"A New prespective to islamic banking"

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Evaluation of Islamic Banking Practices In Pakistan

Introduction:

Modern banking system was introduced into the Muslim countries at a time when they were politically and economically at low ebb, in the late 19th century. The main banks in the home countries of the imperial powers established local branches in the capitals of the subject countries and they catered mainly to the import export requirements of the foreign businesses. The banks were generally confined to the capital cities and the local population remained largely untouched by the banking system. The local trading community avoided the “foreign” banks both for nationalistic as well as religious reasons. However, as time went on it became difficult to engage in trade and other activities without making use of commercial banks. Even then many confined their involvement to transaction activities such as current accounts and money transfers. Borrowing from the banks and depositing their savings with the bank were strictly avoided in order to keep away from dealing in interest which is prohibited by religion.1

With the passage of time, however, and other socio-economic forces demanding more involvement in national economic and financial activities, avoiding the interaction with the banks became impossible. Local banks were established on the same lines as the interest-based foreign banks for want of another system and they began to expand within the country bringing the banking system to more local people. As countries became independent the need to engage in banking activities became unavoidable and urgent. Governments, businesses and individuals began to transact business with the banks, with or without liking it. This state of affairs drew the attention and concern of Muslim intellectuals.

Islamic finance is an old concept but a very young discipline in the academic sense. It lacks the required extent and level of theories and models needed for expansion and implementation of the framework provided by Islam. In these circumstances, unawareness and confusion exist as to the form of the Islamic financial system and instruments.

The main difference between the present economic system and the Islamic economic system is that the later is based on keeping in view certain social objectives for the benefit of human beings and society. Islam, through its various principles, guides human life and ensures free enterprise and trade. That is the reason why the conventional banker does not have to be concerned with the moral implications of the business venture for which money is lent.

Socio-economic justice is central to the Islamic way of life. Every religion has the same basic aim. In an Islamic environment, an individual not only lives for himself, but his scope of activities and responsibilities extend beyond him to the welfare and interests of society at large. The Qur'an is very precise and clear on this issue. There are basically three components of an Islamic economic paradigm:

- That as vice-regent, man should seek the bounties of the land that God has bestowed on humanity. From the wealth thus obtained, he should enjoy his own share.

- That he should be magnanimous to others and use a part of the wealth so obtained also for the benefit of his fellow-beings.

- That his actions should not be willfully damaging to his fellow-beings.

Human society in Islam is based upon the validity of law, of life and the validity of mankind. All these are natural corollaries of the faith. Islamic laws promote the welfare of people by safeguarding their faith, life, intellect, property and their posterity. God nurtures, nourishes, sustains, develops and leads humanity towards perfection. Even though an individual may be making a living because of his efforts, he is not the only one contributing towards that living. There are a number of divine inputs into this effort and therefore, the results of such an effort obviously cannot be construed as entirely proprietary.

Whereas the Islamic banker has a much greater responsibility. This leads us to a very fundamental concept of the Islamic financial system i.e. the relation of investors to the institution is that of partners whereas that of conventional banking is that of creditor-investor.

The Islamic financial system is based on equity whereas the conventional banking system is loan based. Islam is not against the earning of money. In fact, Islam prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or another.

"Those who swallow down usury cannot arise except as one whom Shaitan has prostrated by (his) touch does rise. That is because they say, trading is only like usury; and Allah has allowed trading and forbidden usury. To whomsoever then the admonition has come from his Lord, then he desists, he shall have what has already passed, and his affair is in the hands of Allah; and whoever returns (to it) - these are the inmates of the fire; they shall abide in it [Sura 2:275]."

Not that there was any ambiguity in the Command of Allah. Far be it from Him to give any order to His Servants, which they can not comprehend. The fact is that those who had surplus money and wanted to earn profit did so either by lending it through riba (usury) or by investing it in trade and hypocrites were not prepared to forgo the first option. Hence, they argued that since both were means of earning profit, they were alike and the prohibition of riba did not stand to reason.

The practice of riba i.e. usury was so deep-rooted in society and continuance of the practice was so undesirable, that Allah warned the believers that if they did not desist, they should be prepared for a war against Allah and His Apostle. This warning was heeded by the Muslim Ummah and for more than a thousand years the economies of Muslim states were free from riba. With the ascendancy of Western influence and its suzerainty over Muslim states, the position changed and an interest-based economy became acceptable. Efforts in Muslim countries to revert to an interest-free economy were hampered by many obstacles.

Historical Development:

The first modern experiment with Islamic banking was undertaken in Egypt under cover, without projecting an Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in l963. This experiment lasted until l967 (Ready l98l), by which time there were nine such banks in the country. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi l988). Thus, they functioned essentially as saving- investment institutions rather than as commercial banks. The Nasir Social Bank, established in Egypt in l97l, was declared an interest-free commercial bank, although its charter made no reference to Islam or Shariah (Islamic law).

Interest-Free Rationale:

The essential feature of Islamic banking is that it is interest-free. Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy, it nevertheless derives its specific rationale from the fact that there is no place for the institution of interest in Islam.

Islam prohibits Muslims from taking or giving interest *(riba)* regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged. To be sure, there have been attempts to distinguish between usury and interest and between loans for consumption and for production. It has also been argued that *riba* refers to usury practiced by petty moneylenders and not to interest charged by modern banks and that no *riba* is involved when interest is imposed on productive loans, but these arguments have not won acceptance. Apart from a few dissenting opinions, the general consensus among Muslim scholars clearly is that there is no difference between *riba* and interest. These two terms are used interchangeably.

The prohibition of *riba* is mentioned in four different revelations in the Qur'an. The first revelation emphasizes that interest deprives wealth of God's blessings. The second revelation condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others. The third revelation enjoins Muslims to stay clear of interest for the sake of their own welfare. The fourth revelation establishes a clear distinction between interest and trade, urging Muslims to take only the principal sum and to forgo even this sum if the borrower is unable to repay.

It is further declared in the Qur'an that those who disregard the prohibition of interest are at war with God and His Prophet. The prohibition of interest is also cited in no uncertain terms in the Hadith (sayings of the Prophet). The Prophet condemned not only those who take interest but also those who give interest and those who record or witness the transaction, saying that they are all alike in guilt.

It may be mentioned in passing that similar prohibitions are to be found in the pre Qur'anic scriptures, although the 'People of the Book', as the Qur'an refers to them, had chosen to rationalize them. It is amazing that Islam has successfully warded off various subsequent rationalization attempts aimed at legitimizing the institution of interest. Essentially Muslims need no 'proofs' before they reject the institution of interest: no human explanation for a divine injunction is necessary for them to accept a dictum, as they recognize the limits to human reasoning. No human mind can fathom a divine order; therefore it is a matter of faith *(iman)*. Some scholars have put forward economic reasons to explain why interest is banned in Islam. A common thread through all views is the exploitative character of the institution of interest, although some have pointed out that profit (which is lawful in Islam) can also be exploitative. One response to this is that one must distinguish between profit and profiteering, and Islam has prohibited the latter as well. The question is asked as to what will then replace the interest rate mechanism in an Islamic framework.

There have been suggestions that profit-sharing can be a viable alternative. In Islam, the owner of capital can legitimately share the profits made by the entrepreneur. What makes profit sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing *ratio*, not the rate of return itself that is predetermined. It has been argued that profit-sharing can help allocate resources efficiently, as the profit-sharing ratio can be influenced by market forces so that capital will flow into those sectors which offer the highest profit sharing ratio to the investor, other things being equal.

Modes of financing in Islamic Banks in Pakistan:

Banks adopt several modes of acquiring assets or financing projects. But they can be broadly categorized into three areas: investment, trade and lending.

Investment financing

This is done in three main ways: a) *Musharaka* where a bank may join another entity to set up a joint venture, both parties participating in the various aspects of the project in varying degrees. Profit and loss are shared in a pre-arranged fashion. This is not very different from the joint venture concept. The venture is an independent legal entity and the bank may withdraw gradually after an initial period. b) *Mudarabah* where the bank contributes the finance and the client provides the expertise, management and labor. Profits are shared by both the partners in a pre-arranged proportion, but when a loss occurs the total loss is borne by the bank. c) Financing on the basis of an *estimated rate of return*. Under this scheme, the bank estimates the expected rate of return on the specific project it is asked to finance and provides financing on the understanding that at least that rate is payable to the bank. (Perhaps this rate is negotiable.) If the project ends up in a profit more than the estimated rate the excess goes to the client. If the profit is less than the estimate the bank will accept the lower rate. In case a loss is suffered the bank will take a share in it.

⁂ Trade financing:

This is also done in several ways. The main ones are: a) *Mark-up* where the bank buys an item for a client and the client agrees to repay the bank the price and an agreed profit later on. b) *Leasing* where the bank buys an item for a client and leases it to him for an agreed period and at the end of that period the lessee pays the balance on the price agreed at the beginning an becomes the owner of the item. c) *Hire-purchase* where the bank buys an item for the client and hires it to him for an agreed rent and period, and at the end of that period the client automatically becomes the owner of the item. d) *Sell-and-buy-back* where a client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after certain time for an agreed price. e) *Letters of credit* where the bank guarantees the import of an item using its own funds for a client, on the basis of sharing the profit from the sale of this item or on a mark-up basis.

⁂ Lending:

Main forms of Lending are: a) *Loans with a service charge* where the bank lends money without interest but they cover their expenses by levying a service charge. This charge may be subject to a maximum set by the authorities. b) *No-cost loans* where each bank is expected to set aside a part of their funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc. and to needy consumers. c) *Overdrafts* also are to be provided, subject to a certain maximum, free of charge.

⁂ Services:

Other banking services such as money transfers, bill collections, trade in foreign currencies at spot rate etc. where the bank's own money is not involved are provided on a commission or charges basis.

Morabaha:

This is a mode of sale and purchase of commodities. The agreement is made between the Bank and a Customer, whereby Bank purchases a commodity and sells the same to Customer on a deferred payment basis. The essential features of the Morabaha are:

i. Existence of a tangible commodity/asset of which physical possession can be taken before use or consumption.
ii. Such commodity or asset has to be acquired from third party (commodity/asset already in the possession of the Customer, cannot form basis of the agreement).
iii. Bank sells the commodity/asset to the Customer.

Local Purchase Morabaha (LPO):

i. Bank and the client sign a **Morabaha Agreement.**
ii. Client submits a request for purchase of commodity/asset by specifying quality, quantity and price.
iii. Bank appoints an agent under an **Agency Agreement** (who could be the client) to purchase the asset/commodity on behalf of the bank.
iv. The Agent purchases the commodity under a **Purchase Order** from third party after obtaining disbursement from the bank through **Receipt** and submits a **Declaration** to this effect.
v. Bank sells the commodity/asset to the Client on a cost plus profit basis and the parties agree on a Purchase Price and Due date.

Morabaha Imports (PAD):

i. Bank and Client sign a **Morabaha Agreement**.
ii. In terms of the Morabaha Agreement, the Bank appoints the Client as its Agent through an **Agency Agreement** to import commodities from time to time.
iii. Client submits an application to establish **letter of credit** and the Bank opens it.
iv. Upon negotiation, the Bank creates an advance in the name of the Client, value payment of funds to the beneficiary.
v. Upon receipt of documents and arrival of goods, the Bank and the Client enter into a Morabaha through a **declaration** submitted by the client. Such Morabaha can be spot, where client pays immediately to retire documents or on a deferred payment basis, if the client wishes to pay later.
vi. In case of deferred payment, the Client signs a **promissory note** for the purchase price agreed and the Bank releases the documents.

﴾ Ijarah (Leasing):

Clients use Ijarah financing mainly for financing purchase of plant and machinery. If assets subject to lease are to be freshly acquired, Bank may appoint an agent (could be the client) to do so on its behalf. If Client has already acquired the equipment, Bank will purchase it from Client and lease it back.

i) Bank and Client sign a Lease Finance Agreement whereby Client agrees to take on lease from the Bank for specified assets for an agreed tenor.
ii) Bank appoints an Agent for acquisition of assets, if not already in possession of Client.

iii) Bank intimates Client of acquisition of assets and delivers to place specified by Client.
iv) Term of lease starts from date Client takes possession of assets, whether constructive or physical.
v) Client pays a monthly, or quarterly rental to the Bank for the use of the assets and by virtue of the agreement, becomes owner of asset only after paying a nominal lease end value.

﴾ Musharaka:

Under Islamic jurisprudence, Musharakah means a joint enterprise formed for conducting some business in which all partners contribute financially and share the profit as per pre agreed upon ratios, while the loss is shared according to the ratios of financial contribution of each partner. The Musharakah is an ideal alternate to replace interest based lending with far reaching effects on both production and distribution of capital.

Profit sharing ratios in a Musharakah depend entirely on the estimated profit the business is able to generate.

The Musharakah is a relationship established, by the parties, by mutual contract and therefore all necessary ingredients of a valid contract must be present.

The risk of loss inherent in this mode of financing, ensures that the Bank fully satisfy itself as to the profitability and feasibility of the business venture as well as to the integrity of its Musharakah partners.

﴾ Mudarabah:

This is a 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-maal" while the management and work is an

exclusive responsibility of the other, who is called "Modarib" and the profits generated are shared in a predetermined ratio.

There are two types of Modaraba namely:

a. **Al Modaraba Al Moqayyadah:** Rabb-ul-maal may specify a particular business or a particular place for the Modarib, in which case he shall invest the money in that particular business or place. This is called Al Modaraba Al Moqayyadah (restricted Modaraba).

b. **Al Modaraba Al Mutlaqah:** If Rabb-ul-maal gives full freedom to Modarib to undertake whatever business he deems fit, this is called Al Modaraba Al Mutlaqah (unrestricted Modaraba). However, Modarib cannot, without the consent of Rabb-ul-maal, lend money to anyone. Modarib is authorized to do anything which is normally done in the course of business. If they want to have an extraordinary work which is beyond the normal routine of the traders, it cannot be done without express permission from the Rabb-ul-maal. Modarib is also not authorized to (a) keep another Modarib or a partner (b) mix his own investment in that particular Modaraba without the consent of Rabb-ul-maal.

Current practices followed at Islamic Banks in Pakistan:

Generally speaking, all interest-free banks agree on the basic principles. However, individual banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc. In the following paragraphs, we will describe the salient features common to all banks.

Deposit accounts:

All the Islamic banks have three kinds of deposit accounts: current, savings and investment.

Current accounts:

Current or demand deposit accounts are virtually the same as in all conventional banks. Deposit is guaranteed.

Savings accounts:

Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their

clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk-free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawal demands.

Some Difficulties in Pakistan:

Major hurdles faced by Islamic finance houses are the absence of a necessary legal framework and the lack of adequate infrastructure in the banking and investment fields.

The modern banking system is based on the concept that money should be treated like any other factor of production and must earn some return over a period of time. It is argued that the establishment of large-scale enterprises, and hence material progress, is not possible unless there is an agency that can mobilize financial resources from the public by paying them some interest, while lending these resources to entrepreneurs. By charging these entrepreneurs a higher interest, these agencies were able to utilize the difference (called a spread) to meet their expenses and to make some profit for the owners of the agency (i.e. share-holders). Banks were established to fulfill this need and from the beginning were only authorized to perform this function. They were legally prohibited from entering into trade or industry. When the Government of Pakistan decided to introduce an interest-free banking system, this prohibition was removed. After a lot of in-house the banks were told in June 1984 that they were allowed to deal in only 1 to 12 means of financing (only two were classified as "Financing by Lending").

These two permitted lending without interest by charging the actual expense incurred by the banks to meet their cost of operation and Qarde Hasana. All the rest were either trade-related or investment-type models. These included the purchase of goods by banks and their sale to clients at an appropriate mark-up price on a deferred payment basis, in case of default there being no further mark-up. This sale of goods on mark-up is known as Murabiha. Other types of financing were hire-purchase, leasing, Musharika or profit- and-loss-sharing, equity participation and purchase of shares, etc.

Since Murabiha was the type nearest to lending and since it did not require any expertise in buying and selling commodities, bankers limited most of their financing to this type. In order to eliminate the risk of prospective buyers refusing to accept goods purchased by the banks by reason of not being strictly in accordance with the specifications, banks were allowed to appoint the prospective buyer as their agent for the purchase of the goods and later for the sale of the

goods to the buyer's firm. Furthermore, to give as much leeway to the banks, as safeguards of public money, as possible, the Ulama did not fix a waiting period between the two stages of buying and selling.

The banks did not assume the role of trader and Morabiha degenerated into lending on mark-up. The banks rarely hired persons who knew even the basics of trading, nor did they train their existing staff to learn the art. They did not even bother to find out whether their agents had actually purchased the goods or not. The inability, or reluctance of banks and financial institutions to change over their operations from lending to trading has been a serious impediment to the Islamisation of the economy.

The blame does not entirely fall on the bankers. Depositors have become so accustomed to their money remaining safe and yet earning profit that if a bank had really ventured to trade and incurred a slight loss, then the depositors would have immediately demanded their money back causing the bank to go bankrupt. In the existing state of morality this was more likely to happen. It actually did happen to a few investment companies that had started with good intention, but could not go on giving away handsome profits to their depositors.

A lack of seriousness and dedication in those responsible for the implementation was also another great impediment to the achievement the goal of an interest-free economy. Many of these individuals thought that in the present world, there was no alternative to interest, yet something had to be done because of demands from the government. Some, who were more influenced by Western education and culture, thought that interest banking was not prohibited by Islam. Yet others thought that the efforts being made were only superficial and in reality the new system was no different from the existing system.

One weakness in the implementation of the proposals to eliminate interest from the system was that people were not sufficiently motivated to sacrifice a part of their financial interests for the sake of carrying out the commands of Allah (SWT), and The Prophet (SAW). Anyone attempting to change a well-established practice must be prepared to make some sacrifice for this, as arguably no noble cause has been achieved without any sacrifice. The prevailing level of public morality within the existing legal and taxation system of the state made it an up-hill struggle to rid the banking system of interest. And it remains so. Beyond this, there are many avenues of making profit that would have to be forgone and many types of modern banking services which which also could not be provided by a bank working strictly on Islamic principles. For example, they could not keep their surplus cash in fixed or saving deposits. In spite of these difficulties, those who were engaged in the task of Islamisation took it upon themselves to portray as successful the reforms, while those who pointed out the difficulties were labeled as either a cynic or an opponent of the new system.

Anyone who uttered a word of caution was regarded as someone who did not want the experiment of Islamisation to succeed. As a matter of fact, reward in the

Hereafter (aakhirat) should have been the main purpose of Islamisation. It might not have attracted many people, but the foundation would have been firm.

One great obstacle in the realization of the goal of an interest-free economy has been absence of a proper environment. Unfortunately nothing has been done to produce an ideal or a near ideal Islamic environment by government or public leaders. The most important pre-requisite for the enforcement of Shari'ah is a'dl [translation!!!!!!]. Establishment of the rule of law and ensuring justice to aggrieved persons should be the first task of an Islamic state, yet nothing has been done to achieve this end.

One very important requirement of an ideal environment is an inflation-free economy. Inflation erodes the real value of money, meaning that when a person gives a sum of money on loan and receives the same amount back after one year, he has made a net loss. A major source of inflation is deficit financing. The printing of notes to meet budgetary deficit is in fact an injustice to the public, since the real value of their money is consequently eroded. In this respect too, the government's performance is very discouraging. Government borrowings at high interest rates and the quantum of the government's domestic and foreign debts has reached a level which cannot be sustained. There has also been no effort to change the taxation structure so as to bring it to conform with Shari'ah.

Questions of Morality:

The practices in use by the Islamic banks have evoked questions of morality. Do the practices adopted to avoid interest really do their job or is it simply a change of name? It suffices to quote a few authors.[24]

The Economist writes:

….. Muslim theoreticians and bankers have between them devised ingenious ways of coping with the interest problem. One is *murabaha*. The Koran says you cannot borrow $100m from the bank for a year, at 5% interest, to buy the new machinery your factory needs? Fine. You get the bank to buy the machinery for you -- cost, $100m -- and then you buy the stuff from the bank, paying it $105m a year from now. The difference is that the extra $5m is not interest on loan, which the Koran (perhaps) forbids, but your thanks to the bank for the risk it takes of losing money while it is the owner of the machinery: this is honest trading, okay with the Koran. Since with modern communications the bank's ownership may last about half a second, its risk is not great, but the transaction is pure. It is not surprising that *some Muslims uneasily sniff logic-chopping here*.

Dr Ghulam Qadir says of practices in Pakistan:

Two of the modes of financing prescribed by the State Bank, namely financing through the purchase of client's property with a buy-back agreement and sale of goods to clients on a mark-up, involved the least risk and were closest to the old interest-based operations. Hence the banks confined their operations mostly to these modes, particularly the former, after changing the simple buy-back agreement (prescribed by the State Bank) to buy-back agreement with a mark-up, as otherwise there was no incentive for them to extend any finances. The banks also reduced their mark-up-based financing, whether through the purchase of client's property or through the sale of goods to clients, to mere paper work, instead of actual buying of goods (property), taking their possession and then selling (back) to the client. As a result, there was no difference between the mark-up as practised by the banks and the conventional interest rate, and hence it was judged repugnant to Islam in the recent decision of the Federal Shari'ah court.

As banks are essentially financial institutions and not trading houses, requiring them to undertake trading in the form of buy-back arrangements and sale on mark-up amounts to imposing on them a function for which they are not well equipped. Therefore, *banks in Pakistan made such modifications in the prescribed modes which defeated the very purpose of interest-free financing*. Furthermore, as these two minimum-risk modes of financing were kept open to banks, they never tried to devise innovative and imaginative modes of financing within the framework of musharakah and mudarba.

Prof. Khurshid Ahmad says

Murabaha (cost-plus financing) and *bai' mu'ajjal* (sale with deferred payment) are permitted in the Shari'ah under certain conditions. Technically, it is not a form of financial mediation but a kind of business participation. The Shari'ah assumes that the financier actually buys the goods and then sells them to the client. Unfortunately, the current practice of "buy-back on mark-up" is not in keeping with the conditions on which *murabaha* or *bai' mu'ajjal* are permitted. What is being done is *a fictitious deal which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of Shari'ah injunctions.*

While I would not venture a *fatwa*, as I do not qualify for that function, yet as a student of economics and Shari'ah I regard this practice of "buy-back on mark-up" very similar to *riba* and would suggest its discontinuation. I understand that the Council of Islamic Ideology has also expressed a similar opinion.

Dr Hasanuz Zaman says:

It emerges that practically it is impossible for large banks or the banking system to practice the modes like mark-up, *bai' salam*, buy-back, *murabaha*, etc. in a way that fulfils the Shari'ah conditions. But in order to make themselves eligible to a return on their operations, the banks are compelled to *play tricks with the letters of the law*. They actually do not buy, do not posses, do not actually sell and

deliver the goods; but the transition is assumed to have taken place. By signing a number of documents of purchase, sale and transfer they might fulfill a legal requirement but *it is by violating the spirit of prohibition*.
Again,

It seems that in large number of cases *the ghost of interest is haunting them* to calculate a fixed rate percent per annum even in *musharakah*, *mudarba*, leasing, hire-purchase, rent sharing, *murabaha*, (*bai' mu'ajjal*, mark-up), PTC, TFC, [30]etc. The spirit behind all these contracts seems to make a sure earning comparable with the prevalent rate of interest and, as far as possible, avoid losses which otherwise could occur.

To sum up, in Dr Hasanuz Zaman's words

... many techniques that the interest-free banks are practising are not either in full conformity with the spirit of Shari'ah or practicable in the case of large banks or the entire banking system. Moreover, *they have failed to do away with undesirable aspects of interest. Thus, they have retained what an Islamic bank should eliminate.*

Conclusion:

The preceding discussion makes it clear that Islamic banking is not a negligible or merely temporary phenomenon. Islamic banks are here to stay and there are signs that they will continue to grow and expand. Even if one does not subscribe to the Islamic injunction against the institution of interest, one may find in Islamic banking some innovative ideas which could add more variety to the existing financial network.

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis. It is especially in this sense that Islamic banks can play a catalytic role in stimulating economic development. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. In practice, however, Islamic banks have been concentrating on short-term trade finance which is the least risky.

Part of the explanation is that long-term financing requires expertise which is not always available. Another reason is that there are no back-up institutional structures such as secondary capital markets for Islamic financial instruments. It is possible also that the tendency to concentrate on short-term financing reflects the early years of operation: it is easier to administer, less risky, and the returns

are quicker. The banks may learn to pay more attention to equity financing as they grow older.

It is sometimes suggested that Islamic banks are rather complacent. They tend to behave as though they had a captive market in the Muslim masses that will come to them on religious grounds. This complacency seems more pronounced in countries with only one Islamic bank. Many Muslims find it more convenient to deal with conventional banks and have no qualms about shifting their deposits between Islamic banks and conventional ones depending on which bank offers a better return. This might suggest a case for more Islamic banks in those countries as it would force the banks to be more innovative and competitive. Another solution would be to allow the conventional banks to undertake equity financing and/or to operate Islamic 'counters' or 'windows', subject to strict compliance with the Shariah rules. It is perhaps not too wild a proposition to suggest that there is a need for specialized Islamic financial institutions such as mudarabah banks, murabaha banks and musharaka banks which would compete with one another to provide the best possible services.

With only minor changes in their practices, Islamic banks can get rid of all their cumbersome, burdensome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. All the necessary ingredients are already there. The modified system will make use of only two forms of financing -- loans with a service charge and *Mudarabah* participatory financing -- both of which are fully accepted by all Muslim writers on the subject.

Such a system will offer an effective banking system where Islamic banking is obligatory and a powerful alternative to conventional banking where both co-exist. Additionally, such a system will have no problem in obtaining authorization to operate in non-Muslim countries.

Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service Islamic banks offer over and above the traditional services provided by conventional commercial banks.

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CHAPTER # 1THE PECULIARITIES OF AN ISLAMIC ECONOMIC SYSTEM

- THE ECONOMIC PHILOSOPHY OF ISLAM & INTEREST
- DISTRIBUTON OF WEALTH
  - ➔ THE REAL NATURE OF WEALTH AND PROPERTY
  - ➔ THE IMPORTANCE OF THE ECONOMIC GOALS
- DIFFERENCE BETWEEN ISLAM, CAPITALISM AND SOCIALISM

INTRODUCTION:

One of the forms of capitalism, which has been flourishing in un-Islamic societies, is the interest based investments. There are normally two participants in such transactions. One is the Investor who provides capital on loan and the other

Manager who runs the business. The investor has no concern whether the business runs into profit or loss; he automatically gets an interest (sood) in both outcomes at a fixed rate on his capital. Islam prohibits this kind of trading and the Holy Prophet (SAW) enforced the ruling, not in the form of some moral teaching, but as the law of land.

It is very important to know the definition and forbiddance of riba and the injunctions relating to its unlawfulness from different angles. On the one hand, there are severe warnings of thee Qur'an and Sunnah and on the other, it has been taken today as an integral part of the world economy. The desired liberation from it seems to be infested with difficulties. The problem is very detail oriented and has to be taken up in all possible aspects.

First of all we have to deliberate into the correct interpretation of the Quranic verses on Riba and what has been said in authentic ahadilh and then determine what riba is in the terminology of the Quran and Sunnah, what transaction it covers, what is the underlying wisdom behind its prohibition and what sort of harm it brings to society. The following subjects shall be discussed in detail:

1. The economic philosophy of Islam & Interest.
2. The definition of Riba.
3. The types of Riba: Riba an Nasiyah & Riba al Fadl
4. The laws of Riba al Fadl.
5. Commercial Interest & Usury
6. Simple interest & compound interest.
7. Prohibition of Riba in the light of Quranic verses and ahadilh.

THE ECONOMIC PHILOSOPHY OF ISLAM & INTEREST

The economic philosophy of Islam has no concept of riba because according to Islam, riba is that curse in society which accumulates money around handful of people and it results inevitably in creating monopolies, opening doors for selfishness, greed, injustice and oppression. Deceit and fraud prospers in the world of trade and business. Islam, on the other hand, primarily encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity, social fairness and justice. Due to this reason, Islam renders riba as absolutely haram and strictly prohibits all types of interest based transactions.

The prohibition of Riba in the light of economic philosophy of Islam can be explained with the cost of distribution of wealth in a society.

DISTRIBUTON OF WEALTH

The distribution of wealth is one of the most important and most controversial subjects concerning the economic life of man, which has given birth to global revolutions in the world of today, and has affected every sphere of human activity from international politics down to the private life of the individuals. For many a century now, the question has been the center not only of fervent debates, oral and written both, but even of armed conflicts. The fact, however, is that whatever has been said on the subject without seeking guidance from Divine Revelation and relying merely on human reason, has had the sole and inevitable result of making the confusion worse confounded.

ISLAMIC PERSPECTIVE OF DISTRIBUTION OF WEALTH

In this chapter, we propose to state as clearly and briefly as possible the point of view of Islam in this matter, such as we have been able to deduce from the Holy Qur'an, the Sunnah and The writings of the "Thinkers" on distribution of wealth in the Islamic context.

Before explaining the point, it seems to be imperative to clarify certain basic principles which one can derive from the Quran, and which distinguish the Islamic point of view in economics from non-Islamic systems of economy.

1. THE IMPORTANCE OF THE ECONOMIC GOALS

No doubt, Islam is opposed to monasticism, and views the economic activities of man quite lawful, meritorious, and some times even obligatory and necessary. It approves of the economic progress of man, and considers lawful or righteous livelihood an obligation of the secondary order. Notwithstanding all this, it is no less a truth that it does not consider "economic activity" to be the basic problem of man, nor does it view economic progress as the be-all and end-all of human life.

Many misunderstandings about Islamic economics arise just from confusion between the two facts of considering economics as the ultimate goal of life and considering it as a necessity in order to have a prosperous life through lawful means. Even common sense can suffice to show that the fact of an activity being lawful or meritorious or necessary separate from it being the ultimate goal of human life and the center of thought and action. It is, therefore, very essential to make the distinction as clear as possible at the very outset. In fact, the profound, basic and far-reaching difference between Islamic economics and materialistic economics is just this:

According to materialistic economics,

"Livelihood" is the fundamental problem of man and economic developments are (lie ultimate end of human life,

While according to Islamic economics,

Livelihood may be necessary and indispensable, but cannot be the true purpose of human life.

So, while we find in the Holy Quran the disapproval of monasticism and the order to: "Seek the benevolence of Allah." At the same time we find in the Quran to restrain from the temptations or delusion for worldly life. And all these things in their totality have been designated as "Al-Dunya" ("the mean") — a term which, in its literal sense, does not have a pleasant connotation.

Apparently one might feel that the two commands are contradictory, but the fact is that according to the Quranic view, all the means of livelihood are no more than just stages on man's journey, and his final destination lies beyond them. That destination is the sublimity of character and conduct, and, consequently, the felicity of the other world. The real problem of man and the fundamental purpose of his life is the attainment of these-two goals. But one cannot attain them without traversing the path of this world. So, all those things too which are necessary for his worldly life, become essential for man. It comes to mean that so long as the means of livelihood are being used only as a path leading towards the final destination, they are the benevolence of Allah, but as soon as man gets lost in the mazes of this pathway and allows himself to forget Ins real destination, the very same means of livelihood turn into a
"temptation, or delusion" into a "trial" (8:28).

The Holy Quran has enunciated this basic truth very precisely in a brief verse:

"Seek the other world by means of what Allah has bestowed upon you" (28:77).
This principle has been stated in several other verses too. This attitude of the Holy Quran towards "the economic activity" of man and its two aspects would be very helpful in solving problems of man of Islamic economics.

2. THE REAL NATURE OF WEALTH AND PROPERTY

The other fundamental principle, which can help to solve the problem of the distribution of wealth, is the concept of "wealth" in Islam. According to the illustration of the Holy Quran "wealth" in all its possible forms is a thing created by Allah, and is, in principle His "property". The right of property over a thing, which accrues lo man, is delegated to him by Allah. The Holy Quran explicitly says:
"Give to them from the property of Allah which He has bestowed upon you." (24:33).

According to Quran the reason for this philosophy is that all a man can do is to invest his labor into the process of production. But Allah alone, and no one else, can cause this endeavor to be fruitful and actually productive. Man can do no more than sow the seed in the soil, but to bring out a seedling from the seed and make the seedling grow into a tree is the work of some one other than man. The Holy Quran says:

"Have you considered what you till? Is it you yourselves who make it grow, or is it We who make it grow?" And in another verse:

"Have they not seen that, among the things made by our own hands? We have created cattle

For them, and thus they acquired the right of property over them?" (36:71)

All these verses throw ample light on the fundamental point (hat "wealth", no matter what its form, is in principle ' 'the property" of Allah, and it is He who was bestowed upon man the right to exploit it. So Allah has the right to demand that man should subordinate his exploitation of this wealth to the commandments of Allah.

Thus, man has the "right of property" over the things he exploits, but this right is not absolute or arbitrary or boundless, it carries along with it certain limitations and restrictions which have been imposed by the real owner of the 'wealth'. We must spend it where He has commanded it to be spent, and refrain from spending where He has forbidden. This point has been elucidated more explicitly in the following verse:

"Seek the other world by means of what Allah has bestowed upon you, and do not be negligent about your share in this world. And do good as Allah has done good to you, and do not seek to spread disorder on the earth." (28:77)

This verse fully explains the Islamic point of view on the question of property; it places the following guidelines before us:

Whatever wealth man does possess has been received from ALLAH

Man has to use it in such a way that his ultimate purpose should be the other world

Since wealth has been received from Allah, its exploitation by man must necessarily be subject to the commandment of Allah.

Now, the Divine Commandment has taken two forms:-

(a) Allah may command man to convey a specified production of "Wealth" to another man. This Commandment must be obeyed, because Allah has done good to you, so He may command you to do good to others - "do good as Allah has done good to you".

(b) He may forbid you to use this "wealth" in a specified way. He has every right to do so, because He cannot allow you to use "wealth" in a way which is likely to produce collective ills or to spread disorder on the earth.

This is what distinguishes the Islamic point of view on the, question of property from the Capitalist and Socialist points of view both. Since the mental background of Capitalism is, theoretically or practically, materialistic, it gives man the unconditional and absolute right of property over his wealth, and allows him to employ it, as he likes. But the Holy Quran has adopted an attitude of disapprobation towards this theory of property, in quoting the words of the nation of Hazrat Shu'aib. They used to say:

"Does your way of prayer command you that we should forsake what our forefathers worshipped, or leave off doing what we like with our own properly?" (11:87)

These people used to consider their property as really theirs or "Our property", and hence the claim of "doing what we like" was the necessary conclusion of their position. But the Holy Quran has, in the chapter "Light" substituted the term "the properly of Allah" for the expression "Our possessions", and has thus struck a blow at the very root of the Capitalistic way of thinking. But at the same time, by adding the qualification ("what Allah has bestowed upon you"), it has cut the roots of Socialism as well, which starts by denying man's right to private property. Similarly, ("thus they acquired the right property over them") - a verse in the Chapter "Seen", explicitly affirms the right to private property as a gift from Allah.

DIFFERENCE BETWEEN ISLAM, CAPITALISM AND SOCIALISM

Now we are in a position to draw clear boundary lines that separate Islam, Capitalism and Socialism from one another: -

Capitalism affirms an absolute and unconditional right to private property. Socialism totally denies the right to private property.

But the truth lies between these two extremes - that is Islam admits the right to private property but does not consider it to be an absolute and unconditional right which is bound to cause "disorder on the earth.

Chapter # 2 RIBA IN THE QUR'AN

- First Revelation (Surah- al-Rum, verse 39)
- Second Revelation (Surah al-Nisa', verse 161)
- Third Revelation (Surah Al 'Imran, verses 130-2)
- Fourth Revelation (Surah al-Baqarah, verses 275-81)

RIBA IN THE QUR'AN

- *First Revelation (Surah- al-Rum, verse 39)*

That which you give as interest to increase the peoples' wealth increases not with God; but that which you give in charity, seeking the goodwill of God, multiplies manifold. (30:39)

- *Second Revelation (Surah al-Nisa', verse 161)*

And for their taking interest even though it was forbidden for them, and their wrongful appropriation of other peoples' properly. We have prepared for those among them who reject faith a grievous punishment (4: 161)

- *Third Revelation (Surah Al 'Imran, verses 130-2)*

0 believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy. (3: 130-2)

- ***Fourth Revelation (Surah al-Baqarah, verses 275-81)***

Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest" while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist may keep their previous gains, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein for ever. (275)

- God deprives interest of all blessing but blesses charity; He loves not the ungrateful sinner. (276)
- If you do not do so, then be sure of being at war with God and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it. (279)
- If the debtor is in difficulty, let him have respite until it is easier, but if you forego out of charity, it is better for you if you realize. (280)

CHAPTER # 3 RIBA IN HADITH

- GENERAL
- RIBAAL-FADI

RIBA IN HAD1TH

General

1. From Jabir: The Prophet, may peace be on him, cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said:

"They are all alike [in guilt]." (Muslim, Kitab al-Musaqai, Bab la'ni akili al-riba wu mu'kilihi; also in Tirmidhi and Musnad Ahmad)

2. Jabir ibn 'Abdallah, giving a report on the Prophet's Farewell Pilgrimage, said: The Prophet, peace be on him, addressed the people and said "All of the riba of

Jahiliyyah is annulled. The first riba that I annul is our riba, that accruing to 'Abbas ibn 'Abd al-Muttalib [the Prophet's uncle]; it is being cancelled completely." (Muslim, Kitab al-Hajj, Bab Hajjati al-Nabi, May peace be on him; also in Musnad Ahmad)

3. From 'Abdallah ibn Hanzalah: The Prophet, peace be on him, said: "A dirham of riba which a man receives knowingly is worse than committing adultery thirty-six times" (Mishkat al-Masabih, Kitab al-Buy', Bab al-riba, on the authority of Ahmad and Daraqutni). Bayhaqi has also reported the above hadith in Shii'ab al-iman with the addition that "Hell befits him whose flesh has been nourished by the unlawful."

4. From Abu Hurayrah: The Prophet, peace be on him, said: "On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received interest." (Ibn Majah, Kitab al-Tijarat, Bab al-taghlizi fi al-riba; also in Musnad Ahmad)

5. From Abu Hurayrah: The Prophet, peace be on him, said: "Riba has seventy segments, the least serious being equivalent to a man committing adultery with his own mother." (Ibn Majah)

6. From Abu Hurayrah: The Prophet, peace be on him, said: "There will certainly come a time for mankind when everyone will take riba and if he docs not do so, its dust will reach him." (Abu Dawud, Kilab al-Buyii', Bab fi ijlinabi al-sluibuhat; also in Ibn Majah)

7. From Abu Hurayrah: Tlie Prophet, peace be on him, said: "God would be justified in not allowing four persons to enter paradise or to taste its blessings: like who drinks habitually, he who takes riba, he who usurps an orphan's properly without right, and he who is undutiful to his parents." (Mustadrak al-Hakim, Kilab al-Buyu')

RIBAAL-FADI

1. From 'Umar ibn al-Khattab: The last verse to be revealed was on *riba* and the Prophet, peace be on him, was taken williout explaining it to us; so give up not only *riha* but also *riba/i* [whatever raises doubts in the mind about its rightful-ness]. (Ibn Majah^

2. From Abu Sa'id al-Khudri: The Propliet, peace be on him, said: "Do not sell gold for gold except when it is like for like, and do not increase one over the oilier; do not sell silver for silver except when it is like for like, and do not increase one over the other;

and do not sell what is away [from among these] for what is ready." (Bukhari, *Kitah al-Buyu', Bab bay'i al-fiddali bi al-fiddah;* also Muslim, Tirmidhi, Nasa'i and *Musncul* Alunad)

3. From 'Ubada ibn al-Samit: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dales for dates, and salt for sail - 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." (Muslim, *Kiinh al-Musaqat, Bab al-sarji wa bay'i al-dliahabi bi al-waraqi naqdan;* also in Tirmidhi)

4. From Abu Sa'id al-KLhudri: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, and hand-to-hand. Whoever pays more or takes more has indulged in *riba.* The taker and the giver are alike [in guilt]." (Muslim, *ibid;* and *Musnad* Ahmad)

5. From Abu Sa'id and Abu Hurayrah: A man employed by the Prophet, peace be on him, in Khaybar brought for him *janibs* [dates of very fine quality]. Upon the Prophet's asking him whether all the dates ofKhaybar were such, tlie man replied that this was not the case and added that "they exchanged a *sa'* [a measure] of tills kind for two or tliree [of the other kind]". The Prophet, peace be on him, replied, "Do not do so. Sell [the lower quality dates] for dirhams and then use tlie dirhams to buy *janibs.* [When dates are exchanged against dales] they should be equal in weight." (Bukhari, *Kitah al-Buyu', Bab idha arada bay'a lamrin bi iainrin kliayrun minim;* also Muslim and Nasa'i)

6. From Abu Sa'id: Bilal brought to the Propliet, peace be on him, some *barni* [good quality] dates whereupon the Prophet asked him wliere these were from. Bilal replied, "I had some inferior dates which I exchanged for these - two *sa's* for a *sa'."* The Prophet said, "Oh no, this is exactly *riba.* Do not do so, but when you wish to buy, sell the inferior dates against something [cash] and then buy the better dates with the price you receive." (Muslim, *Kiiab al-Musaqat, Bab al-la'ami mitfilan hi iiiillilin;* also *Musnad* Ahmad)

7. From Fadalah ibn 'Ubayd al-Ansari: On the day ofKJiaybar he bought a necklace of gold and pearls for twelve dinars. On separating the two, he found that the gold itself was equal to more than twelve dinars. So he mentioned this to the Prophet, peace be on him, who replied, "It [jewellery] must not be sold until the contents have been valued separately." (Muslim, *Kitab al-Musaqat, Bab bay'i nl-qiladah fiha kfiaru-ziin wa dhahab;* also in Tirmidhi and Nasa'i)

8. From Abu Umamah: The Prophet, peace be on him, said: "Whoever makes a recommendation for his brotlier and accepts a gift offered by him lias entered *riha* tlirough one of its large gates." *(Bulugh al-Maram, Kitab al-Buyu', Bab ul-riba,* reported on the authority of Ahmad and Abu Dawud)

9. From Anas ibn Malik: The Prophet, peace be on him, said: "Deceiving a mustaral [an unknowing entrant into the market] is *riba."* (Suyuti, *al-Jami' al-Saghir.* under the word *ghaban;* Kanz al-'Ummal, *Kitab al-Buyu', al-Bab al-lhani, al-jasi al-thani,* on the authority of *Sunan al-Bayliaqi)*

10. From 'Abdallah ibn Abi Awfa: The Prophet, peace be on him, said: "A najish [one who serves as an agent to bid up tlie price in an auction] is a cursed taker of *riba."* (Cited by Ibn Hajar al-'Asqalani in his commentary on al-Bukhari called *Path al-Bari, Kitab al-Buyu', Bab al-najsh;* also in SuyutT, *al-Jami al-Saghir,* under the word *al-najish* and Kanz al-'Ummal, *op. cit.,* both on the authority ofTabarani's *al-Kabir)*

CHAPTER # 4RIBA AND ITS TYPES

- DEFINITION OF RIBA OR INTEREST
- CLASSIFICA TION OF RIBA
  - ➔ RIBA NASIYAH
  - ➔ RIBA AL FADL
- WISDOM BEHIND THE PROHIBITION OF RIBA AL FADL

DEFINITION OF RIBA OR INTEREST

The word "Riba" means excess, increase or addition, which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money).

This definition of Riba is derived from the Quran and is unanimously accepted by **all** Islamic scholars. There are two types of Riba, identified to date by these scholars namely *Riba al Nasiyah' and 'Riba al Fadl'. 'Riba al Nasiyah' is defined as excess, which results from predetermined interest (sood) which a lender receives over and above the principle (Ras ul Maal.) 'Riba al Fadl' is defined as excess compensation without any consideration resulting from a sale of goods. 'Riba al Fadl' will be covered in greater detail later.

During the dark ages only the first form (Riba al Nasiyah) was considered to be Riba. However the Prophet Muhammad (P.B.U.H) also classified the second form (Riba al Fadl) as Riba.

The meaning of Riba has been clarified in the following verses of Quran:

"0 those who believe, fear Allah and give up what still remains of the riba if you are believers. But if you do not do so, then be warned of war from Allah and His Messenger. If you repent even now, you have the rig/it of the return of your capital; neither will you do wrong nor will you be wronged." Al Baqarah 2:278-9

These verses clearly indicate that the term riba means any excess compensation over and above the principal which is without due consideration. However, Quran al Kari has not altogether forbidden all types of excess; as it is present in trade as well, which is permissible. The excess that has been rendered haram in Quran is a special type termed **as** riba. In the dark ages, the Arabs used to accept riba as a type of sale, which unfortunately is also being understood at the present times. Islam has categorically made a clear distinction between the excess in capital resulting from sale and excess resulting from interest. The first type of excess is permissible but the second type is forbidden and rendered Haram.

"Seized in this state they say: 'Buying and selling is but a kind of interest', even though Allah has made buying and selling lawful, and interest unlawful."
Al Baqarah 2:27

CLASSIFICA TION OF RIBA

1. The first and primary type is called Riba al Nasiyah or Riba al Jahiliya.
2. The second type is called Riba al Fadl, Riba an Naqd or Riba al Bai.

Since the first type was specified in the Quranic verses before the sayings of Prophet (SAW), this type was termed as Riba al Quran. However the second type was not understood by the Quranic verses alone but also had to be explained by Prophet (SAW), it is also called Riba al Hadees.

RIBA NASIYAH

This is the real and primary form of riba. Since the verses of Quran have directly rendered this type of riba as haram, it is called Riba al Quran. Similarly since only this type was considered riba in the dark ages, it lias earned the name of Riba al Jahiliya. Imam Abu Bakr Hassas Razi has outlined a complete and prohibiting legal definition of Riba al Nasiyah in the following words:

"That kind of loan where specified repayment period and an amount in excess of capital is predetermined.

One of the ahadith quoted by Ali ibn at Talib has defined riba al Nasiyah in similar words. Prophet (SAW) said:

"Every loan that draws interest is riba."

The famous Sahabi Fazala Bin Obaid has also defined riba in similar words:

"Every loan that draws profit is one of the forms of riba"

The famous Arab scholar Abu Ishaq AZ Zajjaj also defines riba in the following words:

"Every loan that draws more than its actual amount"

Riba al Nasiyah refers to the addition of the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest. The prohibition of Riba al Nasiyah is one of those issues which have been confirmed in the revealed laws of all Prophets (AS). Some of the old testaments has rendered riba **as** haram (See Exodus 22:25, Leviticus 25:35-36, Deutronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12). The Quran Karim has also stated the prohibition of Riba in various verses has warned those who persist in practicing it of a war which is certain to be declared on them by Allah Himself and His messenger and has seriously threatened those engaged as writer, witness and dealer in riba transactions.

According to the above definition of Riba an Nasiyah, the giving and taking of any excess amount in exchange of a loan at an agreed rate is included in interest irrespective whether at a high or low rate. It has been proven through ahadith that Prophet (SAW) paid an excess at the loan repayment time but since this excess was not paid through an agreed rate, it cannot be called interest. This clarifies that the word "draws" in the hadith definition" The loan that draws interest is riba." has been used to highlight the giving and taking of excess amount through an agreed rate in the loan contract. **Due to this,** Imam Abu Bakr Hasas has added the word "condition" to the definition.

The fact that Riba al Nasiyah is categorically haram has never been disputed in the Muslim community.

In short, the riba of today which is supposed to be the pivot of human economy and features in discussions on the problem of interest is nothing but this riba, the unlawfulness of which stands proved on the authority of the seven verses of the Quran, of more than forty ahadith and of the consensus of the Muslim community.

Wisdom behind the prohibition of Riba an Nasiyah

First of all, we should realize that there is nothing in the— entire creation of tlic world which has no goodness or utility at all. But it is commonly recognized in every religion and community that things which have more benefits and less harms are called beneficial and useful. Conversely, things that cause more harm and less benefit are taken to be harmful and useless. Even the noble Quran, while declaring liquor and gambling to be haram, proclaimed that they do hold some benefits for people but e curse of sins they generate is far greater than the benefits they yield. Therefore, these cannot be called good or useful; on the contrary, taking these to be acutely harmful and destructive, it is necessary that they be avoided.

The case of Riba al Nasiyah is not different. Here the consumer of riba does have some casual and transitory profits apparently coming to him, but its curse in this world and in the Hereafter is much too severe as compared to this benefit. The riba consumer suffers such a spiritual and moral loss that it virtually takes away the great quality of being 'human' from him. An intelligent person who compares things in terms of their profit and loss, harm and benefit can hardly include things of casual benefit with an everlasting loss in the list of useful things. Similarly no sane and just person will say that personal and individual gain which causes loss to tlie whole community or group is useful. In theft and robbery for example, the gain of the gangster and the take of the thief is all too obvious but it is certainly harmful for the entire community since it ruins its peace and sense of security.

➔ RIBA AL FADL

The second classification of riba is Riba al Fadl. Since the prohibition of this riba has been established on Sunnah, it is also called Riba al Hadees.

Riba al Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase & sale as explained in the famous ahadith:

> **The Prophet said, "Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dales in exchange of equivalent dales, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, In it if a person transacts in excess, it will he usury (riba). However, sell gold for silver anyway you please on the condition it is hand-to-hand (spot) and sell barley for dale anyway you please on the condition it is handle-hand (spot)."**

This ahadith enumerates 6 different commodities namely:

- Gold
- Silver
- Dates
- Wheat
- Salt
- Barley

These six commodities can only be bought and sold in equal quantities and on spot. An unequal sale or a deferred sale of these commodities will constitute Riba. These six commodities in fiqh terminology are called "Amwal-e-Ribawiya". Does this ahadith apply only to the items mentioned in it? Does it concern sales of barley or wheat but not rice? Of dates but not raisins? A complete legal definition differs in every fiqh. Scholars such as Taoos and Qatada hold that Riba al Fadl includes these specified types only, however a majority of Islamic scholars believe that some oilier commodities should also be included. In order to answer the question which other commodities should be included? Some fiqhs hold that the characteristics which are common amongst these items can be used as basis" (illat) for Riba al Fadl. An illat is the attribute of an event lliat entails a particular divine ruling in all cases possessing that attribute; it is the basis for applying analogy. Ribawi goods are therefore goods that exhibit one of the efficient causes occasioning application of riba rules. Various schools define these causes differently:

❄ Imam Abu Hanifa

Imam Abu Hanifa sees only two common characteristics namely:

- Weight
- Volume,

Meaning all these six goods are sold by either weight or volume. Therefore all those commodities, which have weight or volume and are being exchanged, with the same commodity will fall under the rules of Riba al Fadl.

❄ Imam Shaft

The two characteristics observed by Imam Shafi are

- Medium of Exchange or
- Eatable

Therefore this law will apply on everything edible or having the natural ability of becoming a medium of exchange (currency).

❄ Imam Maalik

Imam Maalik identified the following two characteristics:

- Eatables and
- Preserve able

❄ Imam Ahmad Bin Hanbal

Three citations have been related to him:
i) First citation conforms to the opinion of Imam Abu Hanifa. ii) Second citation conforms to the opinion of Imam Shafai.
iii) Third citation includes three characteristics at the same lime namely edible, weight and volume.

After a detailed study of the above schools of thought, it has been declared by Islamic scholars that if a commodity bears both of the two characteristics namely; it has weight and can be used as a medium of exchange, and then the following two kinds of transactions are not allowed when the same goods are being exchanged:

- A deferred sale of goods (A deferred sale is when the goods are returned/ or paid for after some undetermined period)

- A sale of unequal goods

However, when only one of the two characteristics is present to term the sale as Riba al Fadl, then exchange of unequal goods arc allowed but deferred sale is not allowed.

Wisdom behind the prohibition of Riba al Fadl

The prohibition of Riba al Fadl is intended to ensure justice and remove all forms of exploitation through 'unfair' exchanges and to close all back-doors to Riba al Nasiyah because in the Islamic Shariah, anything that serves as a means to the unlawful is also unlawful.

The Laws of Riba al Fadl

After closely analyzing the meaning and interpretation of the above ahadith and their explanation in further ahadith along with issues raised in reference work of Hanafi fiqh, the following rules and laws governing Riba al Fadl comes through clearly:

1. It is evident that the exchange of homogeneous commodities will only lie required if they differ in quality and characteristic e.g. different genus of rice and wheat, superior quality gold and inferior quality gold, mineral salt and sea salt etc. The exchange of any of these six commodities with itself, hut differing in types/quality (which is called barter in modern terminology), even when

considering market role, is prohibited in unequal amount. The reason behind this prohibition is that by exchanging these commodities in unequal amounts there is a fear of developing the rationale in a person eventually leading to interest (sood) based earnings and illegal benefits. Such transactions might also lead to defrauding, /''or example, a shrewd trader may claim that a kilogram of a specific brand of wheat is equivalent to 3 kilograms of the other land because of the excellence of its quality, or this unique piece of gold ornament is equivalent in value to twice its weight in gold; in such transactions there undoubtedly is defrauding of people and harm to them.

As a step to prevent this state, the Shariah has made it a law that exchange of any of these six commodities with itself but differing in quality, is allowed in only one of the following forms:

a) Any difference in value/quality should l) ignored and {lie commodities should be exchanged in equal amounts (equal weight and volume).

b) Instead of direct exchange of commodities of the same kind, a person should sell his commodity against cash at the market value and by someone else's commodity in exchange of cash proceeds at the market value.

2. One of the ways of transacting commodities of the same kind is that a person has a raw material and someone else has a product made of the same material and both decide to exchange their product. In this case, one has to see whether:

• The characteristics of this product lias been totally changed by the industry: For e.g. the remarkable changes that transform raw cotton into cloth or iron into machinery. In this case, it is permissible to transact lesser amount of cloth against greater amount of raw cotton or raw iron having more weight against machinery having lighter weight.

• Little difference has been made to its original form after its formulation: For e.g. Gold which changes its shape in the form of jewelry. In this case, the Shariah holds that such a transaction should not happen in the first place or if it does, the exchange should be in equal weights in order to discourage unfair deals. Another alternative would be to sell gold against cash and (he cash proceeds are used to buy the needed jewelry. This is because if is not possible in a barter transaction, except for an expert, to visualize the fair equivalent of one commodity in terms of all other goods. Hence, the equivalent may be established only approximately thus leading to some injustice to one or the other party. The use of money could therefore help reduce the possibility of an unfair exchange.

Different commodities can be unequally exchanged hut deferred payment is not allowed. For e.g. one kg wheat can be sold against 2 kg date or one gram of gold can be exchanged against 4 grams of silver on the condition that they are spot transactions reason being that such a transaction will surely be carried on the market rate. For e.g. a person who wants to exchange silver for gold on spot will only transact as per the market rate. However, if the transaction is on credit, there is a possibility, no matter how minor, of stepping into interest that cannot be ignored. For e.g. a buyer who has traded 80 tolas silver on credit today on the understanding that it will he exchanged against 2 tolas gold after a month lieu in fact no means to find in advance that 40 tolas silver will be equivalent to one tola gold after a month. Therefore this ascertaining of value in advance actually signifies its roots in interest and gambling. Similarly the seller who has accepted credit has in fact yielded to gambling by hoping that the ratio of gold and silver might come down from 1:40 to 1:35. The law of exchanging different commodities only at spot has been established due to this reason.

The general conditions of sale, however, should be borne in mind while making a trade transaction so that the goods are specified in addition to the cash aspect of the transaction. The right way of specifying is that gold and silver should be under the possession of the sellers or delivered at the place of contract because both goods have the original (natural) price, which cannot he specified until they are delivered? This rule applies to only exchange of gold and silver. Other goods can be exchanged against each other without delivery and can be specified any other way but will be restricted to cash transaction.

For e.g. Zaid made a spot sale of one kg wheat to Dakar with 2 kg salt against future delivery after having identified their goods, this transaction is allowed in Shariah since it meets both conditions:

- The transaction is on spot.
- It is also specified.

However, if Zaid was selling one tola gold to Bakar against 40 tola silver, then it is necessary that both take delivery of their purchased goods at the place of contract because without delivery, goods cannot be specified.

To sum up, the Hanafi Jurists maintain that in case of commodities that weigh or measure, it is illegal to transact unequally or on credit. But in case of different commodities unequal exchange is legal hut credit remains illegal; the transaction in this case too should be spot.

CHAPTER # 5COMMERCIAL INTEREST AND USURY

- THE BACKGROUND OF BOTH TYPES
- FIRST SCHOOL
    - ARGUMENT 1
    - ARGUMENT 2
- SECOND SCHOOL
    - ➔ ARGUMENT 1
    - ➔ ARGUMENT 2

COMMERCIAL INTEREST AND USURY

In the 17 century, two new technical terms of interest have emerged after the establishment of banking system, namely:

1. ***Commercial interest:*** (Tijarti sood) Interest paid on loan taken for productive & profitable purposes.

2. ***Usury:*** (Sarfi sood) Interest paid on loan taken for personal needs and expenses.

THE BACKGROUND OF BOTH TYPES

The present day banking system, which has given interest the moral and legal license, is (lie backbone of the prevalent capitalism.

When Muslim countries became subjugated to west in their economic field, some westernized Muslims in the 19th century, on one side, saw the increasing progress of the west in trade and industry and on the other side saw the shattering economic condition of fellow Muslims slates. They also became conscious of the fact that banking is inevitable in the field of trade and industry not only on national level but also internationally. This prompted them to say that only usury is *haram* (illegal) but not commercial interest because rendering commercial interest *haram* would pose irresolvable problems to their way up to industrialization and economic progress. They only included usury in the term "Riba" as categorically prohibited in Qur'an and Sunnah and freed commercial interest from it calling it totally different from the Western concept of interest. Therefore, it was concluded that the prohibition of Riba was restricted to usury while commercial interest was perfectly Islamic.

There are two schools of thought on this issue. A detailed analysis of their arguments is discussed as under:

First School:

This school presents 2 arguments to support their point that only usury and not commercial interest is prohibited in Islam

➔ Argument 1

Riba as practiced during the days of the Prophet (SAW) was only Usury:

Counter argument

This claim is groundless, since Islam when prohibiting something does not only prohibit one form of it that is prevalent, but all forms that might erupt in future. The changed state does not change the ruling for e.g. Qur'an has prohibited the following:

- **Liquor (Khamar):** During the days of Prophet (SAW) its form and the way of production was totally different from that of the present day liquor but the ruling remains unchanged even though the form lias changed.
- **Pork (Khinzeer):** Irrespective how clean the present day breeding of pigs in high class farms may be, pork will stay prohibited and cannot be rendered *halal* (legal).

- ***Corruption/Immorality (Al Fahsha):*** Although a lot of sophisticated ways have been developed of this evil from tlie lime of Quranic revelations prohibiting it, the ruling stands forever.

The same applies to interest and gambling. By claiming that it was in a different form during Prophet's (SAW) time does not change its ruling. It remains unchanged just as in case of *Khamar, Khinzeer* and *Al fahsha*

➔ **Argument 2**

Commercial interest did not exist in the days of Prophet (SAW)

Counter argument

This claim is also wrong. If one glances through the Islamic and pre Islamic history of Arabia, it will be evident that the interest type at that time was not restricted to usury but loans were granted for commercial and profitable purposes. To quote some examples:

a) "The tribe of Umro bin Aamir used to take interest from the tribe of Mughairah. At the advent of Islam, Mughairah owed heavy interest to Umro bin Aamir." In this narration, the transaction of interest between 2 tribes of Arabia have been pointed out who actually operated as trading companies; both tribes were very wealthy. Could it be that 2 wealthy tribes transacted interest just for personal need and expenses? The interest was simply commercial!

b) History of the city of Ta'if tells us that it was only second to Makkah in trade (their main, exports being liquor, raisins, currants, wheat, wood etc) and industry (major being leather and dyeing). The tribe *of Saqeef* (a tribe of Jews) advanced cash on interest not only to the natives of Ta'if but the business community of Makkah as well e.g. (the tribe of Mughairah who was their permanent customer. This advancement was not only restricted to cash but also to commodities between wealthy tribes of Taif and Makkah who were usually traders and

business men, was only for their commercial purposes not for their consumption and personal needs. One of the ways of receiving interest was to double the principle amount plus interest in case of non payment of loan and this practice was applied to both cash as well as commodities. They had become accustomed to it. At the time of signing the peace treaty with the people of Ta'if, The Prophet (SAW) imposed conditions

i) Total elimination of interest based transactions,

ii) Giving up of interest owed to and from them.

c) The practice of making 2 trade trips, one to Yemen in winters and the other to Syria in summer was started by the tribe of Quraish of Makkah. These trips proved to be very profitable especially since being custodians of Kaa'ba, Quraish were looked at with respect, granted special concessions and protected in transit which was a necessity at that time. This way business & trade became their only means of livelihood. Investment became the order of the day in which women also took part and its circulation flourished and multiplied. With tills background in mind, one can easily visualize that the city of Makkah more or less became the clearinghouse or the banking city and accustomed to their related amenities. It was only natural that interest was one of them. Since they advanced cash for commercial purposes and charged compound interest incase of default by the traders, and this earning of interest was their trade, they argued when Qur'an rendered interest *haram (illegal)* that the transaction of interest based loans is a type of trade in which the return on capital can be earned as in the case of rent received from assets. They could not differentiate between excess in shape of profit during a trade and excess in the shape of interest at tlie lime of repayment of loan.

d) Therefore in pre Islamic days, we see that Syedna Abbas bin Abdul Muttlib and Sycdna Khalid bin Waleed formed a company with Joint capital whose prime business was cash advancement on interest. Similarly Syedna Usman was one of the wealthy businessmen who lent money on interest. There were many other traders dealing full time in interest extending a network of interest based transactions.

e) The way Syedna Zubair bin Awwam, who was famous for his trustworthiness, operated was quite similar to that of modem banking system. People used to deposit with him their capital as Amanah (trust or security). However, Syedna Zubair used to make it clear to the depositors that he would accept the deposits as a 'loan' and not as 'security' (Amanah). Because he knew that he will not be fully liable according to Shariah in case these Amanahs got destroyed but in case of having them as a loan, he will be fully liable to pay them back. He was afraid that in case of losing any deposited amount, his image as the trustworthy caretaker would be damaged. He therefore used the term 'loan' for such deposits to ensure

guaranteed payment so that lie enjoys everyone's confidence in him. Another reason for using tlie word 'loan' was to legalize trading and earning profits on such deposits. Because if he got those deposits as Amanah, he could not utilize it for his business, as it is not permissible in Shariah to use Amanah. This clearly shows that borrowing in those days was not only for consumption purposes but for commercial purposes as well. Syedna Zubair left a will with his son Syedna Abdullah bin Zubair before he died to sell his properly to repay the loan, if required. The total amount calculated after his dealh for repayment by his son was 22 lacs. It is obvious that this loan of 22 lacs was not owed out of any need by a rich Sahaba .such as Syedna Zubair, rather it was an investment of securities that was circulating in trade.

ANOTHER CLEAR ARGUMENT

Syedna Abu Hurairah narrated that the Prophet (SAW) said, "He who does not abandon Mokhabara, will be caught in a war against Allah & his Prophet."

In this narration Prophet (SAW) has rendered Mokhabara illegal just like riba and Has declared a war against those who indulge in it just like riba.

What is Mokhabara

Its actually a division of the crop by agreement between the landlord and cultivator in which the landlord gives his land to cultivator for cultivation purposes in order to gel his pre-agreed amounts of the crop irrespective whether the production is low or high. For e.g. "A" lends his land to 'B' for cultivation on the condition that he will get a predetermined portion on each crop e.g. 5 mounds. Such a transaction is called Mokhabara.

Prophet had called Mokhabara a form of riba. Now one should ponder whether lie referred to usury as the form of riba or he referred to commercial interest. It is similar to commercial interest as both Mokhabara and commercial interest are used for productive businesses. Whereas in the case of usury, the borrower uses tlie loan for personal use and not productive purposes.

To sum up, Prophet (SAW) included Mokhabara in riba which has no similarity with usury rather with commercial interest. The fact that during Prophet's (SAW) lime, tlie dealing in commercial interest was common is proven and also that this form is prohibited.

SECOND SCHOOL:

These group present 2 points in their arguments that are mentioned below:

Argument 1

The factor leading to prohibition of Riba (Interest) is that if a borrower faces a loss, he still has to pay an excess amount over the principal, which is basically an exploitation of his need whereas the lender on (he other hand gets an increase on his surplus capital without any effort which is unjust. But this factor is not found in commercial interest since both the borrower as well as the lender gets profit; (the borrower on the amount he has circulated in business and the lender in shape of interest over Ills principle amount. Therefore, no-one faces unfairness or injustice in this transaction.

Counter argument

This argument is quite appealing and attractive at the face value, as it is based on the assumption that no one suffers in case of commercial interest. But after analysis, it is proved dial Quran has not only prohibited that one party faces a loss and the other gets profit. But it also prohibits one party getting confirmed profit and the other party unconfirmed profit from the same investment as we have studied above in the case of *Mokhubam.*

Argument 2

This argument is based on the Quranic verse "(O *believers do not devour one another's possession wrongfully; rather than that, let there be trading by mutual consent" (Al Nisa* verse 29). In the above verse, Qur'an has prohibited *Wrongful devouring"*[1] which will only arise if the consent of one of tlie parties is absent and naturally tlie party who is devouring consents, the other party never consents; he only gives in since he has no other option. So we come to the conclusion that if the consent and satisfaction of both parties is present in a deal, it cannot be called "Wrongful devouring". According to this logic, commercial interest is permissible since the mutual consent is present of both parties where as riba is prohibited only when one party is getting the excess out of his selfishness and the other party is encountering the loss as he has no other alternative.

Counter argument:

This argument is of superficial nature. Mutual consent is not the criteria to render anything prohibited or not in Islam. Would the act of adultery be allowed if the condition of mutual consent is fulfilled? Similarly, there are many transactions in

business, which arc rendered illegal even with mutual consent. For reference see "Abwab ul Buyu al Batila" where *Muhaqila* and *Talqi al Jalab* being forms of *Bai* where the mutual consent and satisfaction is present and is prohibited by Prophet (SAW). Similarly, mutual consent is present in commercial interest and gambling too but in spite of that, it has been prohibited. Therefore no such criteria exist in the legality of any transaction that both parties approve; rather the approval should be on tlie transaction which has not been prohibited by *Shariah 'h.* To quote tlie words of Qur'an *"Except the legitimate business....."*

CHAPTER # 6THE FEATURES OF A BANK

- THE FEATURES OF A BANK
  - ➔ DEPOSIT CREATION
  - ➔ FINANCING
  - ➔ DISCOUNTING OF BILLS
  - ➔ PROVIDING GUARANTEE FEE
  - ➔ LOCKER SERVICES
- CONCLUSION
- *MUSHARIKAH* IN BANK
- DEPOSITS RUNNING MUSHARIKAH ACCOUNT ON THE BASIS OF DAILY PRODUCTS:

THE FEATURES OF A BANK

The conventional banking, which is interest based, performs the following major activities:

- ➔ **Deposit creation**
- ➔ **Financing**
- ➔ **Discounting of bills**
- ➔ **Providing guarantee fee**
- ➔ **Locker services**

We now would like to make a comparison of these activities with Islamic concept of banking:

Deposit – "qard and not amanah"

The common misconception regarding "deposit" is that it is a form of *umanah* ("amanat/Security). However, according to Shariah definition, deposit has more resemblance to *qard* (qarz/debt) than *amanah.* This conclusion is based on the fact that, in Islam any item is termed as amanah, if it bears all the features of *amanah.* Deposits cannot be termed amanah, as *amanah* has two special features, which are not found in bank deposits, precisely:

- The bank should not use the amanah.
- The bank should not be liable in case of any damage or loss to the ***amanah***.

Whereas in banks, deposits are primarily placed to earn profit, which is only possible when the bank uses these deposits to invest in other business. Hence deposits do not fulfil the First condition of amanah, which says that it should not be used by the care-taker for his own business or benefit.

Secondly, the bank is held 100% responsible for these deposits in all circumstances even in case of loss or damage to the bank. This feature releases deposits from the ruling of *amanah* where the assets will not be returned in case of any damage to the asset resulting from the caretaker's negligence. According to this justification, all three kinds of deposit namely current accounts, fixed deposits and saving accounts are not amanah. They all can be termed as debt.

One school of thought says that only fixed deposit and saving accounts fall under the laws of debt but current account is governed by *amanah.* However, this is also not correct because the bank is as much liable to current account holders as its PLS account holders and is called the "guarantor" in fiqh terminology. Due to Hits feature, current account is also governed by *qard.*

The depositors are not interested in terminology but the end-result of holding an account. Therefore if a bank does not offer security to the assets, the depositors under normal circumstance, will never keep their assets at such a bank. Similarly if the depositors arc told that the status of your account will that be of *amanah* and in case of any loss to the assets, without any negligence of the bank, will not be returned to you, not a single person will put his assets in the bank. Therefore the bank provides the security to the assets which the depositors themselves want.

We therefore conclude that the main intention of the depositors is not to put the assets in banks as *arnanh* rather as *qard,* by having collateral security by appointing the bank as guarantor.

Example of Syedna Zubair bin Awwam:

Hazrat Zubair bin Awwam was famous for his honesty and trustworthiness. Prominent people used to leave with him their properties in trust. Based on their needs they would also withdraw all or part of their properties. It has been

reported in Al Bukhari and Tabaqaat-e-Ibn-e-Saad in respect of Hazrat Zubair bin Awwam that he would decline to accept such property as *amnah* (trust) and accept them rather as a Qard (loan).

The reason for this action on his part was his fear that the property may be lost and it may be suspected that he was lax in its safe-keeping. As such he decided to consider it a loan so that the depositor felt more comfortable and his reputation remained intact. He also did this so that it could become possible for him to employ these funds for trading and earn profit out of them. The loan amount calculated at 2.2 million at the lime of his death by his son Syedna Abdullah bin Zubair was specified as *qard* not *amanah.* He also used the term loan while instructing his son before his death "Son, dispose of my property to settle the loans".

Conclusion

From the above discussion, we come to the conclusion that all three forms of bank deposits are governed by the law of debt as a consequence of which the account holder may withdraw only the assets deposited. Any increase on it will be interest. It lias already been discussed in the chapter of commercial interest that if the purpose of the lender is business or security and not providing financial assistance, then to get an excess amount is also interest, which is prohibited in Islam just like usury.

It is clear from the above arguments and there is a consensus of Muslim scholars on the point that the transactions in Fixed Deposit and Savings Account is prohibited because the bank pays excess to their account holders over their actual capital, which is interest. The Islamic Fiqh Academy Jeddah in their 2nd session has further endorsed such transactions as interest based transaction. Therefore it is illegal for a Muslim to keep their deposits in such accounts. As far as the current account is concerned, the bank does not pay any excess (interest) over the actual capital, therefore holding such an account is allowed.

To sum up, profit given on Fixed deposit and savings accounts is interest and therefore prohibited. However if the banking system is based on Islamic principles, *musharikah* can play a very important role. Therefore we will now discuss how the banks can operate on *musharikah* basis. As we already know a bank has two sides, one where it receives deposits from customers which is called the liability side and the other where it advances finance to investors and businessmen which is called the asset side. Both sides can operate on *musharikah* basis. As far as deposits are concerned, *musharikah* is the only instrument in which monies can be received from customers meaning that every depositor, will

become a partner in bank's business through their deposited money. However, for the asset or finance side, there are other instruments apart from *musharikah* but since those instruments are not covered in our subject, we will slick to the operation of *musharikah.* We will begin by the role of *musharikah* in the deposits and its relevant laws and will then discuss the procedure of *musharikah* in the finance side.

MUSHARIKAH IN BANK DEPOSITS

An important value of an Islamic society is mutual dealings. It also refers to deposits in banks. The operation of fixed deposits and savings account in Islamic banks will be different from conventional banks because the Islamic banks will be based on *musharikuh* (combination of shirkah & modarabah) which like conventional banks, people will invest in two ways:

- Participation in setting up the bank like any joint company by joint investment and the participants will be called the "shareholders". They will have a partnership *(shirkah)* effected by a mutual contract since they have used their capital and deed on the bank and

- Participation by opening their account in fixed deposit, and savings account and participants will be called the "account holders". These will not be the actual owner or shareholders of the bank - rather partners in profit only - meaning that they will have a contract of *modarabah*

The status of the bank or the shareholders will be that of a *modarib* and the account holders will be *Rab-bul-Maal.* The contract known as *musharikuh* will be a combination of *shirkah.* This is the reason why the profit ratio of depositors is less than the actual shareholders and the depositors will not have any voting power or the right of management because they are not involved in the deed but has only supplied the capital. This kind of dual relationship is not uncommon in Islamic Fiqh. Therefore if the *modarib* (Bank or the shareholders) wants to merge his assets with the assets of depositor, it is allowed in which case he will be regarded as owner of half (he assets and *modarib* of the other half. This lias already been discussed at length in a separate chapter on *musharikuh* (combination *of shirkah* and *modarabah).*

In the previous discussion, following facts have been established:

1. ***The actual status of deposits is debt and not*** **amanah.**

2. *The excess paid on loan is interest, not profit.*
3. *If a bank is operating on Islamic principles, the bank and the depositor will have a partnership through a contract of* shirkah *or* modarabah *in which case the depositor's capital will not be regarded as loan.*
4. *The shareholders will act as rubb-ul-mal as well as modarib.*
5. *The depositors will only act as rubb-ul-mal.*
6. *Fixed deposit and saving account mil be converted into* mudaribah *account where the distribution of profit for each partner will be determined in proportion to the actual profit accrued to the business and not according to a fixed ratio or in proportion to the capital invested by him. Fixing lump sum amount is not allowed or any rate of profit tied up with any investment*

7. The entire set up of the bank is on *musharikah* basis (combination of *shirkah* and *modarabah')* where the relationship of the bank and shareholders is through partnership agreement *(shirkah)* because they are participating in labor as well as investment and the relationship between the bank and depositors is only that of *modarabah* because they have only invested without participating in labor. Therefore tills combination of *shirkah* and *modarabah* is called *musharikah* in modem terminology.

DISTRIBUTION OF PROFIT UNDER MUSHARIKAH AGREEMENT

The distribution of profit will be done according to the rules *of musharikah.* Before we begin the summary of the distribution of profit, it is found appropriate to mention here that the conventional banks do not pay interest to current account holders. Therefore there is no need to convert the operation of current account into any Islamic mode of financing. However the distribution of profit to the rest of the partners and account holders will be made on the following rules governing musharikah:

It is not a condition for the final distribution of profit that all assets are liquid - rather the profit and loss is calculated on the basis of evaluation of assets. In case of loss, each partner shall suffer the loss exactly according to the ratio of his investment and in case of profit, the profit will be distributed according to the agreed ratio between the partners. It should be taken into account that both parties are free to determine any ratio of profit of the bank as the manager *(modarib),* therefore it can be agreed mutually that *Rabb-ul-mal* will have a higher profit margin and *modarib* lower. However as a shareholding partner, the share of profit of the *modarib* cannot be less than the ratio of his investment since he is the sole provider of labor. Same rule will apply on the operation of Islamic Banks on the basis of*musharikah.* The actual shareholders apart from being the manager are also shareholding partners, their ratio of profit cannot be less than their ratio of investment. However their ratio of profit as *modarib* can be determined at whatever rate they please.

The above may be explained in the following illustration:

Suppose the total investment of the bank is Rs.15 million in which the depositors have invested Rs.10 million on *modarbah* basis and the shareholders as *modarib* have invested Rs.5 million. This means that one third share of the total capital belongs to the shareholders and two third to the depositors. The role of modarib in the 2/3" capital raised by depositors is played by the shareholders, therefore their ratio of profit as manager (modarib) can be agreed between themselves through mutual consent but their ratio of profit as shareholders cannot be less than 1/3^. If their share is agreed at less than 1/3"[1], it would mean that the depositors' share has exceeded 2/3 although it has been established that they will not be managing the bank and their share of profit will not exceed their ratio of investment.

If it has been agreed in the above example that the shareholders as managing partner will get 1/3 of the profit and the rest 2/3rd will be distributed equally between depositors and shareholders as per the modarbah contract between them, then if for e.g. the profit amount is Rs.15 lacs then the shareholders will get its 1/3 i.e. Rs.5 lacs as the investor *{rubh-ul-mal)* and half of the 2/3rd profit i.e. Rs.5 lacs as the manager (modarib) whereas the other half of the 2/3rd profit will go to the depositor as rub-ul-mal. The following table will clarify the shares of shareholders and depositors:

RUNNING MUSHARIKAH ACCOUNT ON THE BASIS OF DAILY PRODUCTS:

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 upto the date of maturity, and the interest is calculated on the basis of daily products.

Can such an arrangement be possible under the *musharikah* or modurabah 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 musharikah the following procedure may be suggested for this purpose:

- A certain percentage of the actual profit must be allocated for the management.
- The remaining percentage the profit must be allocated for the investors.
- The loss, if any, should be borne by the investors only in exact proportion of their respective investments.
- The average balance of the contributions made to the *musharikah* account calculated on the basis of daily products shall be treated as Hie share capital of the financier.

• 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 *musharikah*. 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 *musharikah* portfolio at the end of the term will be divided based on the average 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 lias 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 musharikah, because the business may have earned huge profits during a period when a particular investor had no money invested in tlic 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 musharikah that a partner should earn profit on his own money only. Once a musharikah pool comes into existence, all the participants, regardless of whether their money is or is not utilized **in a** particular transaction earn the profits accruing to the joint pool. This is particularly true of the Hanafi School, which does not deem it necessary for a valid *musharikah* that the monetary contributions of the partners are mixed up together. It menus that if 'A' has entered into a musharikah contract with 'B', but has not yet disbursed his money into the joint pool, he will be still entitled to a share in the profit of the transactions effected by
•B' for the musharikah through his own money. 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 *musharikah* 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 conditioners for the musharikah 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/- alter 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 Ks. 2000/-

Although the transaction effected by A's money brought loss of Rs. 2000/- while (the profitable deal of air conditioners 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 a loss.

The reason is that once the parties enter into a *musharikah* contract, all the subsequent transactions effected for *musharikali* 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 musharikah.*

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 *musharikah.* But in the proposed running account of *musharikah* 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 *musliarikah,* which should render the *musharikah* 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 *musharikah* that the capital is pre-known to the partners. 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 *musharikah* 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 *musharikah* docs not lead to disputes, because it is generally known when the commodities are purchased for the *musharikah,* therefore it does not lead to uncertainty in the profit at the time of distribution." (Badai-us-sanai v.6 p.63)

It is, therefore, clear from the above that even if the amount of the capital is not known at the time *of musharikah,* 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 *musharikah* 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 Shariah, so far as it does not violate any basic principle *of musharikah.* In the proposed

system, all the partners arc treated ;it par. The profit of each partner is calculated on the basis of the period for which Ins money remained in the joint pool. There is no doubt in the fact that the aggregate profits accrued to the pool is 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 in his famous hadith, as follows:

Muslims are bound by their mutual agreements unless they hold a permissible thing as prohibited or a prohibited tiling as permissible.

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 dales of the commencement of a new term. This arrangement is totally impracticable on the deposit 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 tlie 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.

CHAPTER # 7 *MUSHARIKA*

- DEFINITION AND CLASSIFICATION OF MUSHARAKAH
- MANAGEMENT OF MUSHARAKAH
- TERMINATION OF THE MUSHARKAH
- ISSUES RELATING TO MUSHARKAH
  - LIQUIDITY OF CAPITAL
  - MIXING OF THE CAPITAL
- TENURE OF MUSHARKAH
- TERMINATION OF THE MUSHARKAH

Musharakah

Hadees-e-Qudsi

Allah Subhan-o-Tallah has declared that He will become a partner in a business between *musharikah* until they indulge in cheating or breach of trust (Khayanat).

DEFINITION AND CLASSIFICATION 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 tlie other. "Shirkah" means "Sharing" and in tlie 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 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 tlie 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-Amal* where all the partners jointly undertake to render some services for their customers, and tlie 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 lias actually done, this partnership will be a shirkat-ul-

aOmal which is also called Sliirkat-ul-taqabbul or Shirkat-us-sanai or Shirkat-ul-abdan.

(iii)The third kind of Shirkat-ul-aqd is Shirkat-nl-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 Shirkal-ul-aOmal 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. But (the term Musharka term is a little limited than the term "Shirkah" more commonly used in the Islamic jurisprudence. In fact the term Musliarka refers to a type of shirkat known as "Shirkal-ul-amwal " i.e. all the partners invest some capital into a commercial enterprise.

DEFINITION AND CLASSIFICATION OF MUSHARAKAH

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., etc.

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

Basic Rules of Capital:

The capital in a Musharka agreement should be:

a) Quantified (Ma 'loom): Meaning how much etc.
b) Specified (Mula 'aiyan): Meaning specified currency etc.
c) Not necessarily be merged: The mixing of capital is not required.

d) Not necessarily be in liquid form: Capital share may be contributed cither in cash/liquid or in the form of commodities. In case of a commodity, the market value of the commodity 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. Any work done by one of them in the normal course of business shall be deemed as authorized by all the partners.

Basic Rules of Distribution of Profit

1. 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. E.g. if it is agreed between them that A will get 1% of his investment, the contract is not valid.

2. 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&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.

3. If both partners agree that each will get % of profit based on his capital %, whether both work or not, it is allowed.

4. It is also allowed that if an investor is working, his profit share (%) could be more than his capital base (%) irrespective whether the earlier partner is working or not. E.g. if A&B have invested Rs.1000/- each in a business and it is agreed that only A will work and will gel 2/3rd of the profit while B will get 1/3rd . Similarly if the condition of work is also imposed on B in the agreement, then also the proportion of profit for A can be more than his investment.

5. If a partner has put an express condition in the agreement that he will not 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. However, Hanbali school of thought considers fixing the sleeping partners share more than his investment to be permissible.

6. It is allowed that if a partner is not working, his profit share can be established as less than his capital share.

7. If both are working partners, the share of profit can differ from the ratio of investment. Eg. Zaid & Bakar both have invested Rs.1000/- each. However Zaid gets l/3rd of the total profit and Bakar 2/3rd, this is allowed. This opinion of Imam Abu Hanifa is based on the fact that capital is not the only factor for profit but also labor and work. Therefore although the investment of two partners are same but in some cases quantity and quality of work might differ.

8. If only a few partners are active and others are only sleeping partners, then the share in the profit of the active partner could be fixed at higher than his ratio of investment e.g. A & B put in Rs.100 each and it is agreed that only A will work, then A can take more than 50% of the profit as his share. The excess the receives over his investment will be compensation for his services. **Basic rules of distribution of Loss all scholars are unanimous on the principle of loss sharing in Shariah based on the saying of Syedna Ali ibn Talib (that is as follows:**

"Loss is distributed exactly according to the ratio a/investment and the profit is divided according to the agreement of the partners."

Therefore the loss is always subject to (the ratio of investment e.g. if A lias invested 40% of the capital and B 60%, they must suffer the loss in the same ratio, not more, not less. Any condition contrary to this principle shall render title contract invalid. Powers & Rights of Partners in Musharakah:

After entering into a Musharakah contract, partners have the following rights:

a) The right to sell the mutually owned properly since all partners arc representing each other in Shirkah and all have the right to buy & sell for business purposes.
b) The right to buy raw material or oilier stock on cash or credit using funds belonging to Shirkah to put into business.
c) The right to hire people to carry out business if needed.
d) The right to deposit money & goods of the business belonging to Shirkah as depositor trust where and when necessary.
e) Tlie right to use Shirkah's fund or goods in Mudarabah.
f) Tlie right of giving Shirkah's funds as hiba (gift) or loan. If one partner for purpose of investing in the business lias taken a qard-e-hasana, then paying it becomes liable on both..

TERMINATION OF THE MUSHARKAH

Musharakah will stand terminated in the following cases:

1. If the purpose of forming tlie shirkat has been achieved. For example, if two partners had formed a shirkat for a certain project for e.g. buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, tlie rules are simple and clear in this case. Tlie distribution of profit will be as per (lie agreed rate whereas in case of loss, each partner will bear the loss according to his ratio of investment.

2. Every partner has the right to terminate the musharakah at any lime after giving his partner a notice that will cause the musharakah to end. For dissolving (his partnership, if the assets are liquidated, they will be distributed pro-rata between the partners. However, if this is not the case, the partners may agree either:

a) To liquidate the assets or
b) Distribute the assets as they are.

In case of a dispute between partners whether to seek liquidation of assets or distribute non-liquid assets, the distribution of non-liquid assets will be preferred. Because after the termination of musliarakah, 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. But if the assets are in a form that cannot be distributed such as machinery, then they shall be sold and the sale-proceeds shall be distributed.

3. In case of a death of any one of the partners or any partner becoming insane or incapable of effecting commercial transaction, the musliarakah stands terminated.

4. In case of damage to the share capital of one partner before mixing the same in the total investment and before effecting the purchase, the partnership will stand' terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then file loss will be shared by all and the partnership will not be terminated.

Termination of Musharakah without closing the business

If one of the partners wants termination of the Musharakah, while the earlier 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 oilier partners.

However, in this case, the price of the share of the leaving partner must be determined by mutual consent. 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 oilier partners on tlic liquidation or on the distribution of the assets themselves.

The question arises whether tlic 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. 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 lias 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 (S.A.W)in his famous ahadilh:

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

Dispute Resolution

There shall be a provision for adjudication by a Review Committee to resolve any difference that may arise between the bank and its clients (partners) with respect to any of the provisions contained in the Musharaka Agreement.

Security in Musharka

In case of Mnsharka agreement between Bank and client, the bank shall in his own right and discretion, obtain adequate security from the party to ensure safety of the capital invested/ financed as also for the profit lliat may be earned as per profit projection given by the party. The securities obtained by the bank shall, also as usual, be kept fully insured at tlie party's cost and expenses till Islamic mode of insurance i.e. Takaful

ISSUES RELATING TO MUSHARKAH

Musharakah is a mode of financing in Islam. Following are some issues relating to the tenure of Musharakah, redemption in Musharakah and the mixing of capital in conducting Musharakah. These were discussed previously, they are explained in detail here.

➔ *LIQUIDITY OF CAPITAL*

A question commonly asked in the operation of Musharakah is whether the capital invested needs to be in liquid form or not. The answer as to whether the contract in Musharakah can be based on commodities only or on money varies among the different schools of thought in Islam. For example if Zaid and Bakar agree to invest Rs. lOOO each in a garment business and both keep their investments with themselves. Then if Zaid buys cloth with his investment will it be considered belonging to both Zaid and Bakar or only to Zaid? Furthermore if the cloth is sold, can Zaid alone claim the profit or loss on (lie sale? In order to answer this question the prime consideration should be whether the partnership becomes effective without mixing the two investments profit or loss. This issue can be resolved in the light of Die following schools of thought of different fiqhs:

Imam Malik is of the view that liquidity is not a condition for validity of Musharakah. .Therefore even if a partner contributes in kind to the partnership his share can be determined on the basis of the evaluation according to the prevalent market price at the dale of the contract. However Imam Hanifa and Imam Ahmad do not allow capital of investment to be in kind. The reason for this restriction is as follows:

• Commodities contributed by one partner will always be distinguishable from the commodities given by the other partners therefore they cannot be treated as homogenous capital. If in case of redistribution of share capital to the partners tracing back each partners share becomes difficult. If the share capital was in the form of commodities then redistribution cannot take place because they may have been sold at that time.

Imam Shaft has an opinion dividing commodities into two:

- Dhavvat-ul-amtlial: Commodities which if destroyed can be compensated by similar commodities in quality and quantity. Exampla rice, wheat etc.
- Uliawat-ul-qecmah: Commodities that cannot be compensated by similar commodities like animals.

Imam Shafi is of the view that commodities of the first kind maybe contributed to Musharakah in the capital while the second type of commodities cannot be a part of the capital. In case of Dhawat-ul-amlhal redistribution of capital may take place by giving to each partner the similar commodities he had invested and earlier the commodities need to be mixed so well together that the commodity of one partner cannot be distinguished from commodities contributed by the oilier.

Therefore, it should be remembered that the liquid goods can be made capital of

investment and the market value of the commodities shall determine the share of the partner in the capital.

➔ MIXING OF THE CAPITAL

In case of illiquid capital being used the mixing of capital is an issue. According to Imam Shaft partners' capital should be mixed so well that it cannot be discriminated and this mixing should be done before any business is conducted. Therefore, partnership will not be completely enforceable if any kind of discrimination is present in the partners' capital. His argument is based on the reasoning that unless both investments will be mixed investment will remain under the ownership of the original investor and any profit or loss on trade of that investment will be entitled to the original investor only. Hence such a partnership is not possible where the investment is not mixed.

According to Imam Abu Hanifa, Imam Malik and Imam Ahmed bin hunbul the partnership is complete only with an agreement and the mixing of capital is not important. They are of the opinion that when two partners agree to form a partnership without so far mixing their capital of investment, then if one partner bought some goods for the partnership with his share of investment of Rs. 100,000, these goods will be accepted as being owned by both partners and hence any profit or loss on sale of these goods should be shared according to the partnership agreement.

However, if the share of investment of one person is lost before mixing the capital or buying anything for the partnership business, then the loss will be borne solely by the person who's owned the capital and will not be shared by oilier partners. However if the capital of both had been mixed and then a part of whole had been lost or stolen the loss would have been borne by both.

Since in Hanifa, Malik and Hunbal schools of thought mixing of the capital is not important therefore a very important present day issue is addressed with reference to this principle. If some companies or trading houses enter into partnership for setting up an industry to conduct business they need to open LC for importing tlie machinery. This LC readies the importer through his bank. Now when the machinery reaches the port and the importing companies need to pay for taking possession the latter need to show those receipts in order to take possession of the goods.

Under Shaft school of thought the imported goods cannot become the capital of investment but will remain in the ownership of the person opening the LC because at the time of opening the LC the capital has not been mixed and without mixing the capital musharkah cannot come into existence. Under this situation if tlie goods are lost during shipment the burden of loss will fall upon the opener of the

LC, even though the goods were being imported for tlie entire industry. This is because even though a group of companies had asked for the machinery or imported goods the importers had not mixed their capital at the time of investment.

Contrary to this since the other three schools of thought believe that partnership comes into existence at the time of agreement rather than after the capital has been mixed therefore the burden of loss will be borne by all. This has two advantages:

a) In case of loss the burden of loss will not fall upon one rather will be shared by all the partner firms.

b) If the capital is provided at the time of the agreement it slays blocked for the period during which the machinery is being imported. While if (lie capital was not kept idle, till the actual operation could be conducted with the machinery the same capital could have been used for something else as well.

This shows that the decision of the 3 combined schools of thought are better equipped to handle tlie current import export situation.

TENURE OF MUSHARKAH

For conducting a Musharakah agreement questions also arise pertaining to fixing (lie period of the agreement. For fixing the tenure of the Musharakah following conditions should be remembered:

a) Tlie partnership is fixed for such a long lime that at the end of the tenure no other business can be conducted.
b) Can be for a very short lime period during which partnership is necessary and neither partner can dissolve the partnership.

Under the Hanafi school of thought a person can fix the tenure of the partnership because it is an agreement and an agreement should have a fixed period of lime.

In the hanbal school of thought the tenure can be fixed for the partnership as it's an agency agreement and an agency agreement in this school can be fixed, 'the Malik school however says that shirkat cannot be subjected to a fixed tenure. Shafi school like the Maliki consider fixing the tenure to be not permissible. Their argument is that fixing the period will prohibit conducting tlie business at the end of that period which in turn means that the fixing will prevent them from conducting the business.

TERMINATION OF THE MUSHARKAH

Musharakah will stand terminated in the following cases*:*

1. If the purpose of forming the shirkat has been achieved. For example, if two partners had formed a shirkat for a certain project for e.g. buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, the rules are simple and clear in this case. Tlie distribution of profit will be as per the agreed rate whereas in case of loss, each partner will bear the loss according to his ratio of investment.

2. Every partner has the right to terminate the Musharakah at any time after giving his partner a notice that will cause tlie Musharakah to end. For dissolving this partnership, if the assets are liquidated, they will be distributed pro-rata between the partners. However, if this is not the case, the partners may agree either:

c) To liquidate the assets or
d) Distribute the assets as they are.

In case of a dispute between partners whether to seek liquidation of assets or distribute non-liquid assets, the distribution of non-liquid assets will be preferred because after the termination of Musharakah, all the assets arc in (lie 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. But if the assets are in a form that cannot be distributed such as machinery, then they shall be sold and the sale-proceeds shall be distributed.

5. In case of a death of any one of the partners or any partner becoming insane or incapable of effecting commercial transaction, the Musharakah stands terminated.

6. In case of damage to the share capital of one partner before mixing (lie same in the total investment and before effecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated.

CHAPTER # 8 MODARBAH

- DEFINITION

  - ➔ TYPES OF MODARABAH
  - ➔ DIFFERENCE BETWEEN MUSHARAKAH AND MODARABAH

- INVESTMENT
- MODARABAH EXPENSES
- DISTRIBUTION OF PROFIT & LOSS
- TERMINATION OF MODARABAH

Modarbah

Modarib	Working Capital Partner (brings effort)
Raas-ul-Maal	Investment
Rabb-ul-Maal	Investor (brings capital)
Wakeel	Agent
Ameen	Trustee
Kafeel	Guarantor
Mudarib	Working partner (Manager

- **DEFINITION:**

This is a kind of partnership where one partners gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "Rabb-ul-maal" while the management and work is an exclusive responsibility of the other, who is called "Modarib" and the profits generated arc shared in a predetermined ratio.

- ➔ **Types of Modarabah:**

There are 2 types of Modarabah namely:

1. *Al Modarabah Al Moqayyadah* Rabb-ul-maal may specify a particular business or a particular place for the modarib, in which case he shall invest the money in that particular business or place. This is called Al Modarabah Al Muqayyadah (restricted Modarabah)

2. *Al Modarabah Al Mutluqah:* However if Rabb-ul-maal gives full freedom to Modarib to undertake whatever business lie deems I'll, this is called At Modarabah Al Mullaqali (unrestricted Modarabah). However Modarih cannot. without the consent of Rabb-ul-Maal, lend money to anyone. Modarib is authorized to do anything which is normally done in the course of business. However if they want to have an extraordinary work which is beyond the normal routine of the traders, he cannot do so without express permission from the Rabb-ul-Maal. He is also not authorized to:

a) Keep another Modarib or a partner
b) Mix his own investment in that particular Modarabah without the consent of Rabb-ul Maal.

Conditions of Offer & Acceptance are applicable to both.

A Rabb-ul-maal can contract Modarabah 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 Modarib and the capital of the Modarabah shall be utilized by both of them jointly, and the share of the Modarib.

➔ DIFFERENCE BETWEEN MUSHARAKAH AND MODARABAH:

Musharakah	Modarabah
1. All partners invest.	**Only rabb-ul-maal invests.**
2. All partners participate in the management of the business and can work for it.	Rabb-ul-maal has no right to participate in the management which is carried out by the Modarib only.
3. All partners share the loss to the extent of the ratio of their investment.	Only rabb-ul-maal suffers loss because the modarib docs not invest anything. However this is subject to a condition that the modarib has worked with due diligence.
4. The liability of the partners is normally unlimited. If the liabilities of business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne pro	The liability of rabb-ul-maal is limited **to** his investment unless lie has

rata by all partners. But if the partners agree that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that " partner alone wlio has incurred a debt on the business in violation of the aforesaid condition. 5. As soon as the partners mix up their capital in a joint pool, all tlie assets become jointly owned by all of them according to the proportion of their respective investment. All partners benefit from the appreciation in (lie value of the assets even if profit has not accrued through sales.	permitted the modarib to incur debts **on** his behalf. **The goods purchased by (he modarib are solely owned by rabb-ul-maal and tlie modarib can earn his share in the profit only in case he sells the goods profitably.**

INVESTMENT:

In Modarabah Rabb-ul-Maal provides the investment and the Modarib management therefore the Rabb-ul-Maal should hand over the agreed investment to Modarib and leaves everything to Modarib with no interference from his side but lie lias the authority to:

a) Oversee the Modarib's activities and

b) Work with Modarib if the Modarib consents.

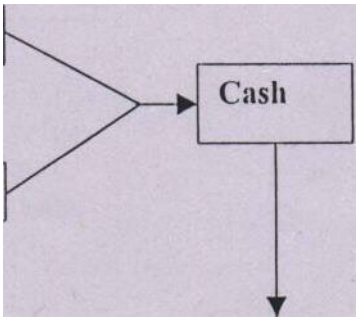
In what form should the capital be? Should it be liquid or non-liquid assets like equipment, land etc. can form capital?

The basic principle is that the capital in Modarabah is valid just the way it is in Shirkah which according to Hanbali fiqh should be in liquid form but according to oilier scholars equipment, land etc. other can also be included as capital. However all agree on the following:,

Assets other than cash can be used as an intermediate step meaning:

Accounts receivable
Or

Equipment/Land



Original Investment ⟶ Can be used for Modarabah

However this is subject to the determination of exact amount of the assets before it is used for Modarabah. If His assets are not correctly evaluated, (the Modarabah is not valid).

MODARAHAH EXPENSES

The Modarib shares profit of the Modarabah as per agreed rate with the investor but his expenses like meals, clothing, conveyance and medical are not borne by Modarabah. However, if he is traveling on business and is overstaying the night, then the above expenses shall be covered from capital. If Modarib goes for a journey which constitutes Safar-e-Sharai (more than 48 miles) but docs not overstay the night, his expenses will not be borne by Modarabah.

All expenses which are incidental to the Modarabah's (unction like wages or employees/workers or Commission in buying/selling or dyeing expenses etc have to be paid by the Modarabah. However all expenses will be included in the cost of commodities which Modarib is selling for e.g. if he is selling ready made garments then the stitching, dyeing, washing expenses etc. can be included by the Modarib in the total cost of the garments.

If the Modarib manages the Modarabah within his city, he will not be allowed any expenses, only his profit share. Similarly, if he keeps an employee, this employee will not be allowed any expenses, just his salary.

If the Modarabah agreement becomes Fasid due to any reason, the Modarib's status will be like an employee, meaning:

a) whether he is traveling or doing business in his city, will not be entitled to any expense such as meals, conveyance, clothing, medicine etc.

b) he will not be sharing any profit and will just gel Ujrat-e-MisI (ordinary pay) for his job.

DISTRIBUTION OF PROFIT & LOSS:

It is necessary for the validity of Modarabah 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 Sluu'iah; 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 Rabb-ul-maal and Modarib. 1 lowcvcr in extreme case wliere the parties have not predetermined the ratio of profit, the, profit will be calculated at 50:50.

The Modarib & Rabb-ul-maal cannot allocate a lump sum amount of profit for any party nor can they determine the share of any party at a specific rate lied up with the capital. For example, if the capital is Rs.100,000/-, they cannot agree on a condition that Rs.10,000 out of the profit shall be the share of the Modarib nor can they say that 20% of the capital shall be given to Rabb-ul-Maal. However they can agree that 40% of the actual profit shall go to the Modarib and 60% to the Rabb-ul-maal or vice versa. It is also allowed that different proportions are agreed indifferent situations. For example, the Rabb-ul-maal can say to Modarib "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, lie can say "If you do the business in your town, you will be entitled lo 30% of the profit and if you do it in another town, your share will be 50% of the profit".

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

All schools of Islamic Fiqh are unanimous on this point. However, Imam Ahmad has allowed for the Modarib to draw his daily expenses of food only From the Modarabah Account. The Hanafi jurists restrict this right of the Modarib only to a situation when he is on a business trip outside his own city. In tills case lie 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.
If the business has incurred loss in some transactions and lias 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.

The Modarabah becomes Void (Fasid) if the profit is fixed in any way. In this case, the entire amount (Profit + Capital) will be the Rabb-ul-maal's. The Modarib will just be an employee earning Ujrat-e-Misl.

The remaining amount will be called (Profit).

This profit will be shared in the agreed (pre-agreed) ratio.

Roles of the Modarib:

- Ameen (Trustee): To look after the investment responsibly, except in case of natural calamities.

- Wakeel (Agent) : To purchase from the funds provided by Rabb-ul-Maal

- Sharcek (Partner): Sharing in any profit Zamin (Liable): To provide for the loss suffered by the Modarabah due to any act on his part.

- Ajeer (Employee): When the Modarabah gets Fasid due to any reason, the Modarib is entitled to only the salary, Ujrat-e-Misl. In case tlicre is a loss, the Modarib will not gel even llie Ujral-e-Misl.

TERMINATION OF MODARABAH

The Modarabah will stand terminated when the period specified in the contract expires. It can also be terminated any time by either of the two parlies by giving notice. In case Rabb-ul-Maal has terminated services of Modarib, he will continue to act as Modarib until he is informed of the same and all his acts will form part of Modarabah.

If all assets of the Modarabah 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 Modarabah are not in cash form, it will be sold and liquidated so that the actual profit may be determined. All loans and payables of Modarabah will be recovered. The provisional profit earned by Modarib and Rabb-ul-Maal will also be taken into account and when total capital is drawn, the principal amount invested by Rabb-ul-Maal will be given to him, balance will be called profit which will be distributed between Modarib and Rabb-ul-Maal at the agreed ratio. If no balance is left, Modarib will not gel anything. If the principal amount is not recovered fully, then the profit shared by Modarib and Rabb-ul-Maal during the term ofModarabah will be withdrawn to pay the principal amount to Rabb-ul-Maal. The balance will be profit which will be distributed between Modarib and Rabb-ul-Maal. In this case loo if no balance is left, Modarib will not get anything.

CHAPTER # 9-PRINCIPLES OF SHAR1A GOVERNING ISLAMIC INVESTMENT FUNDS

- EQUITY FUND
- IJARAH FUND
- COMMODITY FUND
- MURABAHA FUND
- BAI-AL-DAIN
- MIXED FUND

PRINCIPLES OF SHAR1A GOVERNING 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 Shariah. 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 Shariah, 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 Shariah. 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 Shariah, 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 Shariah experts are almost unanimous on the point that if all the transactions of a company arc in full conformity with Shariah, 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 Shariah 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 Shariah. Even if the main, business of a company is halal, 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 Shariah experts in the present century. A group of the Shariah 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 halal. Their basic argument is that every shareholder of a company is a sharik (partner) of the company, and every sharik, 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 shareholder to the company to can on its business in whatever manner the management deems fit. If it is known to the shareholder 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 shareholders 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 shareholders, a company cannot give a veto power to each share-holder. The opinions of individual shareholders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every shareholder in his individual capacity. If a shareholder 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 halal 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 tlic same principle is relevant. If a shareholder 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 haram 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 will willfully indulged in a transaction of interest, but this fact does render the whole business of a company as unlawful. Conditions for investment in Shares.

In the light of the foregoing discussion, dealing in equity shares can be acceptable in Shariah subject to the following conditions:

1. The main business of the company is not violative of 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 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 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 shareholder 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 illiquid 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 assets of a company arc 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 ignorable 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 arc 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 Shariah. An Islamic Equity Fund can be established on this basis. The subscribers to the Fund will be treated in 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 dividend 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 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 the price can be allocated for (the interest received by the company. It is obvious that if all the above requirements of the halal shares are observed, then 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 ignorable as compared to bulk of line 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 halal assets only.

Although this second view is not without force, yet the first view is more precautions 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 there from, 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 mudaribs 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 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 1 at the end of every financial year.

However, it is necessary in Shariah 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 Ijarah fund. 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 'sukuk' — a term recognized in the traditional Islamic jurisprudence. Since these sukuk 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 sukuk 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

sukuk certificates will be determined on the basis of market forces, and are normally based on their profitability.

However, it should be kept in mind that the contracts of leasing must conform to the principles of Shariah 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 halal (permissible) use is possible.

3. The lesser must undertake all the responsibilities consequent to the ownership of the assets.

4. The rental must be fixed and known to the party's right at the beginning of the contract.

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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 Modarabah, because Modarabah, 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, Modarabah 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 Shariah, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

1. The seller must own the commodity at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in Shariah.
2. Forward sales are not allowed except in the case of Salam and Istisna (For their full details the previous chapter of this book may be consulted).

3. The commodities must be halal. 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 previous chapters 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 Shariah, 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 lliat the portfolio owns some commodities at all times.

MURABAHA FUND.

'Murabaha' 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, and 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 murabaha, 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 murabaha 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 Shariah. 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 lie wants to sell it at a discount, as normally happens in tlie bills of exchange, it is termed in Shariah as Bai-al-dain. The traditional Muslim jurists (fuqah) are unanimous on the point that bai-al-dain with discount is not allowed in Shariah. The overwhelming majority of the contemporary Muslim scholars are of (lie same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of Shafai School wherein it is held that the sale of debt is allowed, but they did not

pay attention to the fact that the Shafai 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 Shariah.

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 offeree. 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 lie 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 Shariah 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 arc 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.

CHAPTER # 1THE PECULIARITIES OF AN ISLAMIC ECONOMIC SYSTEM

- THE ECONOMIC PHILOSOPHY OF ISLAM & INTEREST
- DISTRIBUTON OF WEALTH

  - THE REAL NATURE OF WEALTH AND PROPERTY
  - THE IMPORTANCE OF THE ECONOMIC GOALS

- DIFFERENCE BETWEEN ISLAM, CAPITALISM AND SOCIALISM

INTRODUCTION:

One of the forms of capitalism, which has been flourishing in un-Islamic societies, is the interest based investments. There are normally two participants in such transactions. One is the Investor who provides capital on loan and the other Manager who runs the business. The investor has no concern whether the business runs into profit or loss; he automatically gets an interest (sood) in both outcomes at a fixed rate on his capital. Islam prohibits this kind of trading and the Holy Prophet (SAW) enforced the ruling, not in the form of some moral teaching, but as the law of land.

It is very important to know the definition and forbiddance of riba and the injunctions relating to its unlawfulness from different angles. On the one hand, there are severe warnings of thee Qur'an and Sunnah and on the other, it has been

taken today as an integral part of the world economy. The desired liberation from it seems to be infested with difficulties. The problem is very detail oriented and has to be taken up in all possible aspects.

First of all we have to deliberate into the correct interpretation of the Quranic verses on Riba and what has been said in authentic ahadilh and then determine what riba is in the terminology of the Quran and Sunnah, what transaction it covers, what is the underlying wisdom behind its prohibition and what sort of harm it brings to society. The following subjects shall be discussed in detail:

1. The economic philosophy of Islam & Interest.
2. The definition of Riba.
3. The types of Riba: Riba an Nasiyah & Riba al Fadl
4. The laws of Riba al Fadl.
5. Commercial Interest & Usury
6. Simple interest & compound interest.
7. Prohibition of Riba in the light of Quranic verses and ahadilh.

THE ECONOMIC PHILOSOPHY OF ISLAM & INTEREST

The economic philosophy of Islam has no concept of riba because according to Islam, riba is that curse in society which accumulates money around handful of people and it results inevitably in creating monopolies, opening doors for selfishness, greed, injustice and oppression. Deceit and fraud prospers in the world of trade and business. Islam, on the other hand, primarily encourages highest moral ethics such as universal brotherhood, collective welfare and prosperity, social fairness and justice. Due to this reason, Islam renders riba as absolutely haram and strictly prohibits all types of interest based transactions.

The prohibition of Riba in the light of economic philosophy of Islam can be explained with the cost of distribution of wealth in a society.

DISTRIBUTON OF WEALTH

The distribution of wealth is one of the most important and most controversial subjects concerning the economic life of man, which has given birth to global revolutions in the world of today, and has affected every sphere of human activity from international politics down to the private life of the individuals. For many a century now, the question has been the center not only of fervent debates, oral and written both, but even of armed conflicts. The fact, however, is that whatever

has been said on the subject without seeking guidance from Divine Revelation and relying merely on human reason, has had the sole and inevitable result of making the confusion worse confounded.

ISLAMIC PERSPECTIVE OF DISTRIBUTION OF WEALTH

In this chapter, we propose to state as clearly and briefly as possible the point of view of Islam in this matter, such as we have been able to deduce from the Holy Qur'an, the Sunnah and The writings of the "Thinkers" on distribution of wealth in the Islamic context.

Before explaining the point, it seems to be imperative to clarify certain basic principles which one can derive from the Quran, and which distinguish the Islamic point of view in economics from non-Islamic systems of economy.

1. THE IMPORTANCE OF THE ECONOMIC GOALS

No doubt, Islam is opposed to monasticism, and views the economic activities of man quite lawful, meritorious, and some times even obligatory and necessary. It approves of the economic progress of man, and considers lawful or righteous livelihood an obligation of the secondary order. Notwithstanding all this, it is no less a truth that it does not consider "economic activity" to be the basic problem of man, nor does it view economic progress as the be-all and end-all of human life.

Many misunderstandings about Islamic economics arise just from confusion between the two facts of considering economics as the ultimate goal of life and considering it as a necessity in order to have a prosperous life through lawful means. Even common sense can suffice to show that the fact of an activity being lawful or meritorious or necessary separate from it being the ultimate goal of human life and the center of thought and action. It is, therefore, very essential to make the distinction as clear as possible at the very outset. In fact, the profound, basic and far-reaching difference between Islamic economics and materialistic economics is just this:

According to materialistic economics,

"Livelihood" is the fundamental problem of man and economic developments are (lie ultimate end of human life,

While according to Islamic economics,

Livelihood may be necessary and indispensable, but cannot be the true purpose of human life.

So, while we find in the Holy Quran the disapproval of monasticism and the order to: "Seek the benevolence of Allah." At the same time we find in the Quran to

restrain from the temptations or delusion for worldly life. And all these things in their totality have been designated as "Al-Dunya" ("the mean") — a term which, in its literal sense, does not have a pleasant connotation.

Apparently one might feel that the two commands are contradictory, but the fact is that according to the Quranic view, all the means of livelihood are no more than just stages on man's journey, and his final destination lies beyond them. That destination is the sublimity of character and conduct, and, consequently, the felicity of the other world. The real problem of man and the fundamental purpose of his life is the attainment of these-two goals. But one cannot attain them without traversing the path of this world. So, all those things too which are necessary for his worldly life, become essential for man. It comes to mean that so long as the means of livelihood are being used only as a path leading towards the final destination, they are the benevolence of Allah, but as soon as man gets lost in the mazes of this pathway and allows himself to forget Ins real destination, the very same means of livelihood turn into a
"temptation, or delusion" into a "trial" (8:28).

The Holy Quran has enunciated this basic truth very precisely in a brief verse:

"Seek the other world by means of what Allah has bestowed upon you" (28:77).
This principle has been stated in several other verses too. This attitude of the Holy Quran towards "the economic activity" of man and its two aspects would be very helpful in solving problems of man of Islamic economics.

2. THE REAL NATURE OF WEALTH AND PROPERTY

The other fundamental principle, which can help to solve the problem of the distribution of wealth, is the concept of "wealth" in Islam. According to the illustration of the Holy Quran "wealth" in all its possible forms is a thing created by Allah, and is, in principle His "property". The right of property over a thing, which accrues lo man, is delegated to him by Allah. The Holy Quran explicitly says:
"Give to them from the property of Allah which He has bestowed upon you." (24:33).

According to Quran the reason for this philosophy is that all a man can do is to invest his labor into the process of production. But Allah alone, and no one else, can cause this endeavor to be fruitful and actually productive. Man can do no more than sow the seed in the soil, but to bring out a seedling from the seed and make the seedling grow into a tree is the work of some one other than man. The Holy Quran says:

"Have you considered what you till? Is it you yourselves who make it grow, or is it We who make it grow?" And in another verse:

"Have they not seen that, among the things made by our own hands? We have created cattle
For them, and thus they acquired the right of property over them?" (36:71)

All these verses throw ample light on the fundamental point (hat "wealth", no matter what its form, is in principle ' 'the property" of Allah, and it is He who was bestowed upon man the right to exploit it. So Allah has the right to demand that man should subordinate his exploitation of this wealth to the commandments of Allah.

Thus, man has the "right of property" over the things he exploits, but this right is not absolute or arbitrary or boundless, it carries along with it certain limitations and restrictions which have been imposed by the real owner of the 'wealth'. We must spend it where He has commanded it to be spent, and refrain from spending where He has forbidden. This point has been elucidated more explicitly in the following verse:

"Seek the other world by means of what Allah has bestowed upon you, and do not be negligent about your share in this world. And do good as Allah has done good to you, and do not seek to spread disorder on the earth." (28:77)

This verse fully explains the Islamic point of view on the question of property; it places the following guidelines before us:

Whatever wealth man does possess has been received from ALLAH
Man has to use it in such a way that his ultimate purpose should be the other world
Since wealth has been received from Allah, its exploitation by man must necessarily be subject to the commandment of Allah.
Now, the Divine Commandment has taken two forms:-

(a) Allah may command man to convey a specified production of "Wealth" to another man. This Commandment must be obeyed, because Allah has done good to you, so He may command you to do good to others - "do good as Allah has done good to you".

(b) He may forbid you to use this "wealth" in a specified way. He has every right to do so, because He cannot allow you to use "wealth" in a way which is likely to produce collective ills or to spread disorder on the earth.

This is what distinguishes the Islamic point of view on the, question of property from the Capitalist and Socialist points of view both. Since the mental background of Capitalism is, theoretically or practically, materialistic, it gives man the unconditional and absolute right of property over his wealth, and allows him to employ it, as he likes. But the Holy Quran has adopted an attitude of disapprobation towards this theory of property, in quoting the words of the nation of Hazrat Shu'aib. They used to say:

"Does your way of prayer command you that we should forsake what our forefathers worshipped, or leave off doing what we like with our own properly?" (11:87)

These people used to consider their property as really theirs or "Our property", and hence the claim of "doing what we like" was the necessary conclusion of their position. But the Holy Quran has, in the chapter "Light" substituted the term "the properly of Allah" for the expression "Our possessions", and has thus struck a blow at the very root of the Capitalistic way of thinking. But at the same time, by adding the qualification ("what Allah has bestowed upon you"), it has cut the roots of Socialism as well, which starts by denying man's right to private property. Similarly, ("thus they acquired the right property over them") - a verse in the Chapter "Seen", explicitly affirms the right to private property as a gift from Allah.

DIFFERENCE BETWEEN ISLAM, CAPITALISM AND SOCIALISM

Now we are in a position to draw clear boundary lines that separate Islam, Capitalism and Socialism from one another: -

Capitalism affirms an absolute and unconditional right to private property. Socialism totally denies the right to private property.

But the truth lies between these two extremes - that is Islam admits the right to private property but does not consider it to be an absolute and unconditional right which is bound to cause "disorder on the earth.

Chapter # 2 RIBA IN THE QUR'AN

- First Revelation (Surah- al-Rum, verse 39)
- Second Revelation (Surah al-Nisa', verse 161)
- Third Revelation (Surah Al 'Imran, verses 130-2)
- Fourth Revelation (Surah al-Baqarah, verses 275-81)

RIBA IN THE QUR'AN

- *First Revelation (Surah- al-Rum, verse 39)*

That which you give as interest to increase the peoples' wealth increases not with God; but that which you give in charity, seeking the goodwill of God, multiplies manifold. (30:39)

- *Second Revelation (Surah al-Nisa', verse 161)*

And for their taking interest even though it was forbidden for them, and their wrongful appropriation of other peoples' properly. We have prepared for those among them who reject faith a grievous punishment (4: 161)

- *Third Revelation (Surah Al 'Imran, verses 130-2)*

0 believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the Prophet so that you may receive mercy. (3: 130-2)

- *Fourth Revelation (Surah al-Baqarah, verses 275-81)*

Those who benefit from interest shall be raised like those who have been driven to madness by the touch of the Devil; this is because they say: "Trade is like interest"

while God has permitted trade and forbidden interest. Hence those who have received the admonition from their Lord and desist may keep their previous gains, their case being entrusted to God; but those who revert shall be the inhabitants of the fire and abide therein for ever. (275)

- God deprives interest of all blessing but blesses charity; He loves not the ungrateful sinner. (276)
- If you do not do so, then be sure of being at war with God and His Messenger. But, if you repent, you can have your principal. Neither should you commit injustice nor should you be subjected to it. (279)
- If the debtor is in difficulty, let him have respite until it is easier, but if you forego out of charity, it is better for you if you realize. (280)

CHAPTER # 3 RIBA IN HADITH

- GENERAL
- RIBAAL-FADI

RIBA IN HAD1TH

General

1. From Jabir: The Prophet, may peace be on him, cursed the receiver and the payer of interest, the one who records it and the two witnesses to the transaction and said:

"They are all alike [in guilt]." (Muslim, Kitab al-Musaqai, Bab la'ni akili al-riba wu mu'kilihi; also in Tirmidhi and Musnad Ahmad)

2. Jabir ibn 'Abdallah, giving a report on the Prophet's Farewell Pilgrimage, said: The Prophet, peace be on him, addressed the people and said "All of the riba of Jahiliyyah is annulled. The first riba that I annul is our riba, that accruing to 'Abbas ibn 'Abd al-Muttalib [the Prophet's uncle]; it is being cancelled completely." (Muslim, Kitab al-Hajj, Bab Hajjati al-Nabi, May peace be on him; also in Musnad Ahmad)

3. From 'Abdallah ibn Hanzalah: The Prophet, peace be on him, said: "A dirham of riba which a man receives knowingly is worse than committing adultery thirty-six times" (Mishkat al-Masabih, Kitab al-Buy', Bab al-riba, on the authority of Ahmad

and Daraqutni). Bayhaqi has also reported the above hadith in Shii'ab al-iman with the addition that "Hell befits him whose flesh has been nourished by the unlawful."

4. From Abu Hurayrah: The Prophet, peace be on him, said: "On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received interest." (Ibn Majah, Kitab al-Tijarat, Bab al-taghlizi fi al-riba; also in Musnad Ahmad)

5. From Abu Hurayrah: The Prophet, peace be on him, said: "Riba has seventy segments, the least serious being equivalent to a man committing adultery with his own mother." (Ibn Majah)

6. From Abu Hurayrah: The Prophet, peace be on him, said: "There will certainly come a time for mankind when everyone will take riba and if he docs not do so, its dust will reach him." (Abu Dawud, Kilab al-Buyii', Bab fi ijlinabi al-sluibuhat; also in Ibn Majah)

7. From Abu Hurayrah: Tlie Prophet, peace be on him, said: "God would be justified in not allowing four persons to enter paradise or to taste its blessings: like who drinks habitually, he who takes riba, he who usurps an orphan's properly without right, and he who is undutiful to his parents." (Mustadrak al-Hakim, Kilab al-Buyu')

RIBAAL-FADI

1. From 'Umar ibn al-Khattab: The last verse to be revealed was on *riba* and the Prophet, peace be on him, was taken williout explaining it to us; so give up not only *riha* but also *riba/i* [whatever raises doubts in the mind about its rightful-ness]. (Ibn Majah^

2. From Abu Sa'id al-Khudri: The Propliet, peace be on him, said: "Do not sell gold for gold except when it is like for like, and do not increase one over the oilier; do not sell silver for silver except when it is like for like, and do not increase one over the other;

and do not sell what is away [from among these] for what is ready." (Bukhari, *Kitah al-Buyu', Bab bay'i al-fiddali bi al-fiddah;* also Muslim, Tirmidhi, Nasa'i and *Musncul* Alunad)

3. From 'Ubada ibn al-Samit: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dales for dates, and salt for sail - 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." (Muslim,

Kiinh al-Musaqat, Bab al-sarji wa bay'i al-dliahabi bi al-waraqi naqdan; also in Tirmidhi)

4. From Abu Sa'id al-KLhudri: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, and hand-to-hand. Whoever pays more or takes more has indulged in *riba.* The taker and the giver are alike [in guilt]." (Muslim, *ibid;* and *Musnad* Ahmad)

5. From Abu Sa'id and Abu Hurayrah: A man employed by the Prophet, peace be on him, in Khaybar brought for him *janibs* [dates of very fine quality]. Upon the Prophet's asking him whether all the dates ofKhaybar were such, tlie man replied that this was not the case and added that "they exchanged a *sa'* [a measure] of tills kind for two or tliree [of the other kind]". The Prophet, peace be on him, replied, "Do not do so. Sell [the lower quality dates] for dirhams and then use tlie dirhams to buy *janibs.* [When dates are exchanged against dales] they should be equal in weight." (Bukhari, *Kitah al-Buyu', Bab idha arada bay'a lamrin bi iainrin kliayrun minim;* also Muslim and Nasa'i)

6. From Abu Sa'id: Bilal brought to the Propliet, peace be on him, some *barni* [good quality] dates whereupon the Prophet asked him wliere these were from. Bilal replied, "I had some inferior dates which I exchanged for these - two *sa's* for a *sa'."* The Prophet said, "Oh no, this is exactly *riba.* Do not do so, but when you wish to buy, sell the inferior dates against something [cash] and then buy the better dates with the price you receive." (Muslim, *Kiiab al-Musaqat, Bab al-la'ami mitfilan hi iiiillilin;* also *Musnad* Ahmad)

7. From Fadalah ibn 'Ubayd al-Ansari: On the day ofKJiaybar he bought a necklace of gold and pearls for twelve dinars. On separating the two, he found that the gold itself was equal to more than twelve dinars. So he mentioned this to the Prophet, peace be on him, who replied, "It [jewellery] must not be sold until the contents have been valued separately." (Muslim, *Kitab al-Musaqat, Bab bay'i nl-qiladah fiha kfiaru-ziin wa dhahab;* also in Tirmidhi and Nasa'i)

8. From Abu Umamah: The Prophet, peace be on him, said: "Whoever makes a recommendation for his brotlier and accepts a gift offered by him lias entered *riha* tlirough one of its large gates." *(Bulugh al-Maram, Kitab al-Buyu', Bab ul-riba,* reported on the authority of Ahmad and Abu Dawud)

9. From Anas ibn Malik: The Prophet, peace be on him, said: "Deceiving a mustaral [an unknowing entrant into the market] is *riba."* (Suyuti, *al-Jami' al-Saghir.* under the word *ghaban;* Kanz al-'Ummal, *Kitab al-Buyu', al-Bab al-lhani, al-jasi al-thani,* on the authority of *Sunan al-Bayliaqi)*

10. From 'Abdallah ibn Abi Awfa: The Prophet, peace be on him, said: "A najish [one who serves as an agent to bid up tlie price in an auction] is a cursed taker of *riba."* (Cited by Ibn Hajar al-'Asqalani in his commentary on al-Bukhari called *Path al-Bari, Kitab al-Buyu', Bab al-najsh;* also in SuyutT, *al-Jami al-Saghir,* under the

word *al-najish* and Kanz al-'Ummal, *op. cit.,* both on the authority ofTabarani's *al-Kabir)*

CHAPTER # 4RIBA AND ITS TYPES

- DEFINITION OF RIBA OR INTEREST
- CLASSIFICA TION OF RIBA
  - ➔ RIBA NASIYAH
  - ➔ RIBA AL FADL
- WISDOM BEHIND THE PROHIBITION OF RIBA AL FADL

DEFINITION OF RIBA OR INTEREST

The word "Riba" means excess, increase or addition, which correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration (consideration does not include time value of money).

This definition of Riba is derived from the Quran and is unanimously accepted by **all** Islamic scholars. There are two types of Riba, identified to date by these scholars namely *Riba al Nasiyah' and 'Riba al Fadl'. 'Riba al Nasiyah' is defined as excess, which results from predetermined interest (sood) which a lender receives over and above the principle (Ras ul Maal.) 'Riba al Fadl' is defined as excess compensation without any consideration resulting from a sale of goods. 'Riba al Fadl' will be covered in greater detail later.

During the dark ages only the first form (Riba al Nasiyah) was considered to be Riba. However the Prophet Muhammad (P.B.U.H) also classified the second form (Riba al Fadl) as Riba.

The meaning of Riba has been clarified in the following verses of Quran:

"0 those who believe, fear Allah and give up what still remains of the riba if you are believers. But if you do not do so, then be warned of war from Allah and His Messenger. If you repent even now, you have the rig/it of the return of your capital; neither will you do wrong nor will you be wronged." Al Baqarah 2:278-9

These verses clearly indicate that the term riba means any excess compensation over and above the principal which is without due consideration. However, Quran al Kari has not altogether forbidden all types of excess; as it is present in trade as well, which is permissible. The excess that has been rendered haram in Quran is a special type termed as riba. In the dark ages, the Arabs used to accept riba as a type of sale, which unfortunately is also being understood at the present times. Islam has categorically made a clear distinction between the excess in capital resulting from sale and excess resulting from interest. The first type of excess is permissible but the second type is forbidden and rendered Haram.

"Seized in this state they say: 'Buying and selling is but a kind of interest', even though Allah has made buying and selling lawful, and interest unlawful."
Al Baqarah 2:27

CLASSIFICA TION OF RIBA

1. The first and primary type is called Riba al Nasiyah or Riba al Jahiliya.
2. The second type is called Riba al Fadl, Riba an Naqd or Riba al Bai.

Since the first type was specified in the Quranic verses before the sayings of Prophet (SAW), this type was termed as Riba al Quran. However the second type was not understood by the Quranic verses alone but also had to be explained by Prophet (SAW), it is also called Riba al Hadees.

RIBA NASIYAH

This is the real and primary form of riba. Since the verses of Quran have directly rendered this type of riba as haram, it is called Riba al Quran. Similarly since only this type was considered riba in the dark ages, it lias earned the name of Riba al Jahiliya. Imam Abu Bakr Hassas Razi has outlined a complete and prohibiting legal definition of Riba al Nasiyah in the following words:

"That kind of loan where specified repayment period and an amount in excess of capital is predetermined.

One of the ahadith quoted by Ali ibn at Talib has defined riba al Nasiyah in similar words. Prophet (SAW) said:

"Every loan that draws interest is riba."

The famous Sahabi Fazala Bin Obaid has also defined riba in similar words:

"Every loan that draws profit is one of the forms of riba"

The famous Arab scholar Abu Ishaq AZ Zajjaj also defines riba in the following words:

"Every loan that draws more than its actual amount"

Riba al Nasiyah refers to the addition of the premium which is paid to the lender in return for his waiting as a condition for the loan and is technically the same as interest. The prohibition of Riba al Nasiyah is one of those issues which have been confirmed in the revealed laws of all Prophets (AS). Some of the old testaments has rendered riba as haram (See Exodus 22:25, Leviticus 25:35-36, Deutronomy 23:20, Psalms 15:5, Proverbs 28:8, Nehemiah 5:7 and Ezakhiel 18:8,13,17 & 22:12). The Quran Karim has also stated the prohibition of Riba in various verses has warned those who persist in practicing it of a war which is certain to be declared on them by Allah Himself and His messenger and has seriously threatened those engaged as writer, witness and dealer in riba transactions.

According to the above definition of Riba an Nasiyah, the giving and taking of any excess amount in exchange of a loan at an agreed rate is included in interest irrespective whether at a high or low rate. It has been proven through ahadith that Prophet (SAW) paid an excess at the loan repayment time but since this excess was not paid through an agreed rate, it cannot be called interest. This clarifies that the word "draws" in the hadith definition" The loan that draws interest is riba." has been used to highlight the giving and taking of excess amount through an agreed rate in the loan contract. Due to this, Imam Abu Bakr Hasas has added the word "condition" to the definition.

The fact that Riba al Nasiyah is categorically haram has never been disputed in the Muslim community.

In short, the riba of today which is supposed to be the pivot of human economy and features in discussions on the problem of interest is nothing but this riba, the unlawfulness of which stands proved on the authority of the seven verses of the Quran, of more than forty ahadith and of the consensus of the Muslim community.

Wisdom behind the prohibition of Riba an Nasiyah

First of all, we should realize that there is nothing in the— entire creation of tlic world which has no goodness or utility at all. But it is commonly recognized in every religion and community that things which have more benefits and less harms are called beneficial and useful. Conversely, things that cause more harm

and less benefit are taken to be harmful and useless. Even the noble Quran, while declaring liquor and gambling to be haram, proclaimed that they do hold some benefits for people but e curse of sins they generate is far greater than the benefits they yield. Therefore, these cannot be called good or useful; on the contrary, taking these to be acutely harmful and destructive, it is necessary that they be avoided.

The case of Riba al Nasiyah is not different. Here the consumer of riba does have some casual and transitory profits apparently coming to him, but its curse in this world and in the Hereafter is much too severe as compared to this benefit. The riba consumer suffers such a spiritual and moral loss that it virtually takes away the great quality of being 'human' from him. An intelligent person who compares things in terms of their profit and loss, harm and benefit can hardly include things of casual benefit with an everlasting loss in the list of useful things. Similarly no sane and just person will say that personal and individual gain which causes loss to tlie whole community or group is useful. In theft and robbery for example, the gain of the gangster and the take of the thief is all too obvious but it is certainly harmful for the entire community since it ruins its peace and sense of security.

➔ RIBA AL FADL

The second classification of riba is Riba al Fadl. Since the prohibition of this riba has been established on Sunnah, it is also called Riba al Hadees.

Riba al Fadl actually means that excess which is taken in exchange of specific homogenous commodities and encountered in their hand-to-hand purchase & sale as explained in the famous ahadith:

> **The Prophet said, "Sell gold in exchange of equivalent gold, sell silver in exchange of equivalent silver, sell dales in exchange of equivalent dales, sell wheat in exchange of equivalent wheat, sell salt in exchange of equivalent salt, sell barley in exchange of equivalent barley, In it if a person transacts in excess, it will he usury (riba). However, sell gold for silver anyway you please on the condition it is hand-to-hand (spot) and sell barley for dale anyway you please on the condition it is handle-hand (spot)."**

This ahadith enumerates 6 different commodities namely:

- **Gold**
- **Silver**
- **Dates**
- **Wheat**
- **Salt**
- **Barley**

These six commodities can only be bought and sold in equal quantities and on spot. An unequal sale or a deferred sale of these commodities will constitute Riba. These six commodities in fiqh terminology are called "Amwal-e-Ribawiya". Does this ahadith apply only to the items mentioned in it? Does it concern sales of barley or wheat but not rice? Of dates but not raisins? A complete legal definition differs in every fiqh. Scholars such as Taoos and Qatada hold that Riba al Fadl includes these specified types only, however a majority of Islamic scholars believe that some oilier commodities should also be included. In order to answer the question which other commodities should be included? Some fiqhs hold that the characteristics which are common amongst these items can be used as basis" (illat) for Riba al Fadl. An illat is the attribute of an event lliat entails a particular divine ruling in all cases possessing that attribute; it is the basis for applying analogy. Ribawi goods are therefore goods that exhibit one of the efficient causes occasioning application of riba rules. Various schools define these causes differently:

❄ Imam Abu Hanifa

Imam Abu Hanifa sees only two common characteristics namely:

- Weight
- Volume,

Meaning all these six goods are sold by either weight or volume. Therefore all those commodities, which have weight or volume and are being exchanged, with the same commodity will fall under the rules of Riba al Fadl.

❄ Imam Shaft

The two characteristics observed by Imam Shafi are

- Medium of Exchange or
- Eatable

Therefore this law will apply on everything edible or having the natural ability of becoming a medium of exchange (currency).

❄ Imam Maalik

Imam Maalik identified the following two characteristics:

- Eatables and
- Preserve able

❄ Imam Ahmad Bin Hanbal

Three citations have been related to him:

i) First citation conforms to the opinion of Imam Abu Hanifa. ii) Second citation conforms to the opinion of Imam Shafai.

iii) Third citation includes three characteristics at the same lime namely edible, weight and volume.

After a detailed study of the above schools of thought, it has been declared by Islamic scholars that if a commodity bears both of the two characteristics namely; it has weight and can be used as a medium of exchange, and then the following two kinds of transactions are not allowed when the same goods are being exchanged:

• A deferred sale of goods (A deferred sale is when the goods are returned/ or paid for after some undetermined period)

• A sale of unequal goods

However, when only one of the two characteristics is present to term the sale as Riba al Fadl, then exchange of unequal goods arc allowed but deferred sale is not allowed.

Wisdom behind the prohibition of Riba al Fadl

The prohibition of Riba al Fadl is intended to ensure justice and remove all forms of exploitation through 'unfair' exchanges and to close all back-doors to Riba al Nasiyah because in the Islamic Shariah, anything that serves as a means to the unlawful is also unlawful.

The Laws of Riba al Fadl

After closely analyzing the meaning and interpretation of the above ahadith and their explanation in further ahadith along with issues raised in reference work of Hanafi fiqh, the following rules and laws governing Riba al Fadl comes through clearly:

1. It is evident that the exchange of homogeneous commodities will only lie required if they differ in quality and characteristic e.g. different genus of rice and wheat, superior quality gold and inferior quality gold, mineral salt and sea salt etc. The exchange of any of these six commodities with itself, hut differing in types/quality (which is called barter in modern terminology), even when considering market role, is prohibited in unequal amount. The reason behind this prohibition is that by exchanging these commodities in unequal amounts there is a fear of developing the rationale in a person eventually leading to interest (sood) based earnings and illegal benefits. Such transactions might also lead to defrauding, /''or example, a shrewd trader may claim that a kilogram of a specific

brand of wheat is equivalent to 3 kilograms of the other land because of the excellence of its quality, or this unique piece of gold ornament is equivalent in value to twice its weight in gold; in such transactions there undoubtedly is defrauding of people and harm to them.

As a step to prevent this state, the Shariah has made it a law that exchange of any of these six commodities with itself but differing in quality, is allowed in only one of the following forms:

a) Any difference in value/quality should l) ignored and {lie commodities should be exchanged in equal amounts (equal weight and volume).

b) Instead of direct exchange of commodities of the same kind, a person should sell his commodity against cash at the market value and by someone else's commodity in exchange of cash proceeds at the market value.

2. One of the ways of transacting commodities of the same kind is that a person has a raw material and someone else has a product made of the same material and both decide to exchange their product. In this case, one has to see whether:

• The characteristics of this product lias been totally changed by the industry: For e.g. the remarkable changes that transform raw cotton into cloth or iron into machinery. In this case, it is permissible to transact lesser amount of cloth against greater amount of raw cotton or raw iron having more weight against machinery having lighter weight.

• Little difference has been made to its original form after its formulation: For e.g. Gold which changes its shape in the form of jewelry. In this case, the Shariah holds that such a transaction should not happen in the first place or if it does, the exchange should be in equal weights in order to discourage unfair deals. Another alternative would be to sell gold against cash and (he cash proceeds are used to buy the needed jewelry. This is because if is not possible in a barter transaction, except for an expert, to visualize the fair equivalent of one commodity in terms of all other goods. Hence, the equivalent may be established only approximately thus leading to some injustice to one or the other party. The use of money could therefore help reduce the possibility of an unfair exchange.

Different commodities can be unequally exchanged hut deferred payment is not allowed. For e.g. one kg wheat can be sold against 2 kg date or one gram of gold can be exchanged against 4 grams of silver on the condition that they are spot transactions reason being that such a transaction will surely be carried on the

market rate. For e.g. a person who wants to exchange silver for gold on spot will only transact as per the market rate. However, if the transaction is on credit, there is a possibility, no matter how minor, of stepping into interest that cannot be ignored. For e.g. a buyer who has traded 80 tolas silver on credit today on the understanding that it will he exchanged against 2 tolas gold after a month lieu in fact no means to find in advance that 40 tolas silver will be equivalent to one tola gold after a month. Therefore this ascertaining of value in advance actually signifies its roots in interest and gambling. Similarly the seller who has accepted credit has in fact yielded to gambling by hoping that the ratio of gold and silver might come down from 1:40 to 1:35. The law of exchanging different commodities only at spot has been established due to this reason.

The general conditions of sale, however, should be borne in mind while making a trade transaction so that the goods are specified in addition to the cash aspect of the transaction. The right way of specifying is that gold and silver should be under the possession of the sellers or delivered at the place of contract because both goods have the original (natural) price, which cannot he specified until they are delivered? This rule applies to only exchange of gold and silver. Other goods can be exchanged against each other without delivery and can be specified any other way but will be restricted to cash transaction.

For e.g. Zaid made a spot sale of one kg wheat to Dakar with 2 kg salt against future delivery after having identified their goods, this transaction is allowed in Shariah since it meets both conditions:

- The transaction is on spot.
- It is also specified.

However, if Zaid was selling one tola gold to Bakar against 40 tola silver, then it is necessary that both take delivery of their purchased goods at the place of contract because without delivery, goods cannot be specified.

To sum up, the Hanafi Jurists maintain that in case of commodities that weigh or measure, it is illegal to transact unequally or on credit. But in case of different commodities unequal exchange is legal hut credit remains illegal; the transaction in this case too should be spot.

CHAPTER # 5COMMERCIAL INTEREST AND USURY

- THE BACKGROUND OF BOTH TYPES
- FIRST SCHOOL
    - ARGUMENT 1
    - ARGUMENT 2
- SECOND SCHOOL
    - ➔ ARGUMENT 1
    - ➔ ARGUMENT 2

COMMERCIAL INTEREST AND USURY

In the 17 century, two new technical terms of interest have emerged after the establishment of banking system, namely:

1. ***Commercial interest:*** (Tijarti sood) Interest paid on loan taken for productive & profitable purposes.

2. ***Usury:*** (Sarfi sood) Interest paid on loan taken for personal needs and expenses.

THE BACKGROUND OF BOTH TYPES

The present day banking system, which has given interest the moral and legal license, is (lie backbone of the prevalent capitalism.

When Muslim countries became subjugated to west in their economic field, some westernized Muslims in the 19th century, on one side, saw the increasing progress of the west in trade and industry and on the other side saw the shattering economic condition of fellow Muslims slates. They also became conscious of the fact that banking is inevitable in the field of trade and industry not only on national level but also internationally. This prompted them to say that only usury is *haram* (illegal) but not commercial interest because rendering commercial interest *haram* would pose irresolvable problems to their way up to industrialization and economic progress. They only included usury in the term "Riba" as categorically prohibited in Qur'an and Sunnah and freed commercial interest from it calling it totally different from the Western concept of interest. Therefore, it was concluded that the prohibition of Riba was restricted to usury while commercial interest was perfectly Islamic.

There are two schools of thought on this issue. A detailed analysis of their arguments is discussed as under:

First School:

This school presents 2 arguments to support their point that only usury and not commercial interest is prohibited in Islam

➔ Argument 1

Riba as practiced during the days of the Prophet (SAW) was only Usury:

Counter argument

This claim is groundless, since Islam when prohibiting something does not only prohibit one form of it that is prevalent, but all forms that might erupt in future. The changed state does not change the ruling for e.g. Qur'an has prohibited the following:

- **Liquor (Khamar):** During the days of Prophet (SAW) its form and the way of production was totally different from that of the present day liquor but the ruling remains unchanged even though the form lias changed.

- **Pork (Khinzeer):** Irrespective how clean the present day breeding of pigs in high class farms may be, pork will stay prohibited and cannot be rendered *halal* (legal).

- ***Corruption/Immorality (Al Fahsha):*** Although a lot of sophisticated ways have been developed of this evil from tlie lime of Quranic revelations prohibiting it, the ruling stands forever.

The same applies to interest and gambling. By claiming that it was in a different form during Prophet's (SAW) time does not change its ruling. It remains unchanged just as in case of *Khamar, Khinzeer* and *Al fahsha*

➔ **Argument 2**

Commercial interest did not exist in the days of Prophet (SAW)

Counter argument

This claim is also wrong. If one glances through the Islamic and pre Islamic history of Arabia, it will be evident that the interest type at that time was not restricted to usury but loans were granted for commercial and profitable purposes. To quote some examples:

a) "The tribe of Umro bin Aamir used to take interest from the tribe of Mughairah. At the advent of Islam, Mughairah owed heavy interest to Umro bin Aamir." In this narration, the transaction of interest between 2 tribes of Arabia have been pointed out who actually operated as trading companies; both tribes were very wealthy. Could it be that 2 wealthy tribes transacted interest just for personal need and expenses? The interest was simply commercial!

b) History of the city of Ta'if tells us that it was only second to Makkah in trade (their main, exports being liquor, raisins, currants, wheat, wood etc) and industry (major being leather and dyeing). The tribe *of Saqeef* (a tribe of Jews) advanced cash on interest not only to the natives of Ta'if but the business community of Makkah as well e.g. (the tribe of Mughairah who was their permanent customer. This advancement was not only restricted to cash but also to commodities between wealthy tribes of Taif and Makkah who were usually traders and business men, was only for their commercial purposes not for their consumption and personal needs. One of the ways of receiving interest was to double the principle amount plus interest in case of non payment of loan and this practice

was applied to both cash as well as commodities. They had become accustomed to it. At the time of signing the peace treaty with the people of Ta'if, The Prophet (SAW) imposed conditions

i) Total elimination of interest based transactions,

ii) Giving up of interest owed to and from them.

c) The practice of making 2 trade trips, one to Yemen in winters and the other to Syria in summer was started by the tribe of Quraish of Makkah. These trips proved to be very profitable especially since being custodians of Kaa'ba, Quraish were looked at with respect, granted special concessions and protected in transit which was a necessity at that time. This way business & trade became their only means of livelihood. Investment became the order of the day in which women also took part and its circulation flourished and multiplied. With tills background in mind, one can easily visualize that the city of Makkah more or less became the clearinghouse or the banking city and accustomed to their related amenities. It was only natural that interest was one of them. Since they advanced cash for commercial purposes and charged compound interest incase of default by the traders, and this earning of interest was their trade, they argued when Qur'an rendered interest *haram (illegal)* that the transaction of interest based loans is a type of trade in which the return on capital can be earned as in the case of rent received from assets. They could not differentiate between excess in shape of profit during a trade and excess in the shape of interest at tlie lime of repayment of loan.

d) Therefore in pre Islamic days, we see that Syedna Abbas bin Abdul Muttlib and Sycdna Khalid bin Waleed formed a company with Joint capital whose prime business was cash advancement on interest. Similarly Syedna Usman was one of the wealthy businessmen who lent money on interest. There were many other traders dealing full time in interest extending a network of interest based transactions.

e) The way Syedna Zubair bin Awwam, who was famous for his trustworthiness, operated was quite similar to that of modem banking system. People used to deposit with him their capital as Amanah (trust or security). However, Syedna Zubair used to make it clear to the depositors that he would accept the deposits as a 'loan' and not as 'security' (Amanah). Because he knew that he will not be fully liable according to Shariah in case these Amanahs got destroyed but in case of having them as a loan, he will be fully liable to pay them back. He was afraid that in case of losing any deposited amount, his image as the trustworthy caretaker would be damaged. He therefore used the term 'loan' for such deposits to ensure guaranteed payment so that lie enjoys everyone's confidence in him. Another reason for using tlie word 'loan' was to legalize trading and earning profits on such deposits. Because if he got those deposits as Amanah, he could not utilize it for his

business, as it is not permissible in Shariah to use Amanah. This clearly shows that borrowing in those days was not only for consumption purposes but for commercial purposes as well. Syedna Zubair left a will with his son Syedna Abdullah bin Zubair before he died to sell his properly to repay the loan, if required. The total amount calculated after his dealh for repayment by his son was 22 lacs. It is obvious that this loan of 22 lacs was not owed out of any need by a rich Sahaba .such as Syedna Zubair, rather it was an investment of securities that was circulating in trade.

ANOTHER CLEAR ARGUMENT

Syedna Abu Hurairah narrated that the Prophet (SAW) said, "He who does not abandon Mokhabara, will be caught in a war against Allah & his Prophet."

In this narration Prophet (SAW) has rendered Mokhabara illegal just like riba and Has declared a war against those who indulge in it just like riba.

What is Mokhabara

Its actually a division of the crop by agreement between the landlord and cultivator in which the landlord gives his land to cultivator for cultivation purposes in order to gel his pre-agreed amounts of the crop irrespective whether the production is low or high. For e.g. "A" lends his land to 'B' for cultivation on the condition that he will get a predetermined portion on each crop e.g. 5 mounds. Such a transaction is called Mokhabara.

Prophet had called Mokhabara a form of riba. Now one should ponder whether lie referred to usury as the form of riba or he referred to commercial interest. It is similar to commercial interest as both Mokhabara and commercial interest are used for productive businesses. Whereas in the case of usury, the borrower uses tlie loan for personal use and not productive purposes.

To sum up, Prophet (SAW) included Mokhabara in riba which has no similarity with usury rather with commercial interest. The fact that during Prophet's (SAW) lime, tlie dealing in commercial interest was common is proven and also that this form is prohibited.

SECOND SCHOOL:

These group present 2 points in their arguments that are mentioned below:

➔ **Argument 1** .

The factor leading to prohibition of Riba (Interest) is that if a borrower faces a loss, he still has to pay an excess amount over the principal, which is basically an exploitation of his need whereas the lender on (he other hand gets an increase on his surplus capital without any effort which is unjust. But this factor is not found in commercial interest since both the borrower as well as the lender gets profit; (the borrower on the amount he has circulated in business and the lender in shape of interest over Ills principle amount. Therefore, no-one faces unfairness or injustice in this transaction.

Counter argument

This argument is quite appealing and attractive at the face value, as it is based on the assumption that no one suffers in case of commercial interest. But after analysis, it is proved dial Quran has not only prohibited that one party faces a loss and the other gets profit. But it also prohibits one party getting confirmed profit and the other party unconfirmed profit from the same investment as we have studied above in the case of *Mokhubam.*

➔ **Argument 2**

This argument is based on the Quranic verse "(O *believers do not devour one another's possession wrongfully; rather than that, let there be trading by mutual consent" (Al Nisa* verse 29). In the above verse, Qur'an has prohibited *Wrongful devouring"*[1] which will only arise if the consent of one of tlie parties is absent and naturally tlie party who is devouring consents, the other party never consents; he only gives in since he has no other option. So we come to the conclusion that if the consent and satisfaction of both parties is present in a deal, it cannot be called "Wrongful devouring". According to this logic, commercial interest is permissible since the mutual consent is present of both parties where as riba is prohibited only when one party is getting the excess out of his selfishness and the other party is encountering the loss as he has no other alternative.

Counter argument:

This argument is of superficial nature. Mutual consent is not the criteria to render anything prohibited or not in Islam. Would the act of adultery be allowed if the condition of mutual consent is fulfilled? Similarly, there are many transactions in business, which arc rendered illegal even with mutual consent. For reference see "Abwab ul Buyu al Batila" where *Muhaqila* and *Talqi al Jalab* being forms of *Bai* where the mutual consent and satisfaction is present and is prohibited by Prophet

(SAW). Similarly, mutual consent is present in commercial interest and gambling too but in spite of that, it has been prohibited. Therefore no such criteria exist in the legality of any transaction that both parties approve; rather the approval should be on tlie transaction which has not been prohibited by *Shariah 'h.* To quote tlie words of Qur'an *"Except the legitimate business....."*

CHAPTER # 6THE FEATURES OF A BANK

- THE FEATURES OF A BANK
  - ➔ DEPOSIT CREATION
  - ➔ FINANCING
  - ➔ DISCOUNTING OF BILLS
  - ➔ PROVIDING GUARANTEE FEE
  - ➔ LOCKER SERVICES
- CONCLUSION
- *MUSHARIKAH* IN BANK
- DEPOSITS RUNNING MUSHARIKAH ACCOUNT ON THE BASIS OF DAILY PRODUCTS:

THE FEATURES OF A BANK

The conventional banking, which is interest based, performs the following major activities:

- ➔ **Deposit creation**
- ➔ **Financing**
- ➔ **Discounting of bills**
- ➔ **Providing guarantee fee**
- ➔ **Locker services**

We now would like to make a comparison of these activities with Islamic concept of banking:

Deposit – "qard and not amanah"

The common misconception regarding "deposit" is that it is a form of *umanah* ("amanat/Security). However, according to Shariah definition, deposit has more resemblance to *qard* (qarz/debt) than *amanah.* This conclusion is based on the fact that, in Islam any item is termed as amanah, if it bears all the features of *amanah.* Deposits cannot be termed amanah, as *amanah* has two special features, which are not found in bank deposits, precisely:

- The bank should not use the amanah.
- The bank should not be liable in case of any damage or loss to the ***amanah***.

Whereas in banks, deposits are primarily placed to earn profit, which is only possible when the bank uses these deposits to invest in other business. Hence deposits do not fulfil the First condition of amanah, which says that it should not be used by the care-taker for his own business or benefit.

Secondly, the bank is held 100% responsible for these deposits in all circumstances even in case of loss or damage to the bank. This feature releases deposits from the ruling of *amanah* where the assets will not be returned in case of any damage to the asset resulting from the caretaker's negligence. According to this justification, all three kinds of deposit namely current accounts, fixed deposits and saving accounts are not amanah. They all can be termed as debt.

One school of thought says that only fixed deposit and saving accounts fall under the laws of debt but current account is governed by *amanah.* However, this is also not correct because the bank is as much liable to current account holders as its PLS account holders and is called the "guarantor" in fiqh terminology. Due to Hits feature, current account is also governed by *qard.*

The depositors are not interested in terminology but the end-result of holding an account. Therefore if a bank does not offer security to the assets, the depositors under normal circumstance, will never keep their assets at such a bank. Similarly if the depositors arc told that the status of your account will that be of *amanah* and in case of any loss to the assets, without any negligence of the bank, will not be returned to you, not a single person will put his assets in the bank. Therefore the bank provides the security to the assets which the depositors themselves want.

We therefore conclude that the main intention of the depositors is not to put the assets in banks as *arnanh* rather as *qard,* by having collateral security by appointing the bank as guarantor.

Example of Syedna Zubair bin Awwam:

Hazrat Zubair bin Awwam was famous for his honesty and trustworthiness. Prominent people used to leave with him their properties in trust. Based on their needs they would also withdraw all or part of their properties. It has been reported in Al Bukhari and Tabaqaat-e-Ibn-e-Saad in respect of Hazrat Zubair bin

Awwam that he would decline to accept such property as *amnah* (trust) and accept them rather as a Qard (loan).

The reason for this action on his part was his fear that the property may be lost and it may be suspected that he was lax in its safe-keeping. As such he decided to consider it a loan so that the depositor felt more comfortable and his reputation remained intact. He also did this so that it could become possible for him to employ these funds for trading and earn profit out of them. The loan amount calculated at 2.2 million at the lime of his death by his son Syedna Abdullah bin Zubair was specified as *qard* not *amanah.* He also used the term loan while instructing his son before his death "Son, dispose of my property to settle the loans".

Conclusion

From the above discussion, we come to the conclusion that all three forms of bank deposits are governed by the law of debt as a consequence of which the account holder may withdraw only the assets deposited. Any increase on it will be interest. It lias already been discussed in the chapter of commercial interest that if the purpose of the lender is business or security and not providing financial assistance, then to get an excess amount is also interest, which is prohibited in Islam just like usury.

It is clear from the above arguments and there is a consensus of Muslim scholars on the point that the transactions in Fixed Deposit and Savings Account is prohibited because the bank pays excess to their account holders over their actual capital, which is interest. The Islamic Fiqh Academy Jeddah in their 2nd session has further endorsed such transactions as interest based transaction. Therefore it is illegal for a Muslim to keep their deposits in such accounts. As far as the current account is concerned, the bank does not pay any excess (interest) over the actual capital, therefore holding such an account is allowed.

To sum up, profit given on Fixed deposit and savings accounts is interest and therefore prohibited. However if the banking system is based on Islamic principles, *musharikah* can play a very important role. Therefore we will now discuss how the banks can operate on *musharikah* basis. As we already know a bank has two sides, one where it receives deposits from customers which is called the liability side and the other where it advances finance to investors and businessmen which is called the asset side. Both sides can operate on *musharikah* basis. As far as deposits are concerned, *musharikah* is the only instrument in which monies can be received from customers meaning that every depositor, will become a partner in bank's business through their deposited money. However, for

the asset or finance side, there are other instruments apart from *musharikah* but since those instruments are not covered in our subject, we will slick to the operation of *musharikah.* We will begin by the role of *musharikah* in the deposits and its relevant laws and will then discuss the procedure of *musharikah* in the finance side.

MUSHARIKAH IN BANK DEPOSITS

An important value of an Islamic society is mutual dealings. It also refers to deposits in banks. The operation of fixed deposits and savings account in Islamic banks will be different from conventional banks because the Islamic banks will be based on *musharikuh* (combination of shirkah & modarabah) which like conventional banks, people will invest in two ways:

- Participation in setting up the bank like any joint company by joint investment and the participants will be called the "shareholders". They will have a partnership *(shirkah)* effected by a mutual contract since they have used their capital and deed on the bank and

- Participation by opening their account in fixed deposit, and savings account and participants will be called the "account holders". These will not be the actual owner or shareholders of the bank - rather partners in profit only - meaning that they will have a contract of *modarabah*

The status of the bank or the shareholders will be that of a *modarib* and the account holders will be *Rab-bul-Maal.* The contract known as *musharikuh* will be a combination of *shirkah.* This is the reason why the profit ratio of depositors is less than the actual shareholders and the depositors will not have any voting power or the right of management because they are not involved in the deed but has only supplied the capital. This kind of dual relationship is not uncommon in Islamic Fiqh. Therefore if the *modarib* (Bank or the shareholders) wants to merge his assets with the assets of depositor, it is allowed in which case he will be regarded as owner of half (he assets and *modarib* of the other half. This lias already been discussed at length in a separate chapter on *musharikuh* (combination *of shirkah* and *modarabah).*

In the previous discussion, following facts have been established:

1. ***The actual status of deposits is debt and not*** **amanah.**

2. *The excess paid on loan is interest, not profit.*
3. *If a bank is operating on Islamic principles, the bank and the depositor will have a partnership through a contract of* shirkah *or* modarabah *in which case the depositor's capital will not be regarded as loan.*
4. *The shareholders will act as rubb-ul-mal as well as modarib.*
5. *The depositors will only act as rubb-ul-mal.*
6. *Fixed deposit and saving account mil be converted into* mudaribah *account where the distribution of profit for each partner will be determined in proportion to the actual profit accrued to the business and not according to a fixed ratio or in proportion to the capital invested by him. Fixing lump sum amount is not allowed or any rate of profit tied up with any investment*

7. The entire set up of the bank is on *musharikah* basis (combination of *shirkah* and *modarabah')* where the relationship of the bank and shareholders is through partnership agreement *(shirkah)* because they are participating in labor as well as investment and the relationship between the bank and depositors is only that of *modarabah* because they have only invested without participating in labor. Therefore tills combination of *shirkah* and *modarabah* is called *musharikah* in modem terminology.

DISTRIBUTION OF PROFIT UNDER MUSHARIKAH AGREEMENT

The distribution of profit will be done according to the rules *of musharikah.* Before we begin the summary of the distribution of profit, it is found appropriate to mention here that the conventional banks do not pay interest to current account holders. Therefore there is no need to convert the operation of current account into any Islamic mode of financing. However the distribution of profit to the rest of the partners and account holders will be made on the following rules governing musharikah:

It is not a condition for the final distribution of profit that all assets are liquid - rather the profit and loss is calculated on the basis of evaluation of assets. In case of loss, each partner shall suffer the loss exactly according to the ratio of his investment and in case of profit, the profit will be distributed according to the agreed ratio between the partners. It should be taken into account that both parties are free to determine any ratio of profit of the bank as the manager *(modarib),* therefore it can be agreed mutually that *Rabb-ul-mal* will have a higher profit margin and *modarib* lower. However as a shareholding partner, the share of profit of the *modarib* cannot be less than the ratio of his investment since he is the sole provider of labor. Same rule will apply on the operation of Islamic Banks on the basis of*musharikah.* The actual shareholders apart from being the manager are also shareholding partners, their ratio of profit cannot be less than their ratio of investment. However their ratio of profit as *modarib* can be determined at whatever rate they please.

The above may be explained in the following illustration:

Suppose the total investment of the bank is Rs.15 million in which the depositors have invested Rs.10 million on *modarbah* basis and the shareholders as *modarib* have invested Rs.5 million. This means that one third share of the total capital belongs to the shareholders and two third to the depositors. The role of modarib in the 2/3" capital raised by depositors is played by the shareholders, therefore their ratio of profit as manager (modarib) can be agreed between themselves through mutual consent but their ratio of profit as shareholders cannot be less than 1/3^. If their share is agreed at less than 1/3"[1], it would mean that the depositors' share has exceeded 2/3 although it has been established that they will not be managing the bank and their share of profit will not exceed their ratio of investment.

If it has been agreed in the above example that the shareholders as managing partner will get 1/3 of the profit and the rest 2/3rd will be distributed equally between depositors and shareholders as per the modarbah contract between them, then if for e.g. the profit amount is Rs.15 lacs then the shareholders will get its 1/3 i.e. Rs.5 lacs as the investor *{rubh-ul-mal)* and half of the 2/3rd profit i.e. Rs.5 lacs as the manager (modarib) whereas the other half of the 2/3rd profit will go to the depositor as rub-ul-mal. The following table will clarify the shares of shareholders and depositors:

RUNNING MUSHARIKAH ACCOUNT ON THE BASIS OF DAILY PRODUCTS:

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 upto the date of maturity, and the interest is calculated on the basis of daily products.

Can such an arrangement be possible under the *musharikah* or modurabah 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 musharikah the following procedure may be suggested for this purpose:

- A certain percentage of the actual profit must be allocated for the management.
- The remaining percentage the profit must be allocated for the investors.
- The loss, if any, should be borne by the investors only in exact proportion of their respective investments.
- The average balance of the contributions made to the *musharikah* account calculated on the basis of daily products shall be treated as Hie share capital of the financier.

• 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 *musharikah*. 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 *musharikah* portfolio at the end of the term will be divided based on the average 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 lias 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 musharikah, because the business may have earned huge profits during a period when a particular investor had no money invested in tlic 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 musharikah that a partner should earn profit on his own money only. Once a musharikah pool comes into existence, all the participants, regardless of whether their money is or is not utilized **in a** particular transaction earn the profits accruing to the joint pool. This is particularly true of the Hanafi School, which does not deem it necessary for a valid *musharikah* that the monetary contributions of the partners are mixed up together. It menus that if 'A' has entered into a musharikah contract with 'B', but has not yet disbursed his money into the joint pool, he will be still entitled to a share in the profit of the transactions effected by
•B' for the musharikah through his own money. 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 *musharikah* 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 conditioners for the musharikah 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/- alter 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 Ks. 2000/-

Although the transaction effected by A's money brought loss of Rs. 2000/- while (the profitable deal of air conditioners 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 a loss.

The reason is that once the parties enter into a *musharikah* contract, all the subsequent transactions effected for *musharikali* 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 musharikah.*

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 *musharikah.* But in the proposed running account of *musharikah* 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 *musliarikah,* which should render the *musharikah* 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 *musharikah* that the capital is pre-known to the partners. 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 *musharikah* 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 *musharikah* docs not lead to disputes, because it is generally known when the commodities are purchased for the *musharikah,* therefore it does not lead to uncertainty in the profit at the time of distribution." (Badai-us-sanai v.6 p.63)

It is, therefore, clear from the above that even if the amount of the capital is not known at the time *of musharikah,* 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 *musharikah* 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 Shariah, so far as it does not violate any basic principle *of musharikah.* In the proposed

system, all the partners arc treated ;it par. The profit of each partner is calculated on the basis of the period for which Ins money remained in the joint pool. There is no doubt in the fact that the aggregate profits accrued to the pool is 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 in his famous hadith, as follows:

Muslims are bound by their mutual agreements unless they hold a permissible thing as prohibited or a prohibited tiling as permissible.

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 dales of the commencement of a new term. This arrangement is totally impracticable on the deposit 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 tlie 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.

CHAPTER # 7 *MUSHARIKA*

- DEFINITION AND CLASSIFICATION OF MUSHARAKAH
- MANAGEMENT OF MUSHARAKAH
- TERMINATION OF THE MUSHARKAH
- ISSUES RELATING TO MUSHARKAH
  - LIQUIDITY OF CAPITAL
  - MIXING OF THE CAPITAL
- TENURE OF MUSHARKAH
- TERMINATION OF THE MUSHARKAH

Musharakah

Hadees-e-Qudsi

Allah Subhan-o-Tallah has declared that He will become a partner in a business between *musharikah* until they indulge in cheating or breach of trust (Khayanat).

DEFINITION AND CLASSIFICATION 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 tlie other. "Shirkah" means "Sharing" and in tlie 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 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 tlie 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-Amal* where all the partners jointly undertake to render some services for their customers, and tlie 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 lias actually done, this partnership will be a shirkat-ul-

aOmal which is also called Sliirkat-ul-taqabbul or Shirkat-us-sanai or Shirkat-ul-abdan.

(iii)The third kind of Shirkat-ul-aqd is Shirkat-nl-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 Shirkal-ul-aOmal 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. But (the term Musharka term is a little limited than the term "Shirkah" more commonly used in the Islamic jurisprudence. In fact the term Musliarka refers to a type of shirkat known as "Shirkal-ul-amwal " i.e. all the partners invest some capital into a commercial enterprise.

DEFINITION AND CLASSIFICATION OF MUSHARAKAH

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., etc.

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

Basic Rules of Capital:

The capital in a Musharka agreement should be:

a) Quantified (Ma 'loom): Meaning how much etc.
b) Specified (Mula 'aiyan): Meaning specified currency etc.
c) Not necessarily be merged: The mixing of capital is not required.

d) Not necessarily be in liquid form: Capital share may be contributed cither in cash/liquid or in the form of commodities. In case of a commodity, the market value of the commodity 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. Any work done by one of them in the normal course of business shall be deemed as authorized by all the partners.

Basic Rules of Distribution of Profit

1. 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. E.g. if it is agreed between them that A will get 1% of his investment, the contract is not valid.

2. 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&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.

3. If both partners agree that each will get % of profit based on his capital %, whether both work or not, it is allowed.

4. It is also allowed that if an investor is working, his profit share (%) could be more than his capital base (%) irrespective whether the earlier partner is working or not. E.g. if A&B have invested Rs.1000/- each in a business and it is agreed that only A will work and will gel 2/3rd of the profit while B will get 1/3rd . Similarly if the condition of work is also imposed on B in the agreement, then also the proportion of profit for A can be more than his investment.

5. If a partner has put an express condition in the agreement that he will not 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. However, Hanbali school of thought considers fixing the sleeping partners share more than his investment to be permissible.

6. It is allowed that if a partner is not working, his profit share can be established as less than his capital share.

7. If both are working partners, the share of profit can differ from the ratio of investment. Eg. Zaid & Bakar both have invested Rs.1000/- each. However Zaid gets l/3rd of the total profit and Bakar 2/3rd, this is allowed. This opinion of Imam Abu Hanifa is based on the fact that capital is not the only factor for profit but also labor and work. Therefore although the investment of two partners are same but in some cases quantity and quality of work might differ.

8. If only a few partners are active and others are only sleeping partners, then the share in the profit of the active partner could be fixed at higher than his ratio of investment e.g. A & B put in Rs.100 each and it is agreed that only A will work, then A can take more than 50% of the profit as his share. The excess the receives over his investment will be compensation for his services. **Basic rules of distribution of Loss all scholars are unanimous on the principle of loss sharing in Shariah based on the saying of Syedna Ali ibn Talib (that is as follows:**

"Loss is distributed exactly according to the ratio a/investment and the profit is divided according to the agreement of the partners."

Therefore the loss is always subject to (the ratio of investment e.g. if A lias invested 40% of the capital and B 60%, they must suffer the loss in the same ratio, not more, not less. Any condition contrary to this principle shall render title contract invalid. Powers & Rights of Partners in Musharakah:

After entering into a Musharakah contract, partners have the following rights:

a) The right to sell the mutually owned properly since all partners arc representing each other in Shirkah and all have the right to buy & sell for business purposes.
b) The right to buy raw material or oilier stock on cash or credit using funds belonging to Shirkah to put into business.
c) The right to hire people to carry out business if needed.
d) The right to deposit money & goods of the business belonging to Shirkah as depositor trust where and when necessary.
e) Tlie right to use Shirkah's fund or goods in Mudarabah.
f) Tlie right of giving Shirkah's funds as hiba (gift) or loan. If one partner for purpose of investing in the business lias taken a qard-e-hasana, then paying it becomes liable on both..

TERMINATION OF THE MUSHARKAH

Musharakah will stand terminated in the following cases:

1. If the purpose of forming tlie shirkat has been achieved. For example, if two partners had formed a shirkat for a certain project for e.g. buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, tlie rules are simple and clear in this case. Tlie distribution of profit will be as per (lie agreed rate whereas in case of loss, each partner will bear the loss according to his ratio of investment.

2. Every partner has the right to terminate the musharakah at any lime after giving his partner a notice that will cause the musharakah to end. For dissolving (his partnership, if the assets are liquidated, they will be distributed pro-rata between the partners. However, if this is not the case, the partners may agree either:

a) To liquidate the assets or
b) Distribute the assets as they are.

In case of a dispute between partners whether to seek liquidation of assets or distribute non-liquid assets, the distribution of non-liquid assets will be preferred. Because after the termination of musliarakah, 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. But if the assets are in a form that cannot be distributed such as machinery, then they shall be sold and the sale-proceeds shall be distributed.

3. In case of a death of any one of the partners or any partner becoming insane or incapable of effecting commercial transaction, the musliarakah stands terminated.

4. In case of damage to the share capital of one partner before mixing the same in the total investment and before effecting the purchase, the partnership will stand' terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then file loss will be shared by all and the partnership will not be terminated.

Termination of Musharakah without closing the business

If one of the partners wants termination of the Musharakah, while the earlier 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 oilier partners.

However, in this case, the price of the share of the leaving partner must be determined by mutual consent. 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 oilier partners on tlic liquidation or on the distribution of the assets themselves.

The question arises whether tlic 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. 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 lias 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 (S.A.W)in his famous ahadilh:

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

Dispute Resolution

There shall be a provision for adjudication by a Review Committee to resolve any difference that may arise between the bank and its clients (partners) with respect to any of the provisions contained in the Musharaka Agreement.

Security in Musharka

In case of Mnsharka agreement between Bank and client, the bank shall in his own right and discretion, obtain adequate security from the party to ensure safety of the capital invested/ financed as also for the profit lliat may be earned as per profit projection given by the party. The securities obtained by the bank shall, also as usual, be kept fully insured at tlie party's cost and expenses till Islamic mode of insurance i.e. Takaful

ISSUES RELATING TO MUSHARKAH

Musharakah is a mode of financing in Islam. Following are some issues relating to the tenure of Musharakah, redemption in Musharakah and the mixing of capital in conducting Musharakah. These were discussed previously, they are explained in detail here.

➔ *LIQUIDITY OF CAPITAL*

A question commonly asked in the operation of Musharakah is whether the capital invested needs to be in liquid form or not. The answer as to whether the contract in Musharakah can be based on commodities only or on money varies among the different schools of thought in Islam. For example if Zaid and Bakar agree to invest Rs. lOOO each in a garment business and both keep their investments with themselves. Then if Zaid buys cloth with his investment will it be considered belonging to both Zaid and Bakar or only to Zaid? Furthermore if the cloth is sold, can Zaid alone claim the profit or loss on (lie sale? In order to answer this question the prime consideration should be whether the partnership becomes effective without mixing the two investments profit or loss. This issue can be resolved in the light of Die following schools of thought of different fiqhs:

Imam Malik is of the view that liquidity is not a condition for validity of Musharakah. .Therefore even if a partner contributes in kind to the partnership his share can be determined on the basis of the evaluation according to the prevalent market price at the dale of the contract. However Imam Hanifa and Imam Ahmad do not allow capital of investment to be in kind. The reason for this restriction is as follows:

• Commodities contributed by one partner will always be distinguishable from the commodities given by the other partners therefore they cannot be treated as homogenous capital. If in case of redistribution of share capital to the partners tracing back each partners share becomes difficult. If the share capital was in the form of commodities then redistribution cannot take place because they may have been sold at that time.

Imam Shaft has an opinion dividing commodities into two:

- Dhavvat-ul-amtlial: Commodities which if destroyed can be compensated by similar commodities in quality and quantity. Exampla rice, wheat etc.
- Uliawat-ul-qecmah: Commodities that cannot be compensated by similar commodities like animals.

Imam Shafi is of the view that commodities of the first kind maybe contributed to Musharakah in the capital while the second type of commodities cannot be a part of the capital. In case of Dhawat-ul-amlhal redistribution of capital may take place by giving to each partner the similar commodities he had invested and earlier the commodities need to be mixed so well together that the commodity of one partner cannot be distinguished from commodities contributed by the oilier.

Therefore, it should be remembered that the liquid goods can be made capital of

investment and the market value of the commodities shall determine the share of the partner in the capital.

➔ MIXING OF THE CAPITAL

In case of illiquid capital being used the mixing of capital is an issue. According to Imam Shaft partners' capital should be mixed so well that it cannot be discriminated and this mixing should be done before any business is conducted. Therefore, partnership will not be completely enforceable if any kind of discrimination is present in the partners' capital. His argument is based on the reasoning that unless both investments will be mixed investment will remain under the ownership of the original investor and any profit or loss on trade of that investment will be entitled to the original investor only. Hence such a partnership is not possible where the investment is not mixed.

According to Imam Abu Hanifa, Imam Malik and Imam Ahmed bin hunbul the partnership is complete only with an agreement and the mixing of capital is not important. They are of the opinion that when two partners agree to form a partnership without so far mixing their capital of investment, then if one partner bought some goods for the partnership with his share of investment of Rs. 100,000, these goods will be accepted as being owned by both partners and hence any profit or loss on sale of these goods should be shared according to the partnership agreement.

However, if the share of investment of one person is lost before mixing the capital or buying anything for the partnership business, then the loss will be borne solely by the person who's owned the capital and will not be shared by oilier partners. However if the capital of both had been mixed and then a part of whole had been lost or stolen the loss would have been borne by both.

Since in Hanifa, Malik and Hunbal schools of thought mixing of the capital is not important therefore a very important present day issue is addressed with reference to this principle. If some companies or trading houses enter into partnership for setting up an industry to conduct business they need to open LC for importing tlie machinery. This LC readies the importer through his bank. Now when the machinery reaches the port and the importing companies need to pay for taking possession the latter need to show those receipts in order to take possession of the goods.

Under Shaft school of thought the imported goods cannot become the capital of investment but will remain in the ownership of the person opening the LC because at the time of opening the LC the capital has not been mixed and without mixing the capital musharkah cannot come into existence. Under this situation if tlie goods are lost during shipment the burden of loss will fall upon the opener of the

LC, even though the goods were being imported for tlie entire industry. This is because even though a group of companies had asked for the machinery or imported goods the importers had not mixed their capital at the time of investment.

Contrary to this since the other three schools of thought believe that partnership comes into existence at the time of agreement rather than after the capital has been mixed therefore the burden of loss will be borne by all. This has two advantages:

a) In case of loss the burden of loss will not fall upon one rather will be shared by all the partner firms.

b) If the capital is provided at the time of the agreement it slays blocked for the period during which the machinery is being imported. While if (lie capital was not kept idle, till the actual operation could be conducted with the machinery the same capital could have been used for something else as well.

This shows that the decision of the 3 combined schools of thought are better equipped to handle tlie current import export situation.

TENURE OF MUSHARKAH

For conducting a Musharakah agreement questions also arise pertaining to fixing (lie period of the agreement. For fixing the tenure of the Musharakah following conditions should be remembered:

a) Tlie partnership is fixed for such a long lime that at the end of the tenure no other business can be conducted.
b) Can be for a very short lime period during which partnership is necessary and neither partner can dissolve the partnership.

Under the Hanafi school of thought a person can fix the tenure of the partnership because it is an agreement and an agreement should have a fixed period of lime.

In the hanbal school of thought the tenure can be fixed for the partnership as it's an agency agreement and an agency agreement in this school can be fixed, 'the Malik school however says that shirkat cannot be subjected to a fixed tenure. Shafi school like the Maliki consider fixing the tenure to be not permissible. Their argument is that fixing the period will prohibit conducting tlie business at the end of that period which in turn means that the fixing will prevent them from conducting the business.

TERMINATION OF THE MUSHARKAH

Musharakah will stand terminated in the following cases*:*

1. If the purpose of forming the shirkat has been achieved. For example, if two partners had formed a shirkat for a certain project for e.g. buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment, the rules are simple and clear in this case. Tlie distribution of profit will be as per the agreed rate whereas in case of loss, each partner will bear the loss according to his ratio of investment.

2. Every partner has the right to terminate the Musharakah at any time after giving his partner a notice that will cause tlie Musharakah to end. For dissolving this partnership, if the assets are liquidated, they will be distributed pro-rata between the partners. However, if this is not the case, the partners may agree either:

c) To liquidate the assets or
d) Distribute the assets as they are.

In case of a dispute between partners whether to seek liquidation of assets or distribute non-liquid assets, the distribution of non-liquid assets will be preferred because after the termination of Musharakah, all the assets arc in (lie 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. But if the assets are in a form that cannot be distributed such as machinery, then they shall be sold and the sale-proceeds shall be distributed.

5. In case of a death of any one of the partners or any partner becoming insane or incapable of effecting commercial transaction, the Musharakah stands terminated.

6. In case of damage to the share capital of one partner before mixing (lie same in the total investment and before effecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then the loss will be shared by all and the partnership will not be terminated.

CHAPTER # 8 MODARBAH

- DEFINITION

  - ➔ TYPES OF MODARABAH
  - ➔ DIFFERENCE BETWEEN MUSHARAKAH AND MODARABAH

- INVESTMENT
- MODARABAH EXPENSES
- DISTRIBUTION OF PROFIT & LOSS
- TERMINATION OF MODARABAH

Modarbah

Modarib	Working Capital Partner (brings effort)
Raas-ul-Maal	Investment
Rabb-ul-Maal	Investor (brings capital)
Wakeel	Agent
Ameen	Trustee
Kafeel	Guarantor
Mudarib	Working partner (Manager

- **DEFINITION:**

This is a kind of partnership where one partners gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "Rabb-ul-maal" while the management and work is an exclusive responsibility of the other, who is called "Modarib" and the profits generated arc shared in a predetermined ratio.

- ➔ **Types of Modarabah:**

There are 2 types of Modarabah namely:

1. *Al Modarabah Al Moqayyadah* Rabb-ul-maal may specify a particular business or a particular place for the modarib, in which case he shall invest the money in that particular business or place. This is called Al Modarabah Al Muqayyadah (restricted Modarabah)

2. *Al Modarabah Al Mutluqah:* However if Rabb-ul-maal gives full freedom to Modarib to undertake whatever business lie deems I'll, this is called At Modarabah Al Mullaqali (unrestricted Modarabah). However Modarih cannot. without the consent of Rabb-ul-Maal, lend money to anyone. Modarib is authorized to do anything which is normally done in the course of business. However if they want to have an extraordinary work which is beyond the normal routine of the traders, he cannot do so without express permission from the Rabb-ul-Maal. He is also not authorized to:

a) Keep another Modarib or a partner
b) Mix his own investment in that particular Modarabah without the consent of Rabb-ul Maal.

Conditions of Offer & Acceptance are applicable to both.

A Rabb-ul-maal can contract Modarabah 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 Modarib and the capital of the Modarabah shall be utilized by both of them jointly, and the share of the Modarib.

➔ **DIFFERENCE BETWEEN MUSHARAKAH AND MODARABAH:**

Musharakah	Modarabah
1. All partners invest.	**Only rabb-ul-maal invests.**
2. All partners participate in the management of the business and can work for it.	Rabb-ul-maal has no right to participate in the management which is carried out by the Modarib only.
3. All partners share the loss to the extent of the ratio of their investment.	Only rabb-ul-maal suffers loss because the modarib docs not invest anything. However this is subject to a condition that the modarib has worked with due diligence.
4. The liability of the partners is normally unlimited. If the liabilities of business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne pro	The liability of rabb-ul-maal is limited **to** his investment unless lie has

rata by all partners. But if the partners agree that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that " partner alone wlio has incurred a debt on the business in violation of the aforesaid condition. 5. As soon as the partners mix up their capital in a joint pool, all tlie assets become jointly owned by all of them according to the proportion of their respective investment. All partners benefit from the appreciation in (lie value of the assets even if profit has not accrued through sales.	permitted the modarib to incur debts **on** his behalf. **The goods purchased by (he modarib are solely owned by rabb-ul-maal and tlie modarib can earn his share in the profit only in case he sells the goods profitably.**

INVESTMENT:

In Modarabah Rabb-ul-Maal provides the investment and the Modarib management therefore the Rabb-ul-Maal should hand over the agreed investment to Modarib and leaves everything to Modarib with no interference from his side but lie lias the authority to:

a) Oversee the Modarib's activities and

b) Work with Modarib if the Modarib consents.

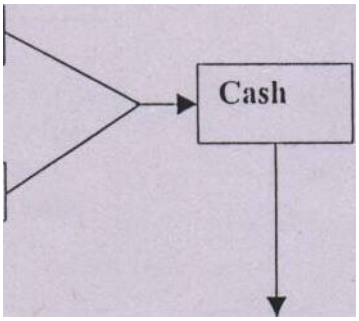
In what form should the capital be? Should it be liquid or non-liquid assets like equipment, land etc. can form capital?

The basic principle is that the capital in Modarabah is valid just the way it is in Shirkah which according to Hanbali fiqh should be in liquid form but according to oilier scholars equipment, land etc. other can also be included as capital. However all agree on the following:,

Assets other than cash can be used as an intermediate step meaning:

Accounts receivable
Or

Equipment/Land



Original Investment ⟶ Can be used for Modarabah

However this is subject to the determination of exact amount of the assets before it is used for Modarabah. If His assets are not correctly evaluated, (the Modarabah is not valid).

MODARAHAH EXPENSES

The Modarib shares profit of the Modarabah as per agreed rate with the investor but his expenses like meals, clothing, conveyance and medical are not borne by Modarabah. However, if he is traveling on business and is overstaying the night, then the above expenses shall be covered from capital. If Modarib goes for a journey which constitutes Safar-e-Sharai (more than 48 miles) but docs not overstay the night, his expenses will not be borne by Modarabah.

All expenses which are incidental to the Modarabah's (unction like wages or employees/workers or Commission in buying/selling or dyeing expenses etc have to be paid by the Modarabah. However all expenses will be included in the cost of commodities which Modarib is selling for e.g. if he is selling ready made garments then the stitching, dyeing, washing expenses etc. can be included by the Modarib in the total cost of the garments.

If the Modarib manages the Modarabah within his city, he will not be allowed any expenses, only his profit share. Similarly, if he keeps an employee, this employee will not be allowed any expenses, just his salary.

If the Modarabah agreement becomes Fasid due to any reason, the Modarib's status will be like an employee, meaning:

a) whether he is traveling or doing business in his city, will not be entitled to any expense such as meals, conveyance, clothing, medicine etc.

b) he will not be sharing any profit and will just gel Ujrat-e-MisI (ordinary pay) for his job.

DISTRIBUTION OF PROFIT & LOSS:

It is necessary for the validity of Modarabah 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 Sluu'iah; 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 Rabb-ul-maal and Modarib. 1 lowcvcr in extreme case wliere the parties have not predetermined the ratio of profit, the, profit will be calculated at 50:50.

The Modarib & Rabb-ul-maal cannot allocate a lump sum amount of profit for any party nor can they determine the share of any party at a specific rate lied up with the capital. For example, if the capital is Rs.100,000/-, they cannot agree on a condition that Rs.10,000 out of the profit shall be the share of the Modarib nor can they say that 20% of the capital shall be given to Rabb-ul-Maal. However they can agree that 40% of the actual profit shall go to the Modarib and 60% to the Rabb-ul-maal or vice versa. It is also allowed that different proportions are agreed indifferent situations. For example, the Rabb-ul-maal can say to Modarib "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, lie can say "If you do the business in your town, you will be entitled lo 30% of the profit and if you do it in another town, your share will be 50% of the profit".

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

All schools of Islamic Fiqh are unanimous on this point. However, Imam Ahmad has allowed for the Modarib to draw his daily expenses of food only From the Modarabah Account. The Hanafi jurists restrict this right of the Modarib only to a situation when he is on a business trip outside his own city. In tills case lie 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.
If the business has incurred loss in some transactions and lias 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.

The Modarabah becomes Void (Fasid) if the profit is fixed in any way. In this case, the entire amount (Profit + Capital) will be the Rabb-ul-maal's. The Modarib will just be an employee earning Ujrat-e-Misl.

The remaining amount will be called (Profit).

This profit will be shared in the agreed (pre-agreed) ratio.
Roles of the Modarib:

- Ameen (Trustee): To look after the investment responsibly, except in case of natural calamities.
- Wakeel (Agent) : To purchase from the funds provided by Rabb-ul-Maal
- Sharcek (Partner): Sharing in any profit Zamin (Liable): To provide for the loss suffered by the Modarabah due to any act on his part.
- Ajeer (Employee): When the Modarabah gets Fasid due to any reason, the Modarib is entitled to only the salary, Ujrat-e-Misl. In case tlicre is a loss, the Modarib will not gel even llie Ujral-e-Misl.

TERMINATION OF MODARABAH

The Modarabah will stand terminated when the period specified in the contract expires. It can also be terminated any time by either of the two parlies by giving notice. In case Rabb-ul-Maal has terminated services of Modarib, he will continue to act as Modarib until he is informed of the same and all his acts will form part of Modarabah.
If all assets of the Modarabah 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 Modarabah are not in cash form, it will be sold and liquidated so that the actual profit may be determined. All loans and payables of Modarabah will be recovered. The provisional profit earned by Modarib and Rabb-ul-Maal will also be taken into account and when total capital is drawn, the principal amount invested by Rabb-ul-Maal will be given to him, balance will be called profit which will be distributed between Modarib and Rabb-ul-Maal at the agreed ratio. If no balance is left, Modarib will not gel anything.
If the principal amount is not recovered fully, then the profit shared by Modarib and Rabb-ul-Maal during the term ofModarabah will be withdrawn to pay the principal amount to Rabb-ul-Maal. The balance will be profit which will be distributed between Modarib and Rabb-ul-Maal. In this case loo if no balance is left, Modarib will not get anything.

CHAPTER # 9-PRINCIPLES OF SHAR1A GOVERNING ISLAMIC INVESTMENT FUNDS

- EQUITY FUND
- IJARAH FUND
- COMMODITY FUND
- MURABAHA FUND
- BAI-AL-DAIN
- MIXED FUND

PRINCIPLES OF SHAR1A GOVERNING 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 Shariah. 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 Shariah, 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 Shariah. 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 Shariah, 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 Shariah experts are almost unanimous on the point that if all the transactions of a company arc in full conformity with Shariah, 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 Shariah 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 Shariah. Even if the main, business of a company is halal, 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 Shariah experts in the present century. A group of the Shariah 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 halal. Their basic argument is that every shareholder of a company is a sharik (partner) of the company, and every sharik, 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 shareholder to the company to can on its business in whatever manner the management deems fit. If it is known to the shareholder 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 shareholders 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 shareholders, a company cannot give a veto power to each share-holder. The opinions of individual shareholders can be overruled by a majority decision. Therefore, each and every action taken by the company cannot be attributed to every shareholder in his individual capacity. If a shareholder 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 halal 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 tlic same principle is relevant. If a shareholder 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 haram 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 will willfully indulged in a transaction of interest, but this fact does render the whole business of a company as unlawful. Conditions for investment in Shares.

In the light of the foregoing discussion, dealing in equity shares can be acceptable in Shariah subject to the following conditions:

1. The main business of the company is not violative of 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 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 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 shareholder 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 illiquid 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 assets of a company arc 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 ignorable 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 arc 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 Shariah. An Islamic Equity Fund can be established on this basis. The subscribers to the Fund will be treated in 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 dividend 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 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 the price can be allocated for (the interest received by the company. It is obvious that if all the above requirements of the halal shares are observed, then 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 ignorable as compared to bulk of line 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 halal assets only.

Although this second view is not without force, yet the first view is more precautions 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 there from, 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 mudaribs 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 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 1 at the end of every financial year.

However, it is necessary in Shariah 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 Ijarah fund. 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 'sukuk' — a term recognized in the traditional Islamic jurisprudence. Since these sukuk 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 sukuk 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 sukuk certificates will be determined on the basis of market forces, and are normally based on their profitability.

However, it should be kept in mind that the contracts of leasing must conform to the principles of Shariah 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 halal (permissible) use is possible.

3. The lesser must undertake all the responsibilities consequent to the ownership of the assets.

4. The rental must be fixed and known to the party's right at the beginning of the contract.

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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 Modarabah, because Modarabah, 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, Modarabah 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 Shariah, it is necessary that all the rules governing the transactions of sale are fully complied with. For example:

1. The seller must own the commodity at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in Shariah.
2. Forward sales are not allowed except in the case of Salam and Istisna (For their full details the previous chapter of this book may be consulted).
3. The commodities must be halal. 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 previous chapters 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 Shariah, 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 lliat the portfolio owns some commodities at all times.

MURABAHA FUND.

'Murabaha' 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, and 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 murabaha, 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 murabaha 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 Shariah. 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 lie wants to sell it at a discount, as normally happens in tlie bills of exchange, it is termed in Shariah as Bai-al-dain. The traditional Muslim jurists (fuqah) are unanimous on the point that bai-al-dain with discount is not allowed in Shariah. The overwhelming majority of the contemporary Muslim scholars are of (lie same view. However, some scholars of Malaysia have allowed this kind of sale. They normally refer to the ruling of Shafai School wherein it is held that the sale of debt is allowed, but they did not pay attention to the fact that the Shafai 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 Shariah.

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 offeree. 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 lie 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 Shariah 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 arc 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.

Evaluation of Islamic Banking Practices In Pakistan

Introduction:

Modern banking system was introduced into the Muslim countries at a time when they were politically and economically at low ebb, in the late 19th century. The main banks in the home countries of the imperial powers established local branches in the capitals of the subject countries and they catered mainly to the import export requirements of the foreign businesses. The banks were generally confined to the capital cities and the local population remained largely untouched by the banking system. The local trading community avoided the "foreign" banks both for nationalistic as well as religious reasons. However, as time went on it became difficult to engage in trade and other activities without making use of commercial banks. Even then many confined their involvement to transaction activities such as current accounts and money transfers. Borrowing from the banks and depositing their savings with the bank were strictly avoided in order to keep away from dealing in interest which is prohibited by religion.1

With the passage of time, however, and other socio-economic forces demanding more involvement in national economic and financial activities, avoiding the interaction with the banks became impossible. Local banks were established on the same lines as the interest-based foreign banks for want of another system and they began to expand within the country bringing the banking system to more local people. As countries became independent the need to engage in banking activities became unavoidable and urgent. Governments, businesses and individuals began to transact business with the banks, with or without liking it. This state of affairs drew the attention and concern of Muslim intellectuals.

Islamic finance is an old concept but a very young discipline in the academic sense. It lacks the required extent and level of theories and models needed for expansion and implementation of the framework provided by Islam. In these circumstances, unawareness and confusion exist as to the form of the Islamic financial system and instruments.

The main difference between the present economic system and the Islamic economic system is that the later is based on keeping in view certain social objectives for the benefit of human beings and society. Islam, through its various principles, guides human life and ensures free enterprise and trade. That is the reason why the conventional banker does not have to be concerned with the moral implications of the business venture for which money is lent.

Socio-economic justice is central to the Islamic way of life. Every religion has the same basic aim. In an Islamic environment, an individual not only lives for himself, but his scope of activities and responsibilities extend beyond him to the welfare and interests of society at large. The Qur'an is very precise and clear on this issue. There are basically three components of an Islamic economic paradigm:

- That as vice-regent, man should seek the bounties of the land that God has bestowed on humanity. From the wealth thus obtained, he should enjoy his own share.

- That he should be magnanimous to others and use a part of the wealth so obtained also for the benefit of his fellow-beings.

- That his actions should not be willfully damaging to his fellow-beings.

Human society in Islam is based upon the validity of law, of life and the validity of mankind. All these are natural corollaries of the faith. Islamic laws promote the welfare of people by safeguarding their faith, life, intellect, property and their posterity. God nurtures, nourishes, sustains, develops and leads humanity towards perfection. Even though an individual may be making a living because of his efforts, he is not the only one contributing towards that living. There are a number of divine inputs into this effort and therefore, the results of such an effort obviously cannot be construed as entirely proprietary.

Whereas the Islamic banker has a much greater responsibility. This leads us to a very fundamental concept of the Islamic financial system i.e. the relation of investors to the institution is that of partners whereas that of conventional banking is that of creditor-investor.

The Islamic financial system is based on equity whereas the conventional banking system is loan based. Islam is not against the earning of money. In fact, Islam prohibits earning of money through unfair trading practices and other activities that are socially harmful in one way or another.

"Those who swallow down usury cannot arise except as one whom Shaitan has prostrated by (his) touch does rise. That is because they say, trading is only like usury; and Allah has allowed trading and forbidden usury. To whomsoever then the admonition has come from his Lord, then he desists, he shall have what has already passed, and his affair is in the hands of Allah; and whoever returns (to it) - these are the inmates of the fire; they shall abide in it [Sura 2:275]."

Not that there was any ambiguity in the Command of Allah. Far be it from Him to give any order to His Servants, which they can not comprehend. The fact is that those who had surplus money and wanted to earn profit did so either by lending it through riba (usury) or by investing it in trade and hypocrites were not prepared to forgo the first option. Hence, they argued that since both were means of earning profit, they were alike and the prohibition of riba did not stand to reason.

The practice of riba i.e. usury was so deep-rooted in society and continuance of the practice was so undesirable, that Allah warned the believers that if they did not desist, they should be prepared for a war against Allah and His Apostle. This warning was heeded by the Muslim Ummah and for more than a thousand years the economies of Muslim states were free from riba. With the ascendancy of Western influence and its suzerainty over Muslim states, the position changed and an interest-based economy became acceptable. Efforts in Muslim countries to revert to an interest-free economy were hampered by many obstacles.

Historical Development:

The first modern experiment with Islamic banking was undertaken in Egypt under cover, without projecting an Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime. The pioneering effort, led by Ahmad El Najjar, took the form of a savings bank based on profit-sharing in the Egyptian town of Mit Ghamr in l963. This experiment lasted until l967 (Ready l98l), by which time there were nine such banks in the country. These banks, which neither charged nor paid interest, invested mostly by engaging in trade and industry, directly or in partnership with others, and shared the profits with their depositors (Siddiqi l988). Thus, they functioned essentially as saving- investment institutions rather than as commercial banks. The Nasir Social Bank, established in Egypt in l97l, was declared an interest-free commercial bank, although its charter made no reference to Islam or Shariah (Islamic law).

Interest-Free Rationale:

The essential feature of Islamic banking is that it is interest-free. Although it is often claimed that there is more to Islamic banking, such as contributions towards a more equitable distribution of income and wealth, and increased equity participation in the economy, it nevertheless derives its specific rationale from the fact that there is no place for the institution of interest in Islam.

Islam prohibits Muslims from taking or giving interest *(riba)* regardless of the purpose for which such loans are made and regardless of the rates at which interest is charged. To be sure, there have been attempts to distinguish between usury and interest and between loans for consumption and for production. It has also been argued that *riba* refers to usury practiced by petty moneylenders and not to interest charged by modern banks and that no *riba* is involved when interest is imposed on productive loans, but these arguments have not won acceptance. Apart from a few dissenting opinions, the general consensus among Muslim scholars clearly is that there is no difference between *riba* and interest. These two terms are used interchangeably.

The prohibition of *riba* is mentioned in four different revelations in the Qur'an. The first revelation emphasizes that interest deprives wealth of God's blessings. The second revelation condemns it, placing interest in juxtaposition with wrongful appropriation of property belonging to others. The third revelation enjoins Muslims to stay clear of interest for the sake of their own welfare. The fourth revelation establishes a clear distinction between interest and trade, urging Muslims to take only the principal sum and to forgo even this sum if the borrower is unable to repay.

It is further declared in the Qur'an that those who disregard the prohibition of interest are at war with God and His Prophet. The prohibition of interest is also cited in no uncertain terms in the Hadith (sayings of the Prophet). The Prophet condemned not only those who take interest but also those who give interest and those who record or witness the transaction, saying that they are all alike in guilt.

It may be mentioned in passing that similar prohibitions are to be found in the pre Qur'anic scriptures, although the 'People of the Book', as the Qur'an refers to them, had chosen to rationalize them. It is amazing that Islam has successfully warded off various subsequent rationalization attempts aimed at legitimizing the institution of interest. Essentially Muslims need no 'proofs' before they reject the institution of interest: no human explanation for a divine injunction is necessary for them to accept a dictum, as they recognize the limits to human reasoning. No human mind can fathom a divine order; therefore it is a matter of faith *(iman)*. Some scholars have put forward economic reasons to explain why interest is banned in Islam. A common thread through all views is the exploitative character of the institution of interest, although some have pointed out that profit (which is lawful in Islam) can also be exploitative. One response to this is that one must distinguish between profit and profiteering, and Islam has prohibited the latter as well. The question is asked as to what will then replace the interest rate mechanism in an Islamic framework.

There have been suggestions that profit-sharing can be a viable alternative. In Islam, the owner of capital can legitimately share the profits made by the entrepreneur. What makes profit sharing permissible in Islam, while interest is not, is that in the case of the former it is only the profit-sharing *ratio*, not the rate of return itself that is predetermined. It has been argued that profit-sharing can help allocate resources efficiently, as the profit-sharing ratio can be influenced by market forces so that capital will flow into those sectors which offer the highest profit sharing ratio to the investor, other things being equal.

Modes of financing in Islamic Banks in Pakistan:

Banks adopt several modes of acquiring assets or financing projects. But they can be broadly categorized into three areas: investment, trade and lending.

Investment financing

This is done in three main ways: a) *Musharaka* where a bank may join another entity to set up a joint venture, both parties participating in the various aspects of the project in varying degrees. Profit and loss are shared in a pre-arranged fashion. This is not very different from the joint venture concept. The venture is an independent legal entity and the bank may withdraw gradually after an initial period. b) *Mudarabah* where the bank contributes the finance and the client provides the expertise, management and labor. Profits are shared by both the partners in a pre-arranged proportion, but when a loss occurs the total loss is borne by the bank. c) Financing on the basis of an *estimated rate of return*. Under this scheme, the bank estimates the expected rate of return on the specific project it is asked to finance and provides financing on the understanding that at least that rate is payable to the bank. (Perhaps this rate is negotiable.) If the project ends up in a profit more than the estimated rate the excess goes to the client. If the profit is less than the estimate the bank will accept the lower rate. In case a loss is suffered the bank will take a share in it.

⁂ Trade financing:

This is also done in several ways. The main ones are: a) *Mark-up* where the bank buys an item for a client and the client agrees to repay the bank the price and an agreed profit later on. b) *Leasing* where the bank buys an item for a client and leases it to him for an agreed period and at the end of that period the lessee pays the balance on the price agreed at the beginning an becomes the owner of the item. c) *Hire-purchase* where the bank buys an item for the client and hires it to him for an agreed rent and period, and at the end of that period the client automatically becomes the owner of the item. d) *Sell-and-buy-back* where a client sells one of his properties to the bank for an agreed price payable now on condition that he will buy the property back after certain time for an agreed price. e) *Letters of credit* where the bank guarantees the import of an item using its own funds for a client, on the basis of sharing the profit from the sale of this item or on a mark-up basis.

⁂ Lending:

Main forms of Lending are: a) *Loans with a service charge* where the bank lends money without interest but they cover their expenses by levying a service charge. This charge may be subject to a maximum set by the authorities. b) *No-cost loans* where each bank is expected to set aside a part of their funds to grant no-cost loans to needy persons such as small farmers, entrepreneurs, producers, etc. and to needy consumers. c) *Overdrafts* also are to be provided, subject to a certain maximum, free of charge.

⁂ Services:

Other banking services such as money transfers, bill collections, trade in foreign currencies at spot rate etc. where the bank's own money is not involved are provided on a commission or charges basis.

Morabaha:

This is a mode of sale and purchase of commodities. The agreement is made between the Bank and a Customer, whereby Bank purchases a commodity and sells the same to Customer on a deferred payment basis. The essential features of the Morabaha are:

i. Existence of a tangible commodity/asset of which physical possession can be taken before use or consumption.
ii. Such commodity or asset has to be acquired from third party (commodity/asset already in the possession of the Customer, cannot form basis of the agreement).
iii. Bank sells the commodity/asset to the Customer.

Local Purchase Morabaha (LPO):

i. Bank and the client sign a **Morabaha Agreement.**
ii. Client submits a request for purchase of commodity/asset by specifying quality, quantity and price.
iii. Bank appoints an agent under an **Agency Agreement** (who could be the client) to purchase the asset/commodity on behalf of the bank.
iv. The Agent purchases the commodity under a **Purchase Order** from third party after obtaining disbursement from the bank through **Receipt** and submits a **Declaration** to this effect.
v. Bank sells the commodity/asset to the Client on a cost plus profit basis and the parties agree on a Purchase Price and Due date.

Morabaha Imports (PAD):

i. Bank and Client sign a **Morabaha Agreement**.
ii. In terms of the Morabaha Agreement, the Bank appoints the Client as its Agent through an **Agency Agreement** to import commodities from time to time.
iii. Client submits an application to establish **letter of credit** and the Bank opens it.
iv. Upon negotiation, the Bank creates an advance in the name of the Client, value payment of funds to the beneficiary.
v. Upon receipt of documents and arrival of goods, the Bank and the Client enter into a Morabaha through a **declaration** submitted by the client. Such Morabaha can be spot, where client pays immediately to retire documents or on a deferred payment basis, if the client wishes to pay later.
vi. In case of deferred payment, the Client signs a **promissory note** for the purchase price agreed and the Bank releases the documents.

﴾ Ijarah (Leasing):

Clients use Ijarah financing mainly for financing purchase of plant and machinery. If assets subject to lease are to be freshly acquired, Bank may appoint an agent (could be the client) to do so on its behalf. If Client has already acquired the equipment, Bank will purchase it from Client and lease it back.

i) Bank and Client sign a Lease Finance Agreement whereby Client agrees to take on lease from the Bank for specified assets for an agreed tenor.
ii) Bank appoints an Agent for acquisition of assets, if not already in possession of Client.

iii) Bank intimates Client of acquisition of assets and delivers to place specified by Client.
iv) Term of lease starts from date Client takes possession of assets, whether constructive or physical.
v) Client pays a monthly, or quarterly rental to the Bank for the use of the assets and by virtue of the agreement, becomes owner of asset only after paying a nominal lease end value.

﴾ Musharaka:

Under Islamic jurisprudence, Musharakah means a joint enterprise formed for conducting some business in which all partners contribute financially and share the profit as per pre agreed upon ratios, while the loss is shared according to the ratios of financial contribution of each partner. The Musharakah is an ideal alternate to replace interest based lending with far reaching effects on both production and distribution of capital.

Profit sharing ratios in a Musharakah depend entirely on the estimated profit the business is able to generate.

The Musharakah is a relationship established, by the parties, by mutual contract and therefore all necessary ingredients of a valid contract must be present.

The risk of loss inherent in this mode of financing, ensures that the Bank fully satisfy itself as to the profitability and feasibility of the business venture as well as to the integrity of its Musharakah partners.

﴾ Mudarabah:

This is a 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-maal" while the management and work is an

exclusive responsibility of the other, who is called "Modarib" and the profits generated are shared in a predetermined ratio.

There are two types of Modaraba namely:

a. **Al Modaraba Al Moqayyadah:** Rabb-ul-maal may specify a particular business or a particular place for the Modarib, in which case he shall invest the money in that particular business or place. This is called Al Modaraba Al Moqayyadah (restricted Modaraba).

b. **Al Modaraba Al Mutlaqah:** If Rabb-ul-maal gives full freedom to Modarib to undertake whatever business he deems fit, this is called Al Modaraba Al Mutlaqah (unrestricted Modaraba). However, Modarib cannot, without the consent of Rabb-ul-maal, lend money to anyone. Modarib is authorized to do anything which is normally done in the course of business. If they want to have an extraordinary work which is beyond the normal routine of the traders, it cannot be done without express permission from the Rabb-ul-maal. Modarib is also not authorized to (a) keep another Modarib or a partner (b) mix his own investment in that particular Modaraba without the consent of Rabb-ul-maal.

Current practices followed at Islamic Banks in Pakistan:

Generally speaking, all interest-free banks agree on the basic principles. However, individual banks differ in their application. These differences are due to several reasons including the laws of the country, objectives of the different banks, individual bank's circumstances and experiences, the need to interact with other interest-based banks, etc. In the following paragraphs, we will describe the salient features common to all banks.

Deposit accounts:

All the Islamic banks have three kinds of deposit accounts: current, savings and investment.

Current accounts:

Current or demand deposit accounts are virtually the same as in all conventional banks. Deposit is guaranteed.

Savings accounts:

Savings deposit accounts operate in different ways. In some banks, the depositors allow the banks to use their money but they obtain a guarantee of getting the full amount back from the bank. Banks adopt several methods of inducing their

clients to deposit with them, but no profit is promised. In others, savings accounts are treated as investment accounts but with less stringent conditions as to withdrawals and minimum balance. Capital is not guaranteed but the banks take care to invest money from such accounts in relatively risk-free short-term projects. As such lower profit rates are expected and that too only on a portion of the average minimum balance on the ground that a high level of reserves needs to be kept at all times to meet withdrawal demands.

Some Difficulties in Pakistan:

Major hurdles faced by Islamic finance houses are the absence of a necessary legal framework and the lack of adequate infrastructure in the banking and investment fields.

The modern banking system is based on the concept that money should be treated like any other factor of production and must earn some return over a period of time. It is argued that the establishment of large-scale enterprises, and hence material progress, is not possible unless there is an agency that can mobilize financial resources from the public by paying them some interest, while lending these resources to entrepreneurs. By charging these entrepreneurs a higher interest, these agencies were able to utilize the difference (called a spread) to meet their expenses and to make some profit for the owners of the agency (i.e. share-holders). Banks were established to fulfill this need and from the beginning were only authorized to perform this function. They were legally prohibited from entering into trade or industry. When the Government of Pakistan decided to introduce an interest-free banking system, this prohibition was removed. After a lot of in-house the banks were told in June 1984 that they were allowed to deal in only 1 to 12 means of financing (only two were classified as "Financing by Lending").

These two permitted lending without interest by charging the actual expense incurred by the banks to meet their cost of operation and Qarde Hasana. All the rest were either trade-related or investment-type models. These included the purchase of goods by banks and their sale to clients at an appropriate mark-up price on a deferred payment basis, in case of default there being no further mark-up. This sale of goods on mark-up is known as Murabiha. Other types of financing were hire-purchase, leasing, Musharika or profit- and-loss-sharing, equity participation and purchase of shares, etc.

Since Murabiha was the type nearest to lending and since it did not require any expertise in buying and selling commodities, bankers limited most of their financing to this type. In order to eliminate the risk of prospective buyers refusing to accept goods purchased by the banks by reason of not being strictly in accordance with the specifications, banks were allowed to appoint the prospective buyer as their agent for the purchase of the goods and later for the sale of the

goods to the buyer's firm. Furthermore, to give as much leeway to the banks, as safeguards of public money, as possible, the Ulama did not fix a waiting period between the two stages of buying and selling.

The banks did not assume the role of trader and Morabiha degenerated into lending on mark-up. The banks rarely hired persons who knew even the basics of trading, nor did they train their existing staff to learn the art. They did not even bother to find out whether their agents had actually purchased the goods or not. The inability, or reluctance of banks and financial institutions to change over their operations from lending to trading has been a serious impediment to the Islamisation of the economy.

The blame does not entirely fall on the bankers. Depositors have become so accustomed to their money remaining safe and yet earning profit that if a bank had really ventured to trade and incurred a slight loss, then the depositors would have immediately demanded their money back causing the bank to go bankrupt. In the existing state of morality this was more likely to happen. It actually did happen to a few investment companies that had started with good intention, but could not go on giving away handsome profits to their depositors.

A lack of seriousness and dedication in those responsible for the implementation was also another great impediment to the achievement the goal of an interest-free economy. Many of these individuals thought that in the present world, there was no alternative to interest, yet something had to be done because of demands from the government. Some, who were more influenced by Western education and culture, thought that interest banking was not prohibited by Islam. Yet others thought that the efforts being made were only superficial and in reality the new system was no different from the existing system.

One weakness in the implementation of the proposals to eliminate interest from the system was that people were not sufficiently motivated to sacrifice a part of their financial interests for the sake of carrying out the commands of Allah (SWT), and The Prophet (SAW). Anyone attempting to change a well-established practice must be prepared to make some sacrifice for this, as arguably no noble cause has been achieved without any sacrifice. The prevailing level of public morality within the existing legal and taxation system of the state made it an up-hill struggle to rid the banking system of interest. And it remains so. Beyond this, there are many avenues of making profit that would have to be forgone and many types of modern banking services which which also could not be provided by a bank working strictly on Islamic principles. For example, they could not keep their surplus cash in fixed or saving deposits. In spite of these difficulties, those who were engaged in the task of Islamisation took it upon themselves to portray as successful the reforms, while those who pointed out the difficulties were labeled as either a cynic or an opponent of the new system.

Anyone who uttered a word of caution was regarded as someone who did not want the experiment of Islamisation to succeed. As a matter of fact, reward in the

Hereafter (aakhirat) should have been the main purpose of Islamisation. It might not have attracted many people, but the foundation would have been firm.

One great obstacle in the realization of the goal of an interest-free economy has been absence of a proper environment. Unfortunately nothing has been done to produce an ideal or a near ideal Islamic environment by government or public leaders. The most important pre-requisite for the enforcement of Shari'ah is a'dl [translation!!!!!!]. Establishment of the rule of law and ensuring justice to aggrieved persons should be the first task of an Islamic state, yet nothing has been done to achieve this end.

One very important requirement of an ideal environment is an inflation-free economy. Inflation erodes the real value of money, meaning that when a person gives a sum of money on loan and receives the same amount back after one year, he has made a net loss. A major source of inflation is deficit financing. The printing of notes to meet budgetary deficit is in fact an injustice to the public, since the real value of their money is consequently eroded. In this respect too, the government's performance is very discouraging. Government borrowings at high interest rates and the quantum of the government's domestic and foreign debts has reached a level which cannot be sustained. There has also been no effort to change the taxation structure so as to bring it to conform with Shari'ah.

Questions of Morality:

The practices in use by the Islamic banks have evoked questions of morality. Do the practices adopted to avoid interest really do their job or is it simply a change of name? It suffices to quote a few authors.[24]

The Economist writes:

….. Muslim theoreticians and bankers have between them devised ingenious ways of coping with the interest problem. One is *murabaha*. The Koran says you cannot borrow $100m from the bank for a year, at 5% interest, to buy the new machinery your factory needs? Fine. You get the bank to buy the machinery for you -- cost, $100m -- and then you buy the stuff from the bank, paying it $105m a year from now. The difference is that the extra $5m is not interest on loan, which the Koran (perhaps) forbids, but your thanks to the bank for the risk it takes of losing money while it is the owner of the machinery: this is honest trading, okay with the Koran. Since with modern communications the bank's ownership may last about half a second, its risk is not great, but the transaction is pure. It is not surprising that *some Muslims uneasily sniff logic-chopping here*.

Dr Ghulam Qadir says of practices in Pakistan:

Two of the modes of financing prescribed by the State Bank, namely financing through the purchase of client's property with a buy-back agreement and sale of goods to clients on a mark-up, involved the least risk and were closest to the old interest-based operations. Hence the banks confined their operations mostly to these modes, particularly the former, after changing the simple buy-back agreement (prescribed by the State Bank) to buy-back agreement with a mark-up, as otherwise there was no incentive for them to extend any finances. The banks also reduced their mark-up-based financing, whether through the purchase of client's property or through the sale of goods to clients, to mere paper work, instead of actual buying of goods (property), taking their possession and then selling (back) to the client. As a result, there was no difference between the mark-up as practised by the banks and the conventional interest rate, and hence it was judged repugnant to Islam in the recent decision of the Federal Shari'ah court.

As banks are essentially financial institutions and not trading houses, requiring them to undertake trading in the form of buy-back arrangements and sale on mark-up amounts to imposing on them a function for which they are not well equipped. Therefore, *banks in Pakistan made such modifications in the prescribed modes which defeated the very purpose of interest-free financing*. Furthermore, as these two minimum-risk modes of financing were kept open to banks, they never tried to devise innovative and imaginative modes of financing within the framework of musharakah and mudarba.

Prof. Khurshid Ahmad says

Murabaha (cost-plus financing) and *bai' mu'ajjal* (sale with deferred payment) are permitted in the Shari'ah under certain conditions. Technically, it is not a form of financial mediation but a kind of business participation. The Shari'ah assumes that the financier actually buys the goods and then sells them to the client. Unfortunately, the current practice of "buy-back on mark-up" is not in keeping with the conditions on which *murabaha* or *bai' mu'ajjal* are permitted. What is being done is *a fictitious deal which ensures a predetermined profit to the bank without actually dealing in goods or sharing any real risk. This is against the letter and spirit of Shari'ah injunctions.*

While I would not venture a *fatwa*, as I do not qualify for that function, yet as a student of economics and Shari'ah I regard this practice of "buy-back on mark-up" very similar to *riba* and would suggest its discontinuation. I understand that the Council of Islamic Ideology has also expressed a similar opinion.

Dr Hasanuz Zaman says:

It emerges that practically it is impossible for large banks or the banking system to practice the modes like mark-up, *bai' salam*, buy-back, *murabaha*, etc. in a way that fulfils the Shari'ah conditions. But in order to make themselves eligible to a return on their operations, the banks are compelled to *play tricks with the letters of the law*. They actually do not buy, do not posses, do not actually sell and

deliver the goods; but the transition is assumed to have taken place. By signing a number of documents of purchase, sale and transfer they might fulfill a legal requirement but *it is by violating the spirit of prohibition*.
Again,

It seems that in large number of cases *the ghost of interest is haunting them* to calculate a fixed rate percent per annum even in *musharakah*, *mudarba*, leasing, hire-purchase, rent sharing, *murabaha*, (*bai' mu'ajjal*, mark-up), PTC, TFC, [30]etc. The spirit behind all these contracts seems to make a sure earning comparable with the prevalent rate of interest and, as far as possible, avoid losses which otherwise could occur.

To sum up, in Dr Hasanuz Zaman's words

... many techniques that the interest-free banks are practising are not either in full conformity with the spirit of Shari'ah or practicable in the case of large banks or the entire banking system. Moreover, *they have failed to do away with undesirable aspects of interest. Thus, they have retained what an Islamic bank should eliminate.*

Conclusion:

The preceding discussion makes it clear that Islamic banking is not a negligible or merely temporary phenomenon. Islamic banks are here to stay and there are signs that they will continue to grow and expand. Even if one does not subscribe to the Islamic injunction against the institution of interest, one may find in Islamic banking some innovative ideas which could add more variety to the existing financial network.

One of the main selling points of Islamic banking, at least in theory, is that, unlike conventional banking, it is concerned about the viability of the project and the profitability of the operation but not the size of the collateral. Good projects which might be turned down by conventional banks for lack of collateral would be financed by Islamic banks on a profit-sharing basis. It is especially in this sense that Islamic banks can play a catalytic role in stimulating economic development. In many developing countries, of course, development banks are supposed to perform this function. Islamic banks are expected to be more enterprising than their conventional counterparts. In practice, however, Islamic banks have been concentrating on short-term trade finance which is the least risky.

Part of the explanation is that long-term financing requires expertise which is not always available. Another reason is that there are no back-up institutional structures such as secondary capital markets for Islamic financial instruments. It is possible also that the tendency to concentrate on short-term financing reflects the early years of operation: it is easier to administer, less risky, and the returns

are quicker. The banks may learn to pay more attention to equity financing as they grow older.

It is sometimes suggested that Islamic banks are rather complacent. They tend to behave as though they had a captive market in the Muslim masses that will come to them on religious grounds. This complacency seems more pronounced in countries with only one Islamic bank. Many Muslims find it more convenient to deal with conventional banks and have no qualms about shifting their deposits between Islamic banks and conventional ones depending on which bank offers a better return. This might suggest a case for more Islamic banks in those countries as it would force the banks to be more innovative and competitive. Another solution would be to allow the conventional banks to undertake equity financing and/or to operate Islamic 'counters' or 'windows', subject to strict compliance with the Shariah rules. It is perhaps not too wild a proposition to suggest that there is a need for specialized Islamic financial institutions such as mudarabah banks, murabaha banks and musharaka banks which would compete with one another to provide the best possible services.

With only minor changes in their practices, Islamic banks can get rid of all their cumbersome, burdensome and sometimes doubtful forms of financing and offer a clean and efficient interest-free banking. All the necessary ingredients are already there. The modified system will make use of only two forms of financing -- loans with a service charge and *Mudarabah* participatory financing -- both of which are fully accepted by all Muslim writers on the subject.

Such a system will offer an effective banking system where Islamic banking is obligatory and a powerful alternative to conventional banking where both co-exist. Additionally, such a system will have no problem in obtaining authorization to operate in non-Muslim countries.

Participatory financing is a unique feature of Islamic banking, and can offer responsible financing to socially and economically relevant development projects. This is an additional service Islamic banks offer over and above the traditional services provided by conventional commercial banks.

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