Riba and Islamic Modes of Finance
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EXECUTIVE SUMMARY

Islam is a complete code of life, not merely limited to belief or moral injunctions for personal conduct. Although it is true that Islam has recognized the right of ownership over one's property, it is one of the fundamental beliefs of a Muslim that everything (including his wealth) ultimately belongs to the creator. Thus, it is every Muslim’s duty to use, whatever the creator has given him, according to the guidelines given by Him.

The most important guideline related to economics is the prohibition of Riba. Of all the things that are prohibited in Islam, fear Allah and give up what still remains of Riba if you are believers. But if you do not, then listen to the declaration of war from Allah and His Messenger. And if you repent, yours is your principal. neither you wrong, nor be wronged” (Quran, 2:278-279).

Since 1979, Pakistan has embarked on a process of Islamization of its financial system; the main thrust has been on these limitations of Riba from the economy. However, people generally believe that there does not exist any financial institution, which fully conforms to Islamic principles. The historical judgment delivered by the Federal Shari’at Court (FSC) in December 1991, which declared a number of existing financial laws and practices as repugnant to the injunctions of Islam

Riba, in the Arabic language, refers to an increase, addition, expansion, or growth. Riba was a well known transaction and was rampant all over Arabia, before the revelation of the Holy Qur'an. The taking any excess over the principal was called Riba, and Arabs had no doubt in understanding its meaning. However, in explaining the injunctions of the Holy Qur'an, the Messenger of Allah (peace be upon him) also added certain transactions of exchange (Bai’). In The. definition of Riba. The former came to be knows 'Riba al-Nasi’ah’ and the latter as 'Riba al-Fndl’. The definition of Riba is, and for the late fourteen hundred years has been, clear to Muslim scholars all over the world. There is a consensus between Muslim jurists that all forms of interest fall under Riba. Still there is a common misunderstanding among some people that it was interest on consumption loans, not on commercial or productive loans whitewalls prohibited in Islam because any interest charged on such loans caused hardships to the borrowers. This argument is invalid because the Qur’anic verse about remitting the principal in the event of borrower’s hardships does not refer to consumption loans. In addition, historical facts reveal that at the time of the evaluation regarding prohibition of Riba, most of interest related transactions used to occur between tribes which used to lend and borrow from each other for trading.

Similarly, people who argue that it is compound interest (or exorbitant rates of interest) and not simple interest which is unlawful. are also incorrect in their assertion. They have misunderstood the meaning of the following verse, and have taken it to be the prohibition compound interest only:

“O those who believe, do not eat Riba multiplied many times. And fear Allah so that you may be successful” (Qur'an, 3:130)
It is an accepted rule of interpreting the Holy Qur'an a verse revealed later takes precedence over a verse revealed earlier. The fact that the verse of Surah Al - Baqarah and Surah An-Nisa which prohibit all from of interest were revealed later that the verse presented above, is sufficient to prove the impressibility of simple interest. Thus any excess which is predetermined over the principal sum in a loan transaction constitutes Riba in all circumstances. It does not make a difference whether the loan is for consumption purpose or for a commercial purpose, and whether threat if interest is high or low, simple or compound, short or long term, between Muslim and a non-Muslim or between a citizen and a state or between two states. Islam has prohibited all from of Riba, and as an alternative provides cetrgtain guidelines related to business and financial transaction. These guidelines have been used but contemporary scholars to devise Islamic modes of announcing based on 'trading', 'Leasing', 'partnership' and 'profit sharing'.

Trading refers to the operation of buying with the intention of selling at a higher price, there by making profit from the difference between the sale price and the purchase price. Mode of financing based on 'trading' include 'Bai' Mu'ajjal', 'Bai, Murabaha', 'Bai' Mu'ajjil is a sale on credit. It is based on the delivery of the good by the seller to the buyer, there by the enabling him to possess and benefit from the good with the understanding that the buyer will pay the agreed upon price at a certain future date. The deferred price is usually higher that the cash price, thereby enabling Bai' Mu'ajjal to be used as a mode of financing. Bai' Murabaha is a sale in which the seller discloses the actual cost he has incurred in acquiring a particular good, and then adds some profit thereon. The profit is determined by mutual cosset, either in lump sum or through an agreed ratio of profit to be charged over the cost. The payment may be made at spot or on a subsequent date agreed upon by the parties. Bai' Salam and Bai' Istisna are to only types of sale in which the subject matter of sale does not exist at the time of the sale contract. As a result, both types of sale are governed by specific rules. In Bai' Salam, the seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advanced price fully paid at spot. In Bai' Istisna, the buyer places an order with a manufacturer to manufacture a specific good for the buyer. The payment can be made at spot or in installments.

Profit Sharing refers to an exchange between capital on one hand and labor on the other. It is a contract between two parties in which one party provides capital to the other party that undertakes the management in exchange of a share in the profit. Profit sharing includes contracts such as 'Mudarabah' and Mazurka' which can be used as a mode of financing. Mudarabah, which can be regarded as a special kind of principal agent relationship, refers to a mode where one party gives money to another for invent it in a business enterprise and both parties share in the profits according to an agreed ratio, /the investment is made by the principal, who is called 'Rabb-ul-Mal', whereas the management and work is the exclusive responsibility of the order party of agent, who is called 'Mudarib' Mudarabah achieves the objective of both the parties: Rab-ul-mal may not have the time or the expertise and experience to turn over capital and trade with it, whereas the Mudarib may not have the adequate capital to put to use his experience and expertise. Unlike Musharakah, the loss of capital, of any, is suffered by the Rabb-ul-mal only (as the Mudarib has not invested anything), while the Mudarib may not have the adequate capital to put to use his experience and expertise. Unlike Musharakah, the loss of capital, if any, is suffered by the Rabb-ul-mal only (as the Mudarib has not invested anything), while the Mudarib gets nothing for his effort. Muzara'a or 'crop sharing' is to give the land to whoever can cultivate it or work in it in exchange of a share in the crop. Similar to Mudarabah, this transaction achieves the
interest of both the landowner and the agent. The landowner may not be in a position of cultivating or working man the land while the agent may not have the land to use his skill and resources.

SECTION-I

RIBA

Prohibition of Riba in Islam.

The discussion that follows shows that Riba is strongly prohibited in Islam. This section discusses, the nature and prohibition of Riba in the light of Holy Qur'an and Sunnah, some misconceptions regarding Riba, and the various drawbacks of dealing in Riba.

Riba in the Holy Qur’an

Dealing with the unlawfulness and prohibition of Riba, there are in the Holy Qur’an verses of Surah Al-Baqarah two verses of Surah An-Nisa, one verse of Surah Al-Imran and one verse of Surah Al-Rum, which are cited below.

1) “Those who take Riba (usury or interest) ill not stand but as stands the one whom the demon has driven crazy by his touch. That is because they’ve said: ‘trading is but like Riba.’ And Allah has permitted trading, and prohibited Riba. So, whoever receives an advice from his Lord and stops, he is allowed what has passed, and his matters up to Allah. And the ones who revert back, those are the people of Fire. There they remain forever Allah destroys Riba and nourishes charities. And Allah does not like any sinful disbelief. Surely those who believe and do good deeds, establish Salat and Zakat have their reward with their lord, and there is no fear for them, nor shall they grieve. O those who believe, fear Allah and give up what still remains of Riba if you are believers. But if you do not, then listen to the declaration of war from Allah and His Messenger. And if you repent, yours is your principal. Neither, you wrong, nor be wronged. And if there be one in misery, then deferment till ease. And that you leave it as alms is far better for you, if you really know. And be fearful of a day when you shall be returned to Allah, then everybody shall be paid, in full, what he has earned, And they shall not be wronged.” (Qur’an, 2:275-281)

2) “O those who believe, do not eat Riba(usury or interest) multiplied many times. And fear Allah, so that you may be successful.” (Qur’an, 3:130)

Riba in Ahadith

The verses above clearly point out that Riba has been strongly prohibited in Islam. ample support can also be found in the Ahadith (sayings) of he holy prophet peace be upon him). A representative sample of these Ahadith is presented below to real firm the prohibition of Riba.

A.1. ”Abstain from the seven disasters”. The people asked him “What are they, O
messenger of Allah?" He replied: to ascribe partners to Allah, to practice sorcery, to unjustly kill one whom Allah has declared inviolable, to take Riba (interest or usury), to exploit the property of an orphan, to escape at the time of war and to slander the chaste women who are believers, unwary." (Shafi 1995a,p.11)

A.2. "A dirham a man receives as Riba (interest or usury) is, in the sight of Allah, more serious than thirty three acts of fornication or adultery in Islam."(Ibid., p.13)

A.3. "The Holy prophet (peace be on upon him) has forbidden the fruits to be sold or purchased before they are eatable, and said, "When Zina (adultery and Riba usury or interest) become rampant in the people of a town they themselves invite the punishment of Allah."(Ibid.,p.13)

A.4. "The society in which Riba becomes rampant is punished with famine, and the society where bribe is rampant is punished with horror(of others)."(Ibid.,p13)

A.5. "Abstain from sins, which are not forgiven: embezzling of the spoils, for whoever embezzles anything will come with it on the Day of Judgment, and the other sin is Riba.: (Ibid., p.14)

Definition of Riba

The meaning of Riba is, and for the last fourteen hundred years has been, quite clear to religious scholars and the oriental lists. Al the major ‘Tafasir’ of the Qur’an (i.e., detailed explanations of the Holy Qur’an) provide a uniform definition of Riba, as does the Encyclopedia of Islam and other oriental lists’ works.

In the Arabic language Riba, Literally, refers to increase, addition, expansion, or growth (Zaman 1993), Riba we well known transaction and was rampant all over Arabia, before the revelation of Qur’an. The taking of any . However, in explaining the injunctions of the Qur’an, the Messenger of Allah peace be upon him) also added certain transactions of exchange(Bai'in the definition Riba. The former came to be known as ‘Riba al-Nasi’ah (or ‘Riba al-jahiliyyah’ or ‘Riba al-Qur’an’), and the latter came to e known as ‘Riba al-fadl’. The following Ahadith of the Holy Prophet (peace be upon him) explain Riba:

1. From Ubada Ibn-al-Samit(may Allah be pleased with him): the prophet (peace be upon him)said :” gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt like for like, equal for equal, and hand-to-hand ;If the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand."(Ibid., pp.238-239)

2. From Abu Sa’id al-Khudri(may Allah be pleased with him): The Prophet(peace be upon him) Said: " Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt alike for like, and -to hand. Whoever pays more or takes more has indulged in Riba. The taker and giver are alike (in guilt)." (Ibid,,p.239)

3. From Abu Sa’id and Abu Hurayrah (May Allah be pleased with him): A man employed by the prophet (peace be upon him) in Khyber brought for him janibs (dates of very fine quality). upon the prophet’s asking him whether all the dates of Khyber were such, the man replied that this was not the case and added that” they exchanged a sa(a measure)
of this kind for two or three (of the other kind).” The Prophet (peace be upon him) replied, “Do not do so. Sell (the lower quality dates) for dirhams and then use the dirhams to buy janibs... (When dates are exchanged against dates) they should be equal in weight.” (Ibid., p.239).

4. From Abu Sa‘īd (May Allah be pleased with him): Bilal (May Allah be pleased with him) brought to the Holy Prophet (Peace be Upon Him) some barni (good quality) dates where upon, the prophet (peace be upon him) asked him where these were from. Bilal (May Allah be pleased with him) replied, “I had some inferior dates which I exchanged for these—two sa’s for a sa”. Thee prophet (peace be upon him) said, “Oh no, this is exactly Riba. Do not do so, but when you wish to buy, sell the inferior dates against something (cash) and then buy the better dates with the price you receive.” (Ibid., p.239)

5. From Fadalah ibn Ubayd al-Ansari (may Allah be pleased with him): On the day of Khyber he bought a necklace of gold and pearls for twelve dinars. On separating the two, he found that the gold itself was equal to more than twelve dinars. So he mentioned this to the Prophet (peace be upon him) who replied, “It (jewelry) must not be sold until the contents have been valued separately.” (Ibid., p.239)

6. From Abu Umamah (May Allah be pleased with him): the Prophet (peace be upon him) said: “Whoever makes a recommendation for his brother and accepts a gift offered by him has entered Riba through one of its large gates.” (Ibid., pp.239-240)

7. From Anas ibn Malik (May Allah be pleased with him): the (peace be upon him) said: Deceiving a mustarsal (an unknowing entrant in to the market) is Riba.” (Ibid., p.240)

8. From Abdullah ibn Abi Awfa (May Allah be pleased with him): The prophet (peace be upon him) said: “A najish (one who serves as an agent bid up the price in an auction) is Riba.” (Ibid., p.240)

Muslim scholars also have come up with two interpretations of Riba, based on the above and similar Hadith.

Imam al-Razi, a great Muslim scholar has said in his Tafsir that Riba takes two forms. It could be Riba in trading transactions, and in loans. The first kind is what comes through the Hadith which rules that increase or decrease in the barter of same commodities is also included under Riba. The second from was what commonly prevailed in ‘Jahiliyyah’ (i.e. pre-Islamic) or pagan Arabia. The known practice was that they would give their money on loan to someone for a fixed period of time and receive ‘profit’ against it every month. If the borrower failed to pay back at the appointed time, the time, the time limit was extended on condition that the amount of Riba was to be further increased.

It appears in Ahkam al Qur’an of al Jassas that Riba is of two kinds, the Riba in buying and selling and Riba without buying and selling. The Riba of ‘Jahiliyyah’ (pre Islamic Arabia) belonged to the second kind; by definition, it means the loan on which ‘profit’ is taken on the basis of time duration. Ibn Rush, a great Muslim scholar, in Bidayah al-Mujtahid, has taken the same view, and has proved the unlawfulness of Riba of taking ‘profit’ on loans, on the authority of the Qur’an the Hadith and the consensus of the Muslim community (Ibid.).

In sharha Ma’anî al Athar, Imam al Tahawi, a famous Hanafi Muslim scholar, has
taken up this subject in great detail. He has said that the Riba mentioned in the Qur’an is openly and clearly, the Riba that was given and taken on loans, and it was known as Riba ‘al Jahiliyyah’/ After that it was through the statement of the Holy Prophet increasing, decreasing or non cash dealing in particular types of buying and selling activity. However, in the absence of fully clear detail governing this kind of Riba, some companions for the Holy Prophet faced difficulty and jurists differed .

Shah Waliullah, a great Muslim Scholar, has said in Hujjatullah-al-Balighah that these (forms of Riba) are two separate things. One is the Riba in real terms, and the other is that which is included in the prohibition of Riba. The Riba in real terms means something additional claimed over the principal in a transaction of loan. But the Ahdith prohibiting Riba include the prohibition of a transaction of bartering certain commodities whereby an additional measure is claimed in exchange of the same commodity (Ibid.).

From the Above discussion it can be concluded that Muslim jurists have given two interpretations of Riba: ‘Riba-al-Nasi’ah’, and Riba al-fadl’.

The Meaning of Riba al-NASI’AH.

Riba al-Nasi’ah has been defined as: “Any lending arrangement that obligates the borrower to pay a certain extra amount over and above the payment of the principal amount against the specified deferment.” (Usmani 1992, p.21). The prevalent form of Riba was Riba al-Nasi’ah. The companions of the Holy Prophet (peace be upon him) understood the meaning of these verses in term of Riba al-Nasi’ah; thus, Riba al-Nasi’ah was categorically regarded as unlawful.

Professor khurshid Ahmad defined Riba as: “Riba is the Qur’anic term for usury or interest, and the definition of Riba as given in the Qur’an is very clear and unambiguous. It categorically forbids Riba as any claim excess of principal sum lent.” (Ahmad 1994,p.33) Similarly, Ibn Jarir, a renowned commentator of the holy Qur’an, has reported from Sayyidna Mujahid that the Riba practiced in Arabia which was prohibited by the Qur’an consisted of giving loan for a fixed period and then taking a fixed increase over and above the principal. If the loan was not paid back on the fixed date, an extension of time was granted on condition that the Riba was to be further increased. The same information has been reported from sayyidna Qatadah (may Allah pleased with him) and from other leading commentators (Shafi 1995c).

In the light of above explanations, it is clear that the word “interest”, as commonly understood in context of banking and financial transaction, pertains to the Riba al-Nasi’ah. Therefore, any extra payment specified in a loan contract over and above the principal amount, falls under the definition of Riba al -Nasi’ah, irrespective of the rate or amount of the extra payment.

The Meaning of Riba al-FADL

Islam wishes to eliminate not merely the exploitation that is intrinsic in the institution of interest, but also that is inherent in all forms of dishonest and unjust exchanges in business
transactions. Such transactions are encompassed by the generic term of Riba al-fadl, which is the second sense in which Riba has been used in Shari'ah Riba al-Fadl occurs in those commodity exchange contracts where a contract provides payment of any extra quantity of the commodity (Usmani 1992).

Arguing from gold and silver, all the Muslim jurists agree that this injunction applies to all commodity money. Arguing from the other four commodities, one view (Hanafi, Hambali, imami and Zaydi) holds that Riba al-Fadl is involved in all goods which can be sold by weight and measure (but not length or count), while a second view (Shafi'i and Hanbali) holds that it covers all edible goods.

To sum up, the giving of loan and then taking interest on it is Riba, which was widely known and practiced during the pre-Islamic Arabia. This was clearly declared unlawful by the Holy Qur'an and was abandoned by the noble companions the moment the verses prohibiting Riba were revealed, and the Holy Prophet (peace be upon him) enforced its prohibition through his judgements in the legal suits. As there was no ambiguity in its connotation, nobody faced any doubt or difficulty in understanding the term. However, the Holy Prophet (peace be upon him) did include some forms of buying and selling with in the range of Riba which the Arabs did not take as Riba. For instance, in the buying and selling of six commodities (mentioned above) on barter basis, he ruled that they be exchanged like for like, equal for equal, and hand-to-hand. Thus, any deviation in measure, more or less, and any credit-oriented transaction with regard to these commodities falls within the purview of Riba.

Drawbacks of Riba

There is nothing in the entire creation for the world, which has no goodness or utility at all. Even in serpents, scorpions, wolves, lions and in arsenic (fatal poison), there are thousands of utilities for human beings. Is it then fair to conclude that there is nothing in this vastness of nature, which could really be termed bad or harmful? Obviously, not. The reason for this, as commonly recognized in every school of thought, is that things which have more benefits and less harms are called beneficial and useful while things that cause more harm than benefit are taken to be harmful and useless. For instance, in robbery, the gain of the gangster and the benefit to the thief is all too obvious, but it is certainly harmful for the entire community as it ruins peace and a sense of security from the society. For this reason, theft is not considered a positive act.

Even the Holy Qur'an, while declaring liquor and gambling to be unlawful, proclaims that they do hold some benefits for people, but the harms they generate is far greater than the benefits they yield. Therefore, these cannot be called good or useful, and it is necessary that they be avoided.

The case of Riba is not different. Although the consumer of Riba does have some temporal benefit apparently coming to him, its cost in this world and in the Hereafter is much more than the benefit. Riba has many negative economic and social implications; some of them are discussed below.

Economic and social drawbacks of Riba
Riba results in the gain of some individuals and the loss of the whole humanity, through concentration of wealth in the hands of few. The reason for this is that the interest based system gives preference in extending credit to those people who are rich and have a sound credit history or a large business. These people can create a large superstructure of finance raised on a narrow equity base in the style of an inverted pyramid. One the contrary, a person with a small capital and net worth cannot get access to credit because he has little or no credit rating, and the banks do not trust him enough to advance a loan ten times more than his worth.

Moreover, due to the presence of interest, many business and projects are not undertaken by businessmen. The end result is that many businesses or projects, which would have been beneficial to the community as a whole, are not undertaken. This in turn hampers the economic prosperity of the whole nation, as stated by Umer Chapra:

The rate of interest tends to be a ‘perverted’ price and reflects price discrimination in favor of the rich - the more ‘credit-worthy’ a borrower is supposed to be, the lower is the rate of interest he pays and vice versa. The result is that ‘big’ business is able to get more funds at a lower price because of its higher credit rating. Thus those who are most able to bear the burden because of their bigness or claimed ‘higher’ productivity bear the least burden. In contrast, medium and small businesses, which may sometimes be more productive in terms of contribution to the national product per unit of financing used and at least equally ‘credit in terms of honesty and integrity, may be able to secure relatively much smaller amounts at substantially higher rates of interest. Hence many potentially high yielding investments are never made because of lack of access to funds, which flow instead into, less productive but secure hands. (Ibid., p.109)

There is yet another economic drawback. The concentration of wealth results in the monopolization of markets by the large capitalists who have the financial muscle to squeeze out the small players. For example, a person with a large capital can buy raw material from the market at a price so low and discounted which the small capitalist cannot get.

Injustice to the lender is another economic/social peril caused by Riba. For example, consider a person with a capital of ten thousand who goes in business worth a hundred thousand, the additional capital advanced by a bank as interest bearing loan. If by chance, he is hit by a loss, his capital sinks and he owes insolvent. The outcome is quite interesting. He bears only ten percent of the loss, while the rest of the loss, that is ninety - percent, is absorbed by the whole community, whose money he had borrowed from the bank to invest in his business. Even if the bank writes off the loss as an interim measure, it is clear that the bank is the pocket of a nation, and the loss ultimately hits the nation. On the contrary, if the borrower or capitalist makes a huge profit in his business, the community gets only a small fixed amount from it, no matter how large the profit is. The outcome is that the borrower gets the major portion of the profit, leaving very little for the community. It also needs to be considered here that no matter what amount of interest is paid by the borrower, in the end, the interest expense is passed on the final consumer (the community) because interest is considered as the financial cost of doing a particular business.
In 1954, the cotton business of Pakistan suffered, to use a word of the Qur'an, with the calamity of 'Muhaq'. The Government rescued the businessmen at a cost of millions of rupees but nobody bothered to realize that all this was a curse of Riba or interest, for the simple reason that cotton dealers had taken mostly interest bearing loans to run the business. Their own capital was insignificant, as Divine decree would have it, the cotton market fell so sharply that the price zoomed down from Rs. 125 to just Rs. 10. The cotton traders were rendered incapable of retiring money to cover bank margins. Left with no choice the market was closed down and SOS was sent to the Government. The Government stepped in, bought off the stocks, not at Rs. 10 but at the raised price of Rs. 90. Thus, it absorbed a loss of millions of rupees and saved these traders from going insolvent. Whose money did the Government have? Naturally, it belonged to the same helpless poor masses of the nation. In short, the naked result of interest is that some individuals reap benefits out of the capital of the entire community and the loss, when it comes, is made to fall on the nation.

Another economic drawback of Riba lies in the predicament of the borrower when he is hit by a major loss. Once this happens, he is unable to survive anymore. To begin with, he never had enough capital the losses of which he could cushion, the loss throws him into a double distress. Not only does he lose his profit and capital but also, at the same time, gets buried under the bank loan for liquidation. As compared to this, should his loss be his entire capital in an interest free business, he would, at the most become penniless but not burdened with huge debt.

**Moral Drawbacks of Riba**

Up to this point, economic and social implications regarding Riba have been discussed. However, the drawbacks of Riba also include the adverse affects on the morality of people.

Sacrifice and generosity are qualities in human morals. Interest loaded business invariably leads to the extinction of this emotional refinement. As a natural consequence, a compulsive consumer of interest would hardly bear to see somebody else rising up to his level with the help of personal effort and his capital. The thought of passing some benefit to somebody from his resources is a far cry. Rather than be merciful to the distressed, the lender would be on the lookout for an opportunity to take undue advantage of the borrower's distress, so that more can be lent to him to get even more interest. Quite often short-term lending is undertaken when the need for accommodation is essentially long term on the assumption that the credit will be rolled over (Ibid).

The constant devouring of interest results in an increased greed for money. This greed and unequal distribution of wealth results in selfishness and jealousy among people, there by leading to the moral degradation of the whole society.

**SECTION-II**

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**Islamic Modes of Financing**

Islam has not presented a model of financing, in its literal sense. Instead, it had given
certain guidelines related to business and financial transactions. Contemporary scholars to devise Islamic modes of financing are using these guidelines. Islamic modes financing, as devise by scholars, are based on trading, leasing, following definitions because Islam treats all transaction from the viewpoint of ‘what is being exchanged’ or ‘what is being traded’.

I. TRADING: trading refers to complete exchange that affects the complete possession

II. LEASING: Leasing refers to ‘exchange which affects the possession of benefits for a specific term’

III. PARTNERSHIP: Partnership refers to ‘exchange by way of mixing assets throughout the partnership’

IV. PROFIT SHARING: Profit Sharing refers to ‘Exchange between capital on one hand and labor on the other’

TRADING

Trading means the operation of buying with the intention of selling through the turnover of capital to make profit from the difference between the sale price and purchase cost (Ibid,) The most important features of trading are:

1. Supplying the goods and services demanded by different individuals.
2. Transferring the possession of goods from the seller to the buyer at contracting.
3. The profit mingling with the price and becoming an inseparable part of the value of the good.

Modes of financing based on trading are ‘Bai’Muajjal’, Murabaha,’ Bai Salam and Bai’ Istitna’ Originally, all four modes of financing based on ‘trading’ are different kinds of sale permissible in Islam. In order to understand an employ these as modes of financing, some basic rules of ‘sale’(or Bai’) need to be understood from an Islamic(or Shari’ah ) viewpoint.

Definition of Sale

‘Sale’ is defined in shari’ah as the exchange of a thing of value by another thing of value with mutual consent (Usman 1991). Such an exchange usually occurs between two parties where one makes an offer while the other reaccept the offer. Offer and acceptance can be communicated through mail, electronic media or whichever channel deemed feasible.
If the offer an acceptance relate to any future date, i.e. nothing is exchanged at present, then Islam considers such a contract to be an agreement or promise to sale, not the ‘sale’ itself (Ibid.). Islam makes it compulsory on everyone to honor one’s promise; if one party does not fulfill it promise, the other party can claim the actual monetary loss, which it incurred due to the promise not being fulfilled by going to the court. For instance, if the seller incurred any transportation expenses to bring the good to a certain place to make the delivery, then, the seller has the right to claim those transportation expenses from the buyer. However, the seller cannot demand any compensation for any opportunity cost because Islam recognizes opportunity cost as a risk inherent in ‘trading for cannot demand the buyer to compensate him for the difference in price. The court, in case of not fulfilling one promise, can turn to imprisonment or corporal punishment, which in turn would deter people from acting against their promises. However, the promisor cannot be held liable if he is unable to fulfill his promise due to any uncontrollable event.

According to Shari’ah, the seller has no right to ask for a security from the buyer in a ‘promise to sale’ contract. If the buyer voluntarily advances any amount of money as a security in a ‘promise of sale’ contract, it should be adjusted for by the seller when taking the final payment from the buyer. The seller has no right to keep the advance and benefit from it if the sale does not occur. According to justice Mufti Muhammad Taqi Usmani,

The promise to sell/purchase is merely a promise. It does not effect the contract of sale itself, therefore, no rights or obligations of an actual sale can arise out of a promise only. Hence no party can ask for security or a collateral for the fulfillment of a promise, because the security or a collateral is justified only where a liability or a debt has actually come into existence, while in the case of promise no debt or liability is created. It is only an undertaking to sell/purchase a commodity in future. When the actual sale occurs on a deferred payment basis, the debt will be created and at that time it will be justified to ask for a security.

**Bai’ Mu‘ajjal as a Mode of Financing**

Bai’ Mu‘ajjal, which is allowed by Shari’ah according to the majority of Muslim jurists, is a sale on credit. The sale on credit is based on the delivery of the good by the seller to the buyer, thereby enabling him to possess and benefit from the good, with the understanding that the buyer will pay the agreed upon price at a certain future date; usually, the deferred price is higher than the cash price. Such a sale can either be deferred payment sale’ or Installment Sale’. Deferred payment sale refers to paying the price entirely at the end of a specified period whereas installment sale refers to paying the price in determined installments at specific periods of time agreed upon by the parties. There is a consensus among majority of scholars on the permissibility of sale on credit if the due date is known (Khoja 1195).

**Bai’ Murabaha as a Mode of Financing**

Bai’ Murabaha refers to a particular kind of sale, having nothing to do with financing in its original sense. The basic ingredient of Murabaha is that the seller discloses the actual cost he has incurred in acquiring that particular good, and then adds some profit thereon. The profit can be determined by mutual consent, either in lump sum or through an agreed ratio of
profit to be charged over the cost. All the expenses incurred by the seller in acquiring the
good like freight, custom duty, etc. can be included in the cost price and the mark up can be
applied on the aggregate cos. Murabaha is valid only where the exact cost of a good can be
ascertained. If the exact cost cannot be ascertained, the good cannot be sold on ‘Murabaha
basis’. The payment in the case of Murabaha may be at the spot or may be on a subsequent
date agreed upon by the parties. Therefore, Murabaha does not necessarily imply the
concept of deferred payment, as generally believed. However, the contemporary Shari’ah
experts have allowed, under certain conditions, to use ‘Murabaha on deferred payment basis’
as a mode of financing . In fact it is the observance of those conditions which draw a clear
line of distinction between the interest-bearing loan and a transaction of Murabaha.

**Bai’ Salam as a Mode of Financing**

Bai’ Salam is a sale of a good whose delivery will be in a future date for a cash price, which
means, it is a financial transaction in which price is advanced in cash to the seller who abides
the delivery of good of determined specification on a definite due date. In other words, the
seller undertakes to supply some specific goods to the buyer at a future date in exchange of
an advanced price fully paid at the spot. There is a consensus among jurists on the
permissibility of Salam because the good in the contract is a recompense for the price paid
in advance .Thus , delivery of the good is deferred in Bai’ Salam as opposed to the price of
the good (which is deferred in Bai’ Mu‘ajjal, i.e. sale on credit.).

Bai’ Salam is beneficial for the seller because he gets the money in advance to cover
his financial needs, whether they are personal expenses, family expenses or expenses for
any productive activity. On the other hand, the buyer or financier gets the good he is
planning to trade on in the time he decides, at a certain price; this in turn protects the
financier from any fluctuations in price of the good he plans to trade in future.

The general rule is that the sale of a thing not owned by the seller is void according to
Shari’ah. However, the Holy Prophet (peace be upon him) has allowed Bai’ Salam subject to
certain conditions, which would be explained later. The basic purpose of Bai’ Salam was to
meet the needs of the small farmers who needed money to grow their crops and to feed
their family up to the time of harvest. After the prohibition of Riba, they could not take
usurious loans. Similarly, The traders of Arabia used to export goods to other places and
used to import some other goods to their homelands, They needed money to undertake
this type of business. They also could not borrow from usurers after the prohibition of Riba.
It was therefore allowed for them that they sell the goods in advance.

**Bai’ Istisna as a Mode of Financing.**

Istisna is the second kind of sale where a commodity is transacted before it comes into
existence. It means to order a manufacturer to manufacture a specific commodity for the
buyer. If the manufacturer undertakes to manufacture the goods for the buyer, the
transaction of Istisna comes into existence. The contract of Istisna creates a moral obligation
on the manufacturer to manufacture the good, but before he starts the work, any one of the
parties may cancel the contract after giving a notice to the other. However, after the
manufacturer has started the work, the contract cannot be canceled unilaterally.
Partnership refers to two or more parties drawing a contract to work together with the condition of dividing the accruing profit between them. The most important traits of a partnership are:

1. Participation in capital whether it is an asset or labor.
2. Partnership in work management and disposal where the rights of ownership and disposal remains with each partner.
3. Participation in the results of the business, whether profit or loss.

Partnership refers to 'Shirkah' in the terminology of Islamic jurisprudence. Shirkah means 'sharing' and has been divided into two kinds in Islamic jurisprudence:

Musharakah as a Mode of Financing.

Musharakah' is analogous to shirkat ul Amwal where two or more persons invest some of their capital in a joint commercial venture. Since Musharakah is a relationship established by the parties through a mutual contract, therefore, all necessary ingredients of a valid contract must be present. For example, the parties should be capable of entering into a contract, the contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc.

Distribution of Profit

1. The proportion of profit to be distributed between the parties must be agreed upon at the time of effecting the contract.

2. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business, and not in the proportion of the capital invested by him. For instance, if X and Y enter into a partnership and it is agreed between them that X shall be given RS. 10,000 per month as his share in the profit, and the rest will go to Y, the Musharakah is invalid according to shari'ah. Similarly, if it is agreed that X will get 10% of his investment in the business, Musharakah contract invalid.

Profit Ratio

Is it necessary that the ratio of profit of each partner conforms to the ratio of capital invested by him? There is a difference of opinion among the Muslim jurists about this question. In the view of Imam Malice and Imam Sheriffs, it is essential for the validity of Musharakah that each partner gets the profit exactly in the proportion of his investment. For example, if X has invested 50% of the total capital, he must get 50% of the profit. On the contrary, the view of Imam Ahamid is that the ratio of profit may differ from the ratio of investment if it is agreed between the partners with their free consent. The third view is presented by Imam Abu Hanifah, which can be taken as via media between the two opinions mentioned above. He says that the ratio of profit can differ from the ratio of investment in normal condition, However, if a partner has put an express condition in the agreement that he will never work for the Musharakah and will remain a sleeping partner throughout the term of Musharakah, then his share of the profit cannot be more than the ratio of his investment.
Sharing of Loss

All the Muslim jurists are unanimous on the point that each partner suffers the loss exactly according to the ratio of his investment.

Nature of the Capital

The share capital in a Musharakah can be contributed either in cash or in the form of commodities. In the latter case, the market value of the commodities shall determine the share of the partner in the capital.

Management of Musharakah

1. Every partner has a right to take part in the management of Musharakah and to work for it. However, the partners can agree upon a condition that the management shall be carried out by one of them, and no other partners shall work for the Musharakah.

2. If all partners agree to work, each one of them is be treated as the agent of the other in all the matters of the business and any work done by one of them in the normal course of business is deemed to be authorized by all the partners.

Termination of Musharakah

1. Every partner has a right to terminate the Musharakah at any time after giving his partner a notice to this effect, whereby the Musharakah will come to an end. If the assets are in cash form, all of them will be distributed prorata between the partners. But if the assets are not liquid, the partners may agree on the liquidation of the assets, or on their distribution or partition between the partners as they are. If there is a dispute between the partners in this matter, the partition or distribution of the non liquid assets as opposed to liquidation is preferred, because after the termination of Musharakah, all the assets are in the are in their joint ownership of the partners, and a co owner has the right to seek partition or separated or partitioned, such as machinery, then they should be sold and the sale proceeds should be distributed.

2. If any of the partners dies, the contract of Musharakah with him stands terminated. His heirs in this case, will have the option either to draw the share of the deceased from the business, or to continue with the contract of Musharakah with the other partner(s).

3. If any one of the partners becomes insane or becomes incapable of effecting commercial transactions, the Musharakah stands terminated.

4. If one of the partners wants termination of the Musharakah, while the other partner or partners like to continue with the business, the is purpose can be achieved by mutual agreement. The partners who want to run the business can purchase the share of the partner who wants to terminate his partnership: termination of Musharakah with one partner does not imply its termination between the other partners.

5. The price of the share of the leaving partner must be determined by mutual consent. If there is a dispute regarding the value of the share and the partners do not arrive at an
agreed price, the leaving partner may compel other partners on the liquidation or on the distribution of the assets themselves.’

6. It is permissible that the partners can agree, while entering into the contract of Musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners, or the majority of them wants to do so, and that a single partner who wants to come out of the partner ship shall have to sell his share to the other partners and shall not force them on liquidation or separation. this condition is justified because other wise it May cause irreparable damage to the other partners. if a particular business has been started with huge amount of money which has been invested in a long term project, an done of the partners seeks liquidation in the infancy of the project, it may be fatal to the interests of the partners as well as to the economic growth of the society, to give him such an arbitrary power of liquidation or separation. such a condition can be supported by the general principle laid down by the holy Prophet (peace be upon him) in his famous Hadith, “All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibits what is lawful”(Ibid)

Other Rules Regarding Musharakah

1. A Musharakah can be created for general purposes as well as for limited and well defined purposes. The managers and executive partners enjoy full freedom to undertake any kind of transactions or businesses if the Musharakah is for general purpose. In limited Musharakah, the executive partners are bound to operate within the limits predetermined by the agreement.

2. A partner can stipulate a higher rate of profit for himself in consideration of some additional services or contributions rendered by him for the business.

3. A business executive is liable for all the damages done to the business due to his negligence, lack of proper care and prudence.‘Ghabn Fahish,’ which refers to purchasing some thing for business at exorbitant rates, is considered gross negligence for which a person responsible is personally able.

4. An executive partner of a Musharakah cannot run a parallel personal business of the same nature and kind run and managed by him for the Musharakah.

5. A partner is not authorized to include, without the permission of other partners, his own business in that of the Musharakah. He is also not authorized to enter into agreement with other Musharakahs without the permission of his partners. Any executive partner is not authorized to give loan without specific approval by other partners.

6. It is permissible to take a mortgage or a guarantee against trespass or negligence from the executive partner but it is not permissible to take any security for profit or capital.

TYPES OF MUSHARAKAH

Musharakah can be ‘permanent’ or ‘decreasing’ permanent Musharakah and Decreasing Musharakah are explained below:
1. Permanent Musharakah is represented in the contribution of the partners to equal or unequal ratios of capital to establish a new project or to participate in an established one (op. cit.,) In this Musharakah, each participant owns a share in the capital permanently and deserves his share of the profit. The partnership originally is intended to continue up to the dissolution of the company. However, it is permissible that one of the parties sells its share to withdraw from the project.

2. Decreasing Musarakah differs from permanent Musharakah only in terms of continuity (Ibid.,). A single partner (or partners), which can be an Islamic financial institutions, from the very beginning does not intend to stay in and continue the partnership up to the liquidation of the company (Ibid.,). It gives the other partners the right to take his place in the ownership of the project, and agrees to assign his share in the partnership to the other partner (or partners) for full payment at one and the same time or gradual disbursement, in accordance with conditions agreed upon. It is a condition in the Decreasing Musharakah that it should not be a mere loan financing operation, but there must be real determination to participate and all the parties should share profit or loss and the management during the period of the partnership. However, a partner can authorize the other partner (or partners) to manage the Musharakah. It is impermissible to include in the contract of Decreasing Musharakah a condition that adjudges the other partner (or partners) to return to the ‘limited period’ partner, the total of his shares in capital in addition to profits accruing from that share, because it would resemble a Riba-based transaction. However, it is permissible for the ‘limited period’ partner to make a promise to sell its shares in the company to the other partner (or partners). It is to be noted that the sale of shares must be concluded as a separate deal with no connection to the contract of Musharakah.

Profit Sharing

Profit sharing refers to a contract between two parties in which one party provides capital to the other party who undertakes the management in exchange of a share in the profit (Ibid.). The most important characteristics of Profit sharing are:

- One party (or parties) provides capital whether it is money (Mudarabah) or a place of land (muzara’a) or fruit trees (Musaqah).

- A party (or parties), different than the one which provided capital, undertakes the management and disposal of capital, where the right of ownership and the right of disposal are separate.

- Only the capital owner bears the monetary loss whereas the two parties share the profit.

Profit sharing includes different kinds of contracts, such as Mudarabah, Muzara’a, Musaqah, etc.

Mudarabah and Muzara’a which can be used as a mode of financing are explained below.
Mudarabah as a Mode of Financing

Mudarabah, which can be regarded as a special kind of principal agent relationship, refers to a mode where one party gives money to another for investing it in a business enterprise. The investment comes from the first party or principal, who is called rabb-ul-mal’. Mudarabah achieves the interest of both the parties: rabb-ul-mal may not have the time or the expertise and experience to turn over capital and trade with it whereas the Musharakah and Mudarabah can be summarized below (op. cit.):

1. Investment in Musharakah comes from all the partners, while in Mudarabah, investment is the sole responsibility of rabb-ul-mail.

2. In Musharakah, all the partners can participate in the management of the business and can work for it; in Mudarabah, rabb-ul-mail has no right to participate in the management, which is carried out by the mudarib only.

3. In Musharakah, all the partners share the loss to the extent of the ratio or their investment while in Mudarabah, the loss, if any, is suffered by the rabb-ul-mail only. This is because the mudarib does not invest anything mudarib’s loss is restricted to the fact that his labor has gone in vain and his work has not brought any fruit to him. However, if the mudarib has worked with negligence or has committed dishonesty, he shall be liable for the loss.

4. The liability of partners in Musharakah is usually unlimited. Therefore, if the liabilities of the business exceeded its assets and the business is liquidated, all the exceeding liabilities shall be borne prorata by all the partners. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition. Contrary to this is the case in Mudarabah. Her the liability of rabb-ul-mail is limited to his investment unless he has permitted the mudarib to incur debts on his behalf.

5. In Musharakah, as soon as the partners mix up their capital in a joint pool, all the assets of the Musharakah become jointly owned by all of them according to the proportion of their respective investment. Thus, each one of them can benefit from the appreciation of the value of the assets, even if profit has not accrued through sales. The case of Mudarabah is different. Here all the goods received by the mudarib are solely owned by the rabb-ul-mail and the mudarib deserves his share in the profit only in case he sells the goods profitably. Therefore, the mudarib is not entitled to claim his share in the assets if their value has increased.

A contract of Mudarabah usually presumes that the mudarib has not invested any thing from his side to the Mudarabah. But there may be situations where the mudarib wants to invest some of his money in the business of Mudarabah. In such cases, Musharakah and Mudarabah can be combined together. In such a case, the mudarib may allocate a certain percentage of actual profit on account of his investment as a Sharik (i.e. partner), and at the same time, he allocate another percentage for his management and work as a mudarib, both the parties can agree on my proportion. However, the only condition is that the sleeping partner or rabb0ul- mal cannot get a percentage of profit more than the proportion of his investment.
LEGAL RULES: Following rules need to be observed in Mudarabah with respect to the business of Mudarabah, distribution of profit and termination of Mudarabah:

Business of Mudarabah

1. The Rabb-ul-mal specify a particular business for the mudarib, in which he shall invest the money, or he may leave it open for the mudarib to undertake whatever business he wishes whereupon the mudarib shall be authorized to invest the money in any business he deems fit.

2. A rabb-ul-mal can contract Mudarabah with more than one person in a single transaction.

3. It means that he can offer his money to X and Y both, so that each one of them can act for him as mudarib shall be distributed between them according to the agreed proportion. In this case, both the mudaribs shall run the business as if they were partners inter se. It is permissible for rabb-ul-mal to variate between them with respect to the share in profit because of their difference in diligence and dexterity.

4. The mudarib or mudaribs, are authorized to do anything which is normally done in the course of business, however, if they want to do a non-routine task, which is beyond the normal routine of the business. they cannot do so without an express permission from the rabb-ul-mal.

5. It is permissible to impose restrictions on the muidarib if the restriction is beneficial and does not constitute a constriction on the mudarib to attain the profit required and is not counterproductive to the purpose of the Mudarabah.

6. It is permissible to take a surety or mortgage from them udaribn to guarantee the payment incase of negligence or trespass or violation of conditions stipulated in the contract. This surety acts as a guarantee to capital or profit.

7. The Mudarib shall collect its share of the profit only after obtaining the permission of the rabb-ul-mal. The mudarib is entitled to collect its share of the profit only after capital is recovered according to the principle. “Profit is protection of capital”. However in the exceptional case of temporary division of profit before the final settlement (while the Mudarabah is still continuing), the losses incurred later shall be made good from the profit distributed earlier.

Distribution of profit

1. It is necessary for the validity of Mudarabah that the parties agree right at the beginning on a definite proportion of the actual profit which shall be received by each of them. Shari has prescribed no particular proportions; rather it has been left to their mutual consent.
2. Rabb-ul-mal and the mudarib cannot agree upon a lump sum amount of profit for any party, nor can they determine each other’s share at a specific rate tied up with the capital. Apart from the agreed proportion of the profit, the mudarib cannot claim any periodical salary or a fee or remuneration for the work done by him for the Mudarabah.

3. If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

Muzara’a as a Mode of Financing

Muzara’a or ‘crop sharing’ is to give the land to whoever can cultivate it or work in it in exchange of a share in the crop (op. cit.). This transaction achieves the interest of both parties, the landowner and the agent. The landowner may not be in a position of cultivating or working in the land while the agent may not have the land to use his skill and resources (Ibid).

1. The landowner supplies the seeds and the machinery and becomes the employer of the worker who works on the land in exchange of some of the produce.

2. The agent supplies the seeds and the machinery, and becomes a tenant in exchange of some of the produce.

LEGAL RULES: Following rules need to be observed in Muzara’a:

1) It is a condition in Muzara’a that the land must be available and the owner must move out of the land so that the agent can work without any hindrance.

2) It is a condition that the crop to be cultivated is specified in the contract.
3) It is a condition to specify the kind of seeds to be sown.

4) The Muzara’a period must be known and sufficient for the cultivation of the land and harvesting of the crop. The landowner recovers the land at the end of the muzara’a contract. The two parties can renew the contract.

5) It is a condition that the two parties share the produce, and the share of each partner is a known prorata ratio in the total. It is invalid to stipulate a specific amount of the produce to either partner.

6) The contract is invalid according to Shari’ah if the share of either partner is something other than the produce.

7) The produce is to be divided according to the ratios agreed upon by the parties. In case of crop failure, neither gets anything: the agent loses the effort and the landowner loses the utility of the land.

8) Everything that is necessary for Muzara’a as lending the farm is borne by the agent as it is in the contract. However, all expenses on the crop are borne by the two parties in the ratio of their shares in the produce.

Conclusion

All the modes of financing discussed above are based on the principles of Shari’ah. The ideal modes of financing according to the Shari’ah are Musharakah and Mudarabah because of their positive affect on the distribution of wealth. However, in the perspective of the current economic setup, there are certain difficulties in using Musharakah and Mudarabah instruments in every type of financing.