

Application of Shari'ah in Islamic banking: Equity based and Debt based Islamic Financial Products and Services

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Islamic Contract Law

Contracts are drawn to ensure the existence of clearly recognised guidelines for all parties involved. They state the standings of all those involved and the condition(s) of the transaction(s) that are to take place. This occurs in both conventional and Islamic banking. The general principle of the Islamic law of contract is contained in the Quranic verse: "O you who believe, fulfil all obligations". The definition of contract (al-'aqd) in Shari'ah law is similar to that in English common law, but is wider in that it includes dispositions which are gratuitous as well as endowments and trusts.

A **contract in Islamic law** consists of an agreement made between two or more parties and the basic elements are quite similar to those of English common law:

- a. **Offer and acceptance** — a contract requires an offer (ijab) and acceptance (qabul). The contract can be oral or in writing, made by signs or gestures, by conduct or through an agent. If the offer is made in writing it remains in force until received by the other party who must then reply promptly.
- b. **Consideration** — as in English common law, consideration may consist of money, goods or services. It must be something which is capable of being given, or, in the case of a service, capable of being performed, and it must not involve materials or acts which are prohibited according to Islamic law.
- c. **Capacity** — the parties entering into a contract must be legally competent. A minor, a person of unsound mind, an insolvent person, a person legally declared a prodigal, an intoxicated person or a person suffering from an illness which leads to his or her death (mard al-mawt) cannot enter into a binding contract.
- d. **Legality** — the purpose of the contract must be legal in terms of the Shari'ah. A contract to grow grapes for winemaking, for example, would be illegal, as would a contract to sell firearms to criminals or to make a loan with interest.
- e. **Absence of duress** — the parties must enter into the contract of their own free will. A contract concluded under duress is null and void.

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Types of Contract in Shari'ah

There are seven types of contract recognised by Shari'ah law and they are as follows:

(i) Al-Tamlikat (acquiring of ownership)

This kind of contract relates to the acquisition of ownership of properties, or the rights to the benefits of properties. The kinds of contract which fall into this category can be further divided into two subgroups, namely:

(a) Uqad al-Muawadhat (contracts of exchange)

In this instance, the acquisition of ownership involves some kind of exchange between two parties involving a sale, hire, money changing, compromise, partition, sale by order and the like.

(b) Uqad al-Tabarruat (contracts of charity)

This kind of contract relates to situations where the ownership of a property is acquired without involving an exchange, for example as a gift, alms, endowment, benevolent loan (al-qard al-hasan) or the assignment of debt. Sometimes a contract may be initiated as a contract of charity, but then later the receiving party is required to give an exchange. Examples of such a contract are guarantees requested by the debtor and gifts with the condition of an exchange. Contracts such as these commence as contracts of charity at the beginning, ending as contracts of exchange.

(ii) Al-Isqatat (releases)

These contracts relate to the dropping of rights against others with or without exchange. If the release is without compensation from the other party, then the release is an absolute release and includes repudiation, remission of the penalty of talion, release from debt and withdrawal from the right to pre-emption. If the release is with compensation from the other party, then it is a release with exchange.

(iii) Al-Itlaqat (permissions)

This kind of contract includes giving total responsibility to individuals, firms or agencies in the appointment of governors and judges; giving a person who is dispossessed of the power of administration, permission to administer his property, or giving permission to a minor to carry on trade; and the appointment of a nominee to take care of one's children after death.

(iv) Al-Taqyidat (restrictions)

Contracts in this group prevent or terminate the performance of certain functions. They include the dismissal of governors, judges and supervisors; the termination of endowments; the termination of the appointment of nominees and agents; and dispossession of the administration of property because of insanity, mental disorder, prodigality or infancy.

(v) Al-Tauthiqat (securities)

This kind of contract is meant to secure debts for their owners and guarantee creditors of debts owing to them. They include guarantees and the assignment of debt and mortgages.

(vi) Al-Ishtirak (partnerships)

These contracts relate to sharing in projects and profits. They include al-mudarabah, where a person gives an amount of money to another to trade or invest with the condition that they share in the profit while the loss is borne by the owner of the capital. They also include partnerships involving the cultivation of land and taking care of trees.

(vii) Al-Hifz (safe custody)

Contracts in this group relate to keeping property safe for its owner and include some of the functions of agency.

Mode of Financial Accommodations

1. **Uqud al-Ishtiraq:** Direct Financial Accommodations
2. **Uqud al-Muawadhat:** Indirect Financial Accommodations

Direct Financial Accommodations

- a. Profit Free Product or Quard -based Product: PFP Quard-e-Hassan
- b. Profit Sharing Product : PSP Mudaraba
- c. Profit and Loss Sharing Product : PLSP Musharaka

Indirect Financial Accommodations

- a. Trading-based Financial Products
- b. Lease-based Financial Products
- c. Service-based Financial Products
- d. Output Sharing-based Financial Products

1. Equity based Islamic Financial Products and Services

Direct Financial Accommodations

PFP or Profit Free Products

- a. 1st Quard-e-Hassan: A loan with service charge, with guaranteed return of the principal amount of the Quard.
- b. 2nd Quard-e-Hassan: A loan without service charge, principal amount of Quard is repayable when the borrower is able to pay without any service charge.

PSP or Profit Sharing Products

Mudaraba: A partnership in profit between capital and management.

- a. Mudaraba Mutlaqa: Unrestricted Mudaraba
- b. Mudaraba Muqaiyyadah: Restricted Mudaraba, on the basis of contract.
- c. Single Mudaraba & Compound Mudaraba
- d. Limited term Mudaraba & Unlimited term Mudaraba
- e. Commingled & non-commingled Mudaraba

PLSP or Profit & Loss Sharing Products

Musharaka: Contracts on the basis of Partnership.

1. Shirkat al-Melk or non-contractual partnership and
2. Shirkat al-Uqud or contractual partnership

Shirkat al-Melk

1. Shirkat al-Melk bil Ekhtiyar: Voluntary partnership and
2. Shirkat al-Melk bil Zabir: Involuntary partnership

Shirkat al-Uqud

1. Shirkat al-Inan: Unequal partnership
2. Shirkat al-Mufawadah: Equal partnership
3. Shirkat al-Abdan : Partnership on labor, skill and management
4. Shirkat al-Wujuh : Goodwill or credit-based partnership

5. Shirkat al-Mudawwana: Partnership for credit purchase and resale with a profit mark-up.
6. Musharaka al-Mutanakissa: Digressive partnership

2. Debt based Islamic Financial Products and Services

Indirect Financial Accommodations

(a) Trading-based Financial Products

- a. Bai-Murabaha: Cost plus profit mark-up, spot payment and spot delivery of commodity.
- b. Bai-Muajjal : Cost plus profit mark-up, spot delivery of commodity on deferred payment basis
- c. Bai-Salaam : Advance purchase or Forward sale. Parallel Salam. Sukuk al-Salam
- d. Bai-Istisna'a: Sale on order for manufacturing supplies. Parallel Istisna'a. Sukuk al-Istisna'a
- e. Bai-al-Dayin : Debt Trading
- f. Bai-bil-Wafah: Buy-back arrangement.
- g. Bai as-Sarf : Currency trading
- h. Bai as-Suyulah : Exchange of liquidity
- i. Bay' al-istighlal: Wafa sale on condition of the lease. Refers to a situation in which a person sells their leasable property to obtain financing on the condition of taking it back later and use it as a lessee in this period.
- j. Bai-Musawama: does not need to declare its cost of goods. It can take any commission from provider (seller) of a commodity or a service for purchasing or acquiring goods and add it to its own revenues.
- k. Bai-Muzaiyada: Sales and purchases made at auctions are valid transactions, so long as the conditions stipulated by Shari'ah are adhered to.
- l. Bai-Istijrar: The contract has embedded options that could be triggered if the underlying asset's price exceeds certain bounds. The contract is complex in that it constituted a combination of options, average prices and Murabaha or cost plus financing. The Istijrar involves two parties, buyer which could be a company seeking financing to purchase the underlying asset and a financial institution.
- m. Tawarruq: A contract where the bank will purchase the from a broker, on behalf of the customer. The customer will, subsequently, sell the commodity to the bank on deferred payment (including profit margin). Once the ownership of the commodity

has been transferred, the bank will then sell the commodity on a spot basis for cash through another broker.

(b) Lease-based Financial Products

First Classification of Ijarah:

1. Ijarah al-Ain: Hire or requisition of usufruct or real goods.
2. Ijarah al-Dimmah: Ijarah for services such as the hire of someone's service.

Second Classification of Ijarah:

1. Ijarah al-Fard: When only one person hires any good or service.
2. Ijarah al-Musha: When a group of persons jointly hire a good or service.

Modern Classification of Ijarah:

1. Operating Lease: Legal title of the leased asset does not pass to the lessee at the end of the lease.
2. Finance Lease or 'Full Payout': Ijarah Muntahiya bit-Tamlik, which concludes with the transfer of the legal title of the leased asset.
3. HPSM Hire Purchase under Shirkatul Melk.
4. Al-Ijarah al-Mausufah fi al-Dhimma: Forward Ijarah or Service Ijarah (to provide financial services for obtaining higher education, medical treatment, halal tourism and Hajj & Umrah services).

(c) Service-based Financial Products

Hawalah

Hawalah means transferring a debt from one debtor to another. That means the 1st debtor is released from debt when hawalah takes place. The transferee is released from his liability if any of four situations occur:

- a. by payment of the debt
- b. by re-transferring the debt to another transferee if the creditor accepts
- c. by confinement of the creditor
- d. if the creditor dies and the person who accepts the transfer is his heir.

Classification of Hawalah:

- a. White Hawalah : When hawalah is used to meet the legitimate consumer's need for remittance services is called White Hawalah
- b. Black Hawalah: When hawalah is used to serve criminal element's purposes then it is called Black Hawalah which indiscriminately exploits the opportunities provided by hawalah.

Wakalah

Agency ship: Wakalah means entrusting a person by another person to act on his behalf as his wakil or representative. It is a very common practice to appoint an agent to facilitate trade operations. Agency is one of the most important elements of Islamic Partnership. As per modern interpretation, relationship between the partners is described as a principal-agent relationship. L/C Under the Contract of Wakalah: The bank establishes the L/C and pays the proceeds to negotiating bank utilizing the customer's deposit; and subsequently releases the documents to the customers. The bank charges the customer Service fees and commission for its services under the Product of ajar (fee).

Kafalah

Kifalah means an obligation, which a person wants to assume in addition to his existing obligation in respect of a demand for something. This may relate to a person, finance or act. When it relates to finance, means an obligation to be met in the event of the principal debtor's inability to honor his obligation.

Jo'alah

Jo'alah is a contract on the basis of which one party (the jaa'el bank of employer) undertakes to pay a specified amount of money (jo'al) to the other party (the amel or contractor) for rendering a specific service in accordance with the terms and conditions of the contract. The concept of jo'alah is similar to that of istisna'a. Whereas in istisna'a the seller provides a physical commodity, in jo'alah the seller provides a service rather than a physical commodity. All other aspects of jo'alah are same as of istisna'a.

(d) Output Sharing-based Financing Products**Muzara'a (Share-cropping):**

Muzara'ah is a contract, in accordance with which, one of the parties gives a plot of land for a fixed period to the other party, to cultivate it and divide the yield. According to Imam ibn Qudama (Al-Moghni-5/309) it is a contract between an owner of a piece of agricultural land and a farmer for farming it in return of a percentage of its crop. Agricultural output may be shared automatically between the two partners as soon as the activity ends regardless to whether the share of the land owner may cover the value of his capital(the land as example) or not.

Musa'qaat (Share-watering):

Musa'qaat is a transaction contract between the owner of a tree and the like, and an amel (agent), against a clear-cut share from the yield, and the "yield" includes fruit, flower petals, etc.

Mugharasah (Share-planting):

It is a type of agricultural partnership where the land and plants are contributed by one party and the work of planting is provided by another party with a portion of plants being given to him.