

Shariah Contracts in Islamic Banking and Finance

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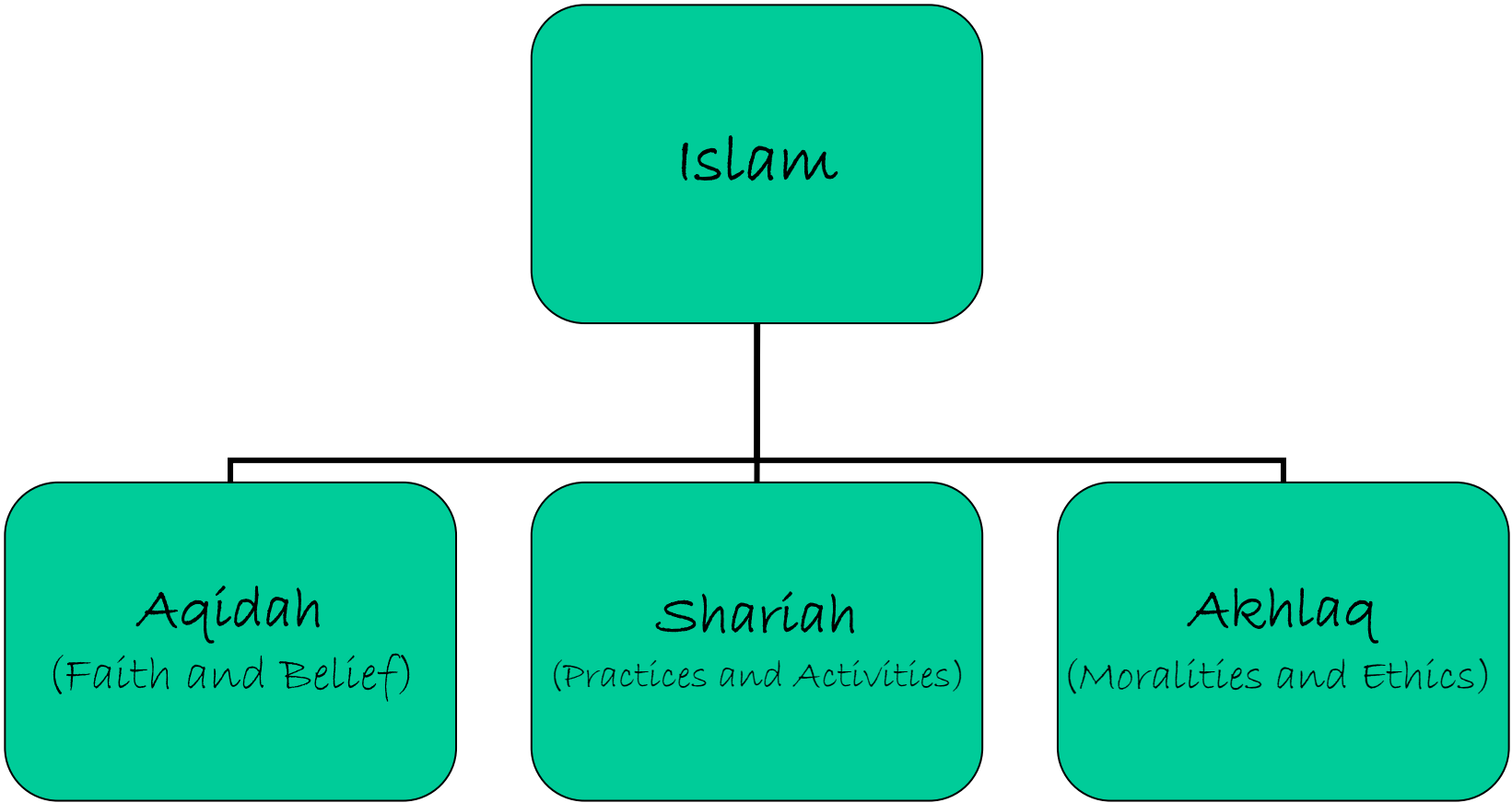
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Bism il-Lah ir-Rahman ir-Rahim

Introduction

Generally Islam permits trade and commerce and the contracts that are applied thereto are termed muamalat in the Shariah. Muamalat are civil contracts and all civil contracts can be used in Islamic banking and finance.

Thus in the concept of Islamic banking and finance the mobilization of deposits is through contracts permissible by the Shariah and the application of funds is also through contracts permissible by the Shariah.



Shariah Requirements

Shariah aspects of Islamic banking and finance revolve around Shariah requirements which refers to:

- avoidance of prohibitions, and
- ensuring that the contract have all their essential elements with their necessary conditions

Shariah Requirements

The prohibitions are:

- Producing and trading of impure materials,
- Producing and trading of materials which are of no use,
- Gharar,
- Riba and
- Involvement of gambling

Gharar

Gharar is divided into two namely:

- 1 - Gharar yasir, i.e. minor or slight gharar, and
- 2 - Gharar fahish, i.e. major or serious gharar

The Gharar that causes a contract to be invalid is **major gharar**.

In general terms major gharar is:

- an uncertainty which is so great that it becomes unacceptable, or
- it is so vague that there is no means of quantifying it.

Gharar

More specifically **major gharar** arises out of one of the following:

- Asset or merchandise does not exist;
- Asset or merchandise cannot be delivered; or
- Asset or merchandise is not according to specifications

Riba

Riba means extra and it is of four kinds. Two kinds are sub-divisions of riba duyun and the other two are sub-divisions of riba buyu'u.

1. Riba duyun (riba out of lending and borrowing)

This kind of riba is the extra amount of money over and above the principal of the loan either:

- imposed by the lender upon the borrower in the contract; or
- promised by the borrower in the contract.

Riba

Riba Duyun is sub-divided into:

- 1.1. Riba qardh i.e. riba is imposed from the beginning.
- 1.2. Riba jahiliyah i.e. there is no riba at the beginning; riba is imposed only after default.

Riba

2. Riba buyu'u (riba in trading transactions).

This kind of riba may occur out of an exchange between two ribawi materials of the same kind where the necessary rule(s) are not observed.

There is no riba in trading transactions where a ribawi material is exchanged with a non-ribawi material like money with a car; or a non-ribawi material is exchanged with another non-ribawi material like rubber with a refrigerator.

Riba

Ribawi materials are divided into two basis and under each basis are the different kinds as follows:

Basis	Basis
Medium of Exchange	Foodstuffs
<ul style="list-style-type: none">→ Gold→ Silver→ Shilling→ £	<ul style="list-style-type: none">→ Grains<ul style="list-style-type: none">• Rice• Wheat• Corn→ Meats<ul style="list-style-type: none">• Beef• Mutton• Chicken• Fishes

Riba

(..continued)

Basis	Basis
Medium of Exchange	Foodstuffs
<ul style="list-style-type: none">→ USD→ Singapore Dollar→ Australian Dollar→ Hong Kong Dollar→ ¥	<ul style="list-style-type: none">→ Vegetables<ul style="list-style-type: none">• Tomatoes• Beans→ Fruits<ul style="list-style-type: none">• Apples• Oranges→ Salts<ul style="list-style-type: none">• Salt• Sugar• Condiments• Medicines

Rules of Exchange of Ribawi Materials

Exchanges	Rules
<p>1. Ribawi materials of the same kind of the same basis. (5 grams of 916 gold for 5 grams of 750 gold; 10 grams of Basmathi rice for 10 grams of A1 rice)</p>	<p>1. Materials must be of the same weight, measurement or number of units. 2. Payment must be on cash terms.</p>
<p>2. Ribawi materials of different kinds of the same basis. (5 grams of gold for RM200; RM3,800 for USD1,000; 10 kgs of rice for 15 kgs of wheat; 1 tonne of palm oil for 2 tonnes of sugar.)</p>	<p>1. Difference in weights, measurements or number of units allowed, 2. Payment must still be on cash terms.</p>

Rules of Exchange of Ribawi Materials, cont.

Exchanges	Rules
<p>3. Ribawi materials of different kinds of different bases. (10 kgs of dates for 1 gm of gold; 30 kgs of wheat for USD10; 1 tonne of palm oil for RM1,500)</p>	<p>- No rules are imposed. (Difference in weights, measurements or number of units allowed.)</p>

Riba

Riba buyu'u is sub-divided into:

- 2.1. **Riba fadhil** i.e. the ribawi materials (of the same kind) exchanged are of different weights, measurements or numbers and they are exchanged at the same time.
- 2.2. **Riba nasiah** or **riba yad** i.e. the ribawi materials exchanged are of equal weights, measurements or numbers but payment of the price and delivery of the goods are made at two different times.

Riba

Islamic banking does not give out loans. Therefore riba out of lending and borrowing does not arise. To avoid involvement with **riba in trading transactions**, Islamic banking must pay proper attention to the requirement that the buying and selling of the following matters must be on cash terms:

Riba

(..continued)

- (i) gold in treasury functions for liquidity,
- (ii) silver in treasury functions for liquidity, and
- (iii) currencies, the currency of each country being considered as a kind, for hedging and payments of imports.

Gambling

Gambling is betting or charging something that will be forfeited if one fails to obtain the greater gain that one hopes for.

Speculation is not gambling. Some jurists say that speculation is prohibited, but contracts involving speculation are still valid.

Forbidden Contracts

Forbidden and void contracts which involve gharar, riba and gambling are:

- Bai al-Mulamasah
- Bai al-Munabazah
- Bai al-Hisat
- Bai Habl-il-Hablah
- Bai al-Madhamin
- Bai al-Malaqih
- Bai al-Gharar
- Lending and borrowing with interest
- Betting

Islamic Muamalat

After taking out the types of muamalat (transactions) that are prohibited, those that are permitted can be divided into three broad categories as follows:

1. Trading Contracts.
2. Contracts of Profit Sharing.
3. Supporting Contracts.

Trading Contracts

Some of the most widely used transactions are;

(A) Cash Sales

- (i) Normal cash sales
- (ii) Sarf (foreign currency exchanges)
- (iii) Exchanges between ribawi materials of different kinds and of the same basis (gold with money or wheat with palm oil)
- (iv) Bai Al-Dayn (debt trading as in Bills of Exchange)

Trading Contracts

(B) Deferred payment sales (debt financing)

- (i) Bai Murabahah (cost plus)
- (ii) Bai Tawliyah (novation)
- (iii) Bai Wadhiah
- (iv) Bai Salam
- (v) Bai Istisna'a (sale by order)
- (vi) Bai Bithaman Ajil (deferred payment sale)
- (vii) Bai Istijrar (supply or whole sale financing)
- (viii) Bai Inah
- (ix) Ijarah (leasing)
- (x) Kiraa' Waqtinaa' (leasing then procurement)

Contracts of Participation

Contracts of participation (equity financing/ profit sharing) are:

- (i) Musharakah (joint venture profit sharing)
- (ii) Mudharabah (trustee profit sharing)
- (iii) Muzaraah (leasing of land for agriculture)
- (iv) Musaqat (watering of orchard)

Supporting Contracts

The Shariah also permits contracts to support and facilitate trading and mobilisation of capital. These contracts are:

- (i) Rahnū (mortgage)
- (ii) Kafalah (guarantee)
- (iii) Wakalah (agency)
- (iv) Wadiyah (safe custody)
- (v) Qardh Hasan (benevolent loan)
- (vi) Hiwalah (transfer of debt)
- (vii) Tabarru'ū (donation)
- (viii) Hibah (gift)
- (ix) Wakf (endowment)
- (x) Ibraa' (rebate)
- (xi) Muqasah (set-off)

Banking Contracts

- In Islamic banking the following contracts may be applied in mobilisation of deposits:
 - (i) Musharakah for shareholders fund
 - (ii) Mudharabah for customers' investments
 - (iii) Wadiah for safe custody and
 - (iv) Qardh Hasan
- For uses of funds all the contracts of debt financing and equity financing may be applied.

Different Features of Contracts

The different features of Murabahah, Istisna'a, Bai Bithaman Ajil and Ijarah.

Murabahah

- Definition: A sale based on the cost price plus profit.
- The cost price or profit must be known to the buyer.
 - Normal practice price paid in a lump sum.

Istisna'a

- Definition: An order made by the buyer for the manufacture of a merchandise according to specifications.
- The merchandise does not exist at the time of contract.

Different Features of Contracts, cont.

Bai Bithaman Ajil

Definition: A sale with the payment of the selling price deferred to an agreed later date.

- The merchandise exists at the time of contract.
- The Shariah does not require that the cost price be known to the buyer.

Ijarah

Definition: A sale of the use of another's property.

- The property rented belongs to the lessor.
- The lessor has the right to repossess the property on default of the lessee.

Ownership of Assets

The purpose of contracts is to obtain ownership of asset or the ownership of benefits of the assets. Where there are two contracts, one immediately following the other proper sequence in their executions must be followed.

This sequence applies-

- in refinancing (Bai Inah)
- in Ijarah facility where the asset must be purchased for the Ijarah or the asset must be leased for secondary lease.

Real Sale and Purchase

In contracts of exchange there must be **real buying and selling** to make them valid:

- there must be mal (assets) being exchange with assets.

To make contracts real and valid they must have **essential elements with their necessary conditions.**

Real Sale and Purchase, cont.

Essential Elements of Contracts

The essential elements of contracts of **Sale** and **Ijarah** are:

Sale

- seller
- buyer
- asset
- price
- contract

Ijarah

- lessor
- lessee
- asset
- benefit (use or usufruct)
- rental
- contract

1. *Contract of Sale*

The essential elements of a contract of sale with the necessary conditions are:

1. Contract : Offer and Acceptance
 - (i) Absolute and in definite and decisive language.
 - in the past or present tense.
 - not in the future or imperative tense.
 - not conditional
 - not limited to a certain period.
 - (ii) The acceptance must agree with the offer.
 - (iii) The offer and acceptance must be made at the one and same meeting.

Contract of Sale, continued

2. The Thing Sold

- (i) It must exist
- (ii) It must be capable of being delivered.
 - free from encumbrances.
- (iii) It must be known
 - by address ,description or specifications.
- (iv) It must be owned by the seller.
 - or agent,or natural,or appointed guardian of the owner (wali mal).

Contract of Sale, continued

- (v) It must have some use.
- (vi) It must be of pure substance.
 - It must not be of any of the following substances:
 - dogs and pigs
 - every intoxicating liquid
 - carcasses
 - blood, pus and vomit
 - droppings and urine
 - milk of animals not eaten by men.

Contract of Sale, continued

3. The Price

- It must be known in currency and absolute amount.

4. The Seller

- (i) He must be capable of taking responsibility.
 - of sound mind (aqil)
 - has attained the age of puberty (baligh)
 - has attained majority (rasheed/ 18 years old)

Contract of Sale, continued

- (ii) He must not be prohibited from dealing with his property.
 - not bankrupt
 - not prodigal
- (iii) There is no coercion exerted him.

5. The Buyer

(The necessary conditions are the same as those for the seller.)

2. *Contract of Leasing*

The essential elements with the necessary conditions are:

1. Contract: Offer and Acceptance
 - (i) In definite and decisive language.
 - in the past or present tense
 - not in the future or imperative tense.
 - (ii) The acceptance must agree with offer
 - (iii) The offer and acceptance must be made at the one and same meeting.

Contract of Leasing, continued

2. The Asset

- (i) It must be owned by the lessor.
 - or agent , or natural , or appointed guardian of the owner(wali mal).

- (ii) It must be specified and known
 - by address description or specifications.

- (iii) It must be delivered to lessee
 - in good working condition.

Contract of Leasing, continued

3. The Benefit (use or usufruct)
 - (i) It can be fixed in value
 - (ii) The lessor has the power and capacity to use and lease the asset
 - (iii) It must be permissible
 - (iv) It must be known
 - the purpose for which the asset is used must be known
 - the period of leasing must be known.
 - (v) It must not be any material part of the asset.

Contract of Leasing, continued

4. The Rental

- It must be known in currency and absolute amount

5. The Lessor

(The necessary conditions are the same as those for buyer and seller.)

6. The Lessee

(The necessary conditions are the same as those for buyer and seller)

3. *Bai Inah*

Bai Inah must meet the following requirements:

1. There must be two separate contracts properly executed. 1st the contract of sale by bank to customer on deferred payment terms. 2nd the contract of repurchase by bank from customer on cash terms.
2. The merchandise or the asset must not be a ribawi material in the medium of exchange category (gold, silver or currency) because all payments for purchases are made in money.
3. Each of the two contracts must have the essential elements and each of the essential element must meet the necessary conditions.

4. *Bai Dayn*

The requirements of Shariah concerning Bai Dayn are:

1. A debt must have been created through a contract of deferred payment sale of goods or service.
2. The goods must have been delivered or the service must have been rendered.
3. The trading of the debt must be on cash terms.

Musharakah & Mudharabah

Musharakah is a general partnership whereby two or more parties enter into a contract to exploit their labour and capital jointly and to share the profits and losses of the partnership.

Mudharabah is a contract where the owner of capital entrusts his funds to an entrepreneur who contributes skills in a business and the profits generated are to be shared between them.

Essential Elements of Musharakah & Mudharabah

Musharakah

- partners
- capital
- business
- profit sharing and
- contract

Mudharabah

- owners of capital
- entrepreneur
- capital
- business
- profit sharing and
- contract

5. *Musharakah*

The essential elements and the necessary conditions are:

1. Partners

- capable of appointing agents & being appointed as agents.

2. Capital

- (i) asset valued in money
- (ii) not debt
- (iii) specific amount
- (iv) paid into capital fund

Musharakah, continued

3. Business

- (i) Halal
- (ii) All partners have right to manage

4. Profit sharing

- (i) According to proportion of shares or according to agreement in fraction ,ratio or percentage; not in absolute amount.
- (ii) Loss borne according to proportion of shares.

5. Contract

- Absolute and in definite and decisive language.

6. *Mudharabah*

The essential elements are necessary conditions are:

1. Contract
 - Absolute and in definite and decisive language.
2. Owner of capital
 - Capable of appointing agents and being appointed as agent.
3. Entrepreneur
 - Capable of appointing agents and being appointed as agent.

Mudharabah, continued

4. Capital
 - (i) In money only
 - (ii) Not debt
 - (iii) Specific amount
 - (iv) Paid to entrepreneur
 - (v) From owner of capital only

5. Business
 - (i) Halal
 - (ii) Managed by entrepreneur only.

6. Profit sharing
 - (i) Profit shared according to agreement in fraction, ratio or percentage ,not in absolute amount.
 - (ii) Loss borne by owner of capital only.

7. Security

The Shariah allows the owner of debt to ask for security for his debt from debtor. Securities are in the form of:

- (i) Rahnū (mortgage in the form asset), and
- (ii) Kafalah (guarantee being a person).

Among characteristics of Rahnū are:

- Sale of mortgaged property is invalid
- Mortgaged property can be sold by court order to pay for the debt for which it is mortgaged. The balance if any, after payment of debt is to be returned to mortgagor.

8. Wadiah

There are two forms of Wadiah:

- (i) Wadiah Yad Amanah (Trustee Safe Custody)
- (ii) Wadiah Yad Dhamanah (Guaranteed Safe Custody)

Originally Wadiah is of Yad Amanah where the custodian has the duty to protect the property by:

- (i) Not mixing or pooling the properties (money) under his custody.
- (ii) Not using the properties.
- (iii) Not charging any fees for safe custody.

If he failed in any of the above Wadiah changes to Yad Dhamanah where:

- he has to return (replace) the properties to the owners if they were lost or destroyed.

9. *Qardh Hasan*

In giving Qardh Hasan the two following matters must be observed:

1. The lender must not impose any extra payment in the contract.
2. The borrower must not promise in the contract to pay anything extra.

10. Ibraa'

Ibraa' is where a creditor lets go of his right to a debt. Normally it is given for early settlement of debt.

Two of the most important characteristics of Ibraa' are:

- (i) The amount of Ibraa' must be known and specified, and
- (ii) When the Ibraa' is given and accepted it is forbidden and invalid for the party who gives to withdraw it.

Thank you
Wassalamu alaikum

Appendix

Islamic Banking and Financing Products Based on Concepts and Contracts

DEPOSITS

1. Wadiah:
 - Current Account
 - Wadiah Savings Account
2. Mudharabah
 - Ijraa Savings Account
 - Wadi Savings Account
 - Mudharabah Savings Account
 - Pewani Savings Account
 - General Investment Account
 - Special Investment Account
 - Sakinah Investment Account
3. Bai Dayn
 - Negotiable Islamic Debt Certificate

Appendix

Islamic Banking and Financing Products Based on Concepts and Contracts

RETAIL FINANCING

1. Bai Bithaman Ajil
 - Baiti House Financing
 - Land Financing
 - Shop & Shophouse Financing
 - Umrah & Ziarah Financing
 - Tour Package Financing
 - Naqad Overdraft Facility
 - Vehicle Financing
 - Golf Financing
 - Education Financing

Appendix

Islamic Banking and Financing Products Based on Concepts and Contracts

2. Bai Istisna'a
 - Baiti Home Financing
 - Shop & Shophouse Financing
 - Machinery/Equipment Financing Scheme
3. Ijarah
 - Shop & Shophouse Financing
 - Personal Computer Financing
 - Machinery/Equipment Financing Scheme
4. Bai Inah
 - Personal Financing
 - Consumer Goods Financing
5. Rahn
 - Al-Rahn Scheme

Appendix

Islamic Banking and Financing Products Based on Concepts and Contracts

TRADE FINANCING

1. Bai Murabahah
 - Letter of Credit
 - Murabahah Working Capital Financing
2. Kafalah
 - Letter of Guarantee
3. Bai Dayn
 - Islamic Accepted Bill - Import
 - Islamic Accepted Bill - Export
 - Islamic Export Credit Refinancing Scheme

OTHER SERVICES

1. Hiwalah
 - Remittances
2. Bai Naqdi
 - Sale/Purchase of Foreign Currency
 - Sale/Purchase of Travellers' Cheques