fixed period, for example "payment due within one month". If no time is stipulated for deferment then the contract is void.

## Bay' al-murābahah

- A trust sale where the seller names the profit mark-up that he is applying to the cost price of goods that he is selling and agrees a sale price with the seller on that basis. (If the cost of the original purchase is not disclosed then the sale is known as bay' al-musāwamah.)
- Seller should name his costs truthfully and the buyer is entitled to trust that this is the case, hence dishonesty in the naming of the original price breaks the rules of trust.
- Shaykh Yūsuf al-Qaradāwī argues that murābahah is permitted on the grounds of ibāhah.
- Nyazee says bay' al-murābahah trades were traditionally cash-settled.
- Murābahah-to-the-purchaser” involves two sales, typically cash purchase by bank followed by a murābahah sale to client on deferred settlement terms.

## Bay' al-salam

- Spot payment of an agreed price (the ra's māl al-salam) by a buyer (al-muslim) with deferred delivery by the seller (al-muslim 'ilayhi) of a defined amount of a fungible object (al-muslim fih) at an agreed time and place.
- Contract facilitates production, especially in agriculture and mining, since producer receives funds in advance of production, hence assisting with financing of production process.
- Cornerstones (for non-Hanafīs):
  - contract parties
  - the object of sale
  - offer and acceptance
- “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”. (Narrated by Ibn Abbās in Ṣaḥīḥ al-Bukhārī, Book of Salam).



## Bay' al-salam (2)

- Existence of the object of sale at time of contract conclusion:
  - Al-Sarakhsī sees bay' al-salam as an exception to normal rules of sale in which the object of sale must exist at contract conclusion.
  - Ibn Rushd: “About the condition whether the species of the muslim fih should be in existence at the time of the contract, Mālik, al-Shāfi'ī, Aḥmad, Iṣḥāq, and Abū Thawr did not stipulate this and said that salam is permitted for a thing out of its season. Abū Hanīfah, his disciples, al-Thawrī and al-Awzā'ī said that it is not permitted unless it is the season of the muslim fih. The proof of those who did not stipulate the season is what occurred in the tradition of Ibn 'Abbās that the people used to contract salam for dates for a period of two or three years, this was approved and not rejected. The reliance of Hanafites is upon the tradition related by Ibn Umar that the Prophet (pbuh) said ‘Do not contract salam in date-palms until they (the dates) begin to ripen.’”

## 'Ijārah

- 'Ijārah “to give something on rent”. Two types:
  - employment of a person whose services are purchased for wages
  - transfer of usufruct of an asset in exchange for rent (e.g. leasing )
- Evidence supporting the validity of ijārah:
  - Qur’ān 65:6 and 28:26-27
  - hadīth narrated by Ibn Umar (ibn Mājah) wherein employers are advised to “pay the hired worker his wages before his sweat dries”
- ijārah prohibited by those who see a lease as:
  - sale of something that does not yet exist (e.g. al-Ḥasan al-Baṣrī)
  - as a double-deferment of countervalues (delivery of price and work deferred)
  - as the sale of an uncertain thing (the asset may be destroyed, worker may die)
- Majority of jurists either see usufruct of asset as likely to exist in the future, hence reducing gharar, or as a contract concluded over time as usufruct comes into existence.
- Allows the lessee to use item without purchasing, lessor earns a return

## ‘Ijārah (2)

- Ownership of the object should be retained by the lessor, hence the object must not be consumed through use (thus one cannot lease food). Money cannot be leased as its usufruct alone would require the disposal of the asset itself and such a transaction also involves ribā.
- Jointly owned assets can be leased subject to the rentals being split pro-rata to the ownership shares.
- A deferred lease start date is permitted (but not according to the Shāfi‘ī school for whom such qualifies as a sale of the non-existent).
- The usufruct must be of a permitted nature (hence one cannot lease obscene material, and a labourer cannot be hired to teach magic or to commit murder).
- One cannot lease property for use in a non-Islamic manner.
- The usufruct must be specified (for example, covering the particular duties and amount of work to be provided by a workman).
- Ijārah must be for a specified period and rental (but note “LIBOR linking”)

# Types of partnership

- Two main types of partnership:
  - sharikah al-'aqd (contractual partnership)
  - sharikah al-mulk (co-ownership)
- Evidence:
  - Qur'ān 38:24: "... and verily, many partners oppress one another, except those who believe and do righteous good deeds, and they are few ..."
  - Hadīth Qudsī: "I will become a partner in a business between two mushariks until they indulge in cheating or breach of trust."
  - Hadīth narrations record that the Prophet (pbuh) saw people using mushārakah and did not prohibit it.
- Three types of partnership:
  - Money capital. All scholars agree that money can be used as the capital contribution to a partnership and this is obligatory according to the Ḥanbalīs.
  - Credit worthiness ("sharikah al-wujūh"), accepted by some scholars.
  - Labour ("sharikah al-abdān") accepted by most scholars.

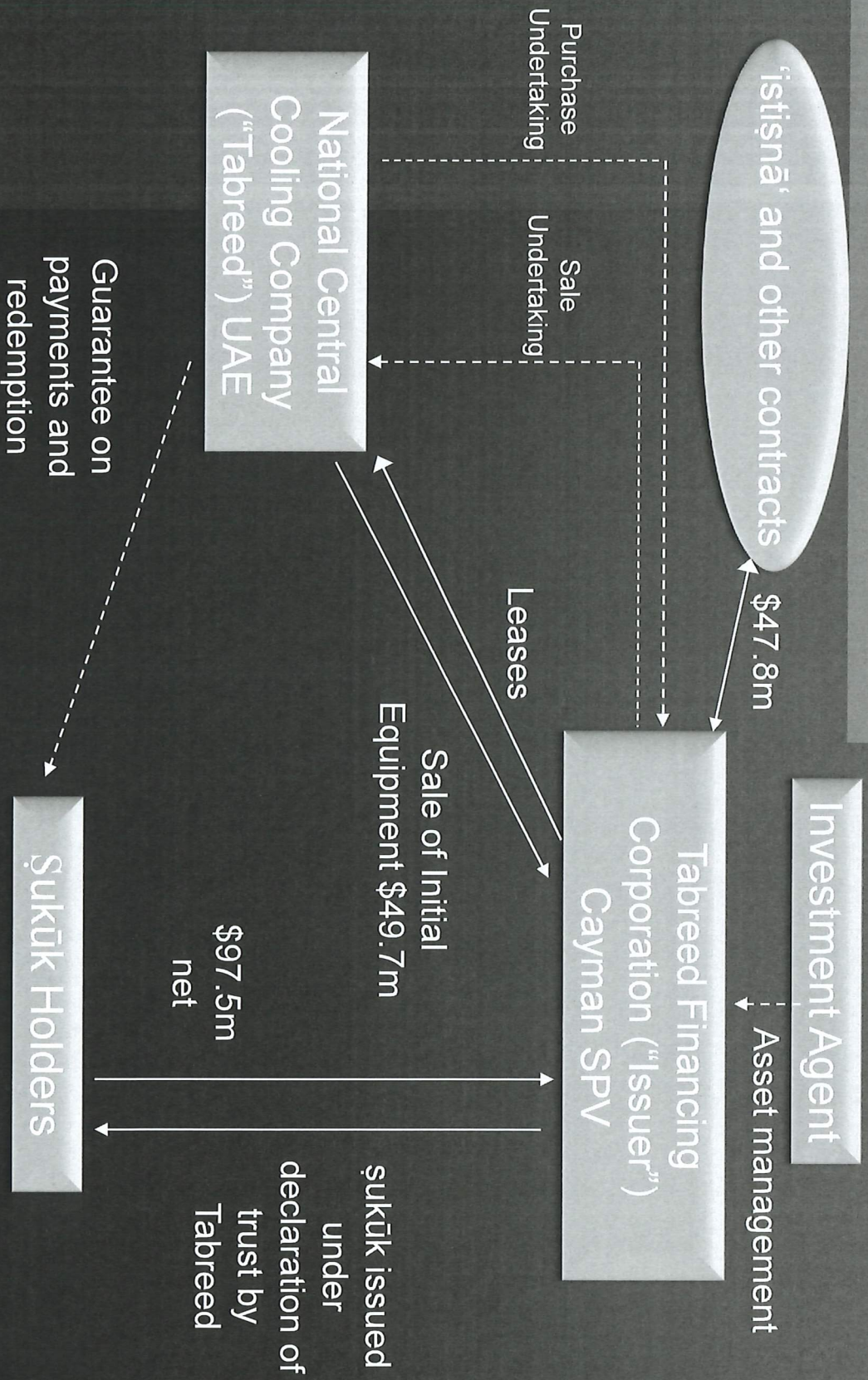
## Conditions on mushārakah capital

- Non-fungibles cannot be the capital of a partnership
  - the value of non-fungibles cannot be accurately ascertained. However, some jurists allow non-monetary fungibles such as grain to be used as the capital of a partnership if they can be valued accurately.
- Mixing of capital
  - the capital must be mixed, hence contribution of two houses to a partnership for renting is not permissible (according to the Hanafīs and the Shāfi‘īs) since two houses cannot be mixed.
- Timing of contribution
  - the partnership capital must be present at time of trading (not necessarily at time of contracting), hence partners can agree to contribute “£1000 tomorrow morning”.
- Profit-sharing ratios
  - to be defined precisely as a proportion of profit, not in absolute amount.
- Loss-sharing
  - all schools agree that losses must be shared pro-rata to capital ratio.

# Mudārabah

- Structure
  - mudārabah (silent partnership) less commonly known as “qirāḍ”, indicating the giving of capital by an investor (rabb al-māl) to an entrepreneur (muḍārib) for undertaking business. Seen as an exception to the prohibition on excessive risk (given that the muḍārib’s recompense for work is uncertain). Sharing of profits must be in a pre-defined ratio, rabb al-māl takes all of any losses.
- Proofs
  - no explicit proofs in Qur’ān (implicit proofs in Qur’ān 62:10 and 73:20 where Muslims are encouraged to seek the bounty of Allāh throughout the land); no reliable proofs in sunnah (Ibn Ḥazm).
  - in ḥadīth narrated by Ibn ‘Abbās, Ibn ‘Abd al-Muṭṭalib used a restricted mudārabah and the Prophet (pbuh) permitted it.
  - There are blessings in three transactions: credit sales, silent partnership, mixing wheat and barley for home (ḥadīth ibn Sinān)
  - ‘Abdullāh and ‘Ubayd Allāh (sons of ‘Umar ibn al-Khaṭṭāb) traded with money from Abū Mūsā al-Ash‘arī in Iraq for delivery to bayt al-māl in Madīnah and ‘Umar which treated as mudārabah (Muwaṭṭa’).

# Şükūk



## Muḍārabah (2)

- rabb al-māl regarded as initiating an agency with muḍārib as agent.
- may be restricted (muḍārabah muqayyada) if the rabb al-māl wishes (limitations are placed upon activities of muḍārib) not permitted by Mālikī/Shāfiʿ schools.
- can be unrestricted (al-muḍārabah al-muṭlaqah) muḍārib trades as he wishes.
- capital is seen as a trust in possession of the muḍārib.
- muḍārib can use capital in a second partnership if rabb al-māl permits (Ḥanafīs)
- if more than one muḍārib, these are a labour partnership within the muḍārabah.
- if more than one rabb al-māl, these are partners in capital ownership.
- ceiling on amount of compensation for one partner is allowed (Ḥanafīs).
- the muḍārib must not receive a salary from his work (essence is sharing of profit).
- the profit-share becomes due to the muḍārib after the return of the original capital amount to the rabb al-māl at the end of the muḍārabah.
- Modern limited liability companies (sharikah dhāt masʿūliyyah mahdūdah) share some features with muḍārabah if shareholders are seen as the rabb al-māl and executive officers as the muḍārib. Executives could be considered as employees of the company, and this is seen as permitted by some scholars on the basis that they are acting as paid agents of the shareholders.



## Wa`d

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- Accepted by consensus when on a unilateral basis.
- Promises are not enforceable in most schools but seen as having moral force
- If bilateral then seen as tantamount to a contract.
- OIC (2nd session Kuwait, 1988) adopts Maliki position and accepts promise as binding .
- Often used unilaterally, for example where a sale is not allowed under sharī'ah, to assure parties that an asset sale will take place at a future date, for example in 'ijārah muntahiyah bi-l-thamlīk.
- Concerns exists over application of unilateral promises to produce double deferral of countervalues (e.g. ISDA IIFM Master Tahawwut Agreement).

## Wakalah

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- Can be restricted or unrestricted.
- Remunerated or non-remunerated.
- Agent possesses principal's property under trust.
- Agents may not appoint sub-agents.
- Rules to limit conflict of interest (e.g. agent can't buy from self).
- Increasingly used as basis for Islamic banks to manage customer deposits (as a paid agent).

## The deposit contract

- Īdā' is an act in which one party (the “depositor”) gives an item for safekeeping by another (the “depository”). The depository must return the deposit when requested, if possible.
- The deposit contract is approved in Qur’ān and ḥadīth:
  - “... let the one who is entrusted discharge his trust (faithfully) ...”
  - “Verily Allāh commands that you should render back the trusts to those to whom they are due ...”
  - Abū Dāwūd and al-Tirmidhī: “Return trusts to the one who entrusted you, but do not betray the one who betrayed you.”
  - Ibn Kathir relates from ‘Abdullah ibn Mas’ūd: “The trust is in the prayer, the trust is in the fasting, the trust is in the ablution, the trust is in the speech, and most severe of them all, deposits.”
- A deposit is a trust in the hands of the depository, hence not guaranteed by depository unless he transgresses. If so, the deposit of trust becomes a “deposit of guarantee” .

