Shari'ah Standards
For
Interest Free Banking

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TRANSLITERATION OF ARABIC WORDS TERMS AND NAMES.
The following table shows the system which we have adopted in transliterating the letters of the Arabic alphabet:

ء ا	consonantal sound	a	ط	.....	t
آ	long vowel	ā	ظ	.....	z
ب	.....	b	ع	... '	apostrophe
ت	.....	t	غ	.....	gh
ث	.....	th	ف	.....	f
ج	.....	j	ق	.....	q
ح	.....	h	ك	.....	k
خ	.....	kh	ل	.....	l
د	.....	d	م	.....	m
ذ	.....	dh	ن	.....	n
ر	.....	r	هـ ه	.....	h
ز	.....	z	و	consonant	w
س	.....	s	و	long vowel	ū
ش	.....	sh	و	diphthong	au
ص	.....	s	ى	consonant	y
ض	.....	d	ى	long vowel	ī
			ى	diphthong	ai

Short vowels:

ـَ *(fatha)* a

ـِ *(kasra)* I

ـُ *(damma)* u

INTRODUCTION

Financial inter-mediation is considered as a basic necessity for every human society in the past and today. History books have always noted the persistent determination of ancient communities for adopting specific arrangement which satisfy their financial inter-mediation requirements. Creation of money (which liberated production resources and safeguarded means of saving methods) has caused division between individuals, namely, the surplus category, which owns financial resources over their immediate needs. The deficit category which require financial resources more than they actually have. Human societies have recognized the need for adopting certain arrangements that will enable the transfer of the surplus to the category of deficit which will virtually entail more economical growth and development as well as high standards of welfare and prosperity for all people.

By the birth of the specialization era and division of work, many profitable activities have changed into institution with specific functions. The same thing can be said about the financial inter-mediation that had been practiced within the framework of social relationship, when monks working at their monasteries, Pharaoh, tribal *sheikhs* and senior traders etc, undertook the role of financial inter-mediation.

However, things had evolved to specialized institutions conducting financial inter-mediation, namely the banks. Traditional banks had therefore been set up to offer financial inter-mediation through loan (from surplus category) and lending (to deficit category). Conditional profit in loans evolved in order to cover the expenses and achieve profits to depositors. Banks in the beginning were maintaining deposits free of charge.

When fierce competition surfaced between banks, they were unable to attract savings without stipulating terms of profits to the depositors. Therefore, traditional bank became a loan seeking and lending institution whose underlying source of income is the difference between positive and negative interest. But, was it possible for the depositors to give loans directly to the investors without the services of the bank?

Contemporary analysis look at the bank as specialized information institution. Securing of true information, follow up and collection of data are indeed a highly expensive processes, yet such banks apart from individual are enjoying the characteristic of economies of large scale which enables such banks to pursue the above processes in a relatively low expenses.

Therefore the conventional work of the bank had been based on isolation of depositors (surplus category) from investors and those seeking finance for their projects (deficit category), as depositors normally do not give attention to the risks of end lenders, as they only take the risk of depositing their monies at the bank, if there is any.

However, the bank takes the risk of end lenders whom it had separated from sources of money. Though, if the lender fails to cover payment of its debts, then the risk will be borne by the bank itself and in normal cases should be indemnified from its profit or capital. However, observers to development of banks in recent days, see clear debility of the role of commercial banks which are based on the concepts of loan giving and lending in sophisticated economies, mainly because improvements relating to maintaining the information and methods of surveillance have led creditors to lean directly towards contacting the investors. Money markets have therefore played an increasing role in financial inter-mediation because they give the creditors the opportunity of bearing direct risks on behalf of the users of money, while the function of banking institution is management on behalf of others, maintaining service charge and arrangement of deals ... etc, are seen by many observers as a trend which will prevail for long time over the contemporary financial development and will lead, as time passes to a further deterioration in the traditional role of the commercial bank (i.e. isolation of risks).

We would see for example, that the revenues acquired by banks such as service charge are increasingly growing in relation to revenue from profit. For the purpose of illustration, the share of commercial banks decreased in the last twenty years in the total U.S financial assets from 40% to 25%, because they were directed towards management of monies instead of lending. As a result of this different mode, securitisition were widely spread, giving the depositors the chance of bearing the responsibility of direct risk of money.

Model of Interest-Free banking

Islamic bank is best known for its financial inter-mediation function which operates without interest. Since about one century ago, *Muslims* had reached the conclusion that the interest given by banks is the core of forbidden usury, because the increase in the loan which is the fundamental function of traditional banks is considered as part of usury and for this reasons banks were not widely known between *Muslims* except during colonial periods – despite its long rooted practice by the Europeans, since many hundreds years go. *Muslims* had therefore strived, after maintaining independence by their respective countries to establish banking systems that will be harmoniously coherent with the rules of *Shari'ah* (Islamic law). They realized that financial inter-mediation is deemed to have been a basic function in the life of human societies and that *Muslims,* had adopted long time ago certain arrangement which would fulfill the need of financial inter-mediation. Transfer of money from the surplus category (i.e. the number of individuals and institutions that owned financial resources surpassing their immediate demand) to the deficit category (i.e. those who require financial resources over-exceeding what they now acquired) were conducted in the past in accordance with the *Mudaraba* mode. *Mudaraba* is a profit sharing company between two kinds of partners, one with his money, named *Rabb ul-maal* and the other with his work and management, named the *Mudareb* or administrative agent (*'Amil*). Upon contracting, the two parties would agree on the method of dividing the profit between them (for example each would take a half or one would take one third and the other two thirds ...etc.), *Rabb ul-maal* may dictate as many condition as he wishes such as curbing the activity of the administrative agent (*'Amil*) by saying do not sell on credit or do not travel with the money ... etc. The profit in which they are partners will not appear except when money is made into cash *Tandeed.* However, if the money over-exceed the capital, then such increase is considered as a profit. If it is less, then the *Mudaraba* is losing.

If there is any losses, such losses will be in the money and the *'Amil* looses his effort and time, because he has no right in the money therefore, his share is from profit only. *Mudaraba* is a trusteeship agreement because it is based on the honesty and faithfulness of the administrative agent (*'Amil*). The *Mudareb* could not guarantee the capital or the profit except when there is a negligence in discharging the duties and management or malfunction other than what is normally considered required to run business. *Mudaraba* in ancient *Muslim* communities was a widely known contract by which merchants were utilizing the money of the public such as men, woman orphans and widows ... etc, there was no need for legal institution with independent financial liability, auditors and

auditing by foreign entities, because people were marked by honesty and faithfulness much better than people in recent days. Therefore, *Muslims* were able to find a mechanism with which financial inter-mediation through *Mudaraba* can practically be achieved.

Therefore, when *Muslims* endeavoured to find an alternative mode to enable the traditional bank to conduct the function of financial inter-mediation without relying on the mode of taking loans from depositors and then lending an investors in accordance with interest procedures. They found in *Mudaraba* an strong base on which this alternative model could be established.

The underlying difference between the Islamic bank and the conventional bank is that the first conducts financial inter-mediation without isolating the risk factor as in the case of the conventional bank. Based on *Mudaraba* principle, the investors, however sustain the risk of the final user of money, in view of the fact that the function of the bank is the "work" as per the (term *Mudaraba*) and management as per (modern banks term). And the bank acquires fees for its management. Therefore the model of the Islamic bank has in fact adopted the new approach, namely provision of chances to investors by taking direct responsibility.

Al-Mudareb Udareb :
One of the significant forms of *Mudaraba* that had been considered by scholars and inforced by *Muslims* in the past was the mode of *Al-Mudareb Udareb*. This principle is based on the fact that the *Mudareb* (*'Amil*) does not undertake the work himself to achieve the profit but leans toward a third party, normally another *Mudareb* who utilizes the money. However, the second party in the first *Mudaraba* contract is the owner of the money (*Rabb ul-mal*) against the third party, provided there should be no relation between the third party and the owner of money. Majority of scholars have legalized this mode if its approved by the original owner of money. It is quite evident in this case that the First *Mudareb* is only an intermediary person and he will get his share from the profit as the result of this inter-mediation. This is the fundamental concept upon which the model of the Islamic bank is based, considering that it is a nominal entity, on independent financial liability and a legal existence whose main function is to be a *Mudareb* who involves in another *Mudaraba* (*Mudareb Udareb*). The depositors of investment accounts are basically the owner of money. Afterwards when the Interest-Free bank offers the necessary financing to investors and businessmen he will be the owner of money and they are the *Mudareb*. The profit of the bank in this case is the difference between the two rates of profit. In short, we find that the

Islamic bank is a financial intermediation whose function is not far away from the conventional bank, but depends on the profit and loss sharing mode and not stipulation of an increment in the loan.

Sources of money

Sources of money in Interest-Free bank which represent the liabilities in its Balance Sheet are:

The Capital :

The capital represents the contribution of the owners of the bank in its establishment. While the capital in the conventional banks is extremely important for ensuring the rights of depositors, the capital in the Islamic bank guarantee the right of depositors in the current accounts only because deposit accounts would be considered as investment accounts that may be subjected to profit or loss and therefore bank does not guarantee it and would not be obliged to refund it, if it is subjected to a loss. Such activity depends on the mode of *Mudaraba* and the bank in this, is *Mudareb* who should not be responsible for undertaking such deposits except in case of negligence or mismanagement, as mentioned earlier.

Investment Account :

The bank in these accounts is a *Mudareb* as we mentioned here above and the depositors are considered to be the owners of money. It is a joint *Mudaraba* in which the *Mudareb* determines its terms and conditions which are accepted by the owners of money by signing specific form which contains such terms and conditions. Accounts may have a multi terms in accordance with the investors wish e.g. 6 months, 9 months ...etc.

Rates of distribution of profit will be specified in the subscription form which normally differs according to its period. Then monies will be collected in one pool and then invested in projects and profit generating finances, taking into account achieving certain portion of liquidity to ensure enough redemption according to prescribed periods. Islamic banks have considered in its work what is so called constructive *Tandeed*, which shows value of assets, profit and loss via accounting means before the actual liquidation. Though it is considered from *Shari'ah* point of view that profit will not be known except after liquidation of *Mudaraba's* assets (capital). However, bank activity which maintain continuation of transactions with long term approach could hardly achieve such cash liquidation in any time. It is understood that final accounts and the profit and loss accounts in all institutions are considered as accounting records,

even if it reflects the monetary value of assets in the institution but the major portion of these assets may well be in the fixed assets and the debts.

Based on such concept, Interest-Free banks have adopted the method of constructive *Tandeed* as accounting procedures which reflect the monetary values of assets are sufficient for making the division. Money will accordingly be redeemed to owners who wish to withdraw from the investment accounts and their share from profits which are realized constructively will be paid to them till the date on which the withdrawal is made. It is understood that such accounting procedures may be carried out annually by the bank or even every season every month. Constructive *Tandeed* has indeed achieved flexibility and efficiency of the Islamic banking work and is considered to be an important contemporary achievement of a greater theological impact.

Current accounts :

Interest-Free banks came as a substitute to conventional bank whose work is based on interest. They strived to extend all types of services needed by people in banking activity. They have therefore became very keen to offer current accounts to depositors who will maintain cheque books which will enable them to withdraw money at any time they wish (or obtain automatic tellers cards). No increase in these accounts will be maintained because they on call accounts. Almost all Islamic banks offers such type of current accounts and it represent an interest-free loan (i.e. free of usury). The bank here is the borrower and the owner of the account is the lender. Current accounts are on call non-deferred loans which may be redeemed by the customer at any time. Because they are warranted loans by the bank, it will not be subjected to any increase because conditional increase or the increase that is known in any loan is considered to be exactly the forbidden usury. Deposits in current accounts are an important source of funds for Islamic banks. The bank retains certain portion of it as cash reserve and the remainder will be invested within its different investment as is customary in banking activity. Profits that would be achieved will be for the bank (i.e. to its owners), because *al-Kharaj Biddaman* and the bank in this case is the warranter which is entitled to any earning or profit achieved from these deposits.

Islamic Financial Modes :

From above we learned that a Interest-Free bank is a financial inter-mediator whose main function is to mediate between the surplus category (savers) and the deficit category (investors, users). To carry out this function, Islamic Bank requires alternative modes for lending on interest

basis method. These modes through which Islamic banks use to work to provide finance for investment and consumption purposes, in origin are well known contracts in Islamic jurisprudence. Nevertheless, they have been developed to suit the purpose and nature of the bank's activity as a financial intermediator. These modes can be divided into two main categories:

1- The first are those modes which based on debts (credit), and
2- The second are profit and loss sharing modes.

These modes are the vehicle of the Islamic bank for generating assets.

Modes of finance based on debts (credit):

Modes of finance which are based on credit mean those transactions in the bank's books which bring absolute payment commitments by the beneficiaries of finance. Therefore the assets of the Islamic bank will be, in the light of these modes similar to the assets of the conventional bank with one major difference that such assets shall remain fixed in its monetary value and shall never be associated with an outside element unlike the situation in conventional bank. However, regardless of finance upswing witnessed through these modes, but they remain as contracts whose main objects are goods and capital assets and not money. This is however, a fundamental difference compared with the debts at conventional banks which normally generate from loans whose core subject is money. Most important among these modes :

Murabaha to Purchase Orderer :

Murabaha contract is one of well known sale modes among *Muslims* in the past and today. Other than bargaining mode under which negotiation is conducted between the seller and the purchaser about the price, negotiation in the *Murabaha* is focused on the average of the profit. This will certainly oblige the seller to dictate the purchase price and other costs such (carriage and storage) to the purchaser. It is therefore characterized as sale of honesty because it depends on the honesty of the seller in determining the cost.

The fundamental principle of sale is the availability of the commodity at the time of sale. But this could not be available to the bank, because, according to its financial inter-mediation function, which distinguishes it from the merchant who can secure warehouses full of commodities and assets such as cars, airplanes, ships and houses. This is why the concept of ordering the purchase is introduced in the contract, and in other words

the bank purchases the goods and assets if it is ordered by a customer to do so. The text of this order is: Bank purchase that commodity and I shall buy it from you with cost and give you this average profit.

The bank will however, be subjected to a high risk by responding to every customer ordering certain commodity, particularly when we understand that no little time may occur between the order of the customer and completion of the transaction by the bank for making the commodity available. Therefore, the idea of "the obligation of the promise" has always been associated with this mode, as the customer who makes promise to the bank that if the bank purchases and owns the commodity then he will buy it from the bank with a profit, this customer should be serious and obliged to fulfill its promise. If this customer defaults to fulfill its promise, this in fact put the bank into a dilemma because the later has actually owned that commodity (a car for example) because of such promise. Therefore, some contemporary scholars have approved that the bank may obligate the customer to compensate it for loss that occurs to the bank as a result of his default and non-compliance. This damage may take the shape of heavy losses inflected by the bank when it sells the commodity to another customer. If sold at the same price or with a profit, then should not have the right to claim compensation from that customer and in the case of loss the bank will only claim the actual damage.

People tend to seek the good offices of the bank for their need of finance because if they have enough money they would not have resorted to the bank. Indeed such people require to pay the price in a number of installments which will be worked out with the bank. This mode, however introduced the installment process for paying the price. The bank often calculate its profit, taking into account the terms of payment. If the customer, deferred or failed to make payment of some installments, the bank, in this case must not increase or claim compensation because this is the very same thing of usury. If the customer is in straitened circumstances and financial difficulties then he must be left until he becomes in an easy circumstances because the price in the *Murabaha* turns into a debt related to the customer's ***dhimma***, under which the provisions of Islamic jurisprudence shall prevail.

Istisna':

Murabaha is convenient for customers who require to purchase a product or an asset, but how can an Islamic bank offers the necessary finance for those who require to set up factory, a commercial centre or a housing compounds without resorting to taking loans with profit? Islamic banks have created the ***Istisna'*** contract to satisfy this purpose.

Istisna' is based on demanding the workmanship and under which a ***Mustasne'*** person asks a manufacturer (***Sane's***) to make a depicted thing (***masnou'***) such as a wooden cupboard or an instrument made of brass or a building ... etc.

The ***Prophet, peace and prayers be upon him*** had ordered the manufacture of an iron ring for him.

Istisna' is one of the old contracts that had been developed through centuries to suit people's need. Under this contract ***al-Sane'*** the maker undertakes to complete the depicted product in a pre-determined period, while the person requesting the product (***al-Mustasne'***) is obliged to pay the price if it satisfy the terms and description of the depicted product. It is worth noting that the manufacturer (***al-Sane'***) is not obliged to carry out the work himself, whereby if he manage to find the product in the same depicted elements they had been originally agreed upon then he can buy it and hand it over to the person who requested it. He can also order the manufacturing of same product by another manufacturer.

Since the customer requires finance, the financial inter-mediation of the bank can then be carried out by virtue of ***Istisna'*** contract so that the manufactured product (***masnou'***) can be completed, (a commercial building for example), thereby allowing the bank to be a manufacturer. Then the bank conclude an agreement with a contractor to make the product for the bank. The relation here exists between the contractor and the bank and not with that customer in most cases. The bank then pays the price in cash and then the customer makes payment in installments in accordance with the agreed terms of payment. It goes without saying that the price which will be paid by customer to the bank in installments will be more than the price paid by the bank in cash to the contractor, the difference between them is the bank's profit.

Salam :

Salam is one of the permissible contracts conducted by *Muslims* in the past. In essence, *Salam* is intended for finance purposes. *Salam* is a sale contract under which the receipt of sold product shall be deferred but payment of the price shall be expedited. As such it is good for peasants who receive money at the beginning of the agricultural season and buy seeds and other requirement and after harvesting the product they will hand over this product as *Salam* the purchaser. Products which may be sold as *Salam* are actually a non-specified products according to their nature and place of production unless they are

pre-described as a liability therefore *Salam* is good for goods that have similarity in nature (***Mithliyaat***) such as wheat, barley and corn ... etc. People's need for *Salam* contract still exist because as we said it a financial contract and is therefore good for banks work. The bank can buy similitude products (***Mithliyaat***) and pay the price forthwith and thereafter receive the goods that it has purchased and sell them.

In order to remain within the framework of financial inter-mediation without committing itself to the work of the traders or as need for warehouses or stores, the bank should enter into a parallel *Salam* contract in which there will be the seller (whereas it has been the purchaser in the first contract). The similitude product shall then be sold by description (not exactly what it had already bought because it would not be permissible to sell the product before receiving it). Delivery period may then be as same as the procurement period. With that the profit of the bank shall be the difference between the purchase price and selling price. The need for parallel *Salam* may exist in the cases of procurement of big quantities by the bank and selling them to several purchasers but at less quantities or in the international transaction and commodity markets.

Lease Ending with Ownership :

Lease contract is an ancient well known instrument under which asset's benefits will be sold to a lessee for a predetermined period with a predetermined price. Financial mode of lease ending with ownership was known by international banks circles more than a century ago but since then it had been modified to match the *Shari'ah* requirements and to suit financial purposes.

The client who requires to obtain an asset (an airplane for example) may get a loan from the conventional bank to buy such plane and pay its price in five years time. He can also maintain such plane from the Islamic bank through a lease contract ending with ownership. In such case, the bank will purchase that airplane and then lease it to that client for five years (for example) with a prescribed and fixed monthly rental charges. Then the bank enters into a commitment under which it will make the necessary undertaking to sell such plane to the client if he so wishes at certain price at the end of the five years period.

Presumably, if the lease contract continues till its termination period, rental payments and selling price will be calculated so as to cover the whole cost borne by the bank, in addition to its customary profit. So, it is an intermediate stage between the lease and the deferred selling.

Lease contracts ending with ownership normally commence with a pledge by the client under which he undertakes to hire such asset when it becomes in the possession and ownership of the bank in the prescribed date.

Someone may argue that there is no significant difference between such contract and the *Murabaha* contract. In fact Islamic banks tend to give preference to lease contracts ending with ownership because they represent a remedy for an underlying problem that exist in the *Murarbaha* contract where the ownership of sold assets in *Murabaha* contracts are immediately transferred and their price will remain as debts whose payment shall consistently become liable by the client. If he deferred or prolonged payment of the installments, the bank will find itself in a dilemma particularly because filing of law suits are extremely expensive and time consuming besides, execution of collaterals is not always favoring. However, any increment over the debt to compensate the bank for delay shall be considered as non-permissible by virtue of Islamic Law (*Shari'ah*). Asset under the lease contract ending with ownership is again characterized by the quality of being under the name and property of the bank until all rental payments are made. However, if the client deferred, or becomes bankrupt, it would then be easy for the bank to retrieve that asset and sell or hire it to another party without resorting to judgement.

Finance Modes based on
Participation in Profits & Loss

Undoubtedly finance modes based on participation in profits and losses are the most distinctive elements for the Islamic banks compared with the conventional banks. Notwithstanding its limited prospects compared with modes of finance which are based on credit, yet they are always subjected to improvement and development. It is an increasing trend that can never be omitted in the activities of Islamic banks.

Finance modes depending on participation in profits and losses mean such modes in which the beneficiary client shall not be obliged by anything except perfection of performance, management and non-deferment of payment of the bank rights and dues if it is entitled to any profit or a capital. The bank will remain a partner in the risks that may be caused to the project which is intended for finance. Important among these modes are :

Mudaraba **:**

It is obvious from above narrative that *Mudaraba* is in essence a financial mode that fulfill the requirements of traders, businessmen and professional entrepreneur who are associated with trade and setting up of projects ... etc. However, the purpose of *Mudaraba* may involve any profitable and profit generating activity. It may also turn to a multi-purpose function within which the worker can determine the focus of its activity. It may also be limited to one or more purposes. The owner of money (***Rabb ul-maal***) may set his own condition for the *Mudareb* provided that the administrative agent '*Amil* must not be held as a guarantor for the losses which may be incurred but he may guarantee the restoration of loss if he failed or abused or neglected to abide by conditions.

No doubt the success of *Mudaraba* contract depends on the honesty of the *Mudareb* because he will be at liberty in dealing with the money during the term of the *Mudaraba* as the owner of the money has no right to interfere in his work. Many Islamic bank showed restraint in working with *Mudaraba* because of dishonesty of many people and lack of surveillance to the client by the bank and this indeed represent a risk called moral risk. However, a number of well-controlled institutions which enjoy high level of accounting discipline and transparency in their commercial activity and financial position have benefited from finance by *Mudaraba* due to low level of moral risk.

Musharakah **(Partnership)**

While the entire money is the property of the bank in *Mudaraba*, partnership is something else where the bank and the client are involved in making the required capital available and they virtually become partners in the capital of the intended project according to their share in the capital. In many cases the management of the project will be entrusted to the client who will thereupon be entitled to receive an additional management fee in addition to its profit in the project according to his share in capital. *Musharakah* is therefore a modern financial mode based on *al-Sharikah* and is well known activity in the Islamic Jurisprudence.

Islamic banks have inclined to adopt the legal opinion which permit disparity in dividing the average of profits according to the contribution in the capital so as to give the clients a share in the profits higher than their share in the capital, because partnership as a financial mode may sometimes entails little shares in capital for the clients compared with the bank. However, sharing of losses must always be associated with the shares of partners in capital. In addition to the above-mentioned

partnership contract, Islamic banks have developed a number of partnership modes that serve several purposes and satisfy various clients needs of which is the diminishing partnership.

Diminishing partnership is a finance mode whose purpose is based on acquiring a sizeable asset by a client such as a commercial building or a housing compound ... etc. At that time the bank and that client become copartners in buying such a building. For example the bank contributes with 95% and the remainder to be contributed by the client. As the purpose of the client is to acquire such building through payment of the price by installments, he will enter into an agreement with the bank under which he will hire the share of the bank (if he wishes to live in the building) and shall thereafter buy parts of this share gradually. He will buy in the first year 10% and thereupon the share of bank decreases from 95% to 85% and thus it will eventually become 100 percent the property of that client. Valuation of the share shall be carried out in accordance with the market price and for this reason comes the partnership element which will be in profit as well as in loss.

Letters of Guarantees

Letters of guarantee are considered to be one of the most important banking services that are needed by people today. Banks offers such services against some fee. Letters of guarantee address the potentials that can be rendered by proficient jurisprudence vision and for finding suitable solutions to problems and contentious matters.

Scholars have unanimously see that fees for guarantee may not be permissible because it is classified under non-lucrative contract and as such assumed to be rendered free of charge. Forbidding of the fee has no text in the *Quran* or *Sunnah*. This is only the consensus of scholars. However it should be justified. After thorough testing and study some contemporary scholars found that the reason why the warrant charge is forbidden is the fear that the entire transaction may turn into usury. As the rule has always been that judgement is spinning around the cause, contemporary scholars have studied the cases in which the guarantee change into usury. They found thus can only be true in the cases where the guaranteed party fails to pay his debt to the beneficiary and therefore the bank find itself compelled to pay on behalf of its client and then claiming the debt from the client. If the client made the payment of L.G. fee to the bank he has actually increased the original debt and by doing so the whole transaction is considered to have the semblance of usury. To avoid usury in the above mentioned transaction the bank should always charges for the actual cost which it has born for the services. However, if

there are any addition, it should be accrued to donation or charitable fund. Thus, the Islamic bank is capable of doing this fundamental need.

Collateral and Pledges in Interest-Free Modes

To minimize financial risks and ensure fulfillment of commitment by clients, banks require that clients offer a number of personal and financial collateral and estate pledges finance is given to them. Banks adopt, in many cases a general rule based on the fact that the market value of such collateral and pledges is higher than the fixed debt of the client. As far as traditional banks are concerned all financial operations are deemed to have been direct or indirect loans which must be met by such collateral. However, Islamic financial modes are not absolutely as such.

Regarding financing modes based on debts, it doesn't matter that clients are required to offer such collateral for documentation of the debts. Such collateral may have a higher value compared with the debt, provided that they should be presented after assertion of the debt of the client.

Concerning the financial modes based on profit and loss sharing such as *Mudaraba* and *Musharakah*, such collateral have no grounds because the client is not indebted to the bank. However, the bank may ask him to present collaterals that make his obligation commensurating with other conditions, but should not be a colleteral for security of the capital or the profit. The client, for example is obliged, in *Mudaraba* to retrieve the capital (or its remainder) and the profit (if there is any)to the bank at the date on which the contract is terminated. He should do that as urgent as possible and without delay or deferment. Though the bank may ask its client to give such guarantees only against these commitments. The client, however remains committed to good performance and indemnifying the bank in the case of negligence or mismanagement. The bank may also request the client to present collateral against such actions.

In the lease ending with ownership, the leased asset is the property of the bank and therefore there is no need for such collateral except against good performance and for documentation commitments relating to payment of current installments ... etc.

The Role of the *Shari'ah* Boards in Interest-Free Banking.

As the work of Islamic banks derive its legitimacy from the principles of *Shari'ah* and its requirement in the banking work, Islamic banks have adopted, since their appearance the method of appointing a legal body (based on *Shari'ah*) whose task is to supervise and control their activity and give advice in relation to what is permissible and what is not

permissible in banking transactions. The final report of such body should be approved by It at the end of the year. These *Shari'ah* Boards have a leading role in the Islamic banking activity, not only because their existence is a source of appeasement to the hearts of ardent *Muslims* who abide by *Shari'ah* in their financial transactions but their existence provide an inexhaustible source for development, new financial modes and solutions for the difficulties faced by the bank.

Islamic banks have followed different attitudes in dealing with these bodies as some of these bodies appoint standing *Shari'ah* Board and give it a sweeping authorities and mandate that are normally associated with the higher authorities in the company (i.e. general meeting of shareholders). While some restrict to one adviser employed by the bank. However, some temporarily seek the advice and so on.

And this is all good thing, the best of which is that pioneering regeneration and contributions of researches which are focusing on banking works and the financial works in general.

Sometimes the members of these bodies are prominent scholars in the field of *Ijtihad* (Independent reasoned interpretation). Therefore a number of contemporary efforts aimed at effectively developing the activities of Islamic banks had been created within these bodies, of which are the questions of the constructive *Tandeed* and *Murabaha* as well as others.

Limits of Works to be Carried out by Interest-Free Banking

Islamic banks are currently giving greater care and attention to product development and there is wide competition among them in this domain, and for this reason they offer everyday new services and variety of arrangements which provide more options for liquidity and risks management to investors and depositors of money. Wouldn't Islamic banks be able to carry out such work? Or should its *Shari'ah* obligations represent an obstacle for carrying out the needs of modern society in the fields of banking services?

The answer for this is that *Shari'ah* restrictions upon which the work of Islamic banks are based, differ from the laws and regulations on which any bank can operate. Sometimes laws themselves restrict the ability of banks to proceed and expand in a certain activity. It is understood for example that securitisation which become one of the most important modern financial developments would not have become so important and effective without the enforcement of U.S acts which hinder banks from

operating outside the boundaries of the licensed state of the bank. The trick was to transfer the assets into something like a security whereas it comes under the act of bank financial notes and hence they can be marketed outside the state. It was clear then that the idea in itself is a good idea and very feasible even without inclining to fraudulent acts and therefore it was widely spread throughout the entire world.

Undoubtedly, *Shari'ah* restrictions will make the Islamic bank different from the conventional bank, but it would not necessarily restrict its ability to develop and achieve high standards of efficiency. The most important elements for upgrading the ability of banks to develop and meet people's requirements are the explicitly of laws, the strict abidance by them and enforcement of inexorable supervision by the central bank over the banking work. Having all these in hand, then the *Shari'ah* abidance may become a tool for perfection and achieving quality work that may not be available as the conventional banks. For the purpose illustration, we offer here a practical situation:

The restriction over circulation of debts in *Shari'ah* made it impermissible for investment in companies equities whose assets are over whelmed by debts. Though Islamic Investment Funds adopted a criterion which limits the debt/equity ratio to only one third of the company capital. Debts and their bad consequences on the company is an illicit matter, but there has never been a major investment portfolio that involve only low indebted companies such as that of the Islamic investment funds. When these Islamic funds appear, people discover by practical test that they are more profitable and more stable compared with others, to the extent that one company which is managing such type of fund had been awarded a notable prize in the U.S and indeed it deserve it because it had drawn the attention to this important investment element. The company had done this because it had abided by the direction of its *Shari'ah* adviser.

Shari'ah would not have closed a door for a non-permissible thing but, have opened many doors for permissible and allowable things, and therefore there are no limits for what can be developed by Islamic banks such as useful services that would benefit the people. This does not mean that we should follow the same modes and same procedures, but the domains for development and innovation have no limits at all.

Dedicated to Humanity

You are the best of peoples, evolved for mankind,
enjoining what is right, forbidding what is wrong,
and believing in Allah. (Holy Koran 3:110)

Chapter One

MURABAHA STANDARD

1 - 1 DEFINITIONS
1 - 2 SCOPE OF STANDARD
1 - 3 TEXT OF STANDARD
1 - 4 EXPLANATORY MEMORANDUM
1 – 5 NOTES AND REFERENCES

1 - 1 Definitions

A. ***Murabaha***: the intermediation of a bank in the purchase of a commodity upon the request of a client and then selling same on deferred payment terms for a price equivalent to the total cost of purchase plus a fixed profit (mark-up) agreed upon by both bank and client.

B. Total Purchase Cost: the purchase price of a commodity plus all expenses incurred by the bank in acquiring ownership of such commodity, less any discount the bank obtains from the buyer.

C. ***Murabaha*** Amount: equals the Total Purchase Cost plus the bank's profit.

D. Promise To Buy: the commitment made by a client to the bank that he will buy the commodity indicated or specified in the Purchase Order.

E. Purchase Order: The procedure whereby the client expresses his desire to the bank that he wishes to purchase a certain specified commodity.

F. Profit: the amount that is in excess of the Total Purchase Cost, which the bank obtains as a return in the ***Murabaha***.

G. ***Murabaha*** Debt: the sum owed by the client after completion of Murabaha, which equals the ***Murabaha*** amount, less any advance payment or installments paid.

H. Bank: A financial intermediary that applies the ***Murabaha*** method in financing.

I. Client: A natural person or a body corporate that requests the bank to buy a certain commodity and then buys same from the bank on ***Murabaha*** terms.

J. Supplier: The third party from whom the bank purchases the commodity and sells same to the client.

K. LIBOR (London Interbank Offered Rate): LIBOR is the rate at which major banks in London are willing to lend Eurodollars to each other. It is used to determine the interest rate charges to credit worthy borrowers for large loans. It is the most influential financing index in financial markets.

L. ***Dhimma***: The qualification of a nominal (company) or a natural person to bear obligations and enjoy rights. Hence debts of companies or persons whether incorporeal property or fungible are tied or related to it ***(dhimma).***

1 - 2 Scope of Standard

A. This standard applies to commodities and all tangible assets that are acceptable in law and *Shari'ah*.

B. This standard does not apply to the selling of gold, silver, money and debt receivables.

C. This Standard is confined to applications involving deferred payment sales that are used as a method of financing by banks and other financial intermediaries institutions.

D. This Standard does not apply to cases of Installment Sales.

1 - 3 Text of Standard

1. The bank may not sell a commodity on ***Murabaha*** basis before acquiring ownership of such commodity and actually possessing same.

2. The minimum requirement stipulated by *Shari'ah* to establish possession of a commodity is for the bank to be liable for the perils thereof.

3. It is not objectionable for the client, when requesting the purchase of the commodity, to promise that he will buy it from the bank if the bank buys the commodity and possesses same from a third party.

4. If the client breaks his promise to buy the commodity, the bank shall have the right to sell the commodity it has bought upon the request of that client to a third party, in which case the bank would be entitled to hold the client liable for the actual loss, if any. Actual loss is the difference between the Total Purchase Cost of the commodity and the selling price of same to a new buyer.

5. It is not objectionable for the bank to purchase only the commodities which are required by the clients and which they promise to buy from the bank.

6. The bank has the right, before buying the commodity, to adopt measures to satisfy itself that the client will honor his promise, including requiring the client to provide securities or a guarantee for fulfillment of the promise.

7. The bank may not receive the price or part thereof before acquiring ownership of the commodity to be sold and actually possessing same.

8. The sale contract must specify the Total Purchase Cost.

9. The ***Murabaha*** Amount must be specified as a lump sum known to both parties upon the execution of the contract.

10. The bank has the right to compute the profit acceptable to it in the manner it deems proper and may, in doing so, make use of prevailing financial indexes (e.g. LIBOR) in order to determine the ***Murabaha*** Amount. It is not objectionable to take account of the term of the contract when computing such amount.

11. The ***Murabaha*** Debt may be paid in one payment or by installments.

12. It is not permissible to increase the ***Murabaha*** debt after the client has assumed liability therefor.

13. It is not permissible for the bank to collude with a supplier to sell back a commodity previously bought by the bank from such supplier. Nor is it permissible for the bank to collude with client to buy-back a commodity previously sold by it to that client.

14. It is not objectionable for the bank to appoint the same client who orders the purchase of a commodity as its agent and to empower him to buy and receive the commodity on its behalf and to subsequently sell it to himself on ***Murabaha*** terms, under the following conditions:

    First: that the bank itself shall hand over the amount (i.e.) price to the seller.

    Second: that the commodity shall go through a designated stage in which the bank would be liable therefor, and that the agency does not lead to protecting the bank against liability in case the commodity perishes before the selling thereof.

    Third: that the bank is not itself capable of directly possessing and selling the commodity

15. It is permissible for both bank and client, if there is a mutual interest involved, and provided that no harm is caused to third parties, to agree not

to disclose the client's agency, so that the client would act as principal vis-a-vis third parties

16. It is not objectionable for the bank to obtain security, immediately or in the future, in the form of mortgages or personal guarantees from the client to secure its debt which arises from the ***Murabaha***.

1 - 4 Explanatory Memorandum

1. The bank may not sell a commodity on *Murabaha* basis before acquiring ownership of such commodity and actually possessing same.

Murabaha is a form of purchase and sale that should satisfy the *Shari'ah* requirements of sale contracts and should not involve anything prohibited by *Shari'ah*. The Prophet PBUH, has prohibited selling what is not one's property. This is reported in a tradition by the Prophet PBUH, reported by ***Ibn 'Omar***, may Allah be pleased with him, as follows: "Lending combined with sale in one contract is not permissible, nor two contracts in one nor profiting without liability, nor selling what is not in one's possession". [1]

The Prophet PBUH, said to ***Hakeem bin Huzam***: "Do not sell what is not in your possession." [2]

This is the consensus of jurists, though they differed on the interpretation of the tradition, some being of the opinion that the prohibition applies to the impermissibility of selling what is not in one's possession. Others took the prohibition to apply to merely the selling of an object which the seller cannot deliver to the buyer. ***al-Shaukani*** says, "It is apparent that prohibition relates to the selling of something not in one's possession or under one's control, with the exception of ***Salam*** (sale contract where price is advanced and sold goods are deferred)."[3] ***Ibn Taimiyyah*** says: "The Prophet, PBUH, has forbidden ***Hakeem bin Huzam*** to sell what is not in his possession. What is meant is either the selling of a specific object, in which case he would be selling third parties' property before buying same, which is debatable; or selling what one is not capable of delivering although it is owned by the seller, which is more likely, in which case he would assume liability for something which may or may not occur." [4]

This clause is perhaps referring to two extremely important matters. The first is that it is stipulated that the bank should obtain ownership of the commodity, the subject of the contract, before executing the contract pertaining to the selling of same to the client. The second is that the fact that the bank owns the commodity does not (in itself) entitle the bank to sell it, as it should first possess same before selling it to its client on ***Murabaha*** terms. The bank's ownership of the commodity is established if the bank has bought it from the supplier thereof, or if the bank owns it in common with a partner, or if the bank satisfies other requirements of ownership.

The manner of possessing the commodity is detailed in the next clause:

2. **The minimum requirement stipulated by *Shari'ah* to establish possession of a commodity is for the bank to be liable for the perils thereof.**

This clause is consistent with the view of all jurists (except the ***Malki*** jurists), which provides that it is not permissible to sell a moveable that is bought before possessing same, because this involves ***gharar*** which invalidates the contract, a sale involving ***gharar*** having been enjoined against. This is due to the fact that no one knows whether the sold object will remain intact or whether it will perish before possession same, so that if it perished then the first sale would be invalid and consequently the second sale would be rescinded because it would be based on the first sale. There is a consensus amongst jurists that there is more than one form of possession, depending on custom, as provided in ***Majallat al-Ahkam al-Shar'iyyah*** (Journal of *Shari'ah* Provisions) (according to the ***Hanbali*** School) under Clause 333:

"The possession of every thing is in accordance with customary practice."

Thus the possession of a property is realized by evacuating same and enabling the buyer to make use of same, so that if the buyer is not able to make use of the sold premises then the evacuation will not be satisfy the

condition of possession the bought object. On the other hand, the possession of a moveable depends on the nature thereof. However, the minimum requirement for satisfaction of the condition of possession under *Shari'ah* is the bank's assumption of the liability of the perishing thereof. This means that the commodities risk will shift from the seller to the buyer. This is realized in practice by designating and separating the commodity (from similar commodities). Thus if the sold object is a motor car, the bank should, before selling it to its client, have bought a certain designated car that is specified in a manner that precludes uncertainty(***jahala***). This is done by specifying the make, year of production, color, chassis number, as well as other particulars that distinguish such car from others, so that if it should perish after being purchased by the bank and before being sold to the client, then the bank would be liable for same.

3. **It is not objectionable for the client, when requesting the purchase of the commodity, to promise that he will buy it from the bank if the bank buys the commodity and possesses same from a third party.**

Bank ***Murabaha*** goes through two stages:

The First Stage: is the stage of the selection by the client of a particular commodity or his designating the specifications thereof, and then asking the bank to buy it with the promise that he will buy the commodity from the bank if the bank acquires ownership of and possesses same.

The Second Stage: is the stage of selling on ***Murabaha*** terms, which follows the bank's acquiring ownership of and possession of the commodity.

There is almost no difference among scholars as regards the permissibility of sale on ***Murabaha*** terms in case buyer has the option to complete the purchase or otherwise. This is because classical jurists, who provided for a form of transaction similar to bank ***Murabaha***, have given the buyer the option to buy or otherwise. Thus in his ***"Kitab al-Umm"***, ***Imam Shafi'i***

says: "if a person shows another a commodity and says, 'buy this and I will give you such and such an amount as profit' and the second buys same, then the purchase is permissible..." He then goes on to say: "Thus if he says: 'buy me (a certain) object' and then describes such object, or if he says: '[buy me] any object you wish and I will give you a profit for same', then this is all the same, the first sale is permissible, and this would be an exercise of his option.."[5]

The Jurist's consensus is that the fulfillment of a promise is deemed desirable but is not an obligation. Hence, no court judgment is passable against the promising party in case of non-fulfillment, though the breaking of a promise deprives the promising party of goodness.[6]

Some jurists hold a different view and maintain that a promise is binding and should be fulfilled and that the party making the promise should be obligated to fulfill same. This is the view of the ***Malki jurist Ibn Shubruma***, who is of the opinion that a promise is absolutely binding the promising party is accountable religiously and legally for the fulfillment of his promise.[7] This view is also held by classical jurists such as ***al-Hassan al-Basri***, Calif ***Omar bin Abdul Aziz***. It was also adjudicated by ***Sa'ed bin 'Amr bin al-Ashwa'*** [8] So did Judge ***Ibn al-'Arabi***, who says: "In our view a promise must be fulfilled in all cases unless there is a justifiable reason for not doing so."[9]

Two opinions are held by ***Malki*** jurists as regards the details of the promises that ought to be fulfilled:

The First: provides that a promise is binding and the fulfillment thereof is binding if the promise is made conditional, even if the party to whom the promise is made has not started to fulfill the stipulated condition.[10]

The Second: provides that a promise is binding and the fulfillment thereof is binding and a judge may obligate the promising party to fulfill same, if the promise is conditional and the promised party has initiated fulfillment of the stipulated condition.[11]

It should be pointed out that the nature of contemporary banking activity requires a certain measure of obligation in transactions and of seriousness with respect to the promises made by the two parties. Therefore, adherence to the view of the majority of jurists that the promise is not binding on either party, such that each is free to complete the transaction or otherwise, is not consistent with current practice whereby people's dealings are duly executed and binding; not to mention the fact that mischief resulting from non-fulfillment of a promise by far outweighs the mischief resulting from being bound to fulfill the promise.

In light of the aforementioned, many contemporary jurists are in favor of the view that a promise to buy emanating from the client should be binding. This is indicated in a ***"fatwa"*** (legal opinion) issued by the Second Islamic Banking Conference held in Kuwait in 1403 H., corresponding to 1983 G., which reads as follows: "... As regards the promise and its binding effect on the party ordering (the purchase) or on the bank, or on both, it is more conducive to the safeguarding of the interest of the bank and the client, as well as to the stability of transactions, to adopt the view of the binding effect of the promise, which is acceptable under *Shari'ah*, and each bank is free to adopt its own view as regards the binding effect of the promise..." The binding effect of the promise in the ***Murabaha*** sale is the subject of a ***fatwa*** by the Academy of Islamic Jurisprudence of the Organization of the Islamic Conference given at the Fifth Conference Session held in Kuwait in 1409 H., corresponding to 1988 G., which ***fatwa*** reads as follows: "A promise to buy, which is unilaterally made by the party giving the order, or the party being ordered to buy, is religiously binding on the party giving the promise, unless there is a justifiable cause [to the contrary]. Promise is binding, in law, if it is made conditional on something and the promised party has initiated action on account of which the promised party incurs expenses as a result of the fulfillment of the promise. The binding effect is determined in such case either by fulfillment of the promise or by making compensation for the damage actually sustained as a result of non-fulfillment of the promise for no justifiable cause."

In view of the aforementioned, Islamic banks have adopted the standard of the binding effect of the promise, in variable degrees, in order to preclude disputes with their clients and to prevent the damage they may sustain if clients are not obligated to fulfill their promises, which damage and mischief by far outweigh, in the opinion of many jurists, those that result if the standard of the non-binding effect of promises is adopted.

4. If the client breaks his promise to buy the commodity, the bank shall have the right to sell the commodity it has bought upon the request of that client to a third party, in which case the bank would be entitled to hold the client liable for the actual loss, if any. Actual loss is the difference between the Total Purchase Cost of the commodity and the selling price of same to a new buyer.

This clause indicates the reason for the binding effect in bank ***Murabaha***. Thus pursuant to the above mentioned resolution of the Academy of Islamic Jurisprudence, which is based on the preponderant opinion of ***Malki*** scholars, the binding effect of the promise on the client does not at all mean obligating him to complete the purchase, because a purchase presupposes mutual acceptance. However, it provides that the client shall be obligated to make compensation for the damage sustained by the bank as a result of the bank entering into a purchase, on the basis of the client's promise, which it would not have entered into if it had not been for the client's promise to buy same.

As indicated in the above mentioned resolution of the Academy of Islamic Jurisprudence, the binding effect is determined "either by fulfillment of the promise or by making compensation for the damage actually sustained [by the promised party] as a result of non-fulfillment of the promise for no justifiable cause."

In case the client did not wish to fulfill his promise and complete the transaction, the bank would sell the commodity to a third party at market current price, so that if the selling results in a loss beyond the actual

purchase cost, then the client shall be obligated to compensate the bank for such loss, in implementation of the juristic rule which says: "Neither harm shall inflected nor reciprocated", Islamic *Shari'ah* having prohibited the inflicting of injury on oneself, let alone on others.

The loss which the bank is entitled to compensation for is the actual loss represented by the difference between the total purchase cost and the selling price to the third party, but does not include compensation for profit lost by the bank as a result of non-completion of the first sale, which is known in banking practice as "the opportunity cost".

5. It is not objectionable for the bank to purchase only the commodities which are required by the clients and which they promise to buy from the bank.

This clause gives a picture of the activities of contemporary Islamic banks, with respect to their function as providing financing to their clients in a manner consistent with *Shari'ah* standards, and that they do not perform the function of merchants who buy commodities and hold on to them pending the rising of prices. Their actual role is to purchase the commodities which clients are interested in, and which they ask the banks to purchase and resell to them. Hence, they buy commodities only upon the request of a client.

There is no harm, from *Shari'ah* point of view, for Islamic banks to purchase commodities only upon the request of their clients. This is because **halal** (permissible) purchase does not necessarily imply that a person should only buy commodities for use, possession or personal consumption. A person may buy only those commodities for which he is certain there are buyers as long as this is consistent with the *Shari'ah* requirements of a sale contract. ***Ibn Taimiyyah*** says: "A buyer may buy a commodity to benefit therefrom or to trade therewith, both objectives being permissible, as unanimously agreed by Muslims [Scholars]..."

He concludes as follows:

"The basic principle of this subject is that: actions are judged according to intentions and each person will be recompensed on the basis of his intention. Thus if he intends what Allah has made lawful, then there is no harm. But if he intends what Allah has made unlawful, and manages to realize what he has intended through deception, then he will be recompensed accordingly. Conditions are those considered as such by people, and sale is what they consider as such, and a lease is what they consider as such."[12]

There is no doubt that one of the aims of Islamic banks is to rid Muslims of usury by providing permissible alternatives that are based on the contract of sale, partnership and others. As we pointed out in the introduction, it is not in the interest of banks nor is it wise for them to occupy the position of merchants. It is, rather, better that the role of banks should be that of a mediator that buys commodities from the suppliers thereof in cash upon the request of clients and consumers and sells same to them on deferred payment terms.

The application of ***Murabaha*** transactions carried out by Islamic banks finds jurisprudential support in what ***al-Shafi'i*** has said in his ***"Kitab al-Umm"***: "if a man shows another man a commodity and says, 'buy this and I will give you such and such an amount as profit' and the second man buys same, then the purchase is permissible..." He then goes on to say, "Thus if he says: 'buy me (a certain) object' and then he describes such object...and I will give you a profit for same', then this is all the same, the sale is permissible..."[13]

This is also the opinion of His Grace ***Sheikh Abdul Aziz bin Abdullah bin Baz*** (The grand Mufti of Saudi Arabia) in answering the following question: "What is your opinion in a case where a client of an Islamic bank wishes to buy goods costing S.R.1,000 and shows or describes same to the Islamic bank, promising that he would buy them from the bank on the basis of a ***Murabaha*** contract that provides for a one year deferred payment terms and a profit of S.R.100, so that, after the bank buys the goods from the owner thereof, the total price would be S.R.1100, this being without obligating the client to fulfill his verbal or written promise?"

The Answer: "If all the particulars in the question were true, then there would be nothing wrong with such transaction, provided that the bank has obtained the ownership of the sold goods and that they are in its possession so that they are no longer owned by the seller. This is in accord with [universally applicable] ***Shari'ah*** criteria." The manner in

which ownership is obtained and possession takes place will be dealt with later.

6. The bank has the right, before buying the commodity, to adopt measures to satisfy itself that the client will honor his promise, including requiring the client to provide securities or a guarantee for fulfillment of the promise.

The bank [may] exert all efforts to make sure that its client who asks it to buy the commodity and sell it to him on ***Murabaha*** terms is serious. To reinforce such seriousness, banks require their clients to provide a certain sum of money that would be a kind of security for fulfillment of their promises. Such a sum is called "margin of seriousness" in Islamic banking jargon.

The margin of seriousness may be considered as a sum that is mortgaged against a future debt, which is in application of the views held by ***Hanafi*** and ***Malki*** scholars, who do not stipulate that a debt, which it is permissible to secure by a mortgage, should have been actually received, as it is permissible for the mortgage to be effected against an anticipated debt. ***al-Zaila'i*** says: "Because what is anticipated is made akin to what actually exists in consideration of need; indeed it is considered as existing from the *Shari'ah* point of view because a mortgage is tantamount to collection (of the debt), and collection does not precede but succeeds liability, as liability must come first for collection of the debt to be based thereon. And because a mortgage presupposes collection, therefore it is considered as actually collected in the sale contract."[14] Commenting on "***Sharh al-Kharshi***", ***Al-'Adawi*** says: "***Ibn al-Hajeb*** says that a mortgage must be against a debt actually incurred or to be incurred at a later date." He goes on to say: "The mortgage may be what has been previously loaned, bought or delivered for the purpose of performing a certain thing. Mortgage would be effected as a result of the first collection."; and the statement of ***Ibn al-Shas***: "A debt need not have been effected before the mortgage.."[15]

The sum paid in the form of a margin of seriousness is not part of the price, as the sale contract would not yet have been concluded. Hence, when the bank receives the amount of margin of seriousness, it should not collect it as part of the sale price, as the bank would in such case be liable for the charge of selling what it does not possess.

Neither can the margin of seriousness be considered as ***'Arboon*** (deposit). The ***'Arboon*** in the view of jurists, who permit it like the ***Hanbali*** jurists, is payable only after, not before, conclusion of the sale contract.[16] And as the margin of seriousness sum is paid when the promise of purchase is made, it may not be considered as ***'Arboon***. This is supported by the resolution of the Academy of Islamic Jurisprudence which was passed in that respect, and which reads as follows: "An ***'Arboon*** sale is a sale whereby the buyer pays a sum of money to the seller on the understanding that if the buyer did take the object of the sale then the deposit would be deducted from the price, but if he did not, then the deposit (i.e. the ***'Arboon***) would go to the seller."

What applies to sale also applies to leases because leases involve a selling (of usufructs). The types of sales that are excluded are those for the validity of which it is stipulated that either the price or the sold object are delivered at the meeting in which the sale contract is concluded (as in ***Salam***), or both price and sold object must be delivered at the same time (such as exchange of usurious commodities and money). It will apply to Murabaha in the stage of making of the promise (to buy the purchased object). It may apply at the time of conclusion of the ***Murabaha*** contract after the promise has been made.(Resolution No. 76/3/86)

The correct interpretation of the margin of seriousness is that it is a mortgaged sum against a debt to be incurred in the future. Therefore, it is stipulated that it should remain in the possession of the client. Thus, it may, for example, be deposited in an investment account, whose return would go to the benefit of the client, the bank having no right to benefit therefrom as it is a mortgage, as the mortgagee is not entitled to benefit from the mortgage, which is the view of the majority of scholars. This is

prompted by the motive to keep away from usury and from illegally swindling people out of their property, and in application of an authentic tradition reported by ***Abu Hurairah***, may Allah be pleased with him to this effect.[17]

When the bank acquires the commodity and the selling has been completed the margin of seriousness must be dismortgaged, in which case the two parties may agree that the whole or part of the sum be converted into an advance payment of the price.

In case the client reneges on his promise to buy the commodity the bank can sell it to a third party. If the sale does not involve a loss, the bank will refund the whole margin of seriousness (and the return thereof, if any) to the client. But if the selling of the commodity to a third party involves a loss, the bank will be entitled to deduct the loss from the margin of seriousness and the balance is refunded to the client, this being by way of compensation of the damage incurred as a result of not honoring a binding promise, on the part of the client, to buy the commodity when the bank has acquired same.

7. The bank may not receive the price or part thereof before acquiring ownership of the commodity to be sold and actually possessing same.

The aim of this clause is to emphasize the fact that the stage of the promise preceding the sale is not a sale, for it may not be effected except after the bank has obtained ownership and possession of the commodity; the possession of the price or part thereof is inconsistent with this concept, because when the bank receives the price in a legal sale contract, this means that it has [legally] earned same, and it would be entitled not to refund anything therefrom to the client. As to the margin of seriousness paid by the client, the rule governing same has already been indicated.

8. The sale contract must specify the Total Purchase Cost.

The rules governing ***Murabaha*** in banking are the same governing ***Murabaha*** sale in Islamic jurisprudence, in that it is considered a sale based on trust which involves a stipulation that the seller shall inform the buyer a number of things, the most important being:

A. **The capital (or first price):** The bank should indicate in detail to the buyer the price it has paid to acquire the commodity, and it must deduct from such price any discount obtained from the seller. Thus if the bank purchases a commodity the price of which is a thousand and was given a discount of one hundred, then the purchase price of the commodity would be nine hundred, not a thousand, the client being entitled to any discount obtained by the bank, as required by the rules governing sales based on trust.[18]

B. **Expenses paid by the bank to acquire the commodity:** Upon executing a sale contract the bank has the right to include any direct expense related to the commodity and that it may also, with the client's consent, add any indirect expenses related to the commodity. However, since it is seldom the case that the two parties come together to detail the expenses before hand, it is

important that only those direct expenses and fees are customarily added to the price, such as expenses related to transport, storage, letters of credit and insurance should be included. Jurists are unanimously agreed that the buyer may add to the price of a commodity all the actual costs it has actually sustained; indeed, it may add to the price of the commodity all cost it has sustained", as they put it[19] according to habit and custom. The bank may add to the expenses of a commodity only those it has paid in the form of money to third parties. Thus it may not add a certain portion to the price against work performed by one of its employees and so on.[20]

Should it not be possible to determine or to indicate in detail the total cost, it would not be objectionable for the parties to agree on what is customarily in practice, as custom in such cases is valid.

9. The *Murabaha* Amount must be specified as a lump sum known to both parties upon the execution of the contract.

The ***Murabaha*** amount is a new term which refers to the price at which the bank sells the commodity to the client. Such price is determined as follows:

Murabaha amount = total purchase cost + bank's profit = price of sale by bank to client.

The total purchase cost is the sum total of what the bank has paid to buy the commodity plus all costs it has paid up to the moment of selling to the client, i.e. what bank has sustained (see clause 8 above).

The ***Murabaha*** amount or the price for which the bank sells the commodity to the client is determined by adding the bank's profit to the total purchase cost, as indicated above. Accordingly, such price should be specified as a lump sum upon the execution of the contract. The majority of ***Malki***, ***Shafi'i*** and ***Hanbali*** scholars are agreed that explicit knowledge of the price is a pillar of the sale contract, while ***Hanafi*** scholars consider the determination of the price one of its conditions. They consider the

pillar of the sale contract as being mutual offer and acceptance, while anything else is a (mere) condition.[21]

In any case, prior knowledge of the price by the contracting parties before execution of the sale contract is necessary for precluding any unknown element ***(Jahala)*** and uncertainty (***gharar***) that lead to conflict. Knowledge of the price presupposes determination of same quantitatively and qualitatively (amount and kind) and no unknown variables or those that can be determined in the future may be left unspecified when determining the price, as when the sale is concluded and the price is made to depend on LIBOR at a certain time in future.

Jahala and usury can not disappear if the price is determined in the contract with the provision that it is likely to change in response to the variability of LIBOR. Stipulating a price increase after the conclusion of a sale contract is tantamount to increasing the amount of a debt that is owed, which is sheer usury.

Therefore, the ***Murabaha*** amount should be specified as a lump sum expressly known to both contracting parties when executing the sale contract, in order to preclude ***gharar***, ***jahala*** and usury.

10. The bank has the right to compute the profit acceptable to it in the manner it deems proper and may, in doing so, make use of prevailing financial indexes (e.g. LIBOR) in order to determine the *Murabaha* Amount. It is not objectionable to take account of the term of the contract when computing such amount.

In a ***Murabaha*** sale it is stipulated that the bank shall specify its profit when selling the commodity to a client, because profit is part of the price, and knowing the price is a condition for the validity of sales. [22]The bank may determine its profit as a lump sum added to its costs, or as a percentage.[23] The method used by the bank to determine the profit which it adds to the purchase price is up to the bank alone.

As Islamic banks sell their clients the commodities and defer payment of the price, they usually take two elements into consideration: **The first:** is the time in which the client will pay the ***Murabaha*** debt. **The second:** is the financing indexes prevailing in the market.

First: banks take the time element into account when determining profit, which increases with the length of the time agreed on when the bank and the client contract for payment of the price. For example, profit should be 10% if payment would be effected in one year, and 20% if effected in two years. Scholars are agreed that this is permissible, for they maintain that the time has a portion of the price. The author of ***Badie' al-Sanaie'*** says: "Cash terms and credit terms are not alike, because a thing that presently exists is better than a credit, and a thing paid now is more valuable than a thing to be paid later".[24] ***Ibn Aabdeen*** said: "Price is increased if payment thereof is deferred.[25] ***al-Nawawi*** said: "Time constitutes a portion of the price.[26] ***al-Zarqani*** said "...because it (i.e. time) has a portion of price and varies according to time proximity or remoteness". [27] ***Ibn Taimiyyah*** says: "Deferred time of payment accounts for a portion of the price". [28]

It may be argued that this method is similar to financing based on a fixed percentage, which is applied by conventional banks. Therefore, a

distinction must be made between the two cases. Determination of profit on the basis of an annual or monthly percentage, depending on the time of repayment, should take place only before the conclusion of the sale contract, i.e. in the stage of negotiations, this being a basis for determining the price demanded for the commodity. However, when the sale contract is being executed there should be one price fixed on the basis of such calculations, which price shall not be increased after the conclusion of the sale for extension of time of payment or other consideration otherwise. Moreover, it is not permissible to provide in the contract for the margin of the ***Murabaha*** separately from the price. The following was stated in the ***Shari'ah*** interpretative judgements of the Islamic Jurisprudence Academy of the Islamic Conference Organization: "It is not permissible, under *Shari'ah*, to provide in contracts of sales on credit, for installment interest separately from cash price, in such a manner that it (interest) is linked to time (of payment) irrespective of whether the parties to the contract have agreed on the interest rate or have linked it to the current rate of interest (Resolution No. 53/2/6).

The Second: Observing the financing indexes prevailing in the market when the profit margin is determined.

This element is also important in the implementation of ***Murabaha***, for Islamic banks often take account of the prevailing international financing indexes when determining the profit margin they charge from their clients, the most important of such indexes probably being the LIBOR.

Islamic banks are aware of the importance of international financing indexes in view of their need to be constantly aware of where they stand in comparison with conventional banks with respect to both the cost of financing or to the transactions carried out by both. Moreover, there is an extremely important point connected with modern management methods, namely that there should be a benchmark for appraisal of management performance and for determining its success or failure. This is because there are at present no fixed standards in the Islamic world in terms of which the financial performance of firms and companies may be

evaluated. Therefore, most of them, including Islamic ones, make use of the interest rate prevailing in the market as a standard for evaluation and for determining the margin of ***Murabaha*** that enables an establishment to survive in the market.

It may be maintained that it is not objectionable to make use of such indexes, pending the establishment of Islamic standards for performance evaluation as recommended by the participants in the seminar on the problems faced by Islamic banks held by the Islamic Jurisprudence Academy in collaboration with the Islamic Research and Training Institute in 1413 A.H. / 1993 A.D. The recommendation reads as follows: "To accelerate the establishment of an Islamically acceptable index as a substitute for the observance of the interest (usury) rate in determining the profit margin in transactions."

11. The *Murabaha* Debt may be paid in one payment or by installments.

A ***Murabaha*** is a sale in which it is permissible to defer payment of the price or to pay same in installments. Hence, it is permissible for the bank and its client to come to an agreement whereby the client would repay the bank's debt in monthly, quarterly or yearly installments. It is provided in the **Majallat *al-Ahkam al-'Adliyyah*** that "selling on deferred installments basis is valid." (Article 245). ***'Ali Haidar*** said: "Just as it is permissible to defer payment of the price and to pay same in installments when the sale is concluded, similarly it is permissible to defer payment and to repay in installments after the sale is concluded, in which case the time specified for deferred payment would be binding.[29]" ***Sheikh 'Ali al-Khafif*** says: "Just as it is permissible to defer payment of the price it is permissible to pay it in installments. Thus if a house is bought for a thousand pounds, divided into ten installments that are payable on specific dates, such stipulation is valid and binding....[30]" The following occurs in ***Hashiyat al-Dassooqi*** "***Tanjeem*** (Installment plan): is deferment for one or two specific installments"[31]

12. It is not permissible to increase the *Murabaha* debt after the client has assumed liability therefor.

After the bank and the client conclude the sale on ***Murabaha*** basis, the client becomes the owner of the commodity and the deferred price becomes an obligation to be discharged by the client at the time agreed upon by both parties.

The bank may under no circumstances require its client to increase the debt he has assumed, whether on account of the extension of the time of the deferred payment/s or otherwise, because this would be tantamount to the pre-Islamic usury, which is unanimously prohibited and which operates by increasing the amount of the debt when the time designated for the deferred payment is extended. This is typified by the rules: "Give me more time and I will pay you more" as jurists have put it.

13. It is not permissible for the bank to collude with a supplier to sell back a commodity previously bought by the bank from such supplier. Nor is it permissible for the bank to collude with client to buy-back a commodity previously sold by it to that client.

This clause refers to " ***'Inah*** ", which is a prohibited form of buying and selling under Islamic *Shari'ah*. Prohibition of **"'Inah "** occurs in a tradition by the Prophet and is consequently understood by the majority of jurists in the way described below. The Prophet's prohibition is reported by Ibn Omar, may Allah be pleased with him, who said : "I heard the Prophet, PBUH, say: 'If you buy and sell on ***"'Inah "*** terms you will be plagued by a humiliation that will be lifted only when you return to the (teachings) of your religion.'" Quoted by ***Abu Dawood*** 3/274, by ***Imam Ahmad*** in his ***Musnad***, 7/27, corrected by ***Sheikh Ahmad Shakir*** and commented on by ***Ibn Taimiyyah***, who said ; "It is reported on good authority. [32]

The prohibited ***"'Inah "*** in banking transactions occurs when a bank sells a commodity to its client for a price, payment of which is deferred, and then it buys it back from the client for a lower price. Or it occurs when a bank buys a commodity from a supplier for a cash price and then re-sells it back to the same supplier for a higher price, payment of which is deferred. This is a well known trick to circumvent a usurious loan, for the buyer of the commodity does not need the commodity; except in as much as this transaction can hide a usurious loan. Thus he resorts to the trick though a fictitious sale contract by introducing the commodity as an intermediary by buying same and re-selling it back to the seller for a lower price. This form is tantamount to a loan the amount of which is increased by a sum equivalent to the difference between the deferred price and the cash price.

The following occurs in ***al-Moughni ma' al-Sharh al-Kabir***: "He who sells a commodity on credit may not buy it for a price that is less than the

price he has sold it for, unless the quality of the commodity has deteriorated ...."

He also said: "It is not permissible for one to sell a commodity for a deferred price and then to buy it back for a lower price in cash." This has been reported by ***Ibn 'Abbas, 'Aishah, al-Hassan, Ibn Sireen, al-Shu'bi, al-Nakha'i,*** and also approved by ***al-Thawri, al-Awza'i, Malik, Ishac,*** and the ***Hanafis***. But it is permitted by ***al-Shafi'i*** because that lower price may be charged by another seller thereof and hence it is permissible for that particular seller, [because it would be] as though he has sold it for a price equivalent to its [original] price."[33]

Some authoritative jurists believe that the prohibited "***'Inah***" sale is that which is effected through collusion by the seller and the buyer. Referring to usurious tricks, ***Ibn Taimiyyah*** says: "One of its possible pretext is the case of "***'Inah***", i.e. selling a commodity on deferred payment basis and buying same from the original buyer for a lower price. This, coupled with collusion, render both sales prohibited, because it is a trick .... but if no collusion is involved, then the second sale is prohibited to ward-off the pretext for ***haram*** to trickery.[34]

But if no collusion is involved in the sale, or if a period of time elapses during which the quality of the commodity changes, or if the price thereof has changed, then the prohibited form of "***'Inah***" does not apply. The author of ***al-Moughni*** has expressly excluded the case of deterioration of the commodity, saying: "unless the quality thereof has deteriorated." With respect to collusion he said: "But if one sells a commodity on cash terms and then he buys it back on credit for a higher price, ***Ahmad*** is reported by ***Harb*** to have said that this is not permissible unless the commodity has changed, because this is made use of as a pretext to deal in usury, for it is akin to "***'Inah***"; and if he buys it on cash terms again for more than its price then it is like the controversial case of "***'Inah***". Our ***Sheikh*** has said: "It is possible that he may buy it back for more than the original price if this does not involve any collusion or trickery but that it has happened by chance, not deliberately, because selling is legal in

standard and is prohibited only in the case of "***'Inah***" on account of the tradition reported therein, though this is not manifestly apparent because resort to this is more often; hence, what is secondary thereto may not be relegated to it."[35]

This has been authorized by the **'Ulama** (religious scholars) who participated in the Third Juristic Ramadan Seminar organized by Dallah al-Baraka Group. Their fatwa (verdict) provided that "if a buyer on ***Murabaha*** terms does not repay the debt on time, the bank, may buy back what it has sold to the client on ***Murabaha*** terms, or part thereof, for a cash price which is due as a liability assumed by the bank. This applies if a period of time elapses after the ***Murabaha*** sale, during which prices usually change, depending on the commodity, which is termed by jurists as "market change". Such purchase by the bank is not akin to the prohibited "***'Inah***" sale....". This is understood to mean that it is permissible, by mutual acceptance, for the bank to buy the commodities it has sold to its clients, for a lower price, after a period of time. It should be pointed out, however, that if such procedure involves a certain measure of collusion or trickery to charge usury, then it will not be permissible. A case in point would be for the bank to sell its client a car on credit and then a certain appropriate period of time elapses and the client would fail to repay. In such case the bank may buy such commodity in cash for a price lower than the deferred price it has sold the commodity for. This is need to satisfy the above mentioned two conditions, namely the absence of collusion by the bank and the client, and the elapse of a period of time during which the quality of the commodity has changed, leading, logically, to a change in the price thereof, as in such case it would have become a used car. This procedure could become a method that would help solve the problem of debtors who fail to repay. It should be reiterated that all this is conditional on absence of collusion and trickery and on the elapse of a period of time during which the commodity changes or the price thereof changes in the market.

14. It is not objectionable for the bank to appoint the same client who orders the purchase of a commodity as its agent and to empower him to buy and receive the commodity on its behalf and to subsequently sell it to himself on *Murabaha* terms, under the following conditions:

First: that the bank itself shall pay the price to the seller.

Second: that the commodity shall go through a stage in which the bank would be liable therefor, and that the authorization [given to the client] should not lead to protecting the bank against liability in case the commodity perishes before selling same.

Third: that the bank itself is not capable of possession and selling the commodity.

An agency is a permissible contract whether it is for selling or buying. The method proposed in this standard is for the bank and the client to conclude an agency contract whereby the bank appoints the client as his agent to buy the commodity in cash on its behalf from third parties by virtue of its being an agent of the bank, and to sell it to himself on ***Murabaha*** terms for a deferred price, which the client shall repay to the bank in installments as per the agreement between the both parties.

Maintaining that this method is permissible is based on the fact that a ***Murabaha*** contract is lawful, and so is the agency contract. Thus combining them together is permissible under *Shari'ah* if they do not lead to anything precluded under *Shari'ah*. However, it should be pointed out that the authorization given by the bank to its client to assume on its behalf all the responsibility of buying and selling, such that the role of the bank is confined only to payment of money to the client, and to subsequently require from the client to pay a specified profit margin, is all fraught with suspicions, particularly on account of the strong similarity with usurious lending; for the bank would pay to the client a sum of money not knowing whether the client has bought the commodity or not,

and then it requires him at the end to repay such sum plus an increment to be called "profit" by the bank while it may in fact be usury.

On the other hand, it may be objected that under this agency there is the possibility of the client favoring himself. Hence, a great many contemporary "Fatwas" (interpretative judgements) have provided that an agency contract is not permissible in the ***Murabaha*** sale, as indicated by the Ulemas who participated in the Second Ramadan Jurists' Seminar organized by Dallah al-Baraka Group, who maintained that it is not permissible on the grounds that "a ***Murabaha*** sale involves special considerations that make it different from a normal sale, as the bank should have a fundamental prominent role in buying the commodity for itself and handing it over and then selling same to the party ordering the purchase, this being to avoid the method of usurious financing and so that the aspect of guarantee bearing commodity-risk, which makes profit lawful, does not vanish. Hence, the Committee opted for adopting the view which states that such agency, with respect to a ***Murabaha*** sale is not permissible."

A similar ***"Fatwa"*** was pronounced by the *Shari'ah* Committee of the Islamic Bank of West Sudan, to the effect that "It is not permissible to give the client cash to buy the goods he requires under ***Murabaha*** terms. The bank must rather buy the goods and acquire ownership thereof and then sell same to him.[36]

The prohibitions in the above mentioned ***"Fatwas"*** are worth considering if ***Murabaha*** is to be rid of the fictitiousness attributed to it. However, it is possible to formulate the agency process in such a manner as to rid it of such fictitiousness, of the charge of usurious financing and of the favoritism which many jurists consider as the reason for prohibiting the agency in buying.

As regards the permissibility of the agency, whereby the agent is authorized to buy from himself, the statements made by certain jurists seem to indicate that it would be permissible if precautions could be taken

against the client favoring himself. The author of ***al-Moughni*** says: "If the agent is authorized to buy from himself then he may do so. The followers of ***al-Shafi'i*** maintain that one of the two views is not permissible because (the client) would face two conflicting and unreconcilable aims in the (agency) contract: to buy cheaply for himself and to seek maximum profit for the principal.

Our view is that since he is authorized to act on his own behalf it is permissible for him to do so, as in the case of authorizing a woman to divorce herself, and because the reason for the prohibition is that the buyer buys the same for himself, this creates suspicion, for its indication to the non-approval by the principal of such action, which action deviates from the generality of application and permission, which permission is expressly granted in it (the agency), therefore what would be generally understood that (Agency) is not permissible is cancelled by the utterance of (the principal) to the contrary.... ***Ibn Qudama*** is of the opinion that designation of the price would serve the purpose. He says: "As to their statement that the object thereof is negated by contradiction in buying and selling, we can reply that if the principal has specified the price and the client buys at such a price then the aim of securing maximum profit would be excluded and no more than what has taken place would be sought, but if he (the principal) has not specified the price then the selling would be constrained by the price of comparable commodities...."[37]

The above provisions indicate that the possibility of the agent favoring himself is the reason why it is not permissible for the agent to buy from or sell to himself.[38] This reason, however, does not operate in ***Murabaha*** because it is not conceivable that the client would favor himself in ***Murabaha*** because it is a sale based on trust in which it is stipulated that the purchase price be expressly specified. Thus if the purchase transactions made by the client are supported by invoices that are approved by the suppliers then it would be inconceivable for the client to favor himself, as it is not in his interest to do so; indeed, he would sustain damage if he were to raise the price of the commodity, as he would have to pay profit on the surplus amount.

As to the selling price, this will be determined after knowing the purchase cost and the profit agreed upon by both parties. Hence, there would be no possibility of claiming that the client could favor himself if he is empowered to sell and purchase for himself. This would justify maintaining that an agency may be permissible in ***Murabaha*** if performed pursuant to the conditions specified in the text of the standard, namely:

First Condition: that the bank itself pay the price. The aim of this condition is to ascertain that the sum paid by the bank is the selling price of an actual commodity, and that the role of the client is only a procedural one. On the other hand, the condition is meant to preclude the fictitiousness of the contract and the suspicion of usury, as a direct relationship would arise in this case between the supplier and the bank through which the bank would ascertain the price of the commodity to be sold.

Second Condition: is that the commodity shall go through a stage in which the bank would be liable for same. Such stage would be specified and expressly indicated in the agency contract signed with the client.

The importance of this condition is summed up in that it is necessary that the bank should be liable in case the commodity it would sell to the client should perish, so that it would not make a profit without assuming the liability associated therewith, which is contrary to the *Shari'ah* rule which says: "Profit is justified when associated with guarantee (liability)" (***al-Kharaj biddaman***).

Although it is not easy to set up a general method through which the bank is made responsible to guarantee (liable for the integrity of) the sold commodity in view of the variety of commodities and the various forms of the selling thereof, yet the standard would still hold and could be applied to each commodity depending on the nature thereof and the manner in which it would be sold.

Third condition: that the bank itself is not capable of possession and selling the commodity.

In certain cases the bank may not be able to carry out the processes of purchase, acquisition and subsequent selling to its client, as in the buying of petroleum or the purchase of commodities from fields and similar types of purchases that require either certain standard procedures that preclude the bank from engaging in the purchase of such commodities, or in case the process of buying requires efforts beyond the capacity of the bank's employees. In such cases it is not objectionable to exceptionally resort to the client himself to undertake the buying and selling to himself as an agent for the bank, and, at the same time, to observe the above mentioned two conditions, namely, that the bank itself should pay the price, and that the agency contract should provide for a specified and explicit stage in which the commodity would be under the guarantee of the bank (it would be liable for the commodity). In this manner the various forms of the process of sale by proxy, whereby the bank would not be relieved of liability for the commodity, may be visualize. To ascertain that the sale relates to an actual commodity, the bank itself would pay the price, through paying the checks drawn up by the client and drawn on an account allocated for that purpose by the bank.

15. It is permissible for both bank and client, if there is a mutual interest involved, and provided that no harm is caused to third parties, to agree not to disclose the client's agency, so that the client would act as principal vis-a-vis third parties.

The agency may be disclosed (made known to others), or it may be undisclosed. When it is disclosed in ***Murabaha***, the client would buy in the name of the bank, drawing up invoices in the name of the bank, paying the purchase price by checks drawn on an account allocated by the bank for that purpose, and all other purchase requirements (need to be performed).

However, should the bank and the client wish to keep the agency undisclosed vis-a-vis third parties, so that the agent would act as a principal, this would be permissible as long as it is in the mutual interest of both parties, and provided that this does not cause any harm to third parties, and that the requirements of ownership and acquisition are not breached. The *Shari'ah* advisor to the Kuwaiti Finance House, ***Sheikh Badr al-Mutawalli 'Abdul Basset***, has given a "***Fatwa***" to this effect: "it is not necessary to announce that he is an agent of the Kuwaiti Finance House. However, making it known that he is an agent is more conducive to controlling the transactions and to specifying the final authority in the execution of the contract." [39]And in case a dispute should arise with respect to a latent defect in the commodity and should it be necessary to sue the original seller, then the bank's client could act as an agent in the lawsuit and in asserting the claim.

16. It is not objectionable for the bank to obtain security, immediately or in the future, in the form of mortgages or personal guarantees from the client to secure its debt which arises from the *Murabaha*.

It is permissible to secure the debt arising from ***Murabaha***, and which is established in the client's ***dhimma,*** with any type of commonly known guarantees, whether through acquired pledge or mortgage or personal guarantees, because it is a debt arising from a sale. No dispute among ***'Ulama***, as far as we know, that it is permissible to secure a debt that is legally contracted.

'Ulama, on the other hand accept taking guarantees from the would be debtors before transaction has taken place. This is the opinion of *Maliki* and *Hanafi* school of thought[40].

However, two types of securities that Islamic banks resort to must be pointed out:

The First: is the mortgage of bank accounts, whether such are current accounts or investment deposits. Such accounts comprise money that is

often held by the bank, in which case the bank would block same. i.e. the client will not be able to withdraw therefrom as long as the mortgage is in force.

The mortgaging of accounts is common practice among banks. This is done for many reasons, one such reason being that some clients prefer to have the bank provide them with finance rather than to use their own funds.

From the ***Shari'ah*** point of view, the mortgaging of accounts must be treated on a par with the mortgaging of money. It is permissible if such money is given to the bank to keep as a trust and not to benefit from the revenue thereof, because the benefits from the mortgage are the rights of the client, which is possible in the case of investment deposits, as the revenue of that mortgaged deposit would go to the client.

It is difficult, however, to compute the revenue of current accounts because they would be mixed with the bank's funds. In such case one may adopt the opinion of jurists who permit the party in whose favor the mortgage is effected to benefit from the mortgage if the mortgaging party so permits, in which case the mortgage contract executed by bank and client should contain a stipulation that allows the bank to benefit from the current account that is mortgaged with it.

The second: is to mortgage the sold commodity as security for the ***Murabaha*** debt.

This mortgage takes the form of the sale of a moveable commodity to be effected by bank and client. The commodity may be a car, which the bank stipulates that it be mortgaged in its favor until the client pays back all the debt installments which relate to his ***dhimma*** (the liability of which it has assumed). Such a condition is permissible and does not run counter to the contract purport requirement as long as the client is able to benefit from all the advantages provided by the commodity. However, the client's ownership of the commodity would not be complete. Thus he can not

transfer the ownership thereof to third parties except after re-payment of the debt installments. The client is entitled to all dispositions connected with the use of the commodity but he can not dispose of the ownership thereof. This is akin to the provisions governing lands, under which the disposer has access to the benefits thereof to the exclusion of ownership. A resolution passed by the Islamic Jurisprudence Academy in its sixth session, supports this view:

" The seller has no right to keep the ownership of the sold commodity after the sale (has been effected), but it is permissible for the seller to stipulate that the buyer shall mortgage the sold commodity with him to secure his right to retrieve the deferred installments."

1-5 Notes & References

[1] Reported by the Five Imams with the exception of Ibn Majah. See *Muntaqa al-Akhbar ma' Sharh Nail ul-Awtar* 5/179, by al-Shaukani.

[2] Included by Ahmad in his *Musnad* 3/402; and by al-Tirmidhi in *Kitab al-Buyuu'* (Book of Sales) 3/534.

[3] *Nail ul Awtar* 5/253, by Al Shaukani.

[4] *Majmou' al-Fatawa*, by Ibn Taimiyyah (Compendium of Legal Opinions) 20/529.

[5] *Kitab al-Umm* 3/39, by al-Shafi'i.

[6] *Kita al-Muhalla* by Ibn Hazm 8/28.

[7] *Kitab al-Muhalla* by Ibn Hazm 8/28.

[8] The book of *'Omdat al-Qaree* by al-'Aini 13/358.

[9] The book of *Ahkam al-Quran* (The Provisions of the Quran) by Ibn al-'Arabi 4/1800.

[10] The book of *Fateh al-'ali al-Malik* by 'Oleesh 1/255.

[11] See the book of *al-Furooq* by al-Qarafi 4/24, and the book of *Fateh al-'ali al-Maliki* by 'Oleesh 1/254.

[12] *Majmou' al-Fatawa* (Compendium of Legal Opinions) 29/446.

[13] Kitab *al-Umm* 3/39, by al-Shafi'i.

[14] *Tabyeen al-Haqaieq* 6/71. See also *Sharh al-Majalla* by al-Atassi 4/144.

[15] al-'Adawi's comment on *Sharh al-Kharshi.*

[16] *Ghayat al-Muntaha* by Sheikh Mara'i 2/26.

[17] Brought out by Ibn Majah in his *Sunan* and by Malik in *al-Muwatta.*

[18] *Badie' al-Sanaie'* 5/222; *al-Moughni* 4/137.

[19] *Badie' al-Sanaie '* 5/233; al-Moughni 4/137

[20] *al-Moughni* 4/137; *Moughni al-Muhtaj* 2/78; *al-Mabsout* 3/80.

[21] Kuwaiti Encyclopedia of Jurisprudence, Bai' entry.

[22] *Badie' al-Sanaie'* 5/221.

[23] *al-Moughni ma' al-Sharh al-Kabir* 4/259 – 260; *Badie' al-Sanaie'* 5/221.

[24] *Badie' al-Sanaie'* 5/187.

[25] *Hashiyat Ibn 'Abdeen* 5/142.

[26] *al-Majmou', 13/6*

[27] *Hashiyat al-Zarqani 'ala Khalil* 5/176.

[28] *Majmou' al-Fatawa*, 29/499.

[29] *Sharh al-Majalla*, by 'Ali Haidar 1/194.

[30] *Ahkam al-Mu'amalat al-Shar'iyyah*, p.464, by Sheikh 'Ali al-Khafif.

[31] Dassooqi's Commentary on *al-Sharh al-Kabir* 4/346.

[32] *Majmou' al-Fatawa* 29/26-30.

[33] *al-Moughni ma' al-Sharh al-Kabir* 4/45.

[34] *Majmou' al-Fatawa* 29/30-31.

[35] *al-Moughni ma' al-Sharh al-Kabir*, 4/45-46.

[36] *Fatwas* of the Islamic Bank of West Sudan.

[37] *al-Moughni ma' al-Sharh al-Kabir* 5/239.

[38] *al-Moughni ma' al-Sharh al-Kabir* 5/237.

[39] *Shari'ah Fatwas in Economic Matters, the Kuwaiti Finance House, V.2, p.162.*

[40] *al-Moughani* 4/368.

Chapter Two

STANDARD OF BANKING ISTISNA'

2-1 Definitions

A. ***Istisna'*** is a contract in term of which a person buys on the spot something that is to be manufactured which the seller undertakes to provide after manufacturing same using materials of his own according to designated specifications against a determined price.

B. ***Banking Istisna'***: The mediation of a bank in financing the manufacture of a commodity or the construction of a certain asset required by a client according to designated specifications.

C. ***Sane':*** is the seller who undertakes, under an ***Istisna'*** contract to supply the client with ***al-masnou'*** (manufactured object) at maturity (the designated time), whether he himself manufactures the object or whether he has it made by another ***sane'***.

D. ***Mustasne'***: is the purchasing party under an ***Istisna'*** contract, who is bound, pursuant to the contract, to accept the manufactured commodity if it conforms to the specifications.

E. Total ***Istisna'*** Cost: is what the bank pays to the end ***sane'*** plus any costs charged by a third party, which the bank bears, up to the moment of handing over of the ***masnou'*** (manufactured commodity) to the ***mustasne'***.

F. Bank's Profit: is the amount which is above the total ***Istisna'*** cost, which the bank realizes as a return from the process of ***Istisna'***.

G. The ***Istisna'*** Amount: is the sum total of the total ***Istisna'*** cost plus bank's profit.

H. The ***Istisna'*** Debt: is the ***Istisna'*** amount less any advance payment made by the client upon signing the contract.

I. The Parallel ***Istisna'*** Contract: The ***Istisna'*** contract signed by the bank with the end ***sane'*** for manufacturing the [required] commodity.

J. ***Masnou':*** is every thing that is manufactured under an ***Istisna'*** contract, which could be a capital asset, buildings, machines, equipment, consumer or production commodities, software and so on, hereinafter referred to as commodity/ commodities.

K. ***Dhimma***: The qualification of a nominal (company) or a natural person to bear obligations and enjoy rights. Hence debts of companies or persons whether incorporeal property or fungible are tied or related to it ***(dhimma).***

2-2 Scope of Standard

1- This standard relates to the processes of financing the manufacture of the commodities which could be specified through description.

2- It does not include the financing of merchants for obtaining unprocessed natural and agricultural crops and products.

3- Excluded from the scope of this standard is the financing of commodities whereby the ***mustasne'*** provides some or all the raw materials, with the exception of cases in which the ***mustasne'*** provides the land, in which case the contract would be confined to the construction.

2-3 Text of Standard

1. The bank may finance the manufacturing of commodities described in ***dhimma*** through an ***Istisna'*** contract.

2. It is permissible to finance the manufacturing of a commodity under an ***Istisna'*** contract, provided that such commodity is permitted, that it can be determined by description and that it can be manufactured.

3. Banking ***Istisna'*** contract shall be binding upon both parties thereof as soon as it is signed.

4. Banking ***Istisna'*** contract does not bind the bank to perform the manufacturing itself; the bank is bound, however, to deliver the ***masnou'*** (manufactured commodity) in conformity with the specifications agreed upon.

5. In an ***Istisna'*** contract the bank may contract with a third party for manufacturing the asset required by the client. In such a case the bank would be a ***mustasne'*** and the third party a ***sane'***. Such subsequent contracting shall not give rise to any contractual obligations between the bank's client and such third party.

6. In a banking ***Istisna'*** contract, the client may pay the price in cash on the spot when the contract is made, or payment may be made on delivery, or it may be a deferred debt payable by the ***mustasne'*** in one payment or in installments, pursuant to the agreement made by the parties involved.

7. When signing a banking ***Istisna'*** contract the ***Istisna'*** amount should be fixed and known to both parties.

8. Once the ***Istisna'*** amount becomes a debt in the ***mustasne' dhimma***, it may not be altered unless the specifications (of the commodity (to be made) are altered.

9. Providing the raw materials to be used in the manufacturing of the commodity is the responsibility of the ***Sane'***, it is not permissible that the ***mustasne'*** participate in providing such materials, or a part thereof.

10. It is not objectionable for the client requiring the manufacture of a commodity to supervise the work of the end- ***sane'*** with whom the bank contracts for the manufacturing of ***masnou'*** (the required commodity), in order to make sure that the ***sane'*** adheres to the specifications agreed upon by the bank and the client, provided that no direct contractual relationship relating to ***masnou'*** should arise between the client and the end-***sane'***.

11. It is permissible for the bank - in case it obtains from the end-***sane'*** a guarantee against latent defects, proper performance, or commitment to provide maintenance after delivery of the manufactured commodity - to transfer same in favor of the client.

12. It is permissible for an ***Istisna'*** contract to provide for services of installation, training on the operation and maintenance of the asset, or any other services related to ***masnou'***.

13. In a situation in which the bank is a ***mustasne'***, it is not objectionable for it to authorize the ***sane'*** to sell the ***masnou'*** for a profit on its behalf to a third party.

14. It is not permissible for the ***sane'*** bank to authorize the ***mustasne'*** client to directly involve to manufacture and execute the ***masnou'*** on its behalf.

2-4 Explanatory Memorandum

1. The bank may finance the manufacturing of commodities described in *dhimma* through an *Istisna'* contract.

A banking ***Istisna'*** contract is a mode through which an Islamic bank can finance its clients, in response to their desires to obtain a commodity, the description of which can be precisely determined, provided that the commodity is one that is prepared and equipped by manufacturing such as buildings, cars, planes and various equipment.

There is no doubt that people have a pressing need to obtain manufactured products. Thus an ordinary man needs to have his house built; the factory owner needs machines and equipment for his factory; airline companies need to replace their old aircraft with new ones. Thus all these and the likes of them need a party to provide them with these commodities which may not be made before a specific buyer is available. This may be for a technical reason that is attributable to the exclusivity and of the specifications and their variability from one buyer to another. On this may be for the enormous price of the commodity and the apprehension of the seller that the selling thereof may be delayed after it has been manufactured. Thus both individuals and companies need a party to finance such products on the basis of an acceptable Shari'ah method.

An Islamic bank is, therefore, capable, through an ***Istisna'*** contract to provide its clients with the commodities they desire, by concluding with them an ***Istisna'*** contract under which the bank would be a ***sane'*** who undertakes to provide the required commodity pursuant to the specifications determined by the client, provided the latter should be a ***mustasne'***, i.e. requiring the manufacturing [of the commodity], and it is up to him to determine the specifications of the commodity he wishes to be manufactured, and he may specify the contractor or the company that will manufacture for him what he requires. Thus the two parties would agree on determining the total cost of an ***Istisna'*** contract to which is

added the bank's profit. In light of the aforesaid the two parties would sign an ***Istisna'*** contract under which the client undertakes to pay the price in the manner agreed with the bank, whether in installments, or in one payment upon delivery, or after a period of time agreed upon by both parties.

It is well known that the bank does not itself perform the manufacturing, for it is neither a ***sane'*** nor a construction company, but is a party whose function is to provide the financing needed for the manufacturing in an acceptable Shari'ah form. Therefore, the bank would agree with a third party, usually the contractor or the company determined by the client to undertake the manufacturing of the commodity, and would conclude a new contract with such party known as a parallel ***Istisna'*** contract that would include all the conditions and specifications agreed upon in its first contract with the client. However, in the new ***Istisna'*** contract, it is the bank that is the ***mustasne'*** that undertakes to pay the price provided that the ***masnou'*** conforms to the specifications agreed upon, and the third party would be the ***sane'*** responsible vis-a-vis the bank to manufacture the commodity according to the specifications set forth in the contract, while the bank would be responsible vis-a-vis the client. Most often, the bank would pay the total cost during the period of manufacture, as provided in an ***Istisna'*** contract. ***al-Kasani*** says: "Under an ***Istisna'*** contract the ownership of the sold commodity in ***al-dhimma,*** is established for the ***mustasne'*** and the ownership of the price is established for the ***sane'***[1].

2. It is permissible to finance the manufacturing of a commodity under an *Istisna'* contract, provided that such commodity is permitted, that it can be determined by description and that it can be manufactured.

This article relates to the conditions that must be satisfied by the commodities that may be financed through an ***Istisna'*** contract. These conditions are:

A. That the commodity to be manufactured is permitted in Shari'ah, which is a general standard that applies to all sales. Thus it is not permitted to sell or manufacture a commodity or an asset that is not permissible in Shari'ah -such as instruments of impermissible amusement, factories of alcoholic beverages, and similar things - and all that is known to be used for impermissible purposes.

B. That the commodity is describable in terms of type, quantity and quality so that it may be identified in a manner that precludes the existence of an unknown element (***jahala***) and uncertainty (***gharar***). ***al-Kasani*** says: "As to the conditions that must be satisfied for it - i.e. ***Istisna'*** among them is to be permissible, these include the indication of the genre, type quantity and quality of ***al-masnou'*** (the commodity to be made), for it can not be known (identified) without such particulars."[2].

Article 390 of ***Majallat al-Ahkam al-'Adliyyah***[3] provides that "It is necessary in an ***Istisna'*** contract to describe and identify ***al-masnou'*** (the commodity to be manufactured)in a form that satisfies the requirement."

C. That the commodity is one that can be manufactured. ***Istisna'*** is not permissible in the case of natural products which do not involve any manufacturing, such as legumes, fruits, grains, etc. for the selling of such products is not effected through ***Istisna'*** but through ***Salam.***

However, it must be pointed out that a great many natural products are now subjected to processing so that they are no longer sold in their raw (original) form, certain chemicals, preservatives, canning etc.... being added to them. Such processes are carried out by manufacturing companies that specialize in treating such products before offering them to consumers. Such processing may confer on the commodity more value than that of the raw material produced agriculturally. Hence, the manufacturing [processing] of such commodities may be carried out through banking ***Istisna'*** contract. Thus the buying of tomatoes in ***dhimma*** (on credit) should be done on the basis of a ***Salam*** contract, while the buying of canned tomato juice, as a consumer commodity, could be done through an ***Istisna'*** contract. Cotton is also bought on the basis of a ***Salam*** contract, while the buying of cotton textiles could be done through an ***Istisna'*** contract. Thus every thing industrially introduced into a commodity may be financed through an ***Istisna'*** contract, provided it satisfies the above mentioned conditions.

3. Banking *Istisna'* contract shall be binding upon both parties thereof as soon as it is signed.

A banking ***Istisna'*** contract is based on all the terms and conditions of the ***Istisna'*** contract set forth in detail by Hanafi jurists, whose views differ from those of jurists of other schools, who consider ***Istisna'*** as ***Salam*** in industries and apply to it the conditions of a ***Salam*** contract, the most important of which is the binding effect of the contract and the need to provide the capital during the session held for concluding the contract, as will be detailed below.

On the other hand, jurists of the Hanafi School consider ***Istisna'*** a special type of sale distinguished by its own rules just as ***sarf*** (exchange) and ***Salam*** are distinguished by their own rules. As regards the binding effect of an ***Istisna'*** contract, ***Hanafi*** opinions have evolved through passage of time. Thus ***Abu Hanifa***, the Imam of the School, considers an ***Istisna'*** contract as one of the unbinding contracts, in the sense that both contracting parties may quit from it before and after completion of the

work involved, provided that the ***mustasne'*** has not seen the commodity. However, after the ***mustasne'*** has seen the commodity, he has the option to accept same or not, while the ***sane'*** would not have such option. Other say: The option is established for both of them. Others, still maintain that neither has a free option. On the binding effect of an ***Istisna'*** contact, the following occurs in ***Badie' al-Sanaie'***: "No difference in opinion among jurists that it is an unbinding contract on both parties before starting the work...." ".... However, after completion of the work and before the ***mustasne'*** has seen the commodity, it is also unbinding; indeed the ***sane'*** may sell it to whomever he wishes because the contract is not established on the object to be manufactured particularly but relates to a similar commodity in ***Sane's dhimma*** [a commitment to make]...."[4].

Abu Yusuf maintains that if "the ***sane'*** has made the commodity in accordance with the stipulated specifications, then the ***sane'*** would forfeit his option, but the ***mustasne'*** would have the option because the ***sane'*** sells a commodity that he has not seen. Hence he has no option. However, the ***mustasne'*** buys what he has not seen. Hence, he has the option...."[5].

The second opinion is of ***Abu Yusuf***; that there is no option in an ***Istisna'*** contract because if option is to be exercised after completion of the work, this would be detrimental to both parties. The following appears in ***al-Badie'***: "***Abu Yusuf*** is reported to have said that neither party has an option, the narration (opinion) of ***Abu Yusuf*** is that the ***sane'*** would have ruined his material and cut his leather and produced the commodity according to the required specifications. Should the ***mustasne'*** refrain from accepting the manufactured commodity, this would be detrimental to the ***sane'***[6]. The author of ***al-Muheet al-Burhani*** quotes ***Abu Yusuf*** as having said that the contract becomes binding as soon as it is concluded.

When weighing the opinion of ***Abu Hanifa*** against statements ascribed to ***Abu Yusuf***, ancient ***Hanafi*** jurists gave preference to the opinion of ***Abu Hanifa***, who says that an ***Istisna'*** contract is not binding even if the ***sane'*** produces a commodity that conforms to the required specifications[7].

However, it seems that the view that an ***Istisna'*** contract is not binding did not prevail for long, particularly after the industrial development witnessed by the world towards the end of the 19th century. Hence, the ***al-Ahkam al-'Adliyyah*** Journal adopted the opinion of ***Abu Yusuf*** that an ***Istisna'*** contract becomes binding the moment it is signed. Thus Article 392 provides as follows: "Once an ***Istisna'*** has been concluded, neither contracting party shall have the right to renege on same, but if the ***masnou'*** does not conform to the required specifications indicated in the contract, the ***mustasne'*** is free to accept or refuse same.

al-Zarqa says: " It is clear from that, that the Journal's Assembly consider that if an ***Istisna'*** is validly concluded it becomes binding on both parties, once it is concluded, and neither party shall have the option to quit same even before the making of the ***masnou'*** has started. (Thus it is treated) as though it were a firm selling of a specific, existing commodity."[8].

To consider an ***Istisna'*** contract binding is perhaps what is appropriate to the requirements of the present age, because "it is dictated by modern, economic and contractual interests even if not advocated by former jurists. Had they witnessed how ***Istisna'*** has evolved and how it has become involved in the needs and transactions of people and had they seen the detrimental effect on the ***sane'*** when the ***mustasne'*** refuses the ***masnou'*** even though it conforms to the specifications, by invoking the standard of the option of seeing the ***masnou'***, in the case of the ***masnou'*** being a big ship or a high-capacity textile factory or railway train, etc. - had they seen all this in the modern age they would not have hesitated to negate the option of seeing the ***masnou'***, and would have considered an ***Istisna'*** contract binding on both the parties thereof, once it has been concluded...."[9].

There is no doubt that what is appropriate to Islamic books in this age is to consider an ***Istisna'*** contract binding on the parties thereof, the moment it is signed.

This is because the obligation assumed by these banks in an ***Istisna'*** contract vis-a-vis the client makes it indispensable for them to enter into a parallel ***Istisna'*** contract with another firm in order to provide the ***masnou'*** pursuant to the specifications, it being known that the binding effect of contracts is the prevailing feature characteristic of this age, as it contributes to the stability of transactions. Thus if ***Istisna'*** contracts were not binding, then the making and construction of aircraft, space rockets and huge buildings would not be possible. This also applies to the other types of large and intricate industries witnessed in the modern age.

4. Banking *Istisna'* contract does not bind the bank to perform the manufacturing itself; the bank is bound, however, to deliver the *masnou'* (manufactured commodity) in conformity with the specifications agreed upon.

In an ***Istisna'*** contract the bank is a special type of mediator between two parties: the client, who requires the manufacturing of a commodity, and the party that will undertake the making of the commodity. As indicated earlier, the bank performs the role of mediator through entering into an ***Istisna'*** contract with a client, under which the bank undertakes to provide the ***masnou'*** pursuant to the specifications. Then the bank concludes another contract with a third party, under which the bank would be a ***moustasne'***, while that third party would be a ***sane'*** who undertakes to provide the ***masnou'*** pursuant to the specifications. However, no contractual obligation whatsoever exists between the client and the third party. Thus the role of the bank vis-a-vis the client is that of a ***sane'***, but it does not necessarily perform the manufacturing itself, as this is not consistent with the function of the bank and with the well-known nature of banks. The bank's obligations in an ***Istisna'*** contract relates to an object that is contractually described in (his) ***dhimma***, so that when it conforms to the specifications then the client is obligated to accept same.

This tendency on which banking ***Istisna'*** is based reflects the preponderance of the juristic opinion which states that the subject of an ***Istisna'*** contract is the manufactured object, not the work performed,

jurists of the ***Hanafi*** School having differed over the subject of an ***Istisna'*** contract, as to whether it is the work of the worker or the object to be made? Some maintained that the subject of the contract is the work performed by the selling ***sane'*** on the object required, which requires that the ***sane'*** should make such object himself. In this case the ***Istisna'*** contract would be a sale of an object whose specifications are indicated and is to be made by the seller himself[10]. This view is championed by a ***Hanafi*** jurist, ***al-Barda'i***, as ***al-Sarkhasi*** says: "***al-Barda'i*** used to say that the subject of the contract is the work because ***Istisna'*** is the involvement in the manufacturing and it is the work (Labor). Hence, naming the contract after it (i.e. ***Istisna'= manufacturing***)is evidence that it is the subject of the contract."[11].

However, the majority of ***Hanafi*** jurists do not share the view of ***al-Barda'i*** as regards the ***Istisna'*** contract. They rather consider that the object of the contract is the object and not the work. ***al-Sarkhasi*** says: "It is more correct to consider that the object of the contract is the thing to be made under the contract, the mention of manufacturing is only for indicating the descriptions thereof."[12]. ***al-Sarkhasi*** bases this opinion on two facts:

The First: is that if the ***sane'*** has a ready made object, or if he has made it before the conclusion of the contract, and if the ***mustasne'*** takes it then the contract would be valid. This means that if the subject of the contract were the work then the commodity would have to be made after the conclusion of the contract.

The Second: Seeing option is established, but the seeing option is established only through the selling of the object. Hence, it is the sold commodity that is the object of the ***Istisna'***, i.e. the manufactured object.

We adhere to the second opinion because what matters in an ***Istisna'*** contract is to produce the ***masnou'*** in accordance with the specifications. If this is so, then a different ***sane'*** would have no great effect as far as the ***mustasne'*** is concerned. Moreover, this tendency helps in making it

possible to use an ***Istisna'*** contract as a means to finance those who wish to finance various assets.

And yet, it is essential that the bank's undertaking should be to provide a commodity that conforms to the specifications, by having same made. The bank should not seek to provide the commodity by buying same from the market, as it is better to finance such operation through a ***Murabaha*** sale or through ***Salam***, etc...., so that the application of an ***Istisna'*** contract would be to the commodities and assets that are made pursuant to the desire of the client. It must be pointed out that the fact that the bank does not itself undertake the manufacturing necessitates that banks stipulate in an ***Istisna'*** contract they sign with clients that the bank shall be free to contract with other parties to provide the asset to be manufactured provided that it complies with the terms of the contract

5. **In an *Istisna'* contract the bank may contract with a third party for manufacturing the asset required by the client. In such a case the bank would be a *mustasne'* and the third party a *sane'*. Such subsequent contracting shall not give rise to any contractual obligations between the bank's client and such third party.**

This article sets forth the nature of the bank's financial intermediation in the application of an ***Istisna'*** contract and the contractual obligations of both the ***mustasne'*** client, the intermediator bank, and the ***sane'*** third party.

Thus pursuant to an ***Istisna'*** contract the bank is a special type of intermediator that undertakes to provide a ***masnou'*** pursuant to specifications, as indicated in Clause (4) of the provision of this standard. The bank's obligation is to provide the commodity, not the work. This is because the subject of the contract, in the opinion of the majority of Hanafi jurists is the object, not the work, as we have indicated under Clause 4 of this standard. Hence, the bank has the right, in order to fulfill its obligations towards the client, to enter into another contract with a third party that undertakes to manufacture the commodity required. This

contract is termed "a parallel ***Istisna'*** contract", under which the bank would be a ***mustasne'*** and the third party a ***sane'***.

However, this new contract does not include any contractual obligation between the client requiring the making of the commodity and the third party that manufactures same. This implies that if the third party does not fulfill its obligations towards the bank, the bank will still be bound towards the client to fulfill all the conditions and requirements of the contract signed by them. This is because the bank's entitlement to the profit results from its guarantee (assuming the responsibility) of providing the commodity to the client in accordance with the specifications. Therefore, any condition that makes the bank's fulfillment of its obligations towards the client dependent on the third party's fulfillment of its obligations towards the bank, is null and void and vitiates the ***Istisna'*** contract.

6. **In a banking *Istisna'* contract, the client may pay the price in cash on the spot when the contract is made, or payment may be made on delivery, or it may be a deferred debt payable by the *mustasne'* in one payment or in installments, pursuant to the agreement made by the parties involved.**

Hanafi jurists, who are credited with the development of the ***Istisna'*** contract in the manner it is currently applied, did not consider an ***Istisna'*** contract a form of a ***Salam*** contract, as other schools of jurisdiction had done. ***Hanafi*** jurists consider it, rather, a self-contained contract, being a special type of sale whose terms are distinct, just as ***sarf*** (exchange) and ***Salam*** have distinct terms of their own. In view of this, ***Hanafi*** jurists have not stipulated in ***Istisna'*** contract the conditions set forth by jurists in a ***Salam*** contract. Thus according to them it is permissible to advance the capital or to defer the payment thereof. In his definition of an ***Istisna'*** contract, ***Ibn Nujaim*** says: "***Istisna'***, in Shari'ah, is (for ***mustasna'***) to say to a shoe maker or another artisan: 'make me a (pair) of shoes having such and such a measurement, or a jar of such and such a size and weight in such and such a form, for such and such (a price)', and pays the

designated price or does not pay anything, and the other party accepts."[13]. There is no doubt that non-stipulation of advancing the capital in an ***Istisna'*** contract has given it a special advantage, for it makes it combine, as such, between the characteristics of a ***Salam*** contract, in terms of the permissibility of selling an object, which would be non-existent when the contract is concluded, and which would be manufactured at a later date, and the characteristic of an ordinary firm sale, in terms of the permissibility of deferring payment of the price, which need not be paid in advance, as in a ***Salam*** contract[14]. Such advantages are appropriate to modern times.

al-Ahkam al-'Adliyyah Journal has adopted this view and provided under Article 391 that it is not stipulated to advance the capital in an ***Istisna'*** contract: "It is not necessary, in an ***Istisna'*** contract, to pay the price on the spot, i.e. when the contract is concluded." A commentator of the Journal, al-Atassi, justified this in that "The ***Istisna'*** transaction is based on broadness and easiness, while requiring the advance payment of the price is contrary thereto."[15].

The Islamic Juristic Academy has passed its Resolution No. (67/3/7) to that effect: "In an ***Istisna'*** contract it is permissible to defer payment of the whole price or to pay same in installments payable on fixed dates and in fixed amounts."

Banking ***Istisna'*** contract when is applied, it would be based on such opinions. Thus it does not stipulate that the client should advance the price to the bank. Neither does it stipulate that the bank should advance the price to the ***sane'***, but they may defer payment of same and pay it in one payment at the end of the contract, or in installments, pursuant to the agreement made by the two parties. In all such cases, it is stipulated that the price should be definitely specified when the contract is made, as provided under Clause 7 of this standard.

7. When signing a banking *Istisna'* contract the *Istisna'* amount should be fixed and known to both parties.

It is stipulated in a banking ***Istisna'*** contract that the ***Istisna'*** amount should be exactly specified and expressed as a specific sum which would be established in the client's ***dhimma*** (i.e. a debt he should pay). This is because the ***Istisna'*** amount is the sum total of the ***Istisna'*** cost, i.e. the cost paid by the bank to the end-***sane'*** and any other costs paid by the bank to a third party up to the moment of delivery of the ***masnou'***, plus the bank's profit.

It is clear that the ***Istisna'*** amount, as indicated above, is the price at which the bank sells the manufactured commodity to the client. Therefore, it should be exactly specified when the contract is made, as a sale contract stipulates that the price shall be determined in such a manner as to preclude the existence of an unknown element (***jahala***). This is done by specifying the amount as a lump sum, the currency (Saudi Riyal or U.S. Dollar) and the dates of payment. The implication of determining the ***Istisna'*** amount as a lump sum when the contract is made is that it is not permissible to link the ***Istisna'*** amount to unknown variables in light of which it is determined in the future, as in linking the determination of the amount to LIBOR, etc. This is because such linkage leads to make the price undetermined, which is tantamount to the existence of an unknown element (***jahala***) that may vitiate the ***Istisna'*** contract, being a kind of sale contract in which determination of the price is stipulated when the contract is made.

However, if it is not possible to determine or to break down the total cost of the ***Istisna'*** and the two parties agree (on the basis)on which how work is to be performed, as, for instance agreeing that the bank would undertake the construction and debit its cost, provided that the client undertakes to pay such cost plus a certain percentage of profit, then this would not be objectionable, because ignorance of the price in such case would be counter-balanced by knowledge at the end [of the transaction], and as the two parties agree on that, there would be no room for dispute.

It should, nevertheless, be stated that, barring the above mentioned case, it is not stipulated in an ***Istisna'*** contract that the bank should disclose its total cost to the client, as it is the case in a ***Murabaha*** sale, because ***Istisna'*** is not a sale based on trust, for it is listed under negotiable sales, in which disclosure of purchase cost is not stipulated.

8. Once the *Istisna'* amount becomes a debt in the *mustasne' dhimma*, it may not be altered unless the specifications (of the commodity (to be made) are altered.

A banking ***Istisna'*** contract is, as indicated above, a sale contract, under which the asset to be made is the sold object and the price is the ***Istisna'*** amount.

When an ***Istisna'*** contract is concluded, the mutual rights of the two parties are established, the asset to be manufactured is established for the client in the bank's ***dhimma*** (as a liability of the bank), and the ***Istisna'*** amount, i.e. the price, is established for the bank in the client's ***dhimma*** (as a liability of the client). Such is the Shari'ah effect of an ***Istisna'*** contract, as al-Kasani says: "As to the rule governing ***Istisna'***, it is the establishment of the ownership for the ***mustasne'*** of the sold object **in *al-dhimma*** (i.e. the ***Sane's dhimma***), and the establishment of the ownership of the price for the ***sane'***[16].

On this basis, if an ***Istisna'*** contract were made between the bank and the client, the ***Istisna'*** amount would be a debt in the client's ***dhimma*** (for which the client would be liable); hence, the bank may not stipulate that the client should increase the amount of the debt against deferring the payment thereof, as this would be a usury [charged on debts or the usury practiced in ***Jahiliyya*** (Pre-Islamic Period), which is prohibited in ***Shari'ah***, and which jurists refer to as: Delay the time for me, I will give you more i.e. ("Give me a delay for payment of the debt and I will increase the amount of the debt").

It is not objectionable in case the client should require works which the contract does not provide for, that this should be effected by virtue of a new contract under which both parties agree on such additional works, the cost thereof, and the bank's profit, as this would not constitute an increase of the ***Istisna'*** amount, but is rather entering into a new contract under new conditions.

9. Providing the raw materials to be used in the manufacturing of the commodity is the responsibility of the Sane', it is not permissible that the *mustasne'* participate in providing such materials, or a part thereof.

Among the stipulations of an ***Istisna'*** contract is the undertaking by the ***sane'*** to produce a ***masnou'*** that conforms to the specifications. This includes his provision of the raw material used in the making of the required commodity. The ***Istisna'*** contract may under no circumstances include a condition obligating the ***mustasne'*** to provide all or part of the raw materials, as this would transform the ***Istisna'*** contract into another contract, namely a hire contract.

Although there is a great similarity between an ***Istisna'*** contract and a contract of hiring of persons in that both involve commissioning for manufacturing (a commodity), yet the basic and essential difference between them relates to the subject of the contract. Thus in a hire contract the work is the subject, while in an ***Istisna'*** contract the subject is the object to be made. This means that in its reality an ***Istisna'*** contract is a sale contract, the subject of which is the object or the commodity, while the subject of a hire contract is the benefit. Thus, when someone requires the making of a certain commodity, he would be interested that the ***sane'*** providing him a manufactured commodity whether, to be made by him or by another party, while in a hire contract for the making of a commodity the hiring party requires the hired party to render a certain service to be applied to a material which the hiring party himself supplies for the purpose of converting same into a processed commodity[17]. ***al-Kasani*** says: "If a person delivers to a blacksmith some iron in order for him to

make a utensil for a specified fee, or [if he delivers] leather to a shoemaker to make a pair of shoes for a specified fee, then this is specifically known and permissible, and does not involve any option, because this is not ***Istisna'***; it is, rather, a hire, and hence it is permissible. Thus if he performs what he is required to do, he will be entitled to the wages...."[18].

In brief, an ***Istisna'*** contract must not contain any stipulation obligating the client to provide the raw material, whether it is essential or secondary, as this would vitiate the ***Istisna'*** contract and would alter the essence thereof, transforming it into a hire contract.

10. It is not objectionable for the client requiring the manufacture of a commodity to supervise the work of the end-*sane'* with whom the bank contracts for the manufacturing of *al-masnou'* (the required commodity), in order to make sure that the *sane'* adheres to the specifications agreed upon by the bank and the client, provided that no direct contractual relationship relating to *al-masnou'* should arise between the client and the end-*sane'*.

To ascertain the conformity of certain types of certain industries, like the building industry, to specifications, it is necessary to supervise same constantly during the stages of construction, because certain parts of such buildings would have to be covered at a certain stage, which makes it impossible to check whether they conform to the specifications agreed upon. In such cases it is not objectionable for the bank and its client to come to an agreement whereby the client shall, whether himself or through a competent party, supervise the end-***sane'*** to make sure that such sane' executes the ***masnou'*** pursuant to the specifications. Such a condition does not conflict with the nature of an ***Istisna'*** contract, because the bank has an interest in the matter on account of its being liable for the making and the client has an interest as well on account of his being the ***mustasne'***. The interest of both parties lies in both parties being reassured as to the conformity of the ***masnou'*** to the specifications and in reducing the chances of disputes that arise between the two parties. However, the

supervision of the ***mustasne'*** client must be based on mutual acceptance, without such supervision involving any changes affecting the right and obligations created by the ***Istisna'*** contract, as the client's contractual relationship should remain solely with the bank and may under no circumstance extend to the third party with whom the bank contracts for the execution of the ***masnou'***. In other wards, giving the client the right of supervision of the work of the end-***sane'*** should not lead to the abandonment by the bank of its commitment to provide the ***masnou'***, and to lay the responsibility on the end-***sane'***, because the bank's entitlement to profit in a banking ***Istisna'*** contract is against the guarantee (commitment of) the bank created by the banking ***Istisna'*** contract, in its capacity as a ***sane'***.

11. It is permissible for the bank - in case it obtains from the end-*sane'* a guarantee against latent defects, proper performance, or commitment to provide maintenance after delivery of the manufactured commodity - to transfer same in favor of the client.

It is customary in some modern industries for the ***sane'*** to offer to the ***mustasne'*** performance guarantee or to undertake to provide maintenance for the manufactured asset for a certain number of years. As there is no direct contractual relationship between the end-***sane'*** and the client who requires the commodity from the bank, it would not be objectionable in such case for the bank to transfer the guarantee it obtains from the ***sane'*** in favor of the client, after handing over of the ***masnou'*** to the client, creating, in doing so, a direct relationship between the client, and the end-***sane'***, in terms of which the end-***sane'*** would perform the maintenance of the asset as stipulated in the contract signed by the bank and the end-***sane'***. To achieve this, the maintenance contract signed by the bank and the end- ***sane'*** must provide that the bank is entitled to benefit from the maintenance services stipulated in the contract through transferring same to another party together with all the conditions and obligations thereof.

12. It is permissible for an *Istisna'* contract to provide for services of installation, training on the operation and maintenance of the asset, or any other services related to *al-masnou*.

This clause reflects the nature of industry in modern times, the industrial process having become a complex and inter-related process that is not confined only to the making of the commodity but relates also to a group of complementary things such as installation, maintenance and training, which have come to be linked to the industrial process. Such complementary processes require a certain measure of skill and knowledge of technology that are very often not available except at the manufacturing companies themselves. Hence, it is common practice to include such services in an ***Istisna'*** contract as an integral part thereof, provided that a specific cost for each of them is determined at the same time.

A banking ***Istisna'*** contact which includes such conditions does not reflect the essence of an ***Istisna'*** contract as being one that relates to the making of an object that is described in ***dhimma***, neither is it a contract related to maintenance or training on operation or installation, for such processes are carried out in case they are separate on the basis of a hire contract, being a service performed on a certain work. However, including such services in an ***Istisna'*** contract very often helps to reduce the cost borne by the client. This requires resorting to a certain criterion that would be a basis and a frame of reference for including such services in an ***Istisna'*** contract. The proposed criterion in this clause is to consider the cost of the services that are complementary to the ***Istisna'*** contract, so that if the cost of such services is less than the cost of the manufacturing of the required commodity, then they may be included in the ***Istisna'*** contract. But if the cost of such services is more than the cost of the commodity required to be made, then it must be separated in a separate contract.

The juristic rule on which this clause was based is "What applies to the majority applies to the whole". Thus as long as the price of the ***masnou'***

includes the cost of the associated services, the contract remains an ***Istisna'*** contract and will be subject to the provisions governing the ***Istisna'*** contract, and vice versa.

13. In a situation in which the bank is a *mustasne'*, it is not objectionable for it to authorize the *sane'* to sell the *masnou'* for a profit on its behalf to a third party.

This clause reflects some possible applications of a banking ***Istisna'*** contract. These include the financing by the bank of industrial companies through entering with them into ***Istisna'*** contracts under which such companies undertake to manufacture commodities of determined specifications.

Although this method can be applied in practice, yet it confronts the difficulty of searching for buyers for the commodities contracted to be made, which forces the bank to provide warehouses for storing same. Such obstacles do not encourage banks to enter into such contracts.

The practical solution for eliminating such obstacles is to make a certain arrangement through signing an agreement beforehand by the bank and the manufacturing companies under which the bank enter with them into ***Istisna'*** contracts by virtue of which it buys the commodities they produce and conclude with them, at the same time, an agency contact under which it delegates to them the task of marketing such products and selling them to the clients of such factories.

Now as the agency given by the bank to the client relates in this case to an agency authorizing the client to sell the commodities contacted to be made, there is no doubt that this is a permissible agency because it is one that authorizes the agent to sell, and sale is a contract which is permissible to be performed through agency. The author of ***al-Moughni*** says: "We are not aware of any dissenting opinion as regards the permissibility of granting an agency that authorizes the agent to sell and buy."[19]. It is not objectionable for such an agency to be against a fee, the bank designating

for the client a certain fee against his marketing of the manufactured products, for an agency is permissible against a fee or without a fee. ***al-Moughni*** provides that "It is permissible to grant an agency against a fee or without a fee"[20].

14. It is not permissible for the *sane'* bank to authorize the *mustasne'* client to directly involve to manufacture and execute the *masnou'* on its behalf.

Although the essence of the bank's role in a banking ***Istisna'*** is that of intermediator between the client, that requires the manufacture, and the end-***sane'***, yet such intermediation should be an authentic and not a false intermediation. This necessitates that the bank assume the execution of the ***masnou'*** through contracting, itself, with the end-***sane'*** and it should assume the responsibility of fulfilling the requirement of the ***mustasne'*** client by providing the manufactured commodity that conforms to the specifications.

Therefore, the bank may not assign such responsibility and delegate same to the ***mustasne'*** client, because this is contrary to the essence of ***Istisna'*** contract which obligates the bank, in its capacity as a ***sane'***, to undertake the manufacturing itself or to contract with a third party. However, when the bank authorizes the client, the role of the bank will be confined to providing the funds alone, without assuming the responsibility of the manufacturing. In this case the ***Istisna'*** contract comes close to being a form of financing on interest basis. Hence, this clause prevents banks from authorizing their clients through agency to undertake the manufacturing and to execute the ***masnou'*** on their behalf in order to avoid the suspicions that may arise in such cases.

2-5 Notes & References

[1] al-Kasani, *Badie' al-Sanaie'* 5/3

[2] al-Kasani, *Badie' al-Sanaie'* 5/2

[3] al-Ahkam al-'Adliyyah Journal

[4] al-Kasani, *Badie' al-Sanaie'* 5/3

[5] al-Kasani, *Badie' al-Sanaie'* 5/4

[6] al-Kasani, *Badie' al-Sanaie'* 5/4

[7] al-Kasani, *Badie' al-Sanaie'* 5/4

[8] al-Zarqa, *'Aqd al-Istisna'* p-22

[9] al-Zarqa, *'Aqd al-Istisna'* p. 24

[10] al-Zarqa, *'Aqd al-Istisna'* p.30

[11] al-Sarkhasi, *al-Mabsout* 12/139

[12] al-Sarkhasi, *al-Mabsout* 12/139

[13] *al-Bahr al-Raeq Sharh Kanz al-Daqaieq* 6/185

[14] al-Zarqa, *'Aqd al-Istisna'* P.28

[15] *Sharh al-Majalla*, by al-Atassi 2/405

[16] al-Kasani, *Badie' al-Sanaie'* 5/3

[17] Dunya, *al-Ju'ala wa al-Istisna'* p. 38

[18] al-Kasani,*Badie' al-Sanaie'* 5/4

[19] Ibn Qudamah, *al-Moughni ma' al-Sharh al-Kabir* 5/203

[20] Ibn Qudamah, *al-Moughni ma' al-Sharh al-Kabir* 5/210

Chapter Three

STANDARD OF BANKING SALAM

3 - 1 Definitions

A. ***al-Salam:*** is a designated contract in Islamic Shari'ah. It is a deferred sale described as a (debt) in the seller's ***dhimma*** for a price paid in advance.

B. ***Banking Salam***: is the entering by a bank into a ***Salam*** contract whether as seller or buyer of a defined quantity of a fungible commodity for a determined period of time for a price paid in cash.

C. ***al-Muslim:*** is the buyer in a ***Salam*** contract. Not to be confused with the Muslim (Moslem), one who professes Islam.

D. ***al-Muslam Ilayhi:*** is the seller of the deferred commodity in a ***Salam*** contract, i.e. the one who receives the ***Salam*** capital (price of commodity) in advance from the buyer.

E. ***al-Muslam Fiihi:*** is the commodity which is the subject of the ***Salam*** contract.

F. Parallel ***Salam*** contract: is the contract under which the bank is a seller of a commodity of the same genre of what it has bought under ***Salam*** terms, but not the very same commodity it has contracted for with the client.

G. ***al-Mithliyaat*** (Fungibles): are the comparable commodities in terms of their characteristics so that the units thereof are comparable and identifiable in the market and could be established as a debt in ***al-dhimma***.

H. ***al-Qaimiyyat:*** are the commodities whose units are so different that they cannot be established as a debt in ***al-dhimma***.

I. ***al-Salam*** capital: is the price of the commodity that is the subject of a ***Salam*** contract.

J. ***Dhimma***: The qualification of a nominal (company) or a natural person to bear obligations and enjoy rights. Hence debts of companies or persons whether incorporeal property or fungible are tied or related to it ***(dhimma).***

3 - 2 Scope of the Standard

1. The fungible commodities of defined characteristics.

2. Does not include gold, silver, money, securities, bonds and shares.

3.3 Text of Standard:

1. The bank may provide its clients with funds through a ***Salam*** contract.

2. In a ***Salam*** contract performed through a bank it is not permissible to advance a deposit (down payment); the whole price must be paid when the contract is made.

3. In a banking ***Salam*** the price must be paid pursuant to customary methods which do not stipulate deferment of payment.

4. If customary practice requires deferring payment of the price to the seller, this would not be objectionable provided it does not exceed three days.

5. For a ***Salam*** contract to be valid it is stipulated that the kind, amount, quality and place of delivery of the commodity be determined in a manner that precludes the existence of an unknown element ***(jahala)***.

6. It is permissible to finance, through a ***Salam*** contract, any describable fungible commodity that whose specifications can be determined, whether grown or manufactured, which is permitted in Shari'ah.

7. Entering into a ***Salam*** contract requires determination of the deferred time and obligating the seller to deliver the commodity which is the subject of the contract on that deferred time.

8. The prices of ***Salam*** commodities to be bought by the bank and the client must be determined, and it is not objectionable to take the time element into consideration in determining the price.

9. If the seller fails to deliver the commodity on the date set forth in the contract, it shall not be objectionable for the two parties to agree on extending the time of delivery, provided that this is done for no consideration; otherwise, the contract is considered as vitiated.

10. The minimum requirements for possession a ***Salam*** commodity are satisfied if the liability for the providing thereof is transferred to the bank upon delivery thereof.

11. It is not objectionable for the bank, as a buyer on ***Salam*** terms, to enter, with the seller of the commodity, into an agency contract authorizing the seller to receive it on its behalf and to materially set it apart from other commodities when the term of delivery is due, and then to sell it to a third party on behalf of the bank.

12. It is not permissible for a bank to sell on ***Salam*** terms the same commodity it has bought on ***Salam*** terms.

13. When the bank is a buyer of a commodity under a ***Salam*** contract it is not objectionable for it to enter into another ***Salam*** contract, as a seller of a similar commodity in terms of kind, quality and quantity, and it is not objectionable for the date of delivery in both contracts to be identical provided that there is no linkage or overlap between the two contracts.

3-4 Explanatory Memorandum of the Standard of Banking *Salam*.

1. The bank may provide its clients with funds through a *Salam* contract.

A ***Salam*** contract is a designated contract in Islamic Jurisprudence and is unanimously approved. It is a binding sale contract under which the seller receives the price in advance, while delivery of the commodity to the buyer is deferred. Evidence of the permissibility of a ***Salam*** sale is based on a tradition of the Prophet, PBUH, going back to the period following his migration to ***Medinah***. He found that people used to make one or two years' advance payment for fruits and approved that, within the framework of Shari'ah regulating terms that provide for the precluding of the existence of an unknown element (***jahala***) and uncertainty (***gharar***) from a ***Salam*** contract. He said: "He who pays in advance shall do so with respect to a definite measure, a definite weight and a definite term (agreed upon, reported by ***Bukhari*** and ***Muslim***)". The majority of jurists have included ***Salam*** sale in the category of the sale of the non-existent, for the seller receives the price of an object to be sold, in respect of which the conditions of ownership and possession (acquisition) are not satisfied at the time of conclusion of the contract. Thus they consider such sale permissible in contradiction to the analogy based on the tradition of the Prophet PBUH reported on the authority of ***Hakim Bin Hizam***: "Do not sell what you do not have", as well as other pieces of evidence which stipulate that one should own and possess a commodity before the selling thereof[1]. Nevertheless, ***Ibn Taimiyyah*** considers that a ***Salam*** contract does not run counter to analogy because he believes that what is intended by the stipulation of ownership and possession is confirmation of the seller's ability to deliver the bought object to the buyer, which ability is assumed to exist in a ***Salam*** contract. ***Ibn Taimiyyah*** has summed up his opinion of this matter by saying: "having realized that the provision is contrary to analogy, we know definitely that it is an invalid analogy"[2].

2. In a *Salam* contract performed through a bank it is not permissible to advance a deposit (down payment); the whole price must be paid when the contract is made.

It is stipulated in a ***Salam*** contract to be valid, that the buyer should pay the seller all the ***Salam*** capital at the time of concluding the contract, without any delay or deferment, so that if they separate before that, then the contract will be null and void. This is the view of ***Hanbali, Shafi'i*** and ***Hanafi*** jurists. ***Malki*** jurists, however, have made it permissible to defer payment of the capital for two or three days with or without any stipulation, this being based on the rule of "what applies to something also applies to what approximates to it", because they consider that a slight delay is excusable because this would be a mere payment routine[3]. All jurists agree that it is not permissible to advance a portion of the capital at the session of conclusion of the contract and to withhold another portion thereof to be paid later on. Thus ***Malki*** jurists consider that the whole transaction would in such case be vitiated. On the other hand, ***Hanafi*** and ***Shafi'i*** jurists consider ***Salam*** as null and void with respect to what has not been paid for at the session of the contract and annulled the share thereof from the ***Muslam Fiihi*** (the commodity which is the subject of the ***Salam*** contract) (The Kuwaiti Encyclopedia of Jurisprudence, 25/204).

3. In a banking *Salam* the price must be paid pursuant to customary methods which do not stipulate deferment of payment.

The price of a commodity may be paid in cash or by any modern method of payment if such method involves payment on sight, such as checks, transfers or drafts, there being no harm in the slight delay resulting from payment procedures if it does not exceed three days, as this is in the nature of payment routine, according to the ***Malki*** School. On the other hand, deferred methods of payment such as promissory notes and bills of exchange are not proper methods for payment of capital in a ***Salam*** contract because deferment of payment is deliberate and is not a procedural contingency.

4. If customary practice requires deferring payment of the price to the seller, this would not be objectionable provided it does not exceed three days.

Reference has already been made to the fact that ***Malki*** jurists have made it permissible to delay payment of the ***Salam*** capital for a period of up to three days, with or without any stipulation.

However, delaying payment of same beyond the three days with a stipulation is not permissible in their view. This is unlike ***Hanafi, Shafi'i*** and ***Hanbali*** jurists, who took a firm stand in disallowing the delay or deferment of payment of the capital. But the expansion of international transactions in the modern age and the need to document the instructions pertaining to withdrawal, payment and the debiting and crediting of accounts made it impossible to complete the process of payment and receipt in one day. Therefore, to preclude difficulties it is possible to adopt the opinion of ***Malki*** jurists in this respect.

5. For a *Salam* contract to be valid it is stipulated that the kind, amount, quality and place of delivery of the commodity be determined in a manner that precludes the existence of an unknown element *(jahala)*.

Jurists are unanimously agreed that commodities whose specifications cannot be determined may not be the subject of ***Salam*** because they give rise to disputes and conflict[4]. They all agree that the ***Muslam Fiihi*** (the subject of the ***Salam*** contract) should be identified as to kind, type and quality, in order to preclude the existence of an unknown element (***jahala***) that leads to disputes. There is no harm in the contracting parties using a standard unit of measurement that is conventionally acceptable for accurately determining the quantity of the ***Muslam Fiihi***, whether such commodity can be determined in terms of weight, gauge, volume, number or length, unless such a commodity is gold or silver. This does not mean, however, that all the features of the commodity should be determined exhaustively, as this is not possible in actual practice and makes it difficult to deliver the ***Muslam Fiihi, al-Kharshi*** has expressed this

condition as follows ".... to determine the features of the ***Muslam Fiihi*** in terms of which the value of the ***Muslam Fiihi*** varies to such an extent as to usually cause disputes among buyers and sellers."[5].

6. It is permissible to finance, through a *Salam* contract, any describable fungible commodity that whose specifications can be determined, whether grown or manufactured, which is permitted in Shari'ah.

As a ***Salam*** commodity would be a debt for which the ***Muslam Ilayhi*** (seller) is liable when the contract is concluded and the price of the commodity is received , jurists have stipulated that the commodity should be a fungible commodity because it is commodities and fungibles that can be a debt that establishes in ***dhimma***. Hence the Prophet, PBUH, is reported to have said in a tradition on the authority of Abdullah bin ***Salam*** and reported by ***Ibn Majah*** that he enjoined a Jew against designating the orchard of a certain people in a ***Salam*** contract, as follows: " at such and such a price, for such and such a time but not from the orchard of such and such people." Jurists are unanimously agreed that commodities whose specifications cannot be determined may not be the subject of a ***Salam*** contract because they give rise to disputes[6]. Hence jurists have stipulated that the ***Muslam Fiihi*** (the subject of a ***Salam*** contract) should be commodities of comparable units, i.e. those that can be gaugeable, measured, weighed and approximately counted. Such commodities are exemplified by agricultural products and a great many standardized products, particularly those that are subject to standard measurements which are familiar in the market. It is worth noting that ***Shafi'i***, ***Hanbali*** and ***Malki*** jurists refer to ***Salam*** contracts with respect to manufactured commodities (designated as ***Istisna'*** by ***Hanafi*** jurists). ***Malki***, ***Shafi'i*** and ***Hanbali*** jurists maintain that the same terms and conditions applicable to ***Salam*** contracts in agriculture also apply in industry, including the condition that the ***masnou'*** (manufactured commodity) should be one of standard comparable units that are familiar in the market.

7. Entering into a *Salam* contract requires determination of the deferred time and obligating the seller to deliver the commodity which is the subject of the contract on that deferred time.

Hanafi, ***Malki*** and ***Hanbali*** jurists are unanimously agreed that determining the time of delivery in a manner that precludes the existence of an unknown element (***jahala***) is a condition that must be satisfied for a ***Salam*** contract to be valid, as a precaution against ***al-Salam al-Haall*** (immediate ***Salam***), unlike ***Shafi'i*** jurists who consider ***al-Salam al-Haall*** (immediate ***Salam***) permissible and did not stipulate that it should involve deferment (i.e. delaying the delivery of the commodity)[7]. We have adopted herein the view of ***Hanafi***, ***Hanbali*** and ***Malki*** jurists, who stipulated the elapse of a period of time in a ***Salam*** contract, because this is a closer to the Prophet's tradition, which requires the indication of an express future time. It is, moreover, more appropriate for modern banking applications. However, jurists of different schools hold different opinions regarding the determination of the extent of the future time. The view of the ***Malki*** as regards the determination of the future time is perhaps the most appropriate for contemporary applications, namely that the minimum time is that beyond which the market (prices) would change[8]. Now as the ***Muslam Fiihi*** is a debt that is due to the ***muslim*** (the buyer) and is a liability assumed by the ***Muslam Ilayhi*** (the seller), this necessitates obligating the seller to deliver the commodity to the buyer at the fixed time. The aim behind this is payment of the debt and precluding any damage that may be sustained by the buyer by not delaying delivery of his commodity beyond the appointed time.

8. The prices of *Salam* commodities to be bought by the bank and the client must be determined, and it is not objectionable to take the time element into consideration in determining the price.

A ***Salam*** contract is known to serve the interest of both the buyer and the seller. Thus the seller is interested in liquidity, which helps him prepare the commodity when delivery is due. On the other hand, the buyer expects to acquire the commodity at a price he most probably deems to be

less than that of a similar counterpart of his commodity in the market when delivery is due. It is known that what exists now (in kind) is better than debt, and having at present is better than having at a later time (deferred). Jurists have expressed this as follows: "Time has portion in the price", in the sense that the price of a commodity fluctuates positively or negatively, depending on how long or short the term during which delivery thereof takes place or the payment of the price thereof takes place. However, this should not be understood to mean that it is possible to assign a special price for the term of delivery (time) because the term of delivery (time) is not in itself a commodity that has a value of its own.

9. **If the seller fails to deliver the commodity on the date set forth in the contract, it shall not be objectionable for the two parties to agree on extending the time of delivery, provided that this is done for no consideration; otherwise, the contract is considered as vitiated.**

It is not objectionable to extend the date stipulated in the contract, if need be, but this should not entail the renewal of the ***Salam*** contract, whether such renewal involves an increase of the quantity of the commodity, the subject of the contract, or an enhancement of the quality thereof, or a reduction of the ***Salam*** capital by refunding a portion thereof to the buyer, or otherwise, which would compensate the buyer against the extension of the date of delivery set forth in the contract, as this would fall within the scope of the rule which says: "Give me more (time) and I will give you more (Money)", which is sheer usury. Hence, the only two options available to the buyer is either to grant the buyer a respite till it is possible for him to fulfill his obligation for no consideration, or to cancel the contract by refunding the capital of ***Salam*** to the buyer.

10. **The minimum requirements for possession a *Salam* commodity are satisfied if the liability for the providing thereof is transferred to the bank upon delivery thereof.**

Malki, ***Shafi'i***, and ***Hanbali*** jurists state that "The form of possession (acquisition) of each commodity depends on the nature thereof"[9]. Thus

there is no one form of taking possession (of a commodity) that applies to all finance (property). Hence there are details relating to the manner of taking possession of various types of property, in which custom plays an important role. On the other hand, ***Shafi'i*** jurists have made a distinction between the form of taking possession, that validates taking action (the disposal of the commodity), which was elaborated by other schools, and taking possession that transfers the guarantee (liability for the commodity) from the seller (to the buyer)[10], for this involves acquisition by the buyer of the sold object whether he has moved it or not, and whether the seller has released it for the buyer or not. Thus once the buyer has taken possession of the object he bought, the seller would no longer guarantee (be liable for) same, in the sense that the guarantee (liability) for the perishing of the commodity would devolve upon the buyer, the seller being released of such guarantee (liability) after the sale has been concluded. This view is closer to modern practice as the interest of the bank in the commodity it buys is no more than reselling same to a third party. Hence, the bank's taking possession of the commodity when the term of delivery thereof is due could be its possession of the warehouse warrant (receipt) specifying the type, quantity and description thereof. It is not necessary to actually move the commodity from such warehouse, as long as the specific location of the commodity in the warehouse is identified and the risk of the perishing thereof resides with the bank. In such case the only authority of the warehouse management on the commodity is to keep same in safe custody, and it would guarantee (be liable for) same only in the case of infringement and default. If such condition is satisfied then the bank may sell the commodity that is available in the warehouse to a third party. This facilitates dealing in international markets of commodities with minimum restrictions.

11. It is not objectionable for the bank, as a buyer on *Salam* terms, to enter, with the seller of the commodity, into an agency contract authorizing the seller to receive it on its behalf and to materially set it apart from other commodities when the term of delivery is due, and then to sell it to a third party on behalf of the bank.

The usual practice in a ***Salam*** contract is for the buyer of the commodity to take possession of same himself when the time of delivery is due, before disposing of same by way of selling to another party, to preclude the selling of the commodity before taking possession of same. However, there are special circumstances, as in international transactions of buying and selling which compel the buyer of a commodity to delegate another party to receive same beyond the geographical borders (of the buyer) and to sell same, on behalf of its owner, to a third party. Such agency (delegating) in buying and selling is permissible in the ***Quran*** and ***Sunnah***, as the delegated agent is trusted with disposing of the rights of the principal entrusted to him, though he does not guarantee (assumes no liability for) same except in case of infringement and default. ***Ibn Qudamah*** says in ***al-Moughni***: "We are not aware of any dissenting opinion as regards delegation in selling and buying." Justifications adduced by jurists of selling and buying on behalf of the principal are "that the principal may not be skilful in selling or buying, or he may not be able to go out to the market, or he may have a finance (property) which he does not know how to trade therein, and he may know but he may not have time to do so, or trading may not become him ...."[11]. No doubt all these description apply on the bank. An agency is also permissible against a fee or without a fee as established in the tradition of the Messenger of Allah, PBUH, whether disclose or undisclose (made known or otherwise) to third parties. It is particularly valid for a delegated agent to take possession of the commodity on behalf of his principal, this being a satisfaction of the Shari'ah stipulation of taking possession which makes it permissible for the principal to benefit from the price of the commodity owned by him.

12. It is not permissible for a bank to sell on *Salam* terms the same commodity it has bought on *Salam* terms.

When a bank enters as a buyer in a ***Salam*** contract then the bank would be a creditor to its client for providing the bank with a fungible commodity described in the client's ***dhimma***. Should the bank offer for sale the same commodity to another client it would be guilty of a

prohibited act under Shari'ah, namely the selling of a ***Salam*** debt. The majority of ***Hanafi***, ***Shafi'i*** and ***Hanbali*** jurists maintain that it is not valid to sell ***al-Muslam Fiihi*** (the commodity which is the subject of a ***Salam*** contract) to that one who is liable for it (the seller) or to another party before taking possession of same. ***Malki*** jurists, however, consider this permissible, unless the commodity is a food stuff[12]. Justification for the stipulation that commodity should be fungible is based on a tradition by the Prophet, PBUH, in which he enjoined against ***Salam*** transactions involving a specific commodity: "At such and such a price, for such and such term, and not from the orchard of such and such people", reported by ***Ibn Majah***. Hence jurists are unanimously agreed that a ***Salam*** contract would be vitiated if the ***Muslam Fiihi*** was a specific object, because if the ***Muslam Fiihi*** is specified then the right of the owner of such object would relate to that same specific object and not to the ***Muslam Ilayhi***, ***dhimma*** which contradicts the purport of ***Salam contract***. Moreover, a specifically designated commodity could perish before the delivery of same becomes due, which would give rise to uncertainty resulting from inability to fulfill the contract[13]. Therefore, specifying such required commodity from such client to be sold itself under a ***Salam*** contract to another client makes that commodity specifically designated and not related to the seller's ***dhimma***, which would vitiate the ***Salam*** contract.

13. When the bank is a buyer of a commodity under a *Salam* contract it is not objectionable for it to enter into another *Salam* contract, as a seller of a similar commodity in terms of kind, quality and quantity, and it is not objectionable for the date of delivery in both contracts to be identical provided that there is no linkage or overlap between the two contracts.

Entering into more than one sale or purchase contract simultaneously is permissible under Shari'ah, ***Salam*** sale being not expected. However, in the latter case, it is forbidden to become involved in selling or buying a debt that is established in ***al-dhimma*** because a ***Salam*** commodity remains a debt in its seller's ***dhimma*** until its delivery time is due. Therefore, if a bank enters, as a buyer of a commodity, into a ***Salam***

contract with a client, it should not designate the same commodity in another ***Salam*** contract under which the bank would be a seller to another client, in order to avoid the selling of a debt and the designating of a specific commodity in the ***Salam*** contract. The two contracts should, rather, be quite independent from each other, without any connection or referring thereof. In this manner the bank could be a buyer in one ***Salam*** contract and a seller in another ***Salam*** contract, and would be able to invest its funds and those of its clients in the international commodity markets, the profit it would make being the difference between the two prices.

3-5 Notes & References

[1] *al-Bahr al-Raeq* 6/169; *Asna al-Mataleb Sharh Rawd al-Taleb* 2/122; *Manh al-Jalil*, by 'Oleesh 3/2.

[2] *Fatawa Ibn Taimiyyah*, Majmou' al-Fatawa, V.20, pp.505 and 529.

[3] *Sharh al-Kharshi* 220/57.

[4] Kuwaiti Encyclopedia of Jurisprudence 25/208.

[5] *Sharh al-Kharshi* 5/213.

[6] *Asna al-Mataleb* 2/130; *Kashaf al-Qina'* 3/276; *Nihayat al-Mouhtaj* 4/195; and *Badie' al-Sanaie'* 5/208.

[7] *al-Umm* 3/95.

[8] *Sharh al-Kharshi* 5/210.

[9] *al-Moughni*, by Ibn Qudamah 4/220

[10] Hashiyat al-Jamal 'ala "*Sharh al-Manhaj*" 3/168.

[11] *al-Moughni* 5/203.

[12] *Bidayat al-Mujtahid* 2/213.

[13] *Nihayat al-Mouhtaj* 4/183; *Bidayat al-Mujtahid* 2/230; *Mawahib al-Jalil* 4/534; *al-Hidayat ma' Fath al-Qadir Wal 'Inayah* "al-Maymanah" 1319 H. 6/219

Chapter Four

STANDARD OF BANKING LEASE

4 - 1 Definitions

A. ***Ijara*** (Lease of objects)[1]: is the selling of a defined benefit (usufruct) against a specific consideration for a fixed period.

B. Banking Lease: is a method of financing based on the lease contract that is well known in Islamic Jurisprudence, under which the bank sells a benefit which it owns, whether by ownership of the object itself or by owning the right of benefit thereto. The special nature of banking lease (in comparison to the standard lease contract).

C. Total Lease Amount: is the total price at which the bank sells the usufructs of an object to the lessee, whether lease payment is made in one or several installments.

D. Term of Lease: is the period during which a client makes lease payments and receives the usufructs within the term of contract.

E. Lessee: is the buyer of the benefit for a fixed term.

F. Lessor: is the seller of the benefit generated by the leased asset, whether as owner of the asset or lessee of the same, acting as sub-lessor.

G. Real Assets: Those tangible assets other than cash and receivables or financial securities.

H. ***Ijara Wa Iqtina***: A term used by Islamic banks to refer to what we call in this standard "Banking Ijara".

I. Financial Lease (full pay-out lease): Lease in which the service provided by the lessor to the lessee is limited to financing equipment. All other responsibilities related to possession of equipment, such as maintenance, insurance and taxes, are born by the lessee. A financial lease is usually non-cancelable and is fully paid out (amortized) over its term. It

also provides an element of profit to lessor (financier), in the form of fixed or variable mark-up.

Financial lease is not acceptable from Shari'ah point of view and it should not be used in Islamic banking.

J. Operating Lease (partial pay-out lease): A lease whereby the contract is written for considerably less than the life of the equipment and the lessor retain part of maintenance and services risk. Most operating leases are cancelable.

4 - 2 Scope of Standard

1. Assets that generate benefits (usufructs) derived from use of same while the substance thereof remains, such as industrial equipment, production machines, real estates, whose ownership a client wishes to acquire at the expiry of the lease contract.

2. Cases in which a bank can acquire the real (fixed) assets or the benefit thereof for a period covering the term of the lease.

4 - 3 Text of Standard

1. The bank may finance its clients who desire to lease instruments, machines, production equipment or buildings through the method of lease that ends in obtaining ownership, whereby the bank would be the lessor and the client the lessee, for a fixed term ending up in the client acquiring ownership of the asset.

2. It is permissible to lease any object or asset that has a permissible benefit while the substance of the asset itself remains capable of producing the usufructs at a level defined by custom or contract.

3. Both the rent and term of lease must be known and nominated in the lease contract.

4. The rent becomes due to the lessor immediately upon the signing of the lease contract. Such rent may be made in one payment or in several payments, within a period that is equal to or is more or less than the term of the lease.

5. If the two parties agree to periodically review the rent stipulated in the contract, then the contract would, upon each review, be considered a new contract, both parties having the option to enter into same.

6. If the lessor receives a deposit from the lessee in the form of *arboon* he may keep it to himself if the lessee does not execute (sign) the contract.

7. The lessor may determine the rent in any manner provided it shall be specified as a fixed sum and known by both parties when the contract is concluded.

8. It is possible to agree on an escalating or diminishing rent as long as the amount/s thereof is/are determined and known to both parties.

9. The lessee may sublet the object to a third party with the consent of the lessor.

10. The owner of a leased object may sell same to a third party before the expiry of the lease term.

11. The lessor may not require the lessee to pay compensation for the wear and tear or the usual depreciation of the leased object. He may, however, claim compensation from the lessee for damage resulting from misuse.

12. The owner of a leased object is entitled to the rent as long as the object is useful for generating the usufruct stipulated in the contract or considered customary for such object. Otherwise, and if it is not capable of producing such benefit, lessee may rescind the contract.

13. The lease contract should specify the types of maintenance to be assumed by the lessee (being a hirer) and those to be assumed by lessor (being an owner) as agreed by both parties pursuant to custom.

14. A bank may agree with its client to buy a certain asset and then to lease it to the client for a fixed period of time, after the expiry of which it shall be offered for sale to the client or to a third party at the then current market price.

15. It shall not be permissible, in the case where the bank buys the leased object from the lessee client, for the sale contract or the lease contract to provide for the re-purchase by the client of such asset for a fixed price. It is permissible for the bank, however, to specify

the price for which it shall be bound by to sell to the lessee, without the latter being bound by same in the lease contract.

16. If the bank desires to insure the asset and be the loss payee then it shall itself bear the insurance cost.

17. If the rental installments in a lease ending up in ownership by lessee are computed so that the lessee would acquire ownership of the asset after a fixed term, and if the client subsequently desires to acquire ownership before that, which would require amending the term of the lease, then it shall not be objectionable to cancel the first lease contract and enter into a new lease contract involving different rental installments.

18. It is not objectionable that bank leases an equipment for a period equivalent to its estimated useful life for a rental value equals to the amount spent to acquire the equipment plus profit, as long as bank bears the normal responsibilities pertaining to ownership of equipment, such as insurance, taxes and structural maintenance.

4 -4 Explanatory Memorandum

1. The bank may finance its clients who desire to lease instruments, machines, production equipment or buildings through the method of lease that ends in obtaining ownership, whereby the bank would be the lessor and the client the lessee, for a fixed term ending up in the client acquiring ownership of the asset.

Ijara is a nominate contract that is permissible in the ***Quran***, the ***Sunnah*** and the consensus. Jurists have applied to it the rules governing sale contract, as the subject of a lease is the usufruct generated by the leased object. Hence, they defined ***Ijara*** as "a compensatory contract involving the transfer of the ownership of a benefit for a consideration." The majority of jurists consider it a binding contract by analogy with sale contracts and in application of the Quranic verse: "O ye who believe! Fulfill (all) obligations (contracts)..."[2] Hence neither party in a lease contract may unilaterally rescind same without the consent of the other except on the same grounds that justify the rescinding of a sale contract, such as the discovery of a defect in the leased object, its perishing or the cessation of the benefit to be derived therefrom. However, ***Hanafi*** jurists have considered it permissible for the lessee to rescind the contract for contingent cause that prevents him from benefiting from the leased object, as in the case of theft or the goods exposed in the lessee's shop catching fire, which prevents the lessee from making use of such shop. In such cases they have approved rescission of the contract by the lessee, by analogical application of the conditions governing the perishing of the leased object.

In actual practice, we find that Islamic banks are not keen on recovering the leased assets after the expiry of the lease contracts. Hence, they agree with their clients in advance to sell them such assets after the expiry of the lease terms. Such agreement takes the form of a promise on the part of the bank to sell the lessee the leased object after the expiry of the lease contract, as will be indicated below in the following clauses. This is what is meant by the lease mode that ends up in ownership. There may seem to

be a similarity between the lease mode ending up in ownership and the well-known method of hire purchase, which is very common in European and other countries. Hire purchase is basically a sale on installment basis and the mortgage of the sold object until the buyer has paid the last installment. The basic differences of this lease mode which ends up in ownership are as follows:

A. In the case of the hire purchase the ownership of the object is transferred to the buyer and the liability of the seller therefor ceases upon making the first payment of the price. However, the sold object remains mortgaged until payment of the last installment. But in the case of the lease method ending up in ownership, the lessor remains the owner of the object, and he remains liable and bearing full risks of ownership until the expiry of the lease contract.

B. In the hire purchase method the installments represent the price of the object itself, while in the lease mode ending up in ownership the installments represent the price of the benefit derived from the object. Hence, the remaining part of the actual leased object is subject to a separate sale contract in the latter case.

2. It is permissible to lease any object or asset that has a permissible benefit while the substance of the asset itself remains.

The majority of jurists are agreed that a lease is applicable only to an object that provides permissible usufructs, while the substance thereof remains. To quote from ***al-Moughni***: "It is permissible to lease any object that provides a permissible benefit, while the substance thereof remains virtually intact..."[3] However, it is not permissible to lease what may not provide a benefit except by the impairment of the substance thereof, in part or as a whole, such as foodstuffs, drinks or the hiring of livestock in order to benefit from their wool, hair or milk, or the hiring of grazing land for its herbage. The reason behind such prohibition as elaborated in the juristic annals, is to preclude any unknown element in the contract, because it involves the selling of a priced object and the

leasing of a benefit at the same time, while the element of the amount involved in the selling and the benefit involved in the lease are unknown, which vitiates both contracts. It is worth noting that ***Ibn Taimiyyah*** and his disciple ***Ibn al-Qayyem*** hold a different view from that of the majority of jurists as regards the permissibility of leasing assets that generate objects that are separable from the assets and the selling of same under separate contracts. ***Ibn Rushd*** of ***Malki*** school of thought has referred to similar cases.

On the other hand, it is not permissible to lease assets if the benefit to be derived therefrom is prohibited, such as the making of alcoholic drinks, gambling, places of sinful entertainment as well as other impermissible activities, as this is tantamount to helping one another in sin and rancor which is specifically prohibited in the ***Quran***.

3. Both the rent and term of lease must be known and nominated in a lease contract.

The rent is the price due to the lessor against the selling of the usufructs. The majority of jurists stipulate the same conditions with respect to rent as those they stipulate with respect to price in a sale contract. To quote from ***al-Moughni*** : "It is stipulated that the rent in a lease contract should be known. We are not aware of any disputable opinion."[4]

Therefore, a contract would be void if the rent involved an unknown element giving rise to disputes. Evidence of this is found in the tradition of the Prophet, PBUH, which was reported by ***al-Baihaqi*** on the authority of ***Abu Hurairah***: "He who hires a worker must inform him of his wages". It is not objectionable that both parties agree on a specific variation in the periodic rent. Such as the agreement that the rent increase or decrease by 10%. This may not be considered as *Jahalah* which leads to disputes, given that such percentage is declared at the beginning of each Ijara period. The knowledge of both parties of this percentage and their acceptance of it precludes any unknown element (*Jahalah*) in the Ijara contract.

The wage need not be in cash because all that may be a price in a sale may be a consideration in a lease, as in exchanging one benefit for another benefit or for another evaluated finance (property). ***Abu Hanifa*** holds a different view from that of the majority of jurists as regards the permissibility of leasing a benefit for one of its kind because for him it is not permissible the deferment (of payment) in such a case.

As to the term (period), this is the criterion that controls the amount of the benefit contracted for, because selling what is not known is not considered valid by all jurists. Hence, the term must be specified to know the benefit that is to be derived during such term, as is the case in identifying the quantity of a sold commodity in terms of gauge, volume, weight and number. However, it should be pointed out that the kind of lease involved in this context is the lease of equipment, machines, buildings and similar things. This is because specifying the term in a lease involving the performance of works is not required such as hiring an individual to do a specific job. There are ramifications governing this matter among various schools, relating to whether the worker is privately or commonly hired, which is not relevant in the case of a lease ending up in ownership.

As to the duration of the term, there is no minimum or maximum duration of the lease for there is no provision in Shari'ah governing that. There are, however, conflicting views among the various schools as regards the stipulation of specifying the point of commencement in the contract. This is stipulated by ***Shafi'i*** jurists, but not so by ***Hanafi*** jurists. There are also differences of opinion as regards leases on monthly basis, as in the case of someone who leases his house every month, or every day or every year, for a certain sum. ***Shafi'i*** jurists consider such a contract void because the term is not specified and because each month must begin with a new contract because each one involves a certain rent. The majority of jurists, however, consider this permissible only in the first month[5]. Therefore, a lease contract must fully specify the term and rent for the whole lease period.

4. The rent becomes due to the lessor immediately upon the signing of the lease contract. Such rent may be made in one payment or in several payments, within a period that is equal to or is more or less than the term of the lease.

This provision indicates that the lessor's entitlement to the rent is established upon the signing of the contract. This is consistent with the ***Hanbali*** and ***Shafi'i*** schools, because a lease is a compensatory contract which requires ownership of both elements involved in a lease (i.e., the benefit to be derived from the leased object and the consideration given against the enjoyment of such benefit), after signing the contract if it is unconditional, just as a seller acquires ownership of the price through selling (a commodity). To quote ***Ibn Qudamah***: "When a lease involves a specified term for a specified rent, then the lessee acquires ownership of the benefits and he becomes liable for the whole rent at the time of signing the contract, unless the two parties agree on a stipulated a deferred payment"[6]. Such view, however, runs counter to that of ***Malki*** and ***Hanafi*** jurists, who are of the opinion that the rent is (payable) at passage of time, unless both parties agree on advancing same in the contract, or unless the lessor advances same to the lessee unconditionally. Otherwise, they maintain that ownership of the rent is acquired gradually in proportion to the portion of usufructs corresponding to the rent, which usufructs, by their very nature, are enjoyed gradually with the passage of time.

For our part, we adopt the standard of the payability of the rent upon the signing of the contract, which is customary practice in this age. Hence being the custom, it is on a par with what may be stipulated in a contract. This eliminates the effect of the other view which does not consider the rent absolutely due unless so stipulated in the contract, because customary practice is akin to a stipulated condition.

It should be pointed out that ***Malki*** jurists consider that payability of the rent upon the signing of the contract is a must, if this is the customary practice, as in the case of hiring pack and riding animals and houses to quote from ***al-Moughni***:[7]. They also consider it a must if the benefits are

guaranteed in the lessor's ***dhimma*** (i.e. by the lessor), which is particularly relevant to our present matter.

5. If the two parties agree to periodically review the rent stipulated in the contract, then the contract would, upon each review, be considered a new contract, both parties having the option to enter into same.

The fluctuation of prices and the changing market conditions make the entering into long-term lease contracts for the same fixed rent originally specified in the contract economically not viable especially for banks. Hence, financial institutions involved in leasing in the West solved this problem by providing in the contract for linking the rent directly with an external index to secure the variability of the rent every time such index changes, which index reflects the cost of financing in the banking system.

This measure is not acceptable from the Shari'ah point of view because the future value of such index is not known, which leads to the rent itself being unknown. We are not aware of any dissenting view among jurists as regards the stipulation of a specified rent in the contract in order to preclude any unknown element. This is because a lease contract is a binding contract. Hence, a lessee may not be obligated in such a contract to pay any unspecified amount/s. However, leasing institutions can protect themselves against price fluctuations through dividing the whole presumed lease term into relatively short and proximate periods, each having an independent lease contract, entering into which would be optional for both parties. In such case it is not objectionable to review the rent regularly to match price fluctuation.

6. If the lessor receives a deposit from the lessee he may keep it to himself if the lessee does not execute (sign) the contract.

'Arboon in jurists terminology is a sum paid by a buyer to a seller as an advance and part of the price. It was a common practice is for a man to buy a commodity and pay the seller a ***dirham*** or more on the

understanding that if he takes the commodity it would be deducted from the price; if not, the seller would keep it. This is what is called sale of ***'Arboon***[8]. The same definition applies in the case of entering into a lease contract because it is a contract involving the selling of a usufruct. However, the whole idea of ***'Arboon*** is accepted only by Hanbali jurists. The majority of jurists, who consider that selling on the basis of ***'Arboon*** is not valid, base their view on a tradition reported by ***Amr bin Shu'aib*** on the authority of his father, on the authority of his grandfather who said: "The Messenger of Allah has enjoined against selling on the basis of payment of a deposit), quoted by ***Abu Dawood***. The majority of jurists also argue that selling on the basis of payment of a deposit involves stipulation of something (advantage) for the seller against no consideration, and considered this as tantamount to unlawfully taking (pocketing) other people's money, and tantamount to an unknown (unspecified) option.

On the other hand, Hanbali jurists do not admit the tradition of enjoining against the selling on the basis of payment of a deposit, and ***Ibn Hajar*** considered it a weak tradition in his ***Talkhees***. For his part, ***Imam Ahmad*** has admitted selling on the basis of payment of a deposit on the basis of what was reported of ***Nafe' bin Hareth*** buying for ***Omar*** the imprisonment house from ***Safwan bin Omayyah*** and stipulating that ***Omar*** would accept that, if not (failing which) ***Safwan*** would be paid such and such a sum. ***al-Athram*** said: "I said to ***Ahmad***: 'Would you go for that?' He said: "What should I say? This is ***Omar*** (May Allah be pleased with him).: (*Ibid).*

7. **The lessor may determine the rent in any manner provided it shall be specified as a fixed sum and known to both parties when the contract is concluded.**

The purpose of this provision is to enable both lessor and lessee to mutually agree on the appropriate rent and to be committed to it in the lease contract, as well as to the other Shari'ah conditions. Therefore, the rent need not be identical with that rent for the same objects prevailing in the market.

Hence, it is not objectionable for a bank to seek guidance in any external indexes for determining the rent, even if such were identical with the interest rates which is prohibited from Islamic point of view, in view of the fact that the forbidding of usury relates to lending or borrowing on the basis of an interest rate. As to the interest rate itself, as a figure, it is not subject to considerations of permissibility or otherwise. However, the rent must not be reviewed in light of such indexes before the expiry of the lease contract, in order to avoid the element of ignorance of the rent as previously indicated under Standard 3.

8. **It is possible to agree on an escalating or diminishing rent as long as the amount/s thereof is/are determined and known to both parties.**

Pursuant to what was said with respect to Clause 4 in the Explanatory Memorandum, the rent becomes due to the lessor upon the signing of the contract unless it is agreed to defer payment thereof or to pay same on installment basis. Such elements must not cause rent to be unknown. Hence as escalator may be in the form of an annual percentage increase in rent where the percentage is decided at the time of contracting.

This being so, it is not objectionable to arrange the due installments in an escalating order or otherwise. However, it must be pointed out that such arrangement is not absolutely acceptable to ***Hanafi*** and ***Malki*** jurists unless a stipulation is made that the rent becomes due upon concluding the contract. In the absence of such stipulation, they maintain that the rent

becomes due in equal payments. But as the rent is customarily due upon concluding the contract, this has come to be tantamount to a condition (Clause 4).

9. The lessee may sublet the object to a third party with the consent of the lessor.

The majority of ***Malki, Shafi'i*** and ***Hanbali*** jurists have unanimously maintained that the lessee is entitled to lease the object to a third party as long as the object is not affected as a result of its being used by a different party, whether for an identical or higher rent (Juristic Encyclopedia 1/267). The only dissenting jurists in that respect are the ***Hanafi*** jurists, who maintain that this is tantamount to making a profit without assuming liability. The majority of jurists reply that taking possession of the object by the lessee on a par with taking possession of the benefit. However, re-leasing the leased object to the same lessor is subject to controversy among the various schools, being considered absolutely permissible by ***Malki*** and ***Shafi'i*** jurists, whether the object is a real estate (building) or a moveable asset, before or after taking possession of same.[9] On the other hand, ***Hanafi*** jurists have forbidden it, while ***Hanbali*** jurists hold two opinions with respect to this matter.

10. The owner of a leased object may sell same to a third party before the expiry of the lease term.

A leased object may be sold to a third party before the expiry of the lease contract, because the subject of the contract of sale is the object, while the subject of the contract in a lease is the benefits. Hence, there is no contradiction in this among the majority of jurists.[10] To quote from ***al-Moughni***: "If someone leases an object and then sells it, the selling is valid. This was stated by ***Ahmad***, whether he sells same to the lessee or to other party." This is also attributed to ***al-Shafi'i***, in one of his two opinions. In his other opinion he maintains that it would not be valid if sold to a party other than the lessee, because the possession of the leased object by the lessee precludes the possibility of handing over the object to

another party. ***Ibn Qudamah*** has countered this argument by stating that the possession of the leased object by the lessee relates only to the benefits, while the sale relates to the object itself. Hence, possession (of the object) by one does not prevent the handing over to the other.

11. The lessor may not require the lessee to pay compensation for the wear and tear or the usual depreciation of the leased object. He may, however, claim compensation from the lessee for damage resulting from misuse.

It is well known that a leased object is subject to wear and tear with the passage of time and as a result of extracting the usual benefit therefrom under the lease contract, the purpose of the contract being to enable the lessee to benefit from and use the object, subject to customary practice, or perhaps to what is stipulated in the contract. The lessee is entitled to benefit from the leased object to the same extent as indicated in the contract or to a lesser extent[11]. However, he is not entitled to benefit therefrom to a greater extent than what is agreed upon. For example, if one hires a car for use within a city, one is not entitled to use same for travel to another neighboring city. Hence, the rent is due to the lessor in return for using the object to the same extent as the benefit contracted for or to a lesser extent. Therefore, the lessor may not require that the object be returned to him in its initial condition, upon the expiry of the contract. Jurists are agreed that the lessee's possession of the object is one of trust so that if the object perishes while in its possession, through no default or infringement on his part that violates customary practice or conditions, he should not guarantee (be held liable for) same. However, if the lessee infringes the conditions of benefiting from the object, or if he is in default as regards the conditions of safeguarding and maintenance, and as regards the rules of use, then he should guarantee (be held liable for) the object in such cases. But as determining the responsibility for default or infringement is subject to disputes and conflicts, it is better to insure the asset. Therefore, it is appropriate that the contract should include all provisions that specify the type or types of benefit to be derived from the

13. The lease contract should specify the types of maintenance to be assumed by the lessee and those to be assumed by the owner, as agreed by both parties pursuant to custom.

It has already been indicated that the lessee holds the asset in trust, which makes him guarantee (liable for same) only in case of infringement or default. It is customary for lessee to be responsible for preventive maintenance and the following and observing of the rules of use and protection. This, obviously, depends on the peculiarity of the leased object and its technical characteristics. Hence, the lessee would guarantee (be liable for) any default in that respect, which may lead to the perishing of the leased object.

On the other hand, the lessor is responsible for seeing to it that the leased object is free of any latent defect which may appear at a later stage during the operation processes. Once the existence of such defect is established, the guarantee fall upon the lessor (and would be held liable). See Clause 12. Consequently, the contract should specify, in a manner that precludes the existence of any unknown element, the limits of liability of both lessee and lessor.

14. A bank may agree with its client to buy a certain asset and then to lease it to the client for a fixed period of time, after the expiry of which it shall be offered for sale to the client or to a third party at the then current market price.

Leasing transactions undertaken by Islamic banks are usually initiated by an application from the client to the bank to buy the asset he is interested in and promising to rent it for a defined period which often ends by the client obtaining ownership of such asset. This sort of arrangement is of special importance to banks because in the nature of their business they do not own the assets prior (to the client's move), nor are they keen on retrieving same upon the expiry of the term of the lease. Therefore, the lease contract made with the client often includes a promise of sale to the

object which is the subject of the contract in a manner that precludes the existence of any unknown element.

12. The owner of a leased object is entitled to the rent as long as the object is useful for generating the benefit stipulated in the contract. Otherwise, and if it is not useful lessee may rescind the contract.

It is known that "A lease is a binding contract of exchange providing for rent to be obtained by the lessor and for benefits to be enjoyed by the lessee."[12]. Therefore, the lessor's entitlement to the rent is against enabling the lessee to acquire the benefit stipulated in the contract throughout the contract term. Any default in this respect on the part of the lessor would cancel his entitlement to the rent that is payable by the lessee, which would lead to the rescission of the contract.

However, the responsibility of the lessor to maintain the leased object in a proper condition for use does not mean that he has to carry out the daily or routine maintenance nor his assuming the responsibility for caring for the object and guarding it against external effects nor such obligations as customary practice usually makes the lessee liable for. What is meant is that the object should not have any apparent or hidden defects that may appear later on as a result of normal use, through no fault of the lessee.

Thus there is no difference in opinion among jurists that the occurrence of the defect during the lease term will cancel the binding effect of the contract if such defect affects the enjoyment of the benefit stipulated in the contract. To quote from ***al-Moughni***: "If a person leases an object and discovers a defect he came to know about it, then he may rescind the contract with no objection (from any jurist)." The defects that do or do not entail rescission are determined by experts[13].

client after the expiry of the term of the lease. Such promise, as will be indicated in the following Clause (No.15), should not be binding on the both parties.

15. It shall not be permissible, in the case where the bank buys the leased object from the lessee client, for the sale contract or the lease contract to provide for the re-purchase by the client of such asset for a fixed price. It is permissible for the bank, however, to specify the price for which it shall be bound by to sell to the lessee, without the latter being bound by same in the lease contract.

Pursuant to the previous clause, this provision indicates that the agreement pertaining to the selling of the asset to the client after the expiry of the lease contract must not specify a fixed sale price because this is akin to selling a ***kaali*** for (another) ***kaali (al-Kaali Billkaali)*** - i.e. selling a debt for (another) debt, in view of the fact that both exchanges considerations would be a debt related to the other party's ***dhimma*** (liability assumed by the other party) at the moment of the conclusion of the contract.

The Prophet, PBUH, has enjoined against selling a ***kaali*** for (another) ***kaali*** in the tradition quoted by ***al-Baihaqi*** and considered weak by ***Ibn Hajar***. Jurists of different schools have several views of the concept of selling a ***kaali*** for (another) ***kaali***, but they all agree that the most important form thereof is the selling of a debt for (another) debt. Now if it is necessary to indicate (in the contract) that the asset would be sold to the client after the expiry of the lease contract, then it would not be objectionable for the bank to nominate the price, which would be akin to the offer in the sale contract, which is permissible, unless acceptance is expressed by the buyer. Therefore, the bank may commit itself to the offer and leave the acceptance open for the client's wish and option at the moment of selling.

16. If the bank desires to insure the asset in its own favor then it shall itself bear the insurance cost.

Contemporary academies of jurisprudence have issued ***fatwa*** about the permissibility of co-operative insurance of machines, equipment and buildings. Therefore, a bank may insure the asset it owns before leasing same to the client in order to safeguard its rights. And as the beneficiary in the insurance is the owner of the asset, it may not burden any other party with the insurance cost, as if he buys a commodity and stipulates that a third party should bear the price thereof, which is tantamount to illegal acquisition of other people's finance (property). However, it shall not be objectionable if the lessee should pay the insurance premium on behalf of the lessor, in which case the premium must be deducted from the rent agreed upon by the two parties.

17. If the rental installments in a lease ending up in ownership are computed so that the lessee would acquire ownership of the asset after a fixed term, and if the client subsequently desires to acquire ownership before that, which would require amending the term of the lease, then it shall not be objectionable to cancel the first lease contract and enter into a new lease contract involving different rental installments.

It is customary in computing the installments of a lease that ends up in ownership to take into consideration the length of the term of the lease that ends in selling (the leased object), it being understood that the length of the term reduces the amount of the remaining portion (residual) of the leased asset, while the shortness of the term increases such amount. This, in turn, is reflected in the amount of the rent in both cases. In other words, amending or deferring the date of the sale of the asset often results in the need to reconsidering the rental installments. Obviously, such amendment may not be made in the same contract.

Moreover, the client's wish to advance or defer the date of the sale indicated in the contract means introducing an amendment to the lease

contract, which necessitates the rescission thereof with the approval of both parties and the conclusion of a new contract.

18. It is not objectionable that bank leases an equipment for a period equivalent to its estimated useful life for a rental value equals to the amount spent to acquire the equipment plus profit, as long as bank bears the normal responsibilities pertaining to ownership of equipment, such as insurance, taxes and structural maintenance.

Banking lease is used in contemporary Islamic banking to help clients meet their needs for financing to acquire equipments or assets. Therefore, a client may request from the bank to buy a specific equipment and leases it back to him and that he promises to lease it for a period which will be set by the bank to be equal to the useful life of that equipment. The bank may determine rental value to be offered to the client on mark-up basis, i.e. cost plus profit. The lease contract can only be concluded after bank posses the equipment, where the client will have to honor his promise to lease and his acceptance of the offered price. Upon conclusion of the lease contract the rental value will be due and payment of which might be on installments basis or lump sum.[14] But the bank as a lessor should be responsible for the equipment's insurance, taxes and structural maintenance. Bank can build in these expenses in the total rental value. However, amount of total rental value should not be changed once it has been set and agreed upon between lessor (bank) and lessee (client).[15]

4-5 Notes & References

[1] As opposed to Hire contract for human services which comes under the same juristic principles in Shari'ah.

[2] *Sura-al-Maida*, Verse (1).

[3] *al-Moughni* (6/129).

[4] *al-Moughni* (6/11).

[5] Wahbah al-Zouhaili, *Islamic Jurisprudence and its guidelines* 39/1.

[6] *al-Moughni* 6/4.

[7] Kuwaiti Encyclopedia of Jurisprudence: 1/47.

[8] Kuwaiti Encyclopedia of Jurisprudence 9/93.

[9] Ibn Rushd al-Qurtubi, *Bidayat al-Mujtahid wa Nihayat al-Mouqtased 2/229.*

[10] Kuwaiti Encyclopedia of Jurisprudence 1/73.

[11] Kuwaiti Encyclopedia of Jurisprudence 1/270.

[12] *al-Moughni* 6/99.

[13] Juristic Encyclopedia 1/275.

[14] *Ibn Qudamah, al-Moughni, 6/4.*

[15] *al-Moughni, 6/11.*

Chapter Five

STANDARD OF MUDARABA FINANCE

5 - 1 DEFINITIONS
5 - 2 SCOPE OF STANDARD
5 - 3 TEXT OF STANDARD
5 - 4 EXPLANATORY MEMORANDUM
5 – 5 NOTES AND REFERENCES

5 - 1 Definitions

A. ***Mudaraba*** Finance: This is a profit-sharing partnership formed between a bank and a client who may be an individual or a body corporate, under which the bank would be ***rabb ul-maal*** (the money provider) in accordance with the well-known rules of ***Mudaraba*** in Islamic *Shari'ah*.

B. ***Mudareb***: The bank's client that invests the ***Mudaraba*** capital.

C. ***Rabb ul-maal***: The bank that provides the ***Mudaraba*** capital.

D. Capital: The cash sum given to a ***Mudareb*** at the time of concluding the contract.

E. Profit: The amount that exceeds the **Mudaraba** capital after deducting the expenses thereof, which is arrived at by actual or constructive ***tandeed*** (conversion of assets into cash).

F. Loss: The amount by which the **Mudaraba** capital diminishes, which is arrived at after actual or constructive ***tandeed*** (conversion of assets into cash).

G. ***Mudaraba*** expenses: The expenses which the parties to a ***Mudaraba*** agree to deduct from the ***Mudaraba*** funds before distribution [of the profit].

H. ***Qismah***: This means the distribution of profit between the bank and the ***Mudareb.***

I. ***Tandeed***: The actual conversion of the ***Mudaraba*** assets into money, or the conversion thereof (constructively) in the account books through evaluating the assets on a specified date.

J. Restricted ***Mudaraba***: A ***Mudaraba*** which is restricted by the bank in terms of time, place or particular type of activity.

K. Unconditional ***Mudaraba***: A ***Mudaraba*** in which the bank gives the ***Mudareb*** a free hand to invest the capital as he deems fit.

L. Discontinuance of partnership: vitiation of a ***Mudaraba*** contract for stipulating a condition which may result in all the profit going to one of the parties.

M. ***Dhimma***: The qualification of a nominal (company) or a natural person to bear obligations and enjoy rights. Hence debts of companies or persons whether incorporeal property or fungible are tied or related to it ***(dhimma).***

5 - 2 Scope of the Standard

Financing profit-generating activities, whether in commerce, industry, real estates or agriculture, or other production or service activities which are permissible under Islamic *Shari'ah*.

5 - 3 Text of the Standard

1. The ***Mudaraba*** capital provided by the bank must be known and designated in a definite currency.

2. If ***rabb ul-maal*** provides a ***Mudareb*** with goods or with assets in kind, then same shall be evaluated in terms of cash in order to determine the ***Mudaraba*** capital.

3 The ***Mudaraba*** capital may be a debt in (related to) the ***Mudareb dhimma*** or any other person, in the latter case it should be made available to the ***Mudareb*** for investing same.

4. The bank shall make the capital available to the ***Mudareb*** by the generally recognized methods, including granting him a bank ceiling, in which the capital would be put at his disposal on demand.

5. The percentage of profit distribution between the bank and the ***Mudareb*** must be determined when the contract is concluded.

6. It is not objectionable in a ***Mudaraba*** finance to agree on a different percentage of profit distribution for the profit which exceeds a certain amount. The bank may cede its share in such surplus profit to the ***Mudareb.***

7. In a ***Mudaraba*** finance, loss shall be borne by the bank except in the cases of infringement, default and breach of contract provisions.

8. In a ***Mudaraba*** finance, the capital is held by the client as a trust. Therefore, he is not guaranteeing the same except in case of infringement or default.

9. It is not objectionable to provide in the contract for agreed upon methods for establishing the occurrence of infringement or default.

10. A ***Mudaraba*** finance is restricted. The client shall guarantee the repayment of the capital if he did not abide by the terms the bank had set for him to observe.

11. A ***Mudareb*** may neither mix his own money with the ***Mudaraba*** finance capital nor give said capital to another ***Mudareb*** except with the permission of the bank.

12. A ***Mudareb*** may not borrow money on the ***Mudaraba*** account; otherwise, he would be deemed to have committed an infringement and shall guarantee the repayment of the capital.

13. In a ***Mudaraba*** finance, it is not objectionable to specify in the contract the expenses that shall be borne by the ***Mudaraba*** and the activities which the ***Mudareb*** undertakes to carry out.

14. A ***Mudareb*** shall, immediately after the ***tandeed***, pay back the capital plus the profit (if any) or minus the loss (if any). Should he fail to do so without [obtaining] the consent of ***rabb ul-maal***, he shall be deemed to be a usurper.

15. The bank may take financial or personal guarantees from the ***Mudareb*** to ensure that he shall repay all the bank's rights without delay.

16. The ***Mudareb*** is responsible for collecting the debts owed to the ***Mudaraba*** whether he realizes profit or loss as a result of his activities.

17. It is not objectionable to provide, in the ***Mudaraba*** finance contract, for setting aside a provision for doubtful debts, provided that such provision shall be deemed to be part of the ***Mudaraba*** expenses that are deducted from the profit.

18. Doubtful debts shall be deemed to be bad debts after the elapse of a mutually agreed upon period of time following the settlement of the contract.

19. The two parties to the contract may agree upon a method for distribution of the surplus between them if the bad debts turn out to be actually less than the provision for setting off doubtful debts.

20. If the bad debts turn out to be actually more than the provision for setting off doubtful debts, the difference shall be deducted from the ***mudareb***'s share in the profit even if such difference entirely absorbs such share.

5 - 4 The Explanatory Memorandum.

1. The *Mudaraba* capital provided by the bank must be known and designated in a definite currency.

Islamic *Shari'ah* jurists have stipulated that the ***Mudaraba*** capital should be explicitly stated to preclude any unknown element that [may] lead to a dispute between ***rabb ul-maal*** and the ***Mudareb***. This is because the realization of profit [cannot] be known except after ensuring that the capital is safe and complete. Therefore, it has been stipulated that the amount of the capital and the denomination of its currency should be explicitly known and stated.

It is stated in ***al-Moughni*** that: "One of the conditions (For making ***Mudaraba*** permissible) is that the amount of the capital thereof should be known; it is not allowable that Mudaraba capital is unknown"[1].

Besides, it is stated in the ***Sharh Muntaha al-Iradat***[2] that a ***Mudaraba*** "is a contract which is vitiated if it involves an unknown element (***jahala***), for it would not be valid if the capital was designated in terms of a basket of ***dirhams*** or ***dinars***, as it is imperative to refer to the capital when the contract terminates in order to determine the profit, which would not be possible unless the capital was explicitly known".

2. If *rabb ul-maal* provides a *Mudareb* with goods or with assets in kind, then same shall be evaluated in terms of cash in order to determine the *Mudaraba* capital.

Where ***rabb ul-maal*** provides goods or assets in kind as the ***Mudaraba*** capital, such goods or assets should be evaluated in terms of cash money, which cash values would be considered the ***Mudaraba*** capital. Such evaluation satisfies the condition of explicit knowledge of the amount of the capital, and precludes the existence of any unknown elements [***jahala***] that [might] lead to disputes[3].

3. The *Mudaraba* capital may be a debt in (related to) the *Mudareb dhimma* or any other person, in the latter case it should be made available to the *Mudareb* for investing same.

It is not objectionable for the ***Mudaraba*** capital to be [in the form of] a debt. Two cases may be involved. In the first one, the capital could be a debt owed by a third party to ***rabb ul-maal***. In such case the contract would be conditional on the collection of such debt from the debtor. It is stated in ***Al-Moughni*** that: "If a man says to another: 'collect the money owed by so and so and invest it in a ***Mudaraba*** transaction' and the man collects the money and invests it, then this would be permissible"[4]. This is because the ***Mudaraba*** was linked to the collected money which was entrusted to him, and the capital would then be cash money and not a [mere] debt. In other words the ***Mudareb*** collects the debt in his capacity as proxy, and holds the collected debt in his capacity as trustee[5]. In the second, the capital could be a debt in the Mudareb ***dhimma*** owed by him to ***rabb ul-maal***, in which case the capital should be an established debt that is payable at the time of concluding the ***Mudaraba*** contract and the ***Mudareb*** should have acknowledged the debt and should be solvent and capable of repaying the debt[6].

4. The bank shall make the capital available to the *Mudareb* by the generally recognized methods, including granting him a bank ceiling, in which the capital would be put at his disposal on demand.

It is imperative that ***rabb ul-maal*** should make the ***Mudaraba*** capital available to the ***Mudareb***, this being effected most obviously by delivering the capital to the ***Mudareb***. Nevertheless, the conditions and customs prevailing nowadays have resulted in the tendency of people to deposit their funds in banks for safekeeping and for organizing their business activities. Therefore, a ***Mudareb*** that receives the ***Mudaraba*** capital in the form of cash money, will no doubt deposit it in a bank. Consequently, banks have tended to shorten this procedure by designating the capital in the form of a limited credit facility, i.e. the capital is made available for the ***Mudareb*** to withdraw therefrom, and shall be recorded

in the books of the bank in an account specially designated for this purpose. The bank's limited credit facility is the maximum amount assigned by the bank for the ***Mudareb*** to withdraw therefrom up to the designated limit within a specified period of time, for the performance of the ***Mudaraba***. Such a limit is equivalent to the maximum amount which the ***Mudaraba*** capital agreed upon by the two parties may reach. For the purpose of distribution of the profit and determination of the capital at the end and liquidation of the ***Mudaraba***, the actual amount drawn by the ***Mudareb*** from the allocated ceiling is taken into account. Basing profit distribution in a ***Mudaraba*** on the capital which was actually used, even though the agreed-upon share [in said capital] is otherwise, is dictated by justice and is not contrary to the rules of transactions in Islamic *Shari'ah*.

In this respect, it is stated in ***Al-Mudwanah*** [A Book of Islamic *Shari'ah* Rules] that: "(He said) ***Malik*** was asked about two men who became partners. The first of the two contributed one thousand and five hundred ***dirhams*** and the second contributed five hundred ***dirhams*** and indicated that he had one thousand ***dirhams*** at a [distant] place he specified. The first remained where he was, and the second left for the place where he alleged he had one thousand ***dirhams*** in order to buy goods for all the money but failed to collect the unpaid one thousand ***dirhams***. So he bought goods for two thousand ***dirhams***. (He said:) ***Malik*** said. "I find that the share of everyone of them in the profit should be proportionate to his contribution to the capital. He found that the second partner, whose one thousand ***dirhams*** were not available, was entitled to the profit of the five hundred ***dirhams*** he had contributed"[7].

5. The percentage of profit distribution between the bank and the *Mudareb* must be determined when the contract is concluded.

Among the conditions that must be satisfied for a ***Mudaraba*** to be valid, a condition connected with the profit provides that the percentage of sharing should be explicitly indicated and that the profit must be a common share, to be distributed, for example, between the two either equally or one of them gets one third and the other receives the remaining

two thirds, and so on. This is because the object of the contract is profit, and if profit was not determined then the contract would become void. In other words, the object of a ***Mudaraba*** is [making] money, and the aim of a ***Mudareb*** is not the activity of the active partner in itself. Therefore, the accruing profit is to be shared in common by the ***Mudareb*** and ***rabb ul-maal***. Thus, it is not permissible to assign to one of them a predetermined profit ***Ibn Qayyem al-Jawziyyah***[8].

If the two contracting parties specify a fixed amount [of profit] for one of them, then such a condition is invalid, for a ***Mudaraba*** requires that the two parties share profit [in common], and the profit realized by a ***Mudaraba*** may be just that amount [assigned to one of them], or even less, in which case all the profit would go to one partner, to the exclusion of the other[9]. This is because a partnership is based on fairness between the two partners. Thus, it would not be fair to assign the profit exclusively to one of the two. On the other hand, when each has a commonly held share, then they will both bear profit and loss, so that if profit accrues, then they will share it; if not, they will both share the loss: one of them losing the benefit of his efforts, the other losing the benefit of [investing] his money. This is the reason why ***wadee'ah*** [loss] affects [the party contributing] the money [is deducted from the capital], for this would be tantamount to loss of the benefit of the money [sic!] ***Ibn Qayyem al-Jawziyyah***[10].

Thus a ***Mudareb*** is entitled to a determined portion of the profit: "any portion that is agreed upon by the two parties, be it one third, a quarter or a half of the profit." (Ibn Rushd, ***Bidayat Al-Mujtahid wa Nihayat Al-Mouqtased***, V.II, p. 236[11]).

6. It is not objectionable in a *Mudaraba* finance to agree on a different percentage of profit distribution for the profit which exceeds a certain amount. The bank may cede its share in such surplus profit to the *Mudareb*.

In a ***Mudaraba***, it is not permissible to assign, at the time of concluding the contract, a lump sum out of the profit to either party. It is permissible, though, to allocate to either of the two parties a part of the profit, such as one third, a quarter or a half "This is an exception from [the rules pertaining to] an unspecified wage in ***Ijara*** , and the reason why such permission is granted is in order to facilitate matters for people"[12].

It is also impermissible for either of the two parties to stipulate a condition that contradicts the purport of the contract and entails the dissolution of their partnership. For example, it is impermissible for one of the two to say to the other: "Use it [the capital] in a ***Mudaraba*** and the profit generated shall be mine."[13].

Whereas agreement in a ***Mudaraba*** contract upon allocating to the ***Mudareb*** a percentage of profit depends on the amount of the profit realized, such a stipulation neither discontinues the partnership nor contradicts the purport of a ***Mudaraba*** contract, for each of the two parties gets a part of the accrued profit. Moreover, it is permissible for ***rabb ul-maal*** or the ***Mudareb*** to stipulate that if profit exceeds a fixed sum of money, he shall be entitled to a designated sum, and the balance shall be shared, for example, equally by the two of them[14].

Some *Shari'ah* boards have issued a ***fatwa*** [*Shari'ah* opinion] to the effect that a ***Mudareb*** that invests his efforts may have a progressive share in the profits, depending on the profit realized by the ***Mudaraba***. (Resolution No. 77 issued by the *Shari'ah* Board of Al-Rajhi Banking Company For Investment). Moreover, ***Al-Barakah*** Symposium indicated in its ***Fatwa*** No. 147 that ***rabb ul-maal*** and the ***Mudareb*** may agree that if profit

exceeds a certain percentage of the capital per annum, then such surplus shall be allocated to the ***Mudareb***.

7. In a *Mudaraba* finance, loss shall be borne by the bank except in the cases of infringement, default and breach of contract provisions.

A ***Mudareb*** is a trustee; therefore, he does not guarantee any part of the capital that is lost unless he has committed an infringement. Besides, loss in a ***Mudaraba*** contract is borne by ***rabb ul-maal*** alone, the ***Mudareb*** bearing no more loss than his work and efforts[15]. In other words, the loss sustained in a ***Mudaraba*** is borne exclusively by the capital [provider], the ***Mudareb*** bearing no part thereof[16].

In order to narrow down the room for controversy, infringement and default should be defined in the very contract of a ***Mudaraba***. Therefore, in addition to the profit distribution percentages and the expenses that are to be borne by the ***Mudaraba***, the contract should define in detail the responsibilities of the ***Mudareb***, to leave no way for controversy in determining [what constitutes] infringement and default. As an additional precaution, it is advisable that the contract designate the members of an arbitration panel, whose task is to determine whether or not the ***Mudareb*** has observed the terms of the contract.

8. In a *Mudaraba* finance, the capital is held by the client as a trust. Therefore, he is not guaranteeing the same except in case of infringement or default.

It is unanimously agreed by the founders of *Shari'ah* schools that the capital is held by the ***Mudareb*** in his capacity as a trustee, for he manages the funds with the permission of ***rabb ul-maal***, and the benefit to be derived from such funds are not confined to him[17].

Besides, stipulating that the ***Mudareb*** shall guarantee the capital is contrary to the purport of the contract and changes the ***Mudaraba*** into a loan. Moreover, as the ***Mudareb*** is a trustee, it may not be stipulated that

he shall be liable for the ***Mudaraba*** capital except in the case of infringement and default on his part. A ***Mudareb*** is deemed to have committed an infringement if he breaches the valid conditions of ***rabb ul-maal***.

If ***rabb ul-maal*** stipulates a valid condition on the ***Mudareb*** and if the ***Mudareb*** fails to observe such condition, it is permissible to hold him liable [for the capital]. Thus if ***rabb ul-maal*** stipulates that he shall sell only on cash terms... the ***Mudareb*** may not breach this stipulation; otherwise, he would guarantee [the capital][18]. Moreover, if a ***Mudareb*** does anything he is not authorized to do; as, for example, if he were to buy something he is prohibited from buying, he would then be deemed to have committed an infringement and would be held liable[19]. On the other hand, if, according to usage and practice, a ***Mudareb*** is supposed to carry out certain activities which are normally associated with such ***Mudaraba*** activity, and if he fails to carry out same, then he shall be in default.

The ***mudareb***'s liability does not mean that he is solely entitled to profit, for if the ***Mudareb*** guarantees only the capital, and is solely entitled to profit, then this may encourage breach and infringement. Therefore, in case of a breach, it is appropriate to adopt the view of ***Malki*** jurists, [namely] that profit, if any, shall be divided according to the condition [stipulated in the contract]. However, the ***Mudareb*** bears the entire loss if it is due to the breach.[20]

To avoid disputes and preclude the existence of unknown elements that entail disputes, the contract must indicate in detail the conditions stipulated by ***rabb ul-maal*** which the ***Mudareb*** must observe, as this would facilitate the task of the arbitration panel in determining whether or not the ***Mudareb*** has observed the stipulations of ***rabb ul-maal***.

9. It is not objectionable to provide in the contract for agreed upon methods for establishing the occurrence of infringement or default.

Infringement and default are terms that are too general to narrow down and are understood differently by different parties. Thus what may be considered an infringement by the bank may not be so considered by the ***Mudareb***. Even jurists of respectable schools "hold different opinions as to what may or not be considered as infringement"[21]. Therefore, in their actual practice, banks make a point of narrowing down the room for any controversy, by attempting to agree, in the contract, upon methods whereby the ***mudareb***'s infringement or default is proved.

The first one of such methods is making sure that the contract shall contain a detailed and accurate description of the ***mudareb***'s tasks and responsibilities as well as the activities which ***rabb ul-maal*** stipulates that the ***Mudareb*** shall not carry out, provided that all this shall be within the limits of valid conditions which do not vitiate the contract.

The Second is providing in the contract for setting up an arbitration panel that would decide on the differences that may arise between the parties to a ***Mudaraba*** contract. Said panel shall act in accordance with the conditions stipulated in the contract and with prevailing commercial practices.

It is acknowledged by *Shari'ah* jurists that ***rabb ul-maal*** may stipulate certain conditions that restrict the ***Mudaraba*** in such a manner as to safeguard his rights and funds lying with the ***Mudareb***. ***Ibn Abbas*** is reported to have said: "When ***Abbas Bin Abdul Muttaleb*** paid money into a ***Mudaraba*** arrangement to someone, he used to stipulate that the ***Mudareb*** should not travel by sea, nor through valleys, nor buy a living animal; otherwise, he would guarantee [the capital]. His stipulation was reported to Allah's Apostle, may the peace, mercy and blessings of Allah be upon him, and he endorsed such stipulation." This is narrated by ***Al-Tabarani*** in ***Al-Awsat***.[22]

If this type of conditions is permissible, then the stipulation of conditions intended to prevent unknown elements that could lead to disputes as regards the methods of proving the commission of infringement and default, is perhaps more essential and necessary in the ***Mudaraba*** contract.

10. A *Mudaraba* finance is restricted. The client shall guarantee the repayment of the capital if he did not abide by the terms the bank had set for him to observe.

There are two types of ***Mudaraba***: unconditional and restricted ***Mudaraba***. The unconditional type is that which is not bound by any restrictions, as in the case when for example one says to the other: "I pay you this money on ***Mudaraba*** basis, provided that we share the profit." The restricted type is that in respect of which ***rabb ul-maal*** restricts the activity of the ***Mudareb*** , as when he stipulates that the ***Mudareb*** shall deal with a certain type of commodities, or when he designates a certain type of sale, a certain region for trading or a certain class of people to deal with. The first type of ***Mudaraba***, namely the unconditional ***Mudaraba***, is permissible in the opinion of the majority of *Shari'ah* jurists, while the restricted ***Mudaraba*** is permissible in the opinion of two ***Imams: Abu Hanifa*** and ***Ahmad Ibn Hanbal***, who have also permitted the stipulation of a period of time for the ***Mudaraba***[23].

In accordance with the opinion which deems a restricted ***Mudaraba*** permissible, a condition stipulated by ***rabb ul-maal*** is binding on the ***Mudareb***, and if the ***Mudareb*** acted in violation of such stipulation, he would guarantee (the capital) and be held liable[24].

For maintaining the stability of transactions and preventing the possibility of any unknown element as much as possible, banks have adopted the opinion which deems that a restricted ***Mudaraba***, including that which limits it to a certain period of time, is permissible, and the ***mudareb***'s failure to observe the restrictions stipulated by the bank in the ***Mudaraba***

contract constitutes an infringement on his part and hence it would be permissible for him to guarantee the ***Mudaraba*** capital.

It is well known that by their nature as financial mediators, banks do not use only their own funds in their various transactions and investments; they also use the funds of their clients lying with the banks in various accounts. In order to protect and safeguard such funds against risks, the provisions included in these standards have incorporated all the measures that would realize such purpose, including those which preclude the bank from entering into unconditional ***Mudaraba*** contracts.

11. A *Mudareb* may neither mix his own money with the *Mudaraba* finance capital nor give said capital to another *Mudareb* except with the permission of the bank.

There are certain acts which a ***Mudareb*** may not do merely under the terms of the contract, but which may be done after obtaining the permission of ***rabb ul-maal***. For example, a ***Mudareb*** may not mix the capital of the ***Mudaraba*** with his own money, nor may he give said capital to another ***Mudareb*** [to use same in a ***Mudaraba*** transaction]. Such acts may be done only with the permission of ***rabb ul-maal***. Accordingly, if ***rabb ul-maal*** tells the ***Mudareb*** to act as he deems fit or gives him permission to act [as he wishes], then he may mix the ***Mudaraba*** capital with his own money or he may give the capital of the ***Mudaraba*** to another ***Mudareb*** [to use same in a ***Mudaraba*** transaction]. Therefore, if ***rabb ul-maal*** tells the ***Mudareb*** to act as he deems proper or as God inspires him, and the ***Mudareb*** is [according to the contract] entitled to half of the profit, and such ***Mudareb*** gives the capital to another ***Mudareb*** to invest same in a transaction and agrees to receive a quarter of the profit of the capital, then this agreement is valid and the [original] ***Mudareb*** is deemed to have literally observed the condition, for he may decide to give it to a more experienced person[25].

12. A *Mudareb* may not borrow money on the *Mudaraba* account; otherwise, he would be deemed to have committed an infringement and shall guarantee the repayment of the capital.

Al-Moughni indicates that a ***Mudareb*** may not effect purchases exceeding the capital of the ***Mudaraba***, as this would vitiate the contract, because the capital, for which the first goods are purchased, is the same capital for which the second goods are purchased. Moreover, a ***Mudareb*** may not effect a second purchase on credit and assume liability thereof as this requires the authorization of ***rabb ul-maal***, according to one of the two opinions held by ***Hanbali*** jurists[26].

Besides, purchases by the ***Mudareb*** exceeding the ***Mudaraba*** capital require an additional guarantee covering the amount of the debt that exceeds the capital, and it is likely that ***rabb ul-maal*** may dispute to bear the [cost of this] guarantee in case of loss; while if profit accrued, then ***rabb ul-maal*** would not be entitled to it while the guarantee would have to be borne by the ***Mudareb***. It is stated in ***Al-Mudwanah Al-Kubra*** as follows: "... (He said:) I asked Malek about certain parties who give other parties funds [as capitals] for ***Mudaraba***, and those who receive such funds sit in [their] shops, buy goods whose prices exceed the funds they received, assume liability therefor, and then they give to ***rabb ul-maal*** [their portions in] the profit of all their purchases. Malek replied: 'This is not proper'" ... According to what I heard from Malek, It is not compatible with the rules of ***Mudaraba*** to buy on credit, to assume liability for the debt and allocate the profit to ***rabb ul-maal***. This is not permissible"[27].

This clause forbids a ***Mudareb*** from buying goods whose prices exceed the capital; otherwise he would guarantee and be held liable [for the capital], this being in order to secure the stability of transactions and preclude the causes of disputes.

13. In a *Mudaraba* finance, it is not objectionable to specify in the contract the expenses that shall be borne by the *Mudaraba* and the activities which the *Mudareb* undertakes to carry out.

This clause aims at minimizing as much as possible the causes of controversy and dispute between a ***Mudareb*** and the bank. Thus, the contract designates the expenses to be borne by the ***Mudaraba***, which have a direct relation with the activities thereof, such as the expenses connected with transportation or storage, or the costs of operation and production ..etc., and those not to be borne by the ***Mudaraba*** and which do not have a direct relation thereto, particularly where the ***Mudareb*** is involved in more than one activity in his type of business.

For example, if the ***Mudareb*** has more than one production line and the ***Mudaraba*** covers only a certain production line, then the ***Mudaraba*** shall not bear the costs of the other production lines. One of the matters which assist in determining the amount and type of expenses in a ***Mudaraba*** is the progress which has taken place in the methods of quantification and in cost accounting. Thus, it is now possible to calculate the average cost of producing one liter of oil or the average cost of producing one bottle of carbonated soft drinks ... etc, which makes it possible to know the total production costs with respect to a designated production cycle. This type of data is available and ***rabb ul-maal*** may obtain same from the client (***Mudareb)*** seeking financing and may verify the authenticity thereof.

This clause aims at prompting the Islamic bank to always insist on designating the ***Mudaraba*** expenses in the contract so far as this is possible. It is noteworthy that such designation of the expenses does not imply that the ***mudareb***'s honesty is questionable or that he is not trustworthy. It is well known that a ***Mudaraba*** contract is based on trust and that the ***Mudareb*** is a trustee to whom the capital of the ***Mudaraba*** is entrusted, as indicated earlier[28]. The prior designation and quantification of ***Mudaraba*** expenses will result in achieving the best possible production or marketing efficiency, and will result in prevention of disputes and in minimizing the possibility of controversy. It should be

noted that the expenses are designated in light of the previous practical experience of the ***Mudareb***, who designates the expenses himself, while the role of the bank is confined to verifying the objectivity and authenticity of such expenses before approving and incorporating same in the contract.

The contract must also designate, as we have indicated earlier, the activities to be carried out by the ***Mudareb*** and those which cause him to be in default if not carried out in the best possible manner. This condition precludes the possibility of disputes which could arise as a result of failure to specify, in the contract, the tasks for which each party is responsible. All such matters are to be designated in light of the general framework of ***Mudaraba*** and in accordance with the valid conditions which do not contradict the ***Mudaraba*** contract nor vitiate such contract[29].

14. A *Mudareb* shall, immediately after the *tandeed*, pay back the capital plus the profit (if any) or minus the loss (if any). Should he fail to do so without [obtaining] the consent of *rabb ul-maal*, he shall be deemed to be a usurper.

The capital of a ***Mudaraba*** is entrusted to the ***Mudareb*** in his capacity as a trustee, during the life of the partnership, and hence he guarantee (be liable for) same. On the other hand, following the winding up and liquidation of the ***Mudaraba***, and when ***rabb ul-maal*** demands his funds plus the profit of the ***Mudaraba***, or minus loss, the ***Mudareb*** should immediately give him back the funds. If the ***Mudareb*** fails to do so, then he would be liable therefor and guarantee (the funds), and would be like a depositary that had, without justifiable cause, delayed or refused returning the deposit to his owner. Besides, if a ***Mudareb*** breached a condition stipulated by ***rabb ul-maal***, by doing, for instance, something he was not authorized to do, he would be held as a usurper[30]. Refusal by the ***Mudareb*** to return the money to ***rabb ul-maal*** is similar to or worse than a breach of a condition stipulated by ***rabb ul-maal***, for, in this case, the ***Mudareb*** would be deemed to have utilized the property of someone else without his permission.

A borrower is deemed a usurper if he fails to return the borrowed thing at the designated date and keeps using it. "If a borrower plants in or builds on the land he borrowed after the lender's permission is terminated, the borrower is deemed a usurper; or if the borrower plants or builds after the expiry of the period of borrowing - when a time limit has been designated for the borrowing - even if the lender has not declared termination of permission, after the expiry of the time limit - then the borrower is also deemed a usurper, for having utilized the property of someone else without his permission"[31].

If a ***Mudareb*** is deemed a usurper in case he fails to give back to ***rabb ul-maal*** his dues when the ***Mudaraba*** is liquidated, and if he invests such dues and realizes profit from such investment, then he shall analogically be subject to the *Shari'ah* rules which apply to a borrower who trades in a consignment entrusted to him without the owner's permission. The reason why both the ***Mudareb*** and the borrower are treated on the same footing and made subject to the same rules is that each of them is a trustee and has committed an infringement as regards the thing entrusted to and invested it without the permission of the owner thereof. The rule of *Shari'ah* is that the actual profit realized in this case should be allocated to the owner, on the basis of the opinion of ***Hanbali*** jurists: "If he usurps prices [of goods] or goods and trades in same, then the owner is entitled to the profit and to the purchased goods"[32].

The *Shari'ah* rule applicable in this case is different from that applicable to debts or loans which debtors refuse to pay, the creditor being unable to take the returns of the invested funds throughout the period of non-payment - whether or not the involved fund is invested by the delinquent debtor during such period - for such returns are deemed to be a form of, or an excuse for taking, usury, as it relates to ***al-dhimma*** (and does not relate to the fund itself). As for the usurped funds held by a usurper, and the rule which applies thereto, which rule originally applies to funds in the possession of trustees, if they have committed an infringement with respect to same, the right of the owner in this case, would relate to the

usurped object (funds) actually or constructively usurped. Therefore, there is no question of suspected usury charged in return for a debt or of the arrangement "give me more (money) and I will give you more (time to pay)" if a usurper and anyone to whom the same *Shari'ah* rule applies - are obligated to pay the actual profit realized from trading in the usurped property, as usury applies to debts which are related to ***dhimma*** and not to rights related to objects (property), and as the right of the owner whose property is usurped is related to the usurped property, not to the usurper's ***dhimma***. Similarly, the right of a partner to his funds, which lie with his partner who refuses to give back the funds without any reason, relates to the funds themselves and not to the other partner's (i.e. usurper's) ***dhimma***. This is because if such funds are entirely lost while in the possession of the other partner -before his refusal to pay them back - there being no infringement or negligence on the part of the other partner, then the partner's right to his share in the capital is forfeited and the other partner does not become liable towards his partner for repayment of the lost funds. On the other hand, a creditor's right to a debt or to the deferred sale price relates only to the debtor's liability and not to any property (From an unpublished ***Fatwa*** by ***Dr. Nazih Hammad***).

15. The bank may take financial or personal guarantees from the *Mudareb* to ensure that he shall repay all the bank's rights without delay.

The original rule is that a ***Mudareb*** is a trustee during the life of the ***Mudaraba***, and he is not held liable to guarantee (the capital) except in the case of infringement or default. Hence, taking guarantees for the purpose of securing the ***Mudaraba*** capital is not permissible. This standard does not propose guarantees for such purpose. However, the standard gives the bank the right to take guarantees from the ***Mudareb*** as a precaution against his procrastination in paying the bank (***rabb ul-maal***) its dues when the ***Mudaraba*** is wound up and liquidated, and in order to compensate the bank and recover its loss in case of infringement or default on the part of the ***Mudareb***. When the ***Mudaraba*** is liquidated, the dues of ***rabb ul-maal*** become a debt relates to the ***Mudareb's dhimma***, and ***rabb ul-maal*** may secure same by a mortgage, as it is the case in all other debts, particularly as a ***mudareb***'s procrastination is exceedingly detrimental to banks, and profits realized by a ***Mudaraba*** may turn into a loss because of the ***mudareb***'s procrastination.

It is well known that a bank's efficiency and capability is not only measured by the amounts of profit it realizes but also by its capability to collect its dues, on maturities and to reinvest them. In fact, any sum that is held by a procrastinating ***Mudareb*** and is frozen and not invested represents a lost opportunity for the bank to make profit.

16. The *Mudareb* is responsible for collecting the debts owed to the *Mudaraba* whether he realizes profit or loss as a result of his activities.

A ***Mudaraba*** is a contract between two parties, one of whom provides funds and the other provides labor [efforts]. This combination of funds and labor is the source from which profit realization is expected. Therefore, each of them is entitled to such portion of profit as is mutually

agreed upon by them. The activities of trading, investment and rotation of funds are among the essential functions and responsibilities of a ***Mudareb***. All the activities relating thereto, such as purchase, storage and transportation or cash sale or sale on credit - if the latter is not prohibited by ***rabb ul-maal*** - and the collection of debts are among the tasks for which a ***Mudareb*** is responsible.

The process of rotating ***Mudaraba*** capital in terms of buying and selling, and the associated ***Mudaraba*** debts constitute contractual relationships which arise between the ***Mudareb*** and his customers, ***rabb ul-maal*** having no connection therewith. Therefore, it is neither necessary nor is it expected that the collection of this type of debts should be a task for which ***rabb ul-maal*** is responsible, particularly if we take into consideration the commercial and financial business relations, especially in the field of banking activities, which preserve for contractual relations their distinct and independent character, which makes it impossible for the bank (***rabb ul-maal***) to engage in the processes of the collection of debts which have not been originally created by it.

17. It is not objectionable to provide, in the *Mudaraba* finance contract, for setting aside a provision for doubtful debts, provided that such provision shall be deemed to be part of the *Mudaraba* expenses that are deducted from the profit.

Financial and commercial firms usually set aside an allowance for doubtful debts, which allowance is calculated as a percentage of the total receivables thereof, and charge such allowance to the loss and profit account. They do so as a precaution against procrastination of their customers, and lest their accounts should show unreal profits which would lead to the distribution of a part of the firm's capital to the partners.

Controlling authorities see to it that the percentage of doubtful debts shall reflect, truthfully and to the highest degree of accuracy, in the balance sheets of such financial and commercial firms - through application of approved accounting standards in auditing offices - the real ability of such

firms to collect their debts. It does not serve the interests of such firms if such percentage is intentionally overestimated or underestimated. This is true because the overestimation thereof would result in reducing the firms' profits and weakening their competitive position. On the other hand, the underestimation thereof might cause a financial disaster to the firm as a result of distributing a portion of their capitals. Therefore, we find that firms always insist that the percentage of doubtful debts should be as accurate as possible, as deviation there from does not serve their interests.

This percentage is calculated by applying precise measurement methods which depend on the previous experience of such firms in collecting debts. It is natural that such firms pay much attention to this subject, as the amounts of their profit depend on their ability to collect their debts. Therefore, the debtors' item is the subject matter of credit studies and accurate accounting and auditing procedures. Such firms would have accumulated experience and established traditions which make it proper to rely on their estimates, which are considered virtually objective.

As banks, when they act as money providers, turn for their ***Mudaraba*** transactions toward corporations which are competent and enjoy a good commercial and financial reputation, the percentage of doubtful debts, that is estimated in light of actual experience, truly reflects the actual state of affairs of the receivables of such corporations. It is evident that the bank also verifies the authenticity of the estimation of such percentage by internal and external methods. The internal methods are studies, conducted by the bank itself, of such corporations, including their debt-collecting ability. The external methods depend on reviewing the percentages of bad debts shown in the final financial accounts of corporations having similar activities, which accounts would have been audited by a chartered accountant in accordance with unified accounting standards that are approved by the concerned controlling authorities. However, the percentage of doubtful debts, which is specified in the contract, affects the profit only in case the actual percentage proves to be more or less than the percentage specified therefor upon the liquidation of the Mudaraba. However, if the percentage specified in the contract is

equal to the actual percentage shown upon the liquidation, then the distributable profit will undergo neither increase nor decrease.

In case the actual percentage is less than the percentage specified in the contract, then this means that the ***Mudaraba*** has realized an additional profit. In the event that the percentage specified in the contract is observed, then such additional profit is allocated to the ***Mudareb***. As ***rabb ul-maal*** is aware of and has approved such condition, then the additional profit to be allocated to the ***Mudareb***, becomes, in this case, equivalent to a gift. This is akin to granting a ***Mudareb*** an additional profit that is linked to the profit realized by the ***Mudaraba***, as has already been discussed and approved under clause (6) of this standard, namely that of ***Mudaraba*** finance. The consensus of *Shari'ah* jurists is that this is permissible so long as it does not annul the partnership. The difference between the content in this clause and the content of clause (6) lies in that in clause (6) assignment of additional profit is stipulated in the contract in advance, while in this clause ***rabb-ul-maal*** assigns such additional profit when the ***Mudaraba*** is liquidated and the profit is distributed.

18. Doubtful debts shall be deemed to be bad debts after the elapse of a mutually agreed upon period of time following the settlement of the contract.

As a ***Mudaraba*** finance is by its nature temporary and as its on a short-term basis, the two parties to the contract, namely the bank (***rabb ul-maal***) and the ***Mudareb*** (the client), may desire to fix a period of time after the liquidation of the ***Mudaraba*** during which the ***Mudareb*** tries to collect as much as possible of the debts that were not paid during the term of the ***Mudaraba***. As it is unimaginable and impractical for such period of time to be open and unlimited, the two parties may find it proper to provide in the contract for a specific limited period of time for collecting the arrears. Following the expiry of such period, any uncollected receivables of the ***Mudaraba*** are deemed bad debts (written off). Such a condition is permissible so long as the two parties have agreed to it, particularly where the ***Mudaraba*** proves, upon liquidation, to have

realized a profit, for the profit resulting from collection of the arrears becomes an additional profit for the two parties, and may be permissible (for each party to waive its right in it).

It may be pointed out that fixing such period of time depends on objective considerations derived from practical experience where doubtful debts become at the end of such a period bad debts. Practical experience has shown that if debts remain in arrears for a certain period, then collection of same becomes virtually impossible.

19. The two parties to the contract may agree upon a method for distribution of the surplus between them if the bad debts turn out to be actually less than the provision for setting off doubtful debts.

This means the ***Mudaraba*** would have actually collected an amount of the debts it had considered a bad debt. This naturally would increase its profits. Such an extra amount may be collected either before the liquidation of the ***Mudaraba*** or after such liquidation and within the agreed-upon period of time indicated in the above clause. In both cases the collection of such amount would increase the profit of the ***Mudaraba***, and the two parties may agree on how it would be divided between them. For this purpose, they may divide it between them according to the agreed-upon percentages or they may agree that either of them would assign it to the other party.

20. If the bad debts turn out to be actually more than the provision for setting off doubtful debts, the difference shall be deducted from the mudareb's share in the profit even if such difference entirely absorbs such share.

If the actual percentage of doubtful debts should exceed the percentage indicated in the contract, then this would mean that the profit shown in the books of account was, in fact, more than the actual profit of the ***Mudaraba***, and that there was a concealed loss which took the form of debts which had not been, and would not be, collected. In term of this

clause, such loss would be borne by the ***Mudareb***, which would cause him to lose from his profit an amount equivalent to such loss. However, as either party may assign a part of his profit to the other party, then similarly, it may also be permissible for either party to assign a part of his profit for covering the loss of profit caused by his misjudgment or failure to shoulder his responsibilities and collect the ***Mudaraba*** debts. Such assignment is obviously permissible provided it does not lead to the discontinuance of the partnership, and that the uncollected debts shall not absorb the ***mudareb's*** entire portion in the profit, in which latter case, the matter would require the mediation of the arbitration panel in order to determine the extent of the ***mudareb's*** default in collecting the ***Mudaraba*** debts that would result in his being held liable [for the uncollected debts].

5-5 Notes & References

[1] *al-Moughni*, 5/191.

[2] *Sharh Muntaha al-Iradat*, V.II, p. 215.

[3] *Sharh Muntaha al-Iradat*, V.II, p. 215.

[4] *al-Moughni* 5/190.

[5] Wahbah al-Zouhaili, *al-Fiqh al-Islami*, V.IV, p.845.

[6] See *al-Fatawa al-Sa'adiyyah*, p. 425.

[7] *al-Mudwanah al-Kubra*, V.IV, p. 34.

[8] *A'lam al-Muwaqqi'een*, V.II, p. 6.

[9] al-Zouhaili, *Islamic Fiqh*, V.IV, p.85.

[10] *A'lam al-Muwaqqi'een*, V.II, p. 6.

[11] *Bidayat al-Mujtahid wa Nihayat al-Mouqtased* V.II, p.236.

[12] *Bidayat al-Mujtahid*, V.II, p. 236.

[13] *Sharh Muntaha al-Iradat*, V.2, p.217.

[14] al-Dareer, *al-Gharar wa Atharuhu fi al-'Uqood*, p. 523.

[15] Ibn Rushd, *Bidayat al-Mujtahid*, V.II, p.236; al-Zouhaili, V.IV, p. 836-7.

[16] *al-Moughni*, 5/148.

[17] *Sharh Muntaha al-Iradat*, V.II; *al-Moughni*, 5/192; al-Zouhaili, *al-Fiqh al-Islami*, V.IV, p. 853-4.

[18] *al-Moughni*, 5/149/151.

[19] *al-Moughni*, 5/165.

[20] al-Dassooqi, *Hashiyat al-Dassooqi 'ala al-Sharh al-Kabir* (Dassooqi's Commentary on *al-Sharh al-Kabir*, V.3, p.527).

[21] *Bidayat al-Mujtahid*, V.II, p.236.

[22] al-Tabarani, al-Awsat; al-Zouhaili, *al-Fiqh al-Islami,* V.IV, p.840 and 838; *al-Moughni*, 5/184; al-Zarqani's Comments on *Malik*'s *Muwatta*, V.III, p.349; *Sharh Muntaha al-Iradat*, V.II, p. 213.

[23] Ibn Rushd, *Bidayat al-Mujtahid*, V.II, p.238; al-Zouhaili, *al-Fiqh al-Islami*, V. IV, p. 84; *al-Moughni*, 5/185; al-Dareer, *al-Gharar wa Atharuhu Fi al-'Uqood*, p.517.

[24] Ibn Rushd, *Bidayat al-Mujtahid*, V.II, p.238; *al-Moughni* 5/149-151.

[25] *Sharh Muntaha al-Iradat*, V.II, pp.217-218; *al-Moughni*,/158, 5/42; al-Zouhaili, V.IV, pp. 857, 859.

[26] *al-Moughni* 5/158.

[27] *al-Mudwanah al-Kubra*, V.IV, p.64.

[28] *Sharh Muntaha al-Iradat*, V.II, p.226; al-Zouhaili, V.IV, p. 854.

[29] *al-Moughni*, 5/186.

[30] al-Zouhaili, V.IV, p.854.

[31] *Sharh Muntaha al-Iradat*, V.II, p. 291.

[32] *al-Moughni*, 5/416.

Chapter Six

STANDARD OF MUDARABA INVESTMENT

6-1 Definitions:

A. A ***Mudaraba*** Investment: This is a profit-sharing partnership formed between the bank and one or more of its clients. In this type of ***Mudaraba***, the bank is the ***Mudareb*** in accordance with the well-known rules of ***Mudaraba*** in Islamic Shari'ah, and is entitled to mix the sums of money invested by the clients, and to permit the clients to join and withdraw from the fund in accordance with rules that are agreed upon in the contract.

B. ***Mudareb*** **(laborer):** This is the bank that is responsible for managing the ***Mudaraba*** capital.

C. ***Rabb ul-maal*** (the money provider): The client/s providing the ***Mudaraba*** capital.

D. Capital: It is the cash money that is given by ***rabb ul-maal*** to a ***Mudareb*** at the time of concluding the contract, such capital being variable depending on additions thereto or withdrawals therefrom during the ***Mudaraba*** term.

E. Profit: This is the amount by which the capital increases on the date of the constructive or actual ***tandeed*** (conversion of the ***Mudaraba*** assets into cash) and deduction of the ***Mudaraba*** expenses.

F. Loss: This is the amount by which the ***Mudaraba*** capital decreases after the constructive or actual ***tandeed***.

G. ***Mudaraba*** Expenses: These are the expenses which the parties to a ***Mudaraba*** agree to deduct from the revenue of the ***Mudaraba*** before dividing the profit between them.

H. Division: This means dividing the profit between the ***Mudareb*** and ***rabb ul-maal*** (the money provider) and the final settlement of the ***Mudaraba.***

I. ***Mudaraba*** Funds: This comprises all the assets purchased with the capital, including the cash money and the accrued profit.

J. ***Tandeed***: Conversion of the ***Mudaraba*** assets into money, either actually or constructively by using accounting methods that are based on evaluation of the assets on a fixed date, on the basis of which the division (of profit) may be effected.

K. Restricted ***Mudaraba***: A ***Mudaraba*** which is restricted by the bank in terms of time, place or particular type of activity.

L. Unconditional ***Mudaraba***: A ***Mudaraba*** in which the bank gives the ***Mudareb*** a free hand to invest the capital as he deems fit.

M. Discontinuance of partnership: vitiation of a ***Mudaraba*** contract for stipulating a condition which may result in all the profit going to one of the parties.

N. ***Dhimma***: The qualification of a nominal (company) or a natural person to bear obligations and enjoy rights. Hence debts of companies or persons whether incorporeal property or fungible are tied or related to it ***(dhimma).***

6-2 Scope of the Standard

The activities of Funds, Investment Portfolios and Investment Accounts.

6-3 Text of the Standard

1. The capital must be a fixed sum of money and designated in a definite currency.

2. The bank's portion in the profit shall be a common share in the total profit to be determined when the contract is concluded.

3. Loss in the ***Mudaraba*** shall be borne by ***rabb ul-maal*** (the money provider) except in the cases of infringement, default and breach of the provisions of the contract.

4. It is not objectionable for the shares in the profit to vary according to the actual period.

5. The ***Mudaraba*** capital is held by the ***Mudareb*** as a trust and, therefore, the ***Mudareb*** shall not guarantee the same except in the cases of infringement or default.

6. In an unconditional investment ***Mudaraba***, the bank is entitled to invest the capital in any manner it deems appropriate.

7. In an investment ***Mudaraba***, the bank may accept funds from various clients and may mix such funds for the purpose of investing same under uniform conditions.

8. The ***Mudaraba*** contract shall specify the expenses that shall be, and those that shall not be, borne by the ***Mudaraba***, as well as the limits of the ***Mudareb's*** responsibility.

9. The bank may not charge its indirect administrative expenses to the ***Mudaraba*** funds.

10. The responsibility of collecting the ***Mudaraba*** debts shall be borne by the ***Mudareb*** whether he realizes profit or loss as a result of his activities.

6-4 The Explanatory Memorandum:

1. The capital must be a fixed sum of money and designated in a definite currency.

Islamic Shari'ah scholars have stipulated that the amount, currency and description of the ***Mudaraba*** capital should be known to preclude the existence of any unknown element that [may] result in a dispute between ***rabb ul-maal*** and the ***Mudareb.*** This is because, in a ***Mudaraba***, no profit is deemed to be realized except after ensuring that the capital is safe and complete, which necessitates that the amount and the currency of the capital be known [from the beginning]. In view of the multiplicity and variety of the currencies used in the ***Mudaraba*** transactions of contemporary Islamic banks, it has become necessary to specify the currency of the capital in order to designate its amount. For example, if a person contributes Dollars to a ***Mudaraba*** capital that is denominated in Saudi Riyals, the Dollars must first be converted into Saudi Riyals at the rate of exchange prevailing on the day of payment in order to determine the amount of such person's capital in the ***Mudaraba***. Besides, if the amount and currency of the capital were not specified and known, then the profit would not be known, and this would vitiate the ***Mudaraba***. It is stated in ***al-Moughni*** that: "One of the conditions of ***Mudaraba*** is that the amount of the ***Mudaraba*** capital should be known as it is not permissible for it to be unknown"[1].

The bank may offer investors more than one ***Mudaraba***, and one ***Mudaraba*** may be denominated in Saudi Riyals, and the other in U.S. Dollars, and so on. The capital would be fixed, in terms of the chosen currency, at the time of subscription of investors.

2. **The bank's portion in the profit shall be a common share in the total profit to be determined when the contract is concluded.**

For a ***Mudaraba*** to be valid, the profit should be a common share so that both the ***Mudareb*** and ***rabb ul-maal*** should have portion in it. Thus they may share the profit equally, or one of them may get one third and the remainder goes to the other, etc., for the object of the contract is profit, and non-determination thereof entails voidness of the contract. In other words, the aim of rabb ul-maal is not the type of activity to be carried out by the ***Mudareb***; it is, rather, the profit to be realized, which is also the aim of the ***Mudareb***. Therefore, the profit is to be commonly shared by the ***Mudareb*** and ***rabb ul-maal*** [in terms of agreed percentages] and it is not permissible to assign to one of them a specific amount of profit[2].

If the two contracting parties specify a fixed amount or all the profit for either of them, then such a condition would be invalid, since ***Mudaraba*** requires that the profit be shared, and should the ***Mudaraba*** realize just this or a lesser amount, then all of the profit would go to one partner, to the exclusion of the other/s. This is because partnerships are based on fair treatment of both partners; allocation of profit to one of them to the exclusion of the other would be unfair[3].

In order to satisfy the condition that the partners shall have a common interest in the profit, it is also impermissible to assign the profit of any particular transaction to either the ***Mudareb*** or rabb ul-maal. The portions of the ***Mudareb*** and of rabb ul-maal in the profit should also be specified when the contract is concluded, for undetermination of such portions could lead to disputes when the profit is distributed.

3. **Loss in the *Mudaraba* shall be borne by rabb ul-maal (the money provider) except in the cases of infringement, default and breach of the provisions of the contract.**

As the ***Mudareb*** is a trustee, and as he should not guarantee and compensate for any damage or loss affecting the capital, except in case of

infringement, it follows that the loss in a ***Mudaraba*** contract is borne by ***rabb ul-maal*** alone, the ***Mudareb*** bearing no part thereof, his loss being confined to his activity and effort[4]. In other words, loss in a ***Mudaraba*** partnership is borne exclusively by the capital, the ***Mudareb*** bearing no part therein[5].

4. It is not objectionable for the shares in the profit to vary according to the actual period.

Most investors tend to prefer short-term investments, and, therefore, they do not attach their investments in ***Mudaraba*** transactions to a longer term unless they are tempted to do so by a higher percentage of profit. For avoiding the undetermination of the share of each of the parties, banks usually announce various percentages of profit allocation according to the terms [of investment]. It is indicated for example, that the ***Mudareb's*** (the bank's) percentage of profit in a ***Mudaraba*** that lasts one month is 20%, 15% in a ***Mudaraba*** that lasts three months, and 10% in a ***Mudaraba*** that lasts one year... and so on. But the problem which banks usually face is that some investors would enter into this last type [one year], then, after several months they would need liquidity; so they would come to the bank wishing to withdraw, which would cause lots of problems. On the other hand, the person who would, out of precaution, enter into a ***Mudaraba*** that lasts one month, having assumed that he might need his capital after such a period, might keep his capital invested for six months or one year. In such case, however, he would lose a share of the profit that is commensurate with the period of time. Therefore, such rule attempts to introduce a certain measure of confidence and fairness among the partners that provide the capital and between them and the ***Mudareb***.

Determination of the percentage of profit for both the ***Mudareb*** and for ***rabb ul-maal*** is undoubtedly one of the conditions for the validity of the ***Mudaraba*** when the contract is concluded. This has been indicated in Clause No. 2 hereof.

Nevertheless, as a ***Mudaraba*** belongs to the category of ***musharakat*** (trading partnership) and not to the category of ***mu'awadat*** (commutative contracts), therefore, what may be excusable in the measure of unfairness and variation involved in the percentage of profit distribution in ***Mudaraba*** is not excusable in ***mu'awadat*** (commutative contracts). It is stated in Ibn Taimiyyah's[6] that:" A ***Mudaraba*** belongs to the category of ***musharakat*** (trading partnerships), not to the category of ***mu'awadat*** wherein specifying the price and the object of sale is a prerequisite, and the category of ***musharakat*** is unlike that of ***mu'awadat***, although it is said that there exists an element of the latter in the former. In ***al-Qawa'ed al-Nouraniyyah***, after his statement concerning ***musaqah*** and one who provides the necessary labor) and ***muzara'ah*** to the effect that they belong to the category of ***musharakat*** and not to that of ***mu'awadat***, Ibn Taimiyyah stated that: "***Gharar*** sale, in ***mu'awadah*** has been forbidden because it is tantamount to earning money wrongfully... such essence does not occur in these ***musharakats*** which are based on sheer fairness, and do not involve any inequity at all, whether in terms of ***gharar*** or otherwise."[7]

Besides, ***Hanafi*** jurists have stated that variation of the (distribution) percentage does not affect the (explicit) knowledge thereof. In this regard ***al-Kasani*** indicated in ***al-Badie'*** the following: "***Sama'a*** said: 'I heard ***Mohammad*** say that a man gave another some money to invest same in a ***Mudaraba***, and told the man that if you buys wheat you shall have one half of the profit and I (the money provider) shall have one half, and if you buys flour with it you shall have one third and I shall have two thirds'"[8]. He (***Mohammad***) said: "This is permissible. He may purchase either of the two he chooses on the condition stipulated by ***rabb ul-maal***, for the latter has given him the option to choose either of the two transactions, which is permissible. This would be like giving a tailor the option to choose between the Roman and Persian styles of tailoring. If he gives him a sum of money and stipulates that if he trades within the district, he shall have one third of the profit, and if he travels, he shall have one half, this is permissible, and the profit shall be divided between

them according to the conditions they stipulated, i.e. if he works within the district, he takes one third, and if he travels, he takes one half."

Hence, the bank may determine a percentage of the profit for every period it designates, such as one month, two months, three months.... and any one of the money providers whose capital remains invested for any designated period shall be granted, out of the actual profit of the ***Mudaraba,*** the equivalent of the percentage that is fixed in advance for such period.

5. The *Mudaraba* capital is held by the *Mudareb* as a trust and, therefore, the *Mudareb* shall not guarantee the same except in the cases of infringement or default.

It is unanimously agreed by the founders of Shari'ah schools that the capital is entrusted to the ***Mudareb*** as a trust, for he manages the fund with the permission of ***rabb ul-maal***, and is not solely entitled to the benefit thereof[9].

Besides, stipulating that the ***Mudareb*** shall guarantee the capital is contrary to the purport of the contract and would change it to a loan. As a ***Mudareb*** is a trustee, he shall not guarantee the ***Mudaraba*** capital except in the case of infringement or default [on its part]. A ***Mudareb*** is deemed to have committed an infringement if he breaches the valid conditions of ***rabb ul-maal***, such as the condition that the ***Mudareb*** shall not travel with the ***Mudaraba*** funds or should not trade in a certain region[10]. If ***rabb ul-maal*** imposes on the ***Mudareb*** a valid condition and the ***Mudareb*** fails to observe such condition, it is permissible to hold the ***Mudareb*** liable and guarantee [the capital]. If ***rabb ul-maal*** stipulates that the ***Mudareb*** shall sell only on cash terms, then the ***Mudareb*** may not breach this condition; otherwise, he would be guarantor[11]. And if the ***Mudareb*** does what he is not allowed to do, as when he buys what he was forbidden to buy, then he shall be considered to have committed an infringement[12].

Furthermore, a ***Mudareb*** guarantees as a result of his default. A ***Mudareb*** is deemed a defaulter if he fails to duly perform his duties and functions which are imposed on him by the ***Mudaraba*** contract, this being determined in light of customary practice. It is noteworthy that determining and establishing the occurrence of infringement or default are difficult matters which often cause controversy between partners. In order to narrow down the possibility of any controversy, it is advisable that the contract define and specify the methods of establishing same, to the extent this is possible. Thus, the contract should contain a detailed and accurate description of the functions and responsibilities of the ***Mudareb***, and should indicate the activities which may and may not be carried out by him.

The bank controlling authorities, such as the Central Bank, obviously play a major role in this respect.

6. In an unconditional investment *Mudaraba*, the bank is entitled to invest the capital in any manner it deems appropriate.

There are two types of ***Mudaraba***: unconditional and restricted ***Mudaraba***. The unconditional type of ***Mudaraba*** is that which is not bound by any restrictions, as for example, when one says to the other: "I pay you this money on ***Mudaraba*** basis, and we shall share the profit". The restricted type of ***Mudaraba*** is that with respect to ***rabb ul-maal*** imposes on the ***Mudareb*** certain conditions, as in the case when ***rabb ul-maal*** stipulates that the ***Mudareb*** shall deal with a certain kind of commodities, or a certain type of sale, a certain region for trading or a certain class of people to deal with. The first type of ***Mudaraba***, i.e. unconditional ***Mudaraba***, is permissible in the opinion of the majority of Shari'ah jurists, while the restricted ***Mudaraba*** is permissible in the opinion of two Imams: ***Abu Hanifa*** and ***Ahmad Ibn Hanbal***, who have also considered that it is permissible to designate a period of time for ***Mudaraba***[13].

As the main function of banks is financial mediation, Islamic banks collect depositors' funds and reinvest same in financing various business activities. This necessitates that such funds be paid to persons that manage same for the purpose of increasing them and realizing profit therefrom. This is known by Shari'ah jurists as the ***al-Mudareb Udareb*** standard a ***Mudareb*** (is entitled to give ***Mudaraba*** capital to another ***Mudareb*** to invest same)[14].

7. In an investment *Mudaraba*, the bank may accept funds from various clients and may mix such funds for the purpose of investing same under uniform conditions.

The concept of Islamic banks is based on ***Mudaraba*** contracts, whereby the bank receives the funds of various depositors on the understanding that it shall invest such funds and share with its clients the profit accruing from such investment, according to the conditions agreed upon when concluding the contract. The investment of such funds frequently necessitates the mixing thereof, particularly in the case of small capitals. This has made it necessary to regulate the ***Mudaraba*** by devising a standard contract under which ***rabb ul-maal*** authorizes the mixing of his funds with those of others in one ***Mudaraba***.

Hanafi jurists and some ***Maliki*** jurists are of the opinion that it is permissible to mix capitals in ***Mudaraba*** at the outset of investment of one of them. Such mixture is consistent with the common practice of merchants, and conforms to the purport of the ***Mudaraba*** contract, because it results in increasing the capital, besides being a method of investment thereof. ***'Ali Mohammad al-Sawwa***[15].

It is noteworthy that Islamic banks mix the funds of money providers only after taking their permission, which is the only condition restricting such mixing. Naturally, banks have investment capacities which enable them to invest the greatest amount possible of the capitals they accumulate. Therefore, it is not expected that a bank's involvement in ***Mudaraba*** with a client should prevent it from entering into a ***Mudaraba*** with another

client, particularly as all the funds are invested in one fund. Besides, there is a practical consideration that prevents banks from admitting new capitals to a [certain] ***Mudaraba*** - if the investment capacities thereof are limited as the admission of new capitals would negatively affect the profits to be distributed in the ***Mudaraba***, which would make the money providers opt for other more profitable ***Mudaraba*** funds.

Moreover, mixing the funds under unified terms affords the bank a measure of flexibility and efficiency in investing the funds, for several money providers are involved in ***Mudaraba*** investment. Therefore, if the bank binds itself to the conditions stipulated separately by every money owner, it will be impossible for the bank to profitably invest the funds.

8. The *Mudaraba* contract shall specify the expenses that shall be, and those that shall not be, borne by the *Mudaraba*, as well as the limits of the *Mudareb*'s responsibility.

This clause aims at minimizing the causes of controversies and disputes between a ***Mudareb*** and the bank. Thus, the contract should designate the expenses that are directly related to the ***Mudaraba***, such as transportation or storage expenses or the costs of operation and production... etc., and those which shall not be borne by the ***Mudaraba*** and which do not have a direct bearing thereon, such as the administrative expenses which might absorb all the profits of the ***Mudaraba*** if such expenses were to be borne by the ***Mudaraba***. Such expenses include, for example, personnel salaries, electricity bills, telephone bills.... etc.

It is, furthermore, not objectionable for the contract to designate the activities which should be performed by the ***Mudareb*** and which, if not perfectly performed, he would be deemed to be in default. Such provision would minimize the possible disputes that might arise as a result of the failure to designate the responsibilities in the contract, provided that such provision shall be consistent with the proper conditions of the[16].

9. The bank may not charge its indirect administrative expenses to the *Mudaraba* funds.

Banks incur certain expenses, such as personnel salaries, electricity bills and telephone bills... etc., or what is called in accounting terms "administrative expenses", which expenses are directly connected with the business of the bank, and which are not caused by the ***Mudaraba*** transactions. This type of expenses is borne by the bank in all cases even if the bank does not act as a ***Mudareb***. Therefore, it is improper to charge such expenses to the ***Mudaraba***, for the ***Mudareb*** (bank) bears such expenses because his activities are not confined only to the ***Mudaraba*** activities. Moreover, the bank can cover the part which relates to the ***Mudaraba*** transactions from its share in the profit.

If such expenses were to be charged to the ***Mudaraba***, they would probably absorb all the profits thereof.

We believe that this condition, that the ***Mudareb*** should bear all its administrative expenses which are not directly related to the ***Mudaraba***, is consistent with what have been stated by Islamic Shari'ah jurists to the effect that the ***Mudareb*** "is entitled to receive the designated portion of the profit and is not entitled to receive anything else, for if he were entitled to receive the expenses, then this would entitle him to take the entire profit if the profit he realized did not exceed the expenses"[17].

10. The responsibility of collecting the *Mudaraba* debts shall be borne by the *Mudareb* whether he realizes profit or loss as a result of his activities.

A ***Mudaraba*** is a contract between two parties one of whom provides funds and the other provides labor [efforts]. This association of funds and labor is the source for the expectation of profit realization. Therefore, each of them is entitled to such portion of profit as is mutually agreed by them. The activities of trading, investment, rotation of funds and paying same to a ***Mudareb*** for investment in ***Mudaraba*** transactions are among

the essential functions and responsibilities of the ***Mudareb***. All the activities relating thereto, such as purchase, storage, and transportation, cash sale or sale on credit - if the latter is not prohibited by ***rabb-ul-maal*** and collection of debts, are among the responsibilities of the ***Mudareb***.

The rotation of a ***Mudaraba*** capital, in terms of buying and selling, and the debts involved which accrue to the ***Mudaraba,*** constitute contractual relationships between the ***Mudareb*** (the bank) and its clients, ***rabb ul-maal*** having no connection therewith. Therefore, it is not necessary or expected that collection of this type of debts should fall on ***rabb ul-maal***, particularly if we take into consideration the commercial and financial business relations, especially in the field of banking, which are characterized by special and distinct contractual relations, which make it impossible for ***rabb ul-maal*** (the client) to undertake the activity of collecting debts which have not been originally created by him.

6-5 Notes & References

[1] al-Moughni, 5/191.

[2] Ibn Qayyem al-Jawziyyah, A'lam al-Muwaqqi'een, V.II, p.6; Ibn Rushd, Bidayat al-Mujtahid wa Nihayat al-Mouqtased, V.II, p. 236.

[3] al-Zouhaili, al-Fiqh al-Islami wa Adillatuhu (Islamic Jurisprudence and Its Guidelines) V.IV, p.850; Ibn Qayyem al-Jawziyyah, A'lam al-Muwaqqi'een, V.II, p.6; Sharh Muntaha al-Iradat, V.II, pp.216-217].

[4] Ibn Rushd, Bidayat al-Mujtahid, V.II, p.236; al-Zouhaili, V.IV, pp.836-7.

[5] al-Moughni, 5/148.

[6] Ibn Taimyyiah, al-Fatawa (20/506).

[7] Ibn Taimyyiah, al-Qawa'ed al-Nouraniyyah P.166.

[8] Badie' al-Sanaie' (6/99 – 100).

[9] Sharh Muntaha al-Iradat, V.II; al-Moughni, 5/192; al Zouhaili, al-Fiqh al-Islami, V.IV, pp. 853-4.

[10] al-Moughni, 5/183-184, 186.

[11] al-Moughni, 5/149.

[12] al-Moughni, 5/165.

[13] Ibn Rushd, Bidayat al-Mujtahid, V.II, p. 238; al-Zouhaili, al-Fiqh al-Islami (Islamic Jurisprudence) V.IV, p.84; al-Moughni, 5/185; al-Dareer, al-Gharar wa Atharuhu Fi al-'Uqood, page 517.

[14] Sharh Muntaha al-Iradat, V.2, pp.217-218; al-Moughni 5/159, 162, al-Zouhaili, V.IV, pp. 857, 859.

[15] al-Fawareq al-Tatbeeqiyyah Bayna al-Mudaraba Fi al-Fiqh al-Islami wa al-Mudaraba al-Mushtarakah, Dirasat, V.19a, First Issue, 1992.

[16] al-Moughni, 5/186.

[17] al-Moughni, 5/152.

Chapter Seven

STANDARD OF AL-SHARIKAH AL-MASRAFIYYA
(A Banking Partnership)
(MUSHARAKAH)

7 - 1 Definitions:

A. ***al-Sharikah*** (partnership): Under this standard ***al-Sharikah*** means any contract made by two or more parties pertaining to capital and work (management) for the purpose of making profit. This is known among jurists as ***Sharikaht ul-amwaal*** (finance partnership).

B. ***al-Sharikah al-Masrafiyya*** (Banking partnership) (***al-Musharakah***): a finance method derived from the partnership contract that is known in Islamic jurisprudence, in which the bank participates with one client or more. It is designated to be called ***Musharakah*** in contemporary banking practice.

C. ***Musharakah*** capital: the total amounts contributed by the bank and its clients in the ***Musharakah***.

D. ***Musharakah*** profit: the sum in excess of the ***Musharakah*** capital at the end of the ***Musharakah*** term, which is distributable among the partners.

E. Points system: is a computation method that helps in determining the portions of partners in capital for the purpose of distribution of profit, on the basis of the period during which their contributions remain operating in the activity of the ***Sharikah*** *(partnership)*.

F. Partner's portion: is the total daily balances of the partner in the ***Musharakah*** account during the ***Musharakah*** term.

G. Loss: the decrease which occurs in the ***Musharakah*** capital when ***tandeed*** (conversion of the assets of the ***Musharakah*** into cash money) takes place.

H. ***Musharakah*** expenses: are the expenses which the partners agree would be borne by the ***Musharakah*** capital before division (of profit).

I. Division: the sharing of profit among the partners and the final settlement of the ***Musharakah***.

J. ***Tandeed***: is the conversion of the ***Musharakah*** assets into money, in actual practice, through sale, or constructively, through accounting methods which rely on the valuation of assets at a certain date and effecting the division (distribution) of profit accordingly.

K. ***Sharikaht al'Anan***: A partnership involves partners who contribute both capital, possibly in different percentages, and perform work, possibly of various types.

L. Discontinuance of the ***Sharikah*** *(partnership)*: is the vitiation of the ***Musharakah*** contract for (stipulating) a condition which may result in all the profit going to one partner.

M. ***Dhimma***: The qualification of a nominal (company) or a natural person to bear obligations and enjoy rights. Hence debts of companies or persons whether incorporeal property or fungible are tied or related to it ***(dhimma).***

7-2 Scope of Standard

1. Participation in financing commercial, industrial, real estate or other investment activities which aim at making profit and which are permissible in Shari'ah.

2. Participation in companies and establishments that aim at making profit.

7-3 Text of Standard

1. Each partner's portion in the ***Musharakah*** capital should be a specified and fixed amount, not necessarily equal to that of the other partner/s.

2. It is stipulated in a ***Musharakah*** contract that when the partners conclude the contract the capital should be available through customary methods, such as depositing same in a current bank account.

3. If the partners make their portions in kind or in the form of money of various currencies, their portions should be valuated in terms of one currency for determination of the ***Musharakah*** capital and the partners' portions therein.

4. Should the bank or its client wish that its debt, which is due on the other party, be a portion in the banking ***Musharakah***, such debt should be due on the date of concluding of the ***Musharakah*** and should be computed at nominal value, provided that such indebted partner shall not be impoverished.

5. It is not objectionable for the partners to delegate the management to one or more partners from amongst them or from other third parties.

6. The conclusion of a ***Musharakah*** (contract) creates a financial ***dhimma*** for the Musharakah, which is independent from (that) of the partners.

7. The bank may enter into a ***Musharakah*** with natural or nominal persons.

8. Profit may be distributed pursuant to the agreement of the partners. However, the loss shall be distributed in proportion to the partners' contributions to the capital.

9. It is not permissible to stipulate that one of the partners shall guarantee the capital (of Musharakah), except in the case of infringement and breach of conditions.

10. It is not permissible to assign the profit of a certain period or transaction carried out within the activities of the ***Musharakah*** to one of the partners; neither is it permissible to stipulate assignment of a lump sum out of the profit to one of the partners.

11. It is permissible to apply the system of points (daily product) for determining the partners' portions and for distributing profit and loss among the partners in the ***Musharakah***.

12. It is not objectionable to limit portion (in capital) of a partner to a ceiling from which the ***Sharikah*** (partnership) withdraws according to its requirements.

13. In a ***Musharakah contract*** it is permissible to agree that the client shall buy the bank's portion piecemeal within an agreed period, after which the ownership of the entire assets of ***Musharakah*** shall pass to the client.

14. If the ***Musharakah*** contract includes a provision relating to a partner buying the bank's portion (in Musharakah) within an agreed period, then concluding a sale contract of thee same would have to be left for a later date.

15. It is not objectionable to provide in a ***Musharakah*** contract that the bank shall sell its portion for a fixed price on a designated date, provided that the partner shall not be obligated to buy same.

7-4 Explanatory Memorandum

1. Each partner's portion in the *Musharakah* capital should be a specified and fixed amount, not necessarily equal to that of the other partner/s.

It is stipulated that each partner's portion in the capital of a ***Sharikah*** (partnership) shall be known in amount and in description, in order to preclude the existence of an unknown element (***jahala***) that leads to dispute.[1] because the non-specification and non-determination of each partner's portion would consequently lead to ignorance of the ***Musharakah*** capital, knowledge of which is stipulated for the validity of the ***Musharakah***. Determination of each partner's portion makes it possible to refer to same at the time of liquidation, division (distribution of profit) or rescission, for (in such cases) it is essential to refer to the capital which is constituted by the partners' portions upon liquidation, so that profit or loss may be determined, which would not be possible if the partners' portions are not known.

For this reason, ***Hanbali*** jurists recite that it is not permissible for the capital to be unknown, arbitrary, absent or a debt, unless the debt is acknowledged to be in the sense of presence, as when a person says to another: "Collect my debt owed by such and such a person and use it.[2]

It is not stipulated that the contribution of both parties be equal in amount[3]. The contribution of one partner may be more than that of the other. Moreover, one of them may be responsible for the ***Sharikah*** (partnership) while the other would not be so responsible[4].

This also appears in ***Sharh Muntaha al-Iradat***: "(It), i.e. ***Sharikaht al-'Anan*** (that each shall bring)... (of his money).. (cash)... (or) if the cash were (of two kinds) such as gold or silver (or) if it were (unequal) as one bringing a hundred and the other two hundred (or) if it were (commonly owned by the

partners, if known) from them (the amount of his funds) as in the case when they inherit him, one would get a half; another, a third; and another, a sixth; and they share therein before the division thereof"[5].

2. It is stipulated in a *Musharakah* contract that when the partners conclude the contract the capital should be available through customary methods, such as depositing same in a current bank account.

A condition stipulated related to the capital of a ***Sharikah*** (partnership) is that it should be ready money when the contract is concluded or when buying takes place. It has been stipulated that the capital should be brought when the contract is made for estimation of the work and realisation of the ***Sharikah*** (partnership), because it is necessary to refer to the capital, which would not be possible if it were not known. Hence, the capital may not be unknown, arbitrary, a debt, or an absent property, because the purpose of the ***Sharikah*** is to make profit, through management (investment), and management cannot be in made in a debt or an absent property, and hence the purpose of the ***Sharikah*** would not be realized, and because the indebted party may not pay back the debt, and the absent property may not turn up.[6].

Although the ***Hanbali*** School stipulates that the capital contributed by all partners should be brought when the contract is made, yet ***Hanbali*** jurists have permitted what could be tantamount to sense of presence (of the money), as when a partner says: "collect my debt which is owed by such and such a person, or collect my deposit from ***Zaid*** and then invest it in a ***Mudaraba***[7].

Therefore, this standard stipulates that the ***Musharakah*** capital should be available so that it may be used for realizing the objectives of the ***Musharakah*** when contracting or buying. Depositing the ***Musharakah*** capital in a bank current account would realize this objective completely. This would enable the partners or the person they appoint as manager of the

Musharakah to withdraw from such account any time he so wishes in order to execute and carry out the business of the ***Musharakah***, such as buying, payment of expenses related to the ***Musharakah*** ...etc. In this manner depositing the ***Musharakah*** capital in a current account would completely secure the presence (availability) of the capital. It makes the capital available for use.

It is worth noting that people are now used to depositing their funds in banks, which makes it easy for them to readily make use of same; and even if deposited in a current bank account, they would be available for partial or total withdrawal any time they wish. In addition, people find safety and security in the safeguarding of such funds.

3. **If the partners make their portions in kind or in the form of money of various currencies, their portions should be valuated in terms of one currency for determination of the *Musharakah* capital and the partners' portions therein.**

In standard, the ***Musharakah*** capital should be in the form of cash money. It has been exceptionally permitted for the capital to be in the form of assets that are valuated in terms of money at the time of contracting. One opinion has been narrated amongst ***Hanbali*** jurists that it is permissible for the ***Musharakah*** capital to be in the form of goods, provided that the value thereof at the time of concluding the contract shall be considered as a capital. For accounting purposes the value of the goods at the time of concluding of the contract shall be credited to each partner.

The capital of a ***Sharikah*** (partnership) may be in dirhams or dinars (money) because they represent the value of perishables and the price of sold objects[8].

While the ***Musharakah*** may be in dirhams and dinars, yet this standard stipulates that they be evaluated in terms of one currency for the purpose of

facilitating the accounting and distribution upon liquidation (of the ***Musharakah***). In addition, acceptance and awareness on the part of the partners of this stipulation is conducive to the acceptance thereof, since the evaluation of the partners' contributions, assuming they are in a currency other than that of the ***Musharakah***, would be in terms of the exchange rate prevailing at the time when the ***Musharakah*** took place.

Among the most important reasons for stipulating that the capital should be in one and the same currency is the fear that the ***Sharikah*** (partnership) would be discontinued if the partners' contributions are made in different currencies, while the ***Musharakah*** business was in a (different) currency, because this would result, at the time of division (distribution of profit), in converting the ***Musharakah*** capital into their original currencies; and should the exchange rate of some of such currencies rise and that of others fall, this would lead to the currencies whose exchange rate has risen to absorb all the profits of the ***Musharakah*** or some of the value of the currencies whose exchange rate has fallen.

These are perhaps some of the reasons that have prompted ***Imam Malik*** to forbid a ***Sharikah*** (partnership) in case capital contributions are in different currencies, as when a partner contributes dirhams, and the other, dinars. ***Ibn al-Qasim*** (said): "***Malik*** said: 'No good would come out if one partner contributes ***dirhams***, and the other, ***dinars*** and if they would then form a ***Sharikah***. (I said): 'The ***Sharikah*** would not be permissible be (as implied by) the statement of ***Malik*** when one contributes ***dirhams***, and the other, ***dinars***.' (He said):'This is not permissible according to ***Malik***.' (I said): 'The original statement of ***Malik*** is that the ***Sharikah*** would not be permissible unless the capital thereof was (in the form of) one (and the same currency), whether ***dirhams*** or ***dinars***.[9]

4. Should the bank or its client wish that its debt, which is due on the other party, be a portion in the banking *Musharakah*, such debt should be due on the date of concluding of the *Musharakah* and should be computed at nominal value, provided that such indebted partner shall not be impoverished.

As previously indicated, the ***Hanbali*** School has approved what is tantamount to the sense of presence (availability) as far as the capital (of Musharakah) is concerned, as when a partner says: "You may collect my debt lying with such and such a person and the ***Musharakah*** would be conditional on effecting such collection[10]. This would also be permissible if the debt was paid and delivered to the ***Mudareb*** or to the ***Sharikah*** (partnership)[11].

Hence, it would not be objectionable in the conclusion of a banking ***Musharakah*** provided that the contribution of the bank or that of the client was a debt for which the other party would be liable, stipulated that the debt should be due at the time of conclusion of the ***Musharakah***. This is because if the debt was not due it would not be possible to collect same, which would vitiate the ***Musharakah*** because the portion of one of the partners in the capital was absent (not available) at the time of conclusion of the ***Musharakah***. Moreover, it is the nominal value of the debt that should be taken into account; otherwise, usury would be suspected because it would involve increasing the amount of the debt on the basis of the rule "Give me more time and I will give you more (money)", or it would involve deduction of the amount of the debt on account of the reduction (discounting of securities).

To guard against the vitiation of the ***Musharakah*** on account of the absence of the capital or a part thereof, or non-receipt or non-presence thereof so that it cannot be placed at the disposal of the partners, this standard has stipulated

that the indebted partner should be capable (of payment) and solvent, so that he may be able to re-pay his crediting partner for representing his portion in the ***Musharakah*** capital.

5. It is not objectionable for the partners to delegate the management to one or more partners from amongst them or from other third parties.

al-Sharikah (partnership) is a joint in rights or management[12]. ***Sharikaht ul-Amwaal*** is a partnership between two or more parties in finance or in a business and the profit which Allah provides, would be distributed among them. It is not stipulated that there should be equality in (the ownership of) the finance (money) or in management[13].

Therefore, any of the parties to a ***Musharakah*** may authorize all or some of the other partners to manage the company on his behalf, since it is not stipulated that the partners should be involved in the work on equal footing. Proxy is known to be permissible, and it is logically required[14].

6. The conclusion of a *Musharakah* (contract) creates a financial *dhimma* for the *Musharakah*, which is independent from (that) of the partners.

The establishment of financial ***dhimma*** of a partnership or a ***Musharakah*** that is independent from (that of) the partners, or what is known as a nominal or legal entity (personality), and the concept of financial liability that is limited to the capital of the partnership or ***Musharakah***, are two new concepts dictated by actual practice, the development of commercial and financial conditions, the complex contractual relationships and the resulting enormous financial establishments in which a great many persons participate, each subscribing for relatively small financial portions.

No juristic seminars or conferences have yet addressed this newly introduced concept and its legal implications for the purpose of adopting an appropriate

Islamic position towards it, though a single study here and there has attempted to explore the aspects thereof and pronounce a verdict for or against it.

Some such studies have accepted the concept of a nominal (legal) entity and the effects thereof, including the limited financial liability of the nominal (legal) entity. Some other studies have made a distinction between the nominal (legal) entity, which they found was acceptable to Islamic jurisprudence, and the implications thereof. Thus they rejected such implications and found them to be rather contrary to the spirit of Islamic jurisprudence and its fairness.

It is worth noting that Egyptian Civil Law, Syrian Civil Law, Jordanian Companies Law and other Arab laws have recognized the concept of the nominal (legal) entity and recognized the fact that it has a financial ***dhimma*** that is independent from that of the partners' financial ***dhimma*** and has a name, residence and nationality[15].

In our attempt to clarify the characteristics of this concept and whether it is consistent with the principles of Islamic Jurisprudence, an effort will be made to delimit the concept of a nominal (legal) entity and then to review same in accordance to juristic judgements in light of the self-evident standards of such judgements and the original permit, and in light of contemporary writings and studies that addressed and scrutinized this subject.

What is meant by a nominal (legal) entity is that a company is considered a nominal person that is independent from the persons or shareholders of the company and that it has a special ***dhimma*** that is separate from that of its shareholders. In other words, the company has an existence that is independent of that of the natural persons constituting it and is capable of having a legal existence of its own, which entails its acquisition of rights and

assumption of obligations and its having its own domicile and a particular nationality.

The concept of a nominal (legal) entity is dictated by the actual state of affairs and springs from the society we live in. Thus government institutions, ministries, universities or economic projects are not persons. Yet, they are an actual fact and have a concrete and distinct existence. But although the concept of a nominal (legal) entity in its legal implications and the effects attaching thereto is a new concept not known to Islamic jurists under this name, yet, the origin of such concept and the meaning thereof are known in Islamic jurisprudence. Jurists have considered an entity for a thing which does not understand as in the case of ***Bait- ul Maal***, mosques and ***waqf***, and the juristic judgements and terms applying to such institutions are not based on the fact that they have a ***dhimma*** and capacity of [assuming] obligations[16].

There are those who maintain that the idea of the nominal entity is not alien to Islamic jurisprudence but that its origin is found in the views of the jurists of Islamic Schools and that this concept had found expression in Islamic jurisprudence before the jurists of positive law established same[17].

Recognition of the concept of the nominal entity and admission of same has been necessitated by the need for a huge number of persons for establishing financial institutions or companies in today's world, and the need of such institutions and companies for huge capitals which cannot be raised by a limited number of people, because they have to be provided by the state or by a large number of shareholders. It is well known that such kind of companies did not exist during the apogee and scientific flourishing of Islamic society. Hence, we find that jurists did not address the links and relations that gather such a great number of people under one financial umbrella that aims at realizing profit or other objectives required by societies

and the establishment of civilization including education, as shouldered by universities, and medical treatment, as undertaken by hospitals...etc.[18]

The importance of the legal personality and the need thereof in contemporary societies derive from the fact that:

A. It regulates and facilitates the transactions in which civil and financial institutions, companies and other entities are involved with their various clients. It is more beneficial and better for a client to deal with a definite and identified entity rather than requiring him to deal with the total shareholders of such institutions, as it may not be possible to gather them all together at one and the same time, whether in economic, legal or other transactions.

B. It makes possible the formation of large financial institutions and joint stock companies, which require enormous capitals, which one or a few individuals cannot raise.

C. If this concept were refused then what would be the alternative in light of which the relation of clients with companies and institutions would be defined, and how would their rights, legal relations and differences be regulated?

As regards the establishment of an independent ***dhimma*** for an institution or a company, we are almost positive that there is no recitation, whether in the Quran or in the Sunna, that precludes the existence of an independent ***dhimma*** for a company. Such ***dhimma***, however, is unlike (less than) that of a natural person. Under the law, a ***dhimma*** represents the actual or potential rights and financial obligations of a particular person. Hence, the ***dhimma*** of an institution or a company in Shari'ah is an added capacity to a company or an institution, that qualifies it to assume obligations and assume liability for financial rights and duties[19].

The Shari'ah objection to the adoption of the concept of the legal personality that has a financial liability may relate to the fact that the concept of a company ***dhimma*** that is independent from the shareholders therein may prevent the company's creditors from collecting their debts and their claims from being asserted against the shareholders. It is as though this concept protects shareholders from the claim by the company's creditors of their dues lying with the company, in case of bankruptcy, and the consequent loss of such rights. This objection may at first sight seem plausible. The fact of the matter, however, is that what prevents the creditors from retrieving their dues which lie with the company is not the concept of the nominal entity (personality) which has an independent liability, but is the bankruptcy of the company. Now the possibility of the loss of the creditors' dues lying with the debtors when the latter are bankrupt, as when their debts exceed their funds, is there even in the case of natural persons. Thus if a natural person were to declare his bankruptcy then this would result in his creditors losing a part of their debts lying with him. Hence, the loss of the creditors' dues lying with companies, in case of bankruptcy, does not relate to the concept of the nominal entity (personality) but relates, rather, to the commercial, management risks or other risks which are associated with all aspects of commercial and investment activities, and which could lead to the declaration of bankruptcy by natural persons or nominal personalities. Therefore, the bankruptcy of a company does not entail the bankruptcy of its shareholders, because its bankruptcy relates to its capital and not to the private property of its shareholders[20].

As we have already pointed out, the nominal personality confers on the company an entity and a ***dhimma*** that are completely independent of those of its shareholders. Thus the financial contributions made by the shareholders to the company's capital would form part of the company's ***dhimma*** and would be its own property, while the share contributed by the shareholder would become separate from his financial liability, his only right therein being that of obtaining the profits thereof as long as the company's activity is

in progress, and of possession his share in its assets upon the winding up or liquidation of same, while the company would be liable to pay back its creditors[21].

Moreover, it is the company that manages such assets within the limits of its objectives as defined in its articles of association and regulations[22]. While a shareholder is not - individually - authorized to choose the manager of the company, to direct its activities or affect its investment decisions. It is this, perhaps, which justifies his not being held liable to pay back the company's debts in case such debts exceed the company's capital. Moreover, limiting the shareholders' liability to the amount of their shares in the company's capital is recognized and permissible in Islamic jurisprudence, just as it is recognized in a ***Mudaraba*** company, where the liability of ***rabb ul-maal*** (capital provider) is commensurate with the amount of capital he has contributed to the ***Mudaraba*** company, ***rabb ul-maal*** not being liable for the company's debts if they exceed the capital he has provided[23].

In light of the aforementioned arguments, it is possible, pursuant to the requirements of public interest, to confer on a company, according to its type, a nominal entity (personality) with an independent ***dhimma*** and an independent existence. Thus it would have a name, a domicile and a nationality, and would assume (independent) liability[24]. This acceptance of the concept of nominal entity (personality) is supported by general Shari'ah rules in keeping with recognized interests. Thus wherever a (public) interest would be involved, Divine Law would be there (to be applied). We know of no contemporary Islamic country that found it possible, or that it would serve any interest, to do without the concept of limited liability in large companies that have a large number of owners. To prohibit that would mean to dislocate large joint stock companies. Moreover, the concept of nominal entity (personality) does not violate any provision in the Quran or the Sunna. Public interest and necessity call for its application to regulate people's transactions. In standard, things are permissible. Allah Almighty says: *"It is*

He Who hath created for you all things that are on earth...[25]. He also says: *"Say: Who hath forbidden the beautiful (gifts) of Allah, which He hath produced for His servants, and the things, clean and pure (which He hath produced) for sustenance?*[26]. The basic aim of Divine Law is to remove difficulties and facilitate people's affairs. Allah Almighty says: *"Allah doth not wish to place you in difficulty."*[27]. He also says: *"Allah intends every facility for you. He does not want to put you to difficulties."*[28].

7. **The bank may enter into a *Musharakah* with natural or nominal persons.**

A bank is by its legal structure a nominal personality. In light of our aforementioned discussion of the concept of a nominal entity (personality) we concluded by adopting such concept in terms of which a company or institution would have an independent financial ***dhimma***, and a legal capacity that qualifies it to act as plaintiff or defendant, and to express its will through a representative[29].

Such attributes give a company the right to carry out all sorts of activities according to its regulations. Thus it may opt for trading and it may buy and sell. This also gives it the right to enter into various types of contracts: ***Mudaraba, Musharakah or Ijara*** (lease) contracts...etc. Hence, a company with a legal personality has the same capacity as a natural person as regards the practicing of business. It can acquire rights and exercise such rights. It has litigation rights and has the capacity of a merchant if it practices commerce. The company, however, has no spirit or feelings. This concept gives a company the right to enter into a ***Musharakah*** with natural persons or with similar nominal entities.

8. Profit may be distributed pursuant to the agreement of the partners. However, the loss shall be distributed in proportion to the partners' contributions to the capital.

Some ***Hanafi*** and ***Hanbali*** jurists maintain that it is permissible to distribute profit in a partnership according to the agreement of the contracting parties, even if this were different from their portions in the capital. ***al-Moughni*** has expressly indicated that: "Profit in all types of partnerships shall be distributed according to the agreement reached by the two contracting parties, whether to be distributed equally between them or otherwise, if the share in profit is common, such as a third of the profit or half...etc (for one of the partners and the remaining for the other). But if they do not specify (the percentage of profit to be distributed between them) in ***Sharikaht al-'Anan*** (a trading partnership) then the profit would be distributed according to their respective contributions to the capital.

However, loss in ***Sharikaht al-'Anan*** is distributed among partners according to their shares in the capital, which is the consensus of the majority of jurists. The distribution of losses among partners pursuant to their agreement is not permissible if such agreement entails that a partner would bear more losses than his share in the capital, in application of the rule "Profit is to be distributed according to the agreement of the partners, while losses are borne according to their respective contributions to the capital"[30]. Thus a stipulation by a partner that the other partner/s shall bear a percentage of losses exceeding his/their share in the capital is not valid. Such stipulation is considered void but does not invalidate the partnership.

Thus we see that in a banking ***Musharakah*** it is not objectionable to distribute the profit according to the agreement between the bank and the client. However, the loss must be distributed according to their respective portion's in the ***Musharakah***.

9. It is not permissible to stipulate that one of the partners shall guarantee the capital (of Musharakah), except in the case of infringement and breach of conditions.

Sharikaht al-'Anan is based on equal duties, rights and powers among partners. Therefore, it is not permissible for one partner to have special privileges at the expense of another, except for one that derives from the nature of the partnership contract pursuant to the valid conditions of the contract, which are not void or which invalidate the partnership[31]. Hence, it is not permissible for a partner to stipulate that another partner shall guarantee (assume liability for) the other party's portion in the capital or for part thereof. Such a stipulation would be invalid, worthless and would be considered non-existent in case the contract were effective[32].

Some ***Hanbali*** jurists are reported to have said that a stipulation that is detrimental to the contract and contrary to its very nature, such as a stipulation that the ***'amil*** (Modareb) in a ***Mudaraba*** shall guarantee (be liable for) the capital, invalidates the contract[33]. It is worth noting that the ***Hanbali*** School considers that the rule pertaining to the effect of invalid stipulations in a partnership contract equally applies to the invalid stipulations in a ***Mudaraba***[34], and that the guarantee (assumption of liability) by a partner for the whole or part of the portion of another (in the capital) is considered to be an invalid stipulation, according to ***Malki*** and ***Shafi'i*** jurists, or that it renders the contract void, as in an opinion held by some ***Hanbali*** jurists, because such a stipulation is inconsistent with the nature of the contract (***al-Zouhaili, al-Fiqh al-Islami*** (Islamic Jurisprudence), v.4, pp.854-5).

The reason why it is not permissible to guarantee the portion of a partner in a ***Musharakah*** might be because that partner whose portion is guaranteed would in fact become a lender vis-a-vis the ***Musharakah*** or the other partners, in which case what he takes on top of his capital would be usury.

10. It is not permissible to assign the profit of a certain period or transaction, carried out within the activities of the *Musharakah*, to one of the partners; neither is it permissible to stipulate assignment of a lump sum out of the profit to one of the partners.

Specifying a certain profit or assigning to a certain partner a lump sum out of the profit or assigning to such a partner a certain transaction would lead to discontinuance of the partnership and would fall within the conditions which make profit unknown, and this would invalidate the contract, because such conditions would be contrary to the purpose that is served by a partnership contract, for every condition which makes profit unknown is considered one that invalidates the partnership, as when it is stipulated that outsider ***Zaid*** shall be given a ***Dirham*** and the remaining profit to the other partners, or stipulating that the profit derived from purchasing wheat shall go to one of the partners and what is derived from purchasing clothes shall go to the other; or assigning to one the profit earned from (selling) a sack [of wheat], and the profit of the other sack to the other partner. In such case the partnership would be invalidated because it would involve the element of ignorance of the right to profit of each partner, or to loss of the profit, and because the element of ignorance would preclude delivery, which would lead to disputes[35].

A ***Mudarabah*** or ***Sharikah*** involving a condition that would involve an element of ignorance of profit is considered invalid, as when it is stipulated that one of the two partners shall receive a definite sum of the profit, or the profit of one of two deals, or part of the profit assigned to an outsider, or that one of them shall be assigned to the profit, to the exclusion of the other partner[36].

Similarly, if a specific amount of profit, say ten or a hundred, were to be designated for a certain partner, then the partnership would become invalid,

because the contract requires the sharing of the profit, and it is possible that profit may accrue only with respect to the contract assigned to one of the partners. Hence, such designation is contrary to the objective of the partnership contract[37].

11. It is permissible to apply the system of points (daily product) for determining the partners' portions and for distributing profit and loss among the partners in the *Musharakah*.

The system of points (daily product) relates to the taking into consideration of the period of time during which a monetary unit is held in the ***Musharakah*** transactions. Thus a participant who contributes, say, S.R. 1,000.00 for a period of one year is entitled to a share in the profit exceeds that of a participant who contributes an equivalent sum, i.e. S.R.1,000.00 but, for, say, a period of six months.

Application of the system of points for distributing profits in Islamic banking activities has been dictated by practical necessity and the requirements of fairness and the sound standards of the fair distribution of profit. Banks have adopted this system in order to secure for their clients a great measure of flexibility in their participation in ***Mudaraba*** or in ***Musharakah*** at any time of the year, and also to make it possible for them to withdraw any time they wish.

Thus if a client contributes a sum of S.R.500.00 at the beginning of the year and such sum was held till the end of the fiscal year, then he shall be entitled to a share in the profit equivalent to that of S.R.1,000.00 provided by another client for a period of only six months in the same ***Musharakah*** or ***Mudaraba***. Now, as the first sum was held for a period of 12 months in the ***Musharakah***, while the second sum was held for a period of six months, the computing of the two portions for the purpose of distribution of profit by applying the system of points will be as follows:

First client's portion	= 500 x 12	=	6,000
Second clients' portion	= 1000 x 6	=	6,000
Total portions		=	12,000

Thus the system of points represents a method of computation that makes it possible to distribute profit accurately and fairly. Moreover, it is consistent with the nature of ***Musharakah***, which involves the distribution of profit according to the funds contributed by each partner if profit is not specified and not indicated in the contract[38].

12. It is not objectionable to limit portion (in capital) of a partner to a ceiling from which the *Sharikah* (partnership) withdraws according to its requirements.

In the practical application of the banking ***Musharakah,*** a special ***Musharakah*** account is opened in which the portions of the partners are deposited. The client's cash portion is deposited therein, and the bank's portion would be a bank ceiling available for withdrawing therefrom.

It is worth noting that ***Musharakah*** may not utilize all the bank's portion which is determined in the form of a ceiling. Therefor, the bank's share in the profit would be determined on the basis of its funds that were actually utilized in the ***Musharakah***, which is approved by the transaction rules in Islamic jurisprudence, and which is required by the standards of fairness and equality, as distribution of profits in a partnership should be commensurate with the funds contributed by each partner, although his contribution which was agreed upon was different. It is mentioned in ***al-Mudwanah***: " (He said) ***Malik*** was asked about the case of two partners, one of whom contributed one thousand and five hundred ***dirhams***; the other contributed five hundred and indicated that he had one thousand ***dirhams*** at such and such a place. The first remained where he was, and the second left for the place where he

alleged he had one thousand ***dirhams*** in order to buy for all the money, but was unable to collect his one thousand which he alleged were there. So he bought goods for two thousand. (He said) ***Malik*** Said :'In my opinion each of the two partners is entitled to profit according to the amount of money he actually contributed and he did not conceded to the partner who was unable to collect his one thousand ***dirhams*** any profit beyond what is commensurate with the five hundred he had actually contributed."[39].

The ***Musharakah*** carries out its business on the basis of such account. Thus, when it buys or pays any expenses, it draws from that account. And if it obtains any revenues from its sales, such revenues are also deposited and recorded in that account.

It is worth noting that such account is opened with the bank, being a party in the ***Musharakah***, and in the nature of the bank's activities the funds deposited in that account become mixed with the other funds kept in the bank so that it would not be possible to set them apart. It is well known that the process of depositing funds in banking system has developed and reached a highly sophisticated level, whereby, a client could deposit in his account at any of the bank's branches. Hence, the bank may benefit from such revenues which are deposited in the ***Musharakah*** account, it being understood that the partner bank may not realize an additional advantage or profit for itself from such revenues, to the exclusion of its client partner.

To overcome this problem, particularly in view of the fact that it is not possible in practice to prevent the use of such funds by the bank, and in order to achieve fairness so that the client who is the bank's partner shall not suffer any damage, such funds would have to be considered as withdrawn from the bank's share in the ***Musharakah***. This would lead to reducing the bank's points for the purpose of distribution of the profit and consequently the bank would receive profit that is commensurate with its contribution to the capital, which is consistent with, and would realize, fairness. Obviously, this

treatment entails that the bank's portion in the ***Musharakah*** capital would change with any movement in such account, whether in terms of depositing or withdrawing. This is because depositing would reduce the bank's portion, while withdrawing would increase it. Such arrangement, pursuant to the established standards of a partnership, may necessitate that any change in the bank's portion in the capital should entail a new ***Musharakah***, which requires liquidation (of the partnership) and distribution (of the profit).

Hence, every movement in the ***Musharakah*** account is in fact a liquidation of a previous ***Musharakah*** and a commencement of a new ***Musharakah*** involving a new capital. Thus banking ***Musharakah*** seems in fact a series of successive ***Musharakahs***, where each occasion of withdrawing or depositing in the ***Musharakah*** account gives the bank a new portion in a new capital in a new ***Musharakah,*** which entails a constructive liquidation without actual distribution (of the profits), distribution being effected at the end of the term when the series of successive ***Musharakahs*** are liquidated.

13. In a *Musharakah contract* it is permissible to agree that the client shall buy the bank's portion piecemeal within an agreed period after which the ownership of the entire assets of *Musharakah* shall pass to the client.

The purchase by the client of the bank's portion in the ***Musharakah*** could be dictated by practical necessity. As we have already indicated, the request by a client that the bank enter into a partnership with him is intended to be a method of financing that is acceptable in Shari'ah. Moreover, the role of the bank is in its nature one of financial mediation. Hence, the buying by a party to a contract of another party's portion would realize the interest of both parties, both parties being interested in such buying: the bank is interested in the sale as long as it makes a profit, and the client is interested in buying, as soon as it obtains sufficient funds for buying the bank's share.

The client may buy the whole of the bank's portion in one go or piecemeal, i.e. the client buys each time part of the bank's share. Therefore, both parties may agree in the contract that one of them would buy the portion of the other. This may be indicated in the contract, provided that the sale shall take place separately on each occasion for a price to be agreed upon by the parties each time selling takes place.

It is not permissible to determine the selling price in advance in a ***Musharakah*** contract. However, it must be indicated that the price shall be the market price at the time of sale. This is because determining the price in advance and indicating this in the contract may lead to the discontinuance of the partnership, for such predetermined price may result in the bank selling its share for more than its market price, which may would take up all the profit, particularly in view of the fact that some methods used to determine the selling price are based on a fixed rate of profit commensurate with the bank's share in the capital. If the bank were to sell its share at cost, it would practically secure its capital and would make the partner bear any loss.

In addition, such stipulation implies linkage of the sale to something that will occur in the future, for the sale would have been concluded while the effects thereof would be deferred to that date which is fixed in the ***Musharakah*** contract, and linkage of a sale to (something that will occur in) the future is prohibited by jurists[40].

We conclude from that, that it is possible for the bank to agree with its client that the latter shall buy the bank's portion piecemeal within an agreed period provided that the purchase price is not specified but is left till the time of sale, lest this should lead to linkage of the sale to (something in) the future.

14. If the *Musharakah* contract includes a provision relating to the partner buying the bank's portion (in Musharakah) within an agreed period, then concluding a sale contract of the same would have to be left for a later date.

By the very financing nature of the bank, it may wish to opt out of the ***Musharakah*** within a certain period of time. Therefore, it may choose to sell its portion to its partner. On the other hand, the partner may find it in his interest to buy the bank's portion in the ***Musharakah***. In such case the two parties would agree that one party shall buy the portion of the other party in the ***Musharakah*** within that designated period. Thus the bank would give its partner an open offer to sell to him its portion within a period stipulated in the contract, the client being free to buy or not. However, should the client (himself) wish to buy the bank's portion then they would execute a sale contract in which the price of purchase would be fixed.

15. It is not objectionable to provide in a *Musharakah* contract that the bank shall sell its portion for a fixed price on a designated date, provided that the partner shall not be obligated to buy same.

It is also possible in the ***Musharakah*** contract to specify a certain price for which the bank would sell its portion to its partner client on a future date, provided that the client shall be free to buy or otherwise. Such undertaking by the bank does not entail linkage (relating) of the sale contract to the future, as the sale contract would not be complete because it hinges on the acceptance of the partner, which acceptance completes the basic requirement of a sale contract[41]. Neither does this lead to guarantee the bank's capital (even if it has specified the price of its portion at its original cost) because the partner has the option to buy or otherwise.

Thus the bank's obligation is a unilateral offer, and it is well known that such offer does not constitute a sale, which sale may not be effected on the basis thereof alone, for the acceptance, by the other party is essential for the two volition's to coincide . Hence, this standard gives the client the option so that the two volition's do not coincide in mutual offer and acceptance, which would lead to linkage the sale contract to future and also to avoid discontinuance of the partnership, as previously indicated under this standard: the standard of banking ***Musharakah.***

7-5 Notes & References

[1] See *Sharh Muntaha al-Iradat*, V.II, p.208.

[2] *al-Moughni*, 5/127; Dr. Saleh bin Zabin al-Marzooki, *Joint Stock Companies under Saudi Law*, p. 86.

[3] *al-Moughni*, 5/127.

[4] al-Zouhaili, *al-Fiqh al-Islami wa Adillatuhu* (Islamic Jurisprudence and its Guidelines), V.IV, p.797.

[6] *Sharh Muntaha al-Iradat*, V.II, p.208.

[6] *al-Moughni*, 5/127; *Sharh Muntaha al-Iradat*, v.2, p.208; al-Zouhaili, *al-Fiqh al-Islami wa Adillatuhu* (Islamic Jurisprudence), V.IV, p.806.

[7] Dr. Saleh bin Zaben al-Marzooki, *Joint Stock Companies under Saudi Law* p.86.

[8] See *Sharh Muntaha al-Iradat*, V.II, p.208.

[9] *al-Mudwanah al-Kubra*, V.IV, p.35.

[10] *al-Moughni*, 5/190-191; Dr. Saleh bin Zaben al-Marzooki, *Joint Stock Companies under Saudi Law*, p.86.

[11] al-Zouhaili, *al-Fiqh al-Islami wa Adillatuhu* (Islamic Jurisprudence and its Guidelines), V.IV, p.845.

[12] *al-Moughni* 5/109.

[13] al-Zouhaili, *al-Fiqh al-Islami wa Adillatuhu* (Islamic Jurisprudence and its Guidelines, p.797.

[14] *al-Moughni*, 5/202.

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[18] See Abdul-Aziz al-Khayat, *al-Sharikaht* (Companies), V.I, pp.212-3.

[19] See Abdul Aziz al-Khayat, *al-Sharikaht* (Companies), V.I, p.223.

[20] Dr. Saleh Ben Zaben, *Sharikaht al-Musahama fi al-Nizam al-Saudi* (A joint Stock Company under Saudi Law), pp.221-2.

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[22] Professor Mohammad Hashem Awad, *Dalil al-'Amal fi al-Bunuk al-Islamiyya* Guide of Work in Islamic Banks, p.14.

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[25] *Surat Ul-Baqarah*, verse 29.

[26] *Surat Ul-A'raf*, verse 32.

[27] *Surat Ul-Maida*, verse 6.

[28] *Surat Ul-Baqarah*, verse 185.

[29] al-Khayat, *al-Sharikaht*, V.I, p.222.

[30] al-Zouhaili, *al-Fiqh al-Islami*, V.IV, p.797.

[31] *Sharh Muntaha al-Iradat*, V.IV, pp.207-8, 213.

[32] *Sharh Muntaha al-Iradat*, V.II, p.213, al-Zouhaili, *al-Fiqh al-Islami*, V.IV, p.854.

[33] *al-Moughni*, 5/187.

[34] *al-Moughni*, Index, p.479.

[35] *Sharh Muntaha al-Iradat*, V.II, p.213.

[36] *al-Moughni*, 5/186.

[37] al-Zouhaili, *al-Fiqh al-Islami*, V.IV, p.805.

[38] *al-Moughni*, 5/141.

[39] *al-Mudwanah al-Kubra*, V.IV, p.34.

[40] al-Zouhaili, *al-Fiqh al-Islami*, V.IV, pp.246-7.

[41] al-Zouhaili, *al-Fiqh al-Islami*, V.IV, pp.246-7.

Glossary

'Amil: The party which provides work and management in a Mudaraba contract.

'Arboon: A sum of money (deposit) paid by the purchaser to the seller, on condition that, if the purchaser takes the goods then this money will be considered as a part of the price and if he defaults then that deposit will be taken by the seller.

Ayah: A verse of the *Quran*.

Bait ul-Maal: State treasury.

Dhimma: The qualification of a nominal (company) or a natural person to bear obligations and enjoy rights. Hence debts of companies or persons whether incorporeal property or fungible are tied or related to it ***(dhimma).***

Fatwa *(pl)* ***Fatawa***: Formal Shari'ah opinion on a specific matter given by Muslim Scholar (***'Alim***) see also ***'Ulama.***

Fiqh: Islamic jurisprudence.

Gharar: Risk and uncertainty. A contract would be replete with gharar if the outcome is not contractually certain and that rights and obligations of the parties are not fixed. Wagering would be the most gharar ridden contract.

Ijtihad: An independent reasoned interpretation for texts of *Quran* and *Sunnah* to reach a verdict or conclusion in certain matter.

'Imam: The word is used in many different senses, its most common being a leader of the congregation at prayer; it is also used to denote the founders of different schools of Muslim jurisprudence (Medhahib) or other eminent jurists. It is also used to refer to the ruler.

'Inah: Selling of an object on deferred payment basis with a condition to buy it back from the person to whom it was sold on cash at a lower price. It is considered as a device to borrow money under the guise of sale.

'Iwad: Price and sold object in a contract of exchange are both called ***'Iwad*** .

Ijarah: (Lease of objects): is the selling of a defined benefit against a specific consideration for a fixed period.

Istisna': is a contract in term of which a person buys on the spot something that is to be manufactured which the seller undertakes to provide after manufacturing same using materials of his own according to designated specifications against a determined price.

Jahalah: Unknown elements in the contract. An example would be buying one sheep of a herd of sheep without identification of the particular one that is sold. So we know that one is sold but we don't know which. If the contract states sale of something which could be one sheep or something else then it is gharar. Hence all Jahalah is gharar but not vice versa.

Kaali: Means deferred, it refers here to debt.

al-Kaali Billkaali: A sale contract where both price and sold object are deferred, and sale of debt to the debtor (or to other) on deferred payment basis for the same amount of debt or with excess.

al-Kharaj: Earnings or benefits generated from owning an asset.

al-Kharaj biddaman: Who ever is responsible for damage or loss of an asset, deserves to receive any earning, generated by that asset. Therefore, if a person buys a house and rents it, then had to return it back because of a defect in the house, that person is the rightful owner of the rent paid to him during that period. This is because if anything goes wrong with the house during that period it would be his responsibility.

Masnou': is every thing that is manufactured under an ***Istisna'*** contract, which could be a capital asset, buildings, machines, equipment, consumer or production commodities, software and so on, hereinafter referred to as commodity / commodities.

Medhahib (singular, *Medhhab*): Islamic schools of jurisprudence. There are four main *Sunni* schools, ***Malki, Hanafi, Shafi'i*** and ***Hanbali***. See also, ***al-Medhhab al Malki, al-Hanafi, al-Shafi'i,*** and ***al-Hanbali***.

al-Medhhab al-Hanafi: A school of Islamic thought, named after Abu Hanifa Al-No'man who is considered the founder of this school, he was one of the great Muslim jurists, who interpreted Quranic teaching and Prophet's, peace on him, Tradition. ***Al-Medhhab al-Hanafi*** was the first of the Sunni school of jurisprudence.

al-Medhhab al-Hanbali: A school of Islamic thought, named after its founder, Ahmed Ibn Hanbal.

al-Medhhab al-Malki: A school of Islamic thought, named after its founder, Malik Ibn Anas.

al-Medhhab al-Shafi'i: A school of Islamic thought, and named after its founder, Mohammad Ibn Idris Al-Shafi'i.

al-Mithliyaat (Fungibles): are the comparable commodities in terms of their characteristics so that the units thereof are comparable and identifiable in the market and could be established as a debt in ***dhimma*** (q.v.) such as wheat, oil, copper.... etc.

al-Mudareb Udareb: This concept means that a *Mudareb* instead of indulge in business by himself he advances *Mudaraba* to another *Mudareb* to work on it. Hence, this concept consists of two *Mudaraba* contracts where the *Mudareb* in the first contract is the *Rabbul-mal* in the second one.

al-Muslam Fiihi: is the commodity which is the subject of the ***Salam*** contract.

al-Muslam Ilayhi: is the seller of the deferred commodity in a ***Salam*** contract, i.e. the one who receives the ***Salam*** capital (price of commodity) in advance from the buyer.

al-Muslim: is the buyer in a ***Salam*** contract. Not to be confused with the Muslim (Moslem), one who professes Islam.

Mu'awadah (pl) ***Mu'awadat***: Exchange of ***'Iwad*** (q.v.), i.e. exchange price and commodity in a sale contract.

Mudaraba Finance: This is a profit-sharing partnership formed between a bank and a client who may be an individual or a body corporate, under which the bank would be ***rabb ul-maal*** (q.v.) (the money provider) in accordance with the well-known rules of ***Mudaraba*** (q.v.) in Islamic Shari'ah.

Mudaraba Investment: This is a profit-sharing partnership formed between the bank and one or more of its clients. In this type of ***Mudaraba*** (q.v.), the bank is the ***Mudareb*** (q.v.) in accordance with the well-known rules of ***Mudaraba*** (q.v.) in Islamic Shari'ah, and is entitled to mix the sums of money invested by the clients, and to permit the clients to join and withdraw from the fund in accordance with rules that are agreed upon in the contract.

Mudareb: The bank's client that invests the ***Mudaraba*** capital.

Murabaha: The intermediation of a bank in the purchase of a commodity upon the request of a client and then selling same on deferred payment terms for a price equivalent to the total cost of purchase plus a fixed profit (mark-up) agreed upon by both bank and client.

Musaqah: A fruit sharing agreement between an Orchard owner and one who provides the necessary labour.

Musharakah: see ***Al-Musharakah Al-Masraffiya***.

Musharakat: (pl) of ***Musharakah.*** Sometimes the plural of ***Musharakah*** is used to refer to both Musharakah and Mudaraba

Mustasne': is the purchasing party under an ***Istisna'*** contract, who is bound, pursuant to the contract, to accept the manufactured commodity if it conforms to the specifications

Muzara'ah: Share cropping agreement.

Quran: The Holy Book of Muslims consisting of the revelations made by *Allah* to the Prophet Mohammad (pbuh) during his prophethood life. The *Quran* consists of 30 parts, 114 chapters (*Surah*) and over 6600 verses (*Ayyah*).

Qismah: This means the distribution of profit between the bank and the ***Mudareb.***

al-Qaimiyyat: are the commodities whose units are so different that they cannot be established as a debt in ***dhimma***.

Rabb ul-maal: The bank that provides the ***Mudaraba*** capital.

Riba (usury): Any amount in excess of the loaned amount charged by the lender from the debtor.

Sane': is the seller who undertakes, under an ***Istisna'*** contract to supply the client with ***al-masnou'*** (q.v.) (manufactured object)at maturity (the designated time), whether he himself manufactures the object or whether he has it made by another ***sane'*** (q.v.).

Sarf: Sale (Exchange) money for money.

Shari'ah: Islamic law; refers to the divine guidance as given by the *Quran* and *Sunnah* and embodies all aspects of the Islamic faith, including beliefs and practices.

al-Salam: is a nominate contract in Islamic Shari'ah. It is a deferred delivery sale described as a debt in the seller's ***dhimma*** (q.v.) the price is paid in advance, while the sold commodity is deferred to a specified future delivery date.

al-Salam Al-Haall: A Salam contract where both commodity and consideration are exchanged simultaneously without commodity being deferred.

al-Sharikah (partnership): Under this standard ***Al-Sharikah*** means any contract made by two or more parties pertaining to capital and work (management) for the purpose of making profit. This is known among jurists as ***sharikat ul-amwaal*** (finance partnership).

al-Sharikah Al-Masrafiyya (Banking partnership) (***Al-Musharakah***): a finance method derived from the partnership contract that is known in Islamic jurisprudence, in which the bank participates with one client or more. It is designated to be called ***Musharakah*** in contemporary banking practice.

Sharikat Al'Anan: A partnership involves partners who contribute capital jointly, possibly in different percentages, and perform work, possibly of various types on the agreement that they will share profit according to their agreement and loss proportionately to their share in capital.

Surah: A chapter of the *Quran*. There are 114 *Surahs* of varying lengths in the *Quran*.

Sunnah: Traditions of Prophet Mohammad "PBUH". *Sunnah* include the Prophet sayings, doing, or practice tacitly approved by Him. *Sunnah* is the most important source of the Islamic faith after the *Quran*.

Tandeed: is the conversion of the ***Musharakah*** assets into money, in actual practice, through sale, or constructively, through accounting methods which rely on the valuation of assets at a certain date and effecting the division (distribution) of profit accordingly.

'Ulama *(pl)* ***'Alim:*** Muslim Scholar who is knowledgeable in Islamic jurisprudence (***Fiqh***).

Waqf: endowment

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Topic: Islamic jurisprudence, mainly on al Medhhab al-Hanbali.

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Author: Zakaria al-Ansari (926 H)
Topic: Explanation and interpretation for *Rawd al-Taleb* (q.v.) on al-Medhhab al-Shafi'i.

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Author: Zain al-'Abdeen Ibn Nujaim (Died 970 H)
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Topic: Islamic jurisprudence on al-Medhhab al-Maliki, it refers also to other Medhahib opinions.

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Topic: Islamic Banking and Islamic modes of financing.

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Author: Abdul Rahman Ibn Nasir al-Sa'adi. The author who passed away recently is considered one of contemporary 'Ulama in Gulf area.
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Author: Mohammad 'Oleesh (1299 H)
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Author: al-Dareer
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Author: Sheikh Mara'i
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Author:
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Author: Abdullah Ibn Ahmad al-Nasfi (Died, 710 H)
Topic: A text in al-Medhhab al-Hanafi. The text has been published many times in India and Egypt, it has been interpreted by many scholars: al-Zaila'a (743 H), al-Harawi (811 H), al-'Aini (855 H) and Ibn Nujaim (970 H).

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Author: Ahmed Ibn Taimiyyah (661- 628 H)
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Musnad Ahmad
Author: Ahmad Ibn Hanbal 241 H
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Author: al-Nawawi (Died, 676 H)
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Author: Mohammad 'Oleesh (1299 H)
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Manhaj al-Talibeen wa 'Omdat al-Mufteen
Author: Muhi al-Deen al-Nawawi (Died, 676 H)
Topic: Text in al-Medhhab al-Shafi'i, published many times first one was in 1882 with a French translation.

Mawahib al-Jalil fi Mukhtasar Khalil
Author: al-Hatab (Died, 954 H)
Topic: Interpretation for *Mukhtasar Khalil* (q.v.), published in Cairo 1329 H.

al-Muwatta
Author: Malik Ibn Anas, (179 H)
Topic: Sunnah.

al-Moughni (14 volumes) including index
Author: Abdullah Ibn Ahmed Ibn Qudamah, who passed away in 630-H (1209-G) approximately
Topic: Islamic jurisprudence mainly al-Medhhab al-Hanbali, the book also refers to other Medhhab in case of different opinions.

Moughni al-Mouhtaj ila Sharh al-Manhaj
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Topic: Islamic jurisprudence on al-Medhhab al-Shafi'i. It is an explanatory interpretation for *Manhaj al-Talibeen* text for al-Nawawi (q.v.).

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Author: al-Imam Malik Ibn Anas (93-179 H)
Topic: Imam Malik Fatawa and opinions on different Shari'ah topics and Islamic jurisprudence issues. The book was narrated by Abdul Rahman Ibn al-Qasim.

al-Muhalla (12 volumes)
Author: Ali Ibn Ahmed Ibn Hazm (384-456 H)
Topic: Islamic jurisprudence. The book bases verdicts (fatawa) and opinions on the appearance and direct meaning of Nuss (text of Quran or Sunnah).

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Author: Dia al-Deen Khalil (Died, 776)
Topic: Text in al-Medhhab al-Maliki. It has above one hundred interpretations by different authors. These include, al-Hatab (954 H) al-Zarqani (1099 H), Mohammad 'Oleesh (1299 H).

Nail al-Awtar (4 volumes)
Author: Mohammad Ibn 'Ali al-Shaukani (1172 – 1255 H)
Topic: Sunnah (Prophet Mohammad PBHU traditions). The book is interpretation of a collection of Ahadith (Prophet's traditions).

Nihayat al-Mouhtaj ila Sharh al-Manhaj
Author: Shams al-Deen al-Manufi al-Masri (Died, 1004 H)
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Omdat al-Qaree
Author: al-'Aini (855 H)
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Author: Mohammad Amin Ibn 'Abdin (1198 – 1306 H)
Topic: Islamic jurisprudence on al-Medhhab al-Hanafi. The book is explanatory and elaboration on *Al-Dur al-Mukhtar* book.

Sahih al-Bukhari
Author: Mohammad Ibn Isma'il al-Bukhari (256 H)
Topic: Collection of Prophet Mohammad PBUH Sunnah.

Sahih Muslim
Author: Muslim Ibn al-Hajaj (261 H)
Topic: Prophet Mohammad PBUH tradition (Sunnah).

Sahih al-Tirmidhi
Author: al-Tirmudhi (279 H)
Topic: Sunnah.

Sharh al-Kharshi
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Sharh Muntaha al-Iradat
Author: al-Bahoofi
Topic: Islamic jurisprudence on al-Medhhab al-Hanbali.

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Author: Abdul Aziz al-Khayat
Topic: Companies (partnership) principles, rules and regulations in Islamic jurisprudence.

Sunan Abu Dawood
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al-Sunan al-Kubra
Author: al-Baihaqi (458 H)
Topic: Sunnah.

Tabyeen al-Haqaieq
Author: al-Zaila'i (742 H)
Topic: Islamic jurisprudence on al-Medhhab al-Hanafi.

al-Umm
Author: al-Shafi'i, Imam al-Medhhab al-Shafi'i
Topic: Islamic jurisprudence from al Medhhab al Shafi'i point of view.

Zarqani's comments on Malik's Muwatta
Author: Mohammad al-Zarqani (1055 – 1122 H)
Topic: Interpretation and comments on Malik's *Muwatta*. *Al-Muwatta* is a collection of Prophet (PBUH) traditions and sayings.