

Islamic Modes of Financing

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Abstract

The operations of markets based on Riba or unfair contracts and the risk of speculation (*Gharar*) are inapplicable as the basic principle of the Shariah. The Commission for Transformation of Financial System gave approval for the Islamic modes of financing on the basis of *Musharaka*, *Mudaraba*, *Murabaha*, *Musawama*, Leasing, Salam and *Istisna*. *Murabaha* is 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. *Ijara* means to transfer the usufruct of a particular property to another person in exchange for rent claimed from him. Salam is a sale where by 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. *Istisna* is a kind of sale where a commodity is transacted before it comes into existence. *Musharka* can be separated into two kinds. *Sharikat ul Mulk*, it refers to combined ownership of the property by two or more parties and *Sharikat ul Aqd*, it means partnership by mutual contract. *Mudaraba* is a special kind of partnership, where one partner gives money to another for investing it in a commercial enterprise. Islamic Scholars have consensus that *Sharikah* and *Mudarabah* are the real modes of Islamic finance. *Murabaha*, *Ijarah*, *Salam* and *Istisna* were adopted modes of finance temporarily for interim periods. When *Sharikah* and *Mudarabah* are established, others will be withdrawn. Until we do not adopt *Sharikah* and *Mudarabah* as major modes of finance, we shall not be able to change prevailing economic system into *Riba* free Islamic economic system in its true sense.

Keywords: Islamic Banking; Modes of Finance; Islamic Economic

The fundamental objective of Islamic finance is to fulfill the teachings of the Holy Quran, as opposed to capitalist approach to get maximum return from financial assets.

The operations of markets based on Riba or unfair contracts, the risk of speculation (*Gharar*) are inapplicable as the basic principle of the Shariah. The Holy Quran does not contain any condemnation regarding the investments which are morally acceptable and have the benefits of fair and legitimate profit.

Islamic law reflects the general spirit of Allah's commands that control all the aspects of Muslim life. Islamic finance is directly related to

spiritual values and social justice. In Islam there is no separation between religion and the state of business.

Receiving and paying interest is prohibited for Muslims as per the injunctions of Shariah law which prevents vigilant Muslims from involving in prohibited economic transactions.

Some conditions governing Islamic investment can be described as follows:

- Money does not make money in itself, but it is effective only if it involves in a task, activity, or job.
- All the investment must be made on the basis of profit and loss sharing; investment is lawful only in those business activities which are not prohibited.
- There will be no gharar in business contracts, it means that uncertainty, and ignorance and the conditions which lead to disputes are strictly prohibited.

Islamic Modes of Financing:

In pursuant to the judgment of the supreme court on Riba dated December 23, 1999 the commission for Transformation of Financial System was set up in the State Bank of Pakistan. The commission gave approval for the Islamic modes of financing on the basis of Musharaka, Mudaraba, Murabaha, Musawama, Leasing, Salam and Istisna. The Shariah board also gave approval of these financial modes in order to circulate the business of Banks conducting Islamic banking in Pakistan. Details of these essentials are given below.

1. Murabaha

It is the most frequently exercised mode of Islamic financing which is practically implemented in financial institutions and in other financial transactions.

It is defined as:

“Murabaha is 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” (1)

For financial transactions by using Murabaha, it is very important that all conditions of sale defined by the Islamic jurists should be fulfilled.

For example:

- I) Before sale, the commodity of sale has to be in the possession of vendor.
- II) If the sale is attributed to a future date or event, it will be regarded as void and if parties want to effect sale, a fresh sale contract is required.
- III) Price should be certain for the validity of the sale

IV) The delivery of the commodities must be certain etc.

Now we can explain financial transactions by using Murabaha in following points

- 1: On the time of sale the cost of goods sold is expressed in mudaraba and sells the commodity by adding profit with the mutual consent of both parties
- 2: Cost include all expenses like carrying charges and other taxes etc, but the administrative expenses like salaries of staff and rent are not included.
- 3: The validity of Murabaha depends on the fact that parties should know about the exact cost otherwise Musawama is used.
- 4: Most preferred way is that the financier himself purchase commodity but due to non applicability of the concept, they can also higher agent for purchasing commodity on their behalf.
- 5: Commodity should be purchased from the third party
- 6: Payment can be made on deffered basis with the mutual consent of both parties.

So, we can conclude by saying that this Islamic instrument is not a loan that bears interest but it practiced as a sale of commodity by adding some agreed profit whose payment can be made in some future date.(2)

Ijara:

“It is also a term used in Islamic Fiqh, which means to give some thing on rent”

Ijara has two different types:

- 1: If a person provide services and wage is given as compensation, in this sense employee is called Mustajir and the employee is called Ajir.
- 2: Other type is regarding the usufruct of assets and properties. So Ijara means “to transfer the usufruct of a particular property to another person in exchange for rent claimed from him”. (3)

For this concept the term Leasing is used in English, lessor is called Mujir and the lessee is called Mustajir and the rent payable is called Ujrah.

Now we briefly explain some basic Islamic rules for second type of Ijara

- 1: For valid lease contract property must be in the possession of lessor.
- 2: The liabilities rising from owner ship of property shall be born by lessor.
- 3: Lease asset is only used for purpose mentioned in lease contract.

- 4: Damage to the leased asset by misuse or negligence must be born by lessee.
- 5: Properties of two or more persons can be leased out and the leasing amount is dispersed according to the respective share in the property.
- 6: Rent amount must be fixed, but it is permitted that for different phase, different rent is fixed.
- 7: If the rent is not paid on agreed time the lessee can be accountable to pay price calculated in approved rate. (4)

So these concepts are used for financing of this type.

Salam:

As it is known very well, according to the jurisprudence of Islam it is compulsory for the validity of contract that the physical ownership is necessary for the seller. But it has two exceptions based on some defined conditions we will discuss both separately.

Salam:

“A sale where by 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”.(5)

Holy prophet (PBUH) allowed Salam on following circumstances: (6)

- 1: Full payment should be made from the end of buyer because salam is allowed with keeping in mind the unavailability of finance of the seller like farmers.
- 2: Salam is available for those supplies for which quality and quantity can be differentiated separately
- 3: It is compulsory to mention in the contract regarding accurate date and place of delivery.
- 4: Contract is not applicable on particulare fied or commodity such as particular land of rice or fruit because particular field ban be destroyed.
- 5: While contracting, the quantity of commodity must be clearly specified leaving no ambiguity in the mind of any party.

So salam is beneficial for both parties, seller enjoys advance payment while buyer take the benefit of price lower than the spot rate.

Istisn'a:

Istisna is a mode of finance it is defined as:

“Kind of sale where a commodity is transacted before it comes into existence”.(7)

We can say in current era of global business a party orders to manufacture a product and for this some time he/she have to pay advance payment.

The important point in the case of Istasna that the manufacturer uses its own material for production otherwise the contract will be of Ijara rather than Istisna.

Also it is important to fix the price with the approval of concerned people and specification of product should also be settled.

There are some differences between Istisna and Salam:

- 1) In Istisna manufacturing of commodity is necessary
- 2) In salam full price is paid in advance but in Istisna there is no such condition
- 3) Delivery time is important time of Salam and not of Istisna.(8)

Musharakah:

The term of Musharkah is used in Islamic mode of financing it comes from **word Sharikah**, that means **sharing**. It can be separated into two kinds.

1) Sharikat ul Milk:

It refers to combined ownership of the property by two or more parties; it has two ways.

1. At the option of parties, such as jointly purchase of equipment.
2. It comes automatically for example heir's ownership of property after the death of concerned person.

2) Sharikat ul Aqd:

It means partnership by mutual contract

It has further three sub divisions:

1. Sharikat-ul-amaal
2. Sharikat-ul-amwaal
3. Sharikat-ul-wajooh. (9)

We can explain some rules of Musharakah on over all basis as under.

- All the valid conditions of sale should be present in the Musharkah for its validity.
- Investment comes from all parties
- Percentage of profit should be determined when contract is made
- Lumpsum amount is not allowed in Musharakah
- Ratio of profit distribution is a contradictory point in Musharakah.
- According to Imam Malik and Shafi profit is shared according to the percentage of investment. According to Imam Ahmad profit sharing ration can be different from investment. Imam Abu Hanifah make a coordination between the both point of views. According to him if

the partner will remain sleeping through out the contract the profit should not exceed from its investment.

- On the point of loss all the Islamic jurists are given one view that loss will be distributed according to the share of investment.
- Any partner can exercise its right for the termination of contract.
- If the partner dies or insane then the contract is automatically terminated.

Mudaraba:

Mudaraba 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 Rabul Mall and the management is exclusively done by Mudarib.

- I) Rabul Mall may specify a specific business and Mudarib have to do that business.
- II) Rabul Mall can contract with more than one person
- III) Islam has not specify the percentage of profit it depends upon the parties mutual consent, but it is prohibited strictly to allocate lump sum amount to any party.
- IV) Any party can terminate the contract only condition is a notice to other party. (10)

Islamic Scholars have consensus that Sharikah and Mudarabah are the real modes of Islamic finance. Murabaha, Ijarah, Salam and Istisna were adopted modes of finance temporarily for interim periods. When Sharikah and Mudarabah are established, others will be withdrawn. But it can not be made possible up till now. Ijarah and Murabaha are the major modes of Islamic finance which are being used. Main cause of not using Sharikha and Mudarabah as mode of finance in our financial institutions is that the partner and Mudariba in Sharikah and Mudarabah are “Ameen” not Dhamin of investment (Capital) according to the Shariah. Most of the investors are not investing their capital in Sharikah and Mudarabah based instruments and products in financial institutions because they do not trust others about their investments. They want to ensure the security of their capital.

Without implementing teachings and injunctions of Islam in our individual and collective life, we cannot have the true results from any system which is presented in Shariah to solve our problems. Untill we do not adopt Sharikah and Mudarabah as major modes of finance, we shall not be able to change

prevailing economic system into Riba free Islamic economic system in its true senses.

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