

THE ABCs OF ISLAMIC FINANCE & INVESTMENT

Prof Dr Engku Rabiah Adawiah
IIUM Institute of Islamic Banking & Finance (IiBF)
eradawiah@gmail.com

TALKING POINTS





INTRODUCTORY

WHAT IS ISLAMIC FINANCE?



Islamic finance involves financial products & services that are compliant to Islamic principles & rules



Islamic financial services are wide ranging – covering almost all types of financial products & services



Also known as “Shari`ah compliant” finance

Note:



- Shari`ah refers to Islamic principles as sourced from 2 primary sources, i.e. Quran & Sunnah
- Shari`ah covers all aspects of human behavior or conduct, belief & moral/ethical values

ISLAMIC FINANCE RAISON D'ETRE

RAISON D'ETRE / ORIGINAL & IMMEDIATE GOALS

Religious requirement

Obedience to God

Shari'ah compliance

COMMERCIAL/FINANCIAL GOALS?

Legitimate Profits

Competitive

Good Returns to Investors



LONG-TERM/ULTIMATE GOAL: ALIGNMENT WITH MAQASID AL-SHARIAH

Equitable & just economic/financial system where there is attainment of Maqasid al-Shari'ah (well-being of humanity & life as a whole)

UNDERLYING PHILOSOPHY



The concept of wealth as a trust from God – the accountability factor / moral or religious conscience



The prohibition of unfair / oppressive practices



The promotion of honesty, transparency, justice and fairness in commercial dealings



Establishing measures to safeguard the contracting parties' interests in the contract

MAIN FEATURES OF ISLAMIC FINANCE



Riba-free: money does not create money – need trade/real economic activities



Gharar-free: contractual uncertainties must be avoided



No trading/investment in prohibited commodities – e.g. liquor, pork

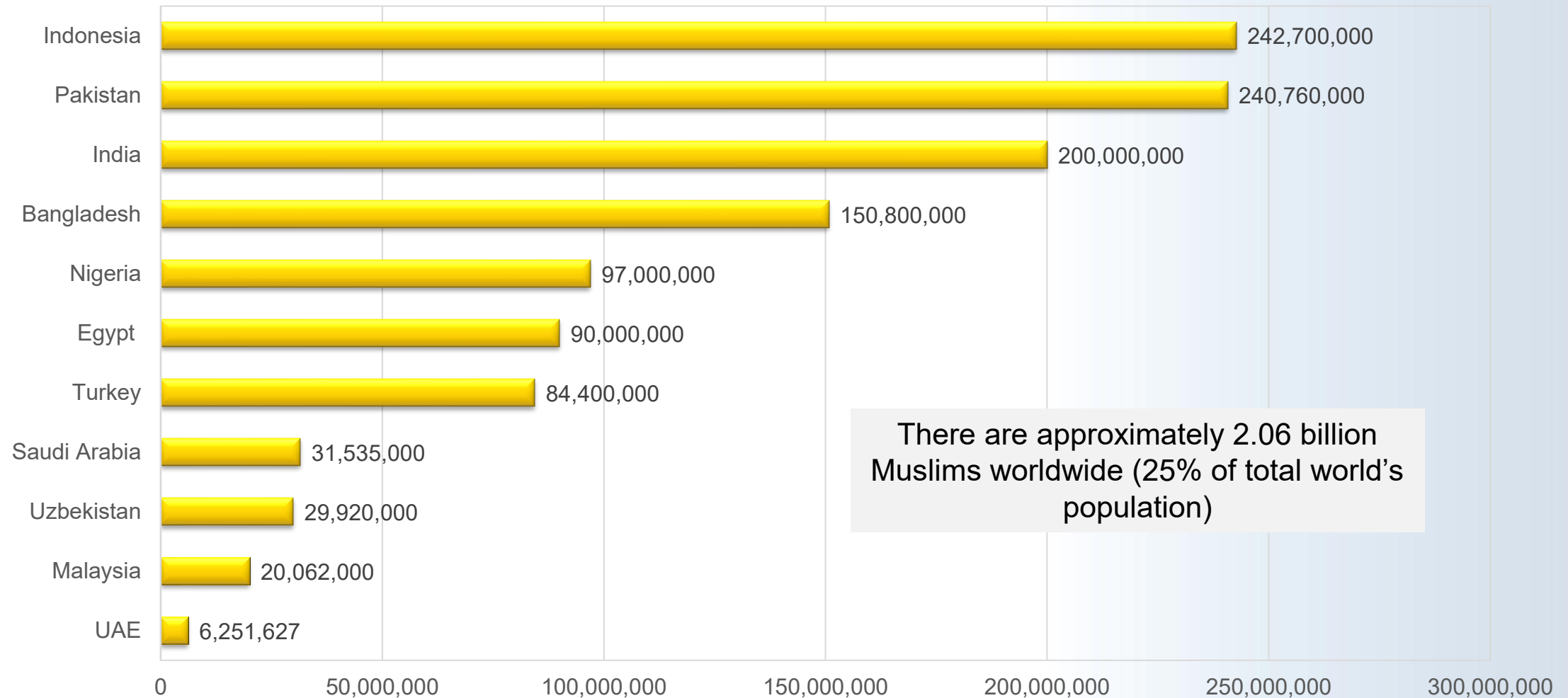


Main contractual relationship is not lender-borrower – but trading, leasing or partner relationship

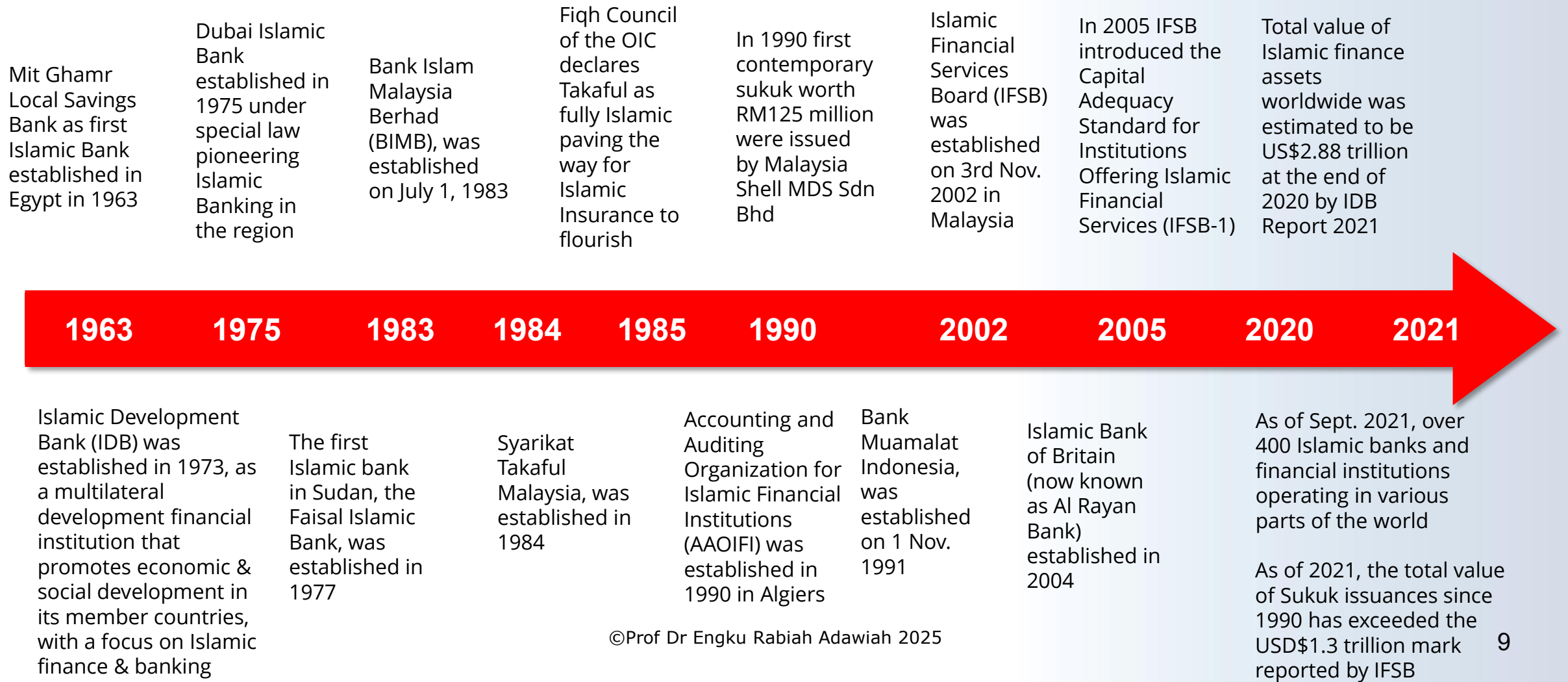


Trade profit or profit & loss sharing; not premium/interest imposed on principal loan/deposit

TARGET MARKET: MUSLIM POPULATION 2024



EVOLUTION OF INSTITUTIONAL FRAMEWORK





FUNDAMENTAL PRINCIPLES

BASIC PRINCIPLES IN ISLAMIC FINANCE

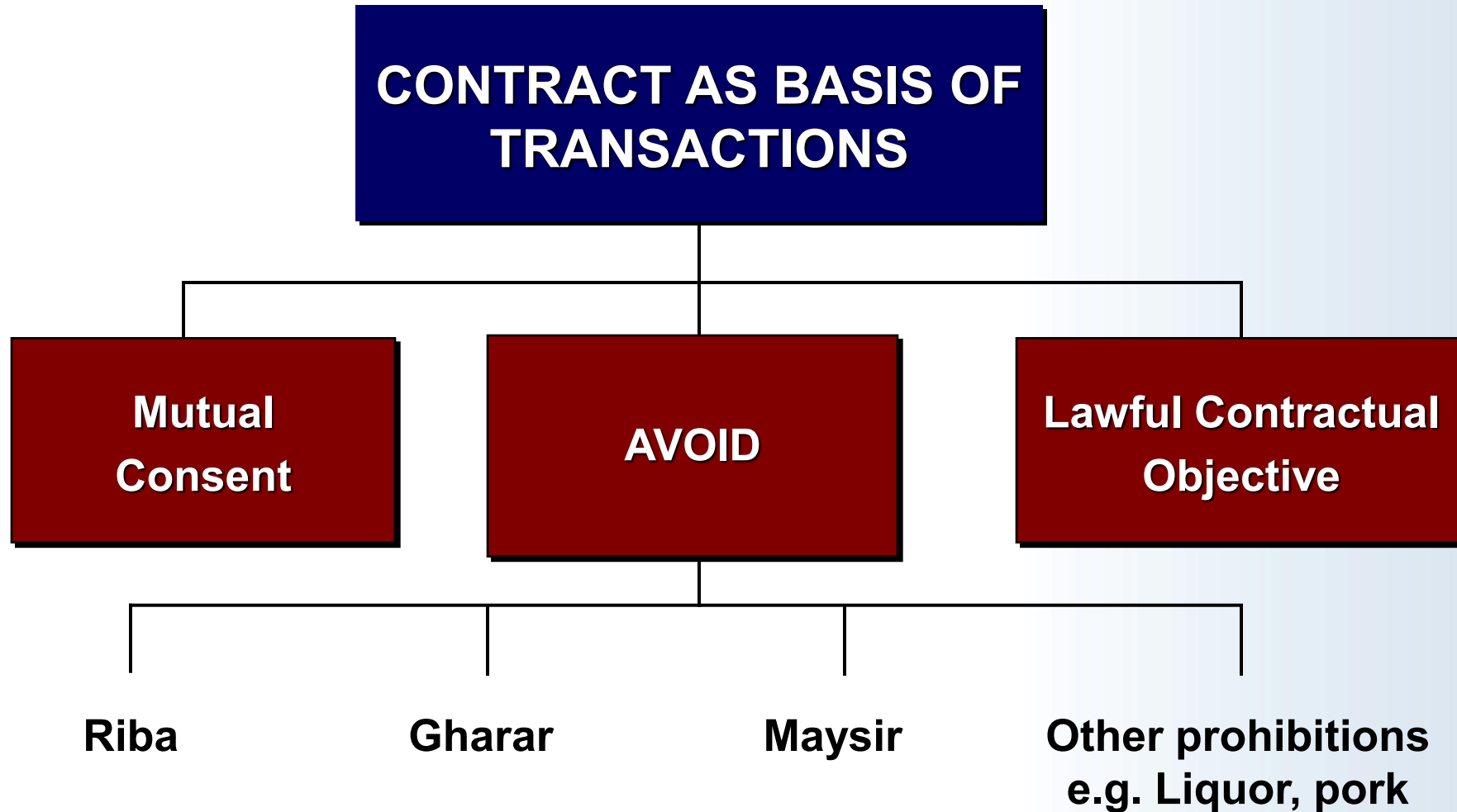
Aqd (contract) as basis of transactions

- Must be based on Shariah compliant contracts.
- Contracts must comply with all the contractual rules.

The parameter: avoid prohibitions

- Lawful contracts should avoid all prohibited elements.
- Should not contravene any established principles of Islamic law.

SHARI'AH COMPLIANCE: MAIN PRINCIPLES

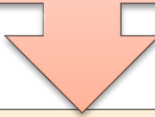




THE DO'S

ENCOURAGEMENT OF TRADE BY MUTUAL CONSENT

The Quran encourages work and trade



The Prophet (s.a.w.) himself was a trader



The encouragement of trade is evidenced by the many instruments of trade available during the Prophet's lifetime and in Islamic history thereafter

MAIN CONTRACTUAL PRINCIPLES?



There is a general freedom of the parties to enter into contracts & make contractual terms, as long as:

- the parties consented
- they do not contravene any Shari`ah provisions



This principle is known as freedom to contract, which is based on:

- Surah al Nisa':29
- Saying of Prophet: *"Muslims are bound by their (contractual) stipulations except those that prohibit the permissible or permit the prohibited"*

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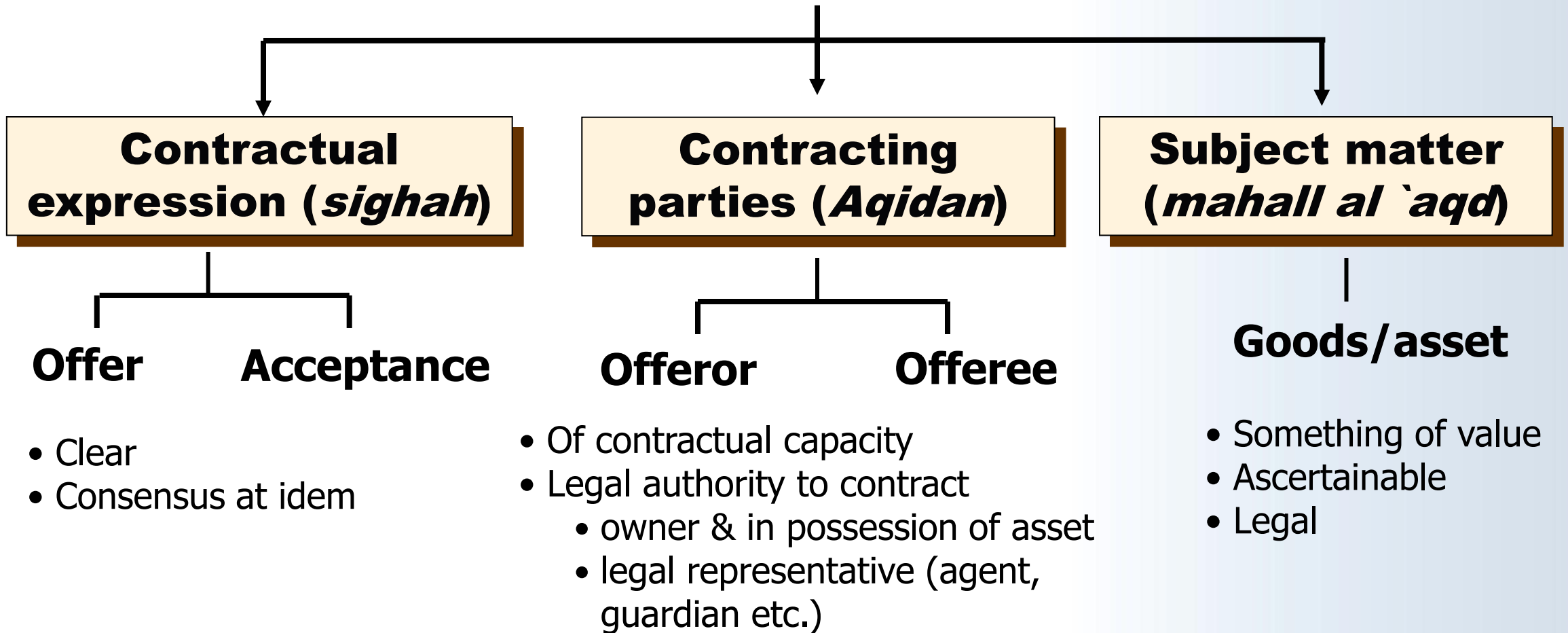
Another important contractual principle is the binding nature of contracts once concluded:

- Surah al Al Maidah(5:1)

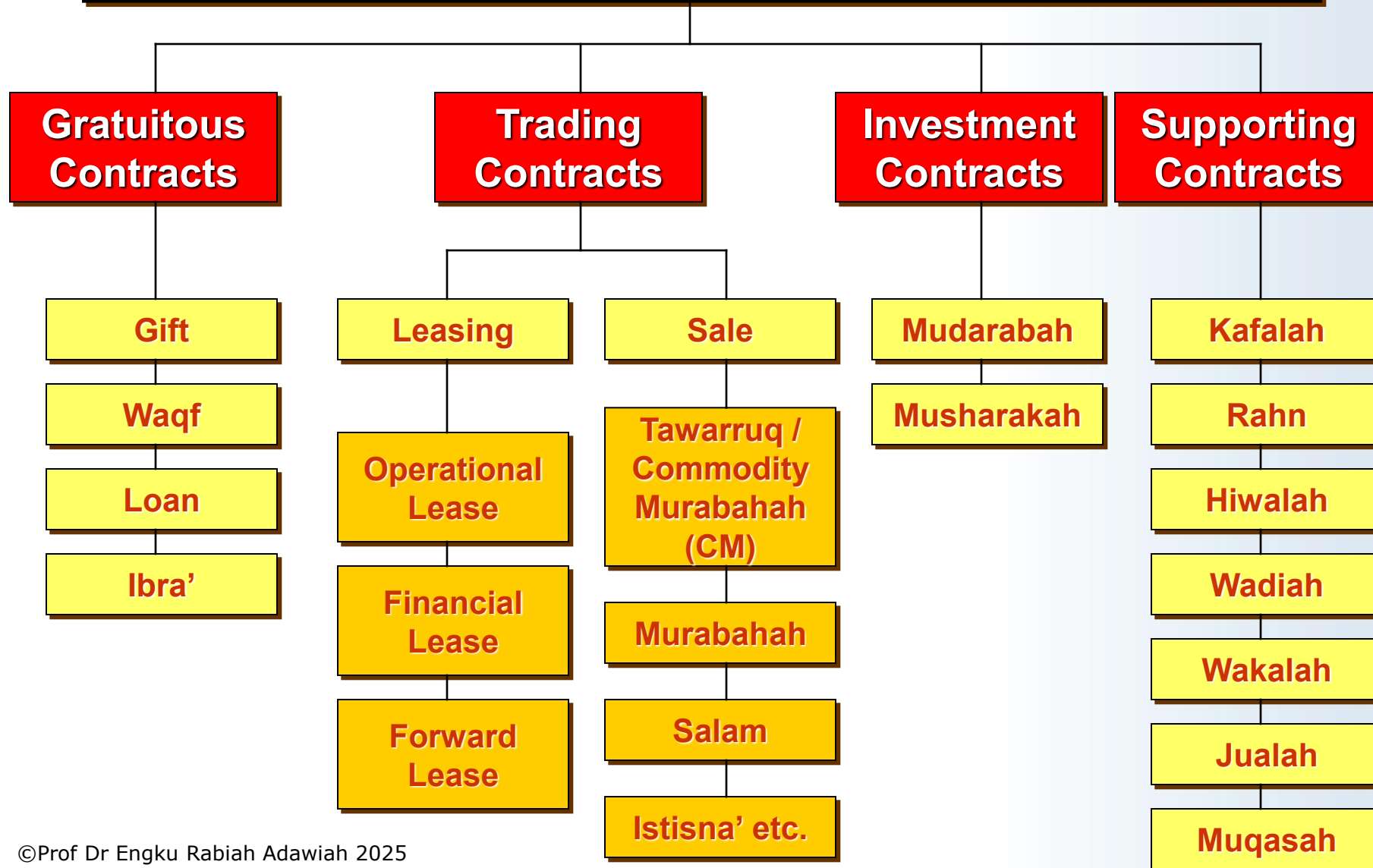


In Islamic contracts, the certainty of performance of the contractual obligations (e.g. delivery of goods & payment of price), as well as elimination of any avoidable future disputes between the contracting parties are given high priority

ESSENTIAL ELEMENTS & CONDITIONS FOR A VALID CONTRACT



KEY ISLAMIC COMMERCIAL CONTRACTS





THE DON'TS

RIBA

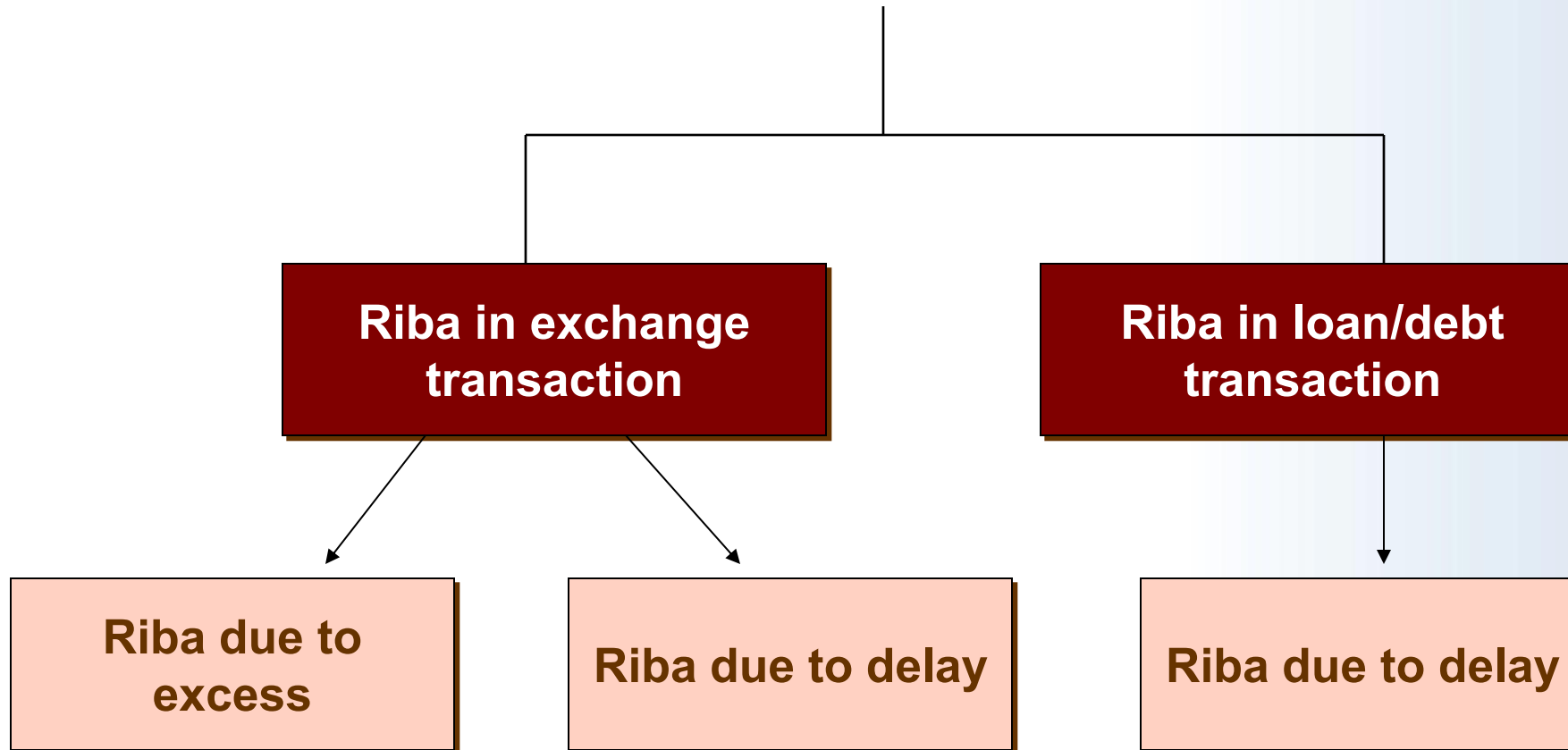
Riba – prohibited in many Quranic verses & sayings of Prophet s.a.w.

Meaning of Riba: every excess in return of which no reward or equivalent counter value is paid, in short, every unjust enrichment is riba

In contemporary finance, riba normally occurs in:

- All interest-based lending activities
- Fixed return on deposits in conventional banking
- Forward Forex, etc.

TYPES OF RIBA



PROHIBITION OF RIBA (Loan)

Surah al-Baqarah, ayat 275

“ ... But Allah hath permitted trade and forbidden usury



Interpretative Efforts



What amounts to

Trade

Criteria

- Fair exchange of goods or value
- Fair distribution of risk & return

Usury

Criteria

- Oppressive / unfair distribution of risk & return
- Unjustified enrichment at expense of others

PROHIBITION OF RIBA (Exchange)

Sunnah of the Prophet:

Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt - like for like, equal for equal, and hand-to-hand (spot); if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand or spot transaction."



Interpretative Efforts



Application



Currency

Rules

- Same denomination
 - At Par
 - Spot
- Different denomination
 - Spot



Staple Food

Rules

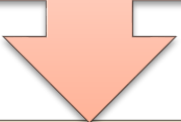
- Same Type
 - At Par
 - Spot
- Different Type
 - Spot

SUMMARY OF RULES UNDER THE HADITH

• money₁ + money₁	=	2 conditions: – Equality – Hand-to-hand
• food₁ + food₁	=	2 conditions: – Equality – Hand-to-hand
• money₁ + money₂	=	1 condition: – Hand-to-hand
• food₁ + food₂	=	1 condition: – Hand-to-hand
• money + food	=	No condition – free trading
• others + others	=	No condition – free trading

GHARAR

Meaning: has a range of negative connotations, such as, uncertainty, deception, risk, hazard, ignorance etc.



If there is gharar, the contracting party/ies do not really understand the attributes / consequence of the contract



Under Islamic law, gharar is prohibited because its existence in the contract may deny the parties of equal bargaining power & informed decision making; or there may be risks on deliverability of the object of the contract

PROHIBITION OF GHARAR

Surah an- Nisa': ayat 29

“ ... squander not your property amongst yourself unjustly (batil) except it be a trade among you by mutual consent...”



Interpretative Efforts



What amounts to



Unjust (batil)



Trade by Mutual Consent

Criteria

- All illegal & defective elements in contracts including gharar & uncertainty

Criteria

- Offer & Acceptance, indicating consent
- Elimination of mistake, fraud etc

PROHIBITION OF GHARAR IN SUNNAH

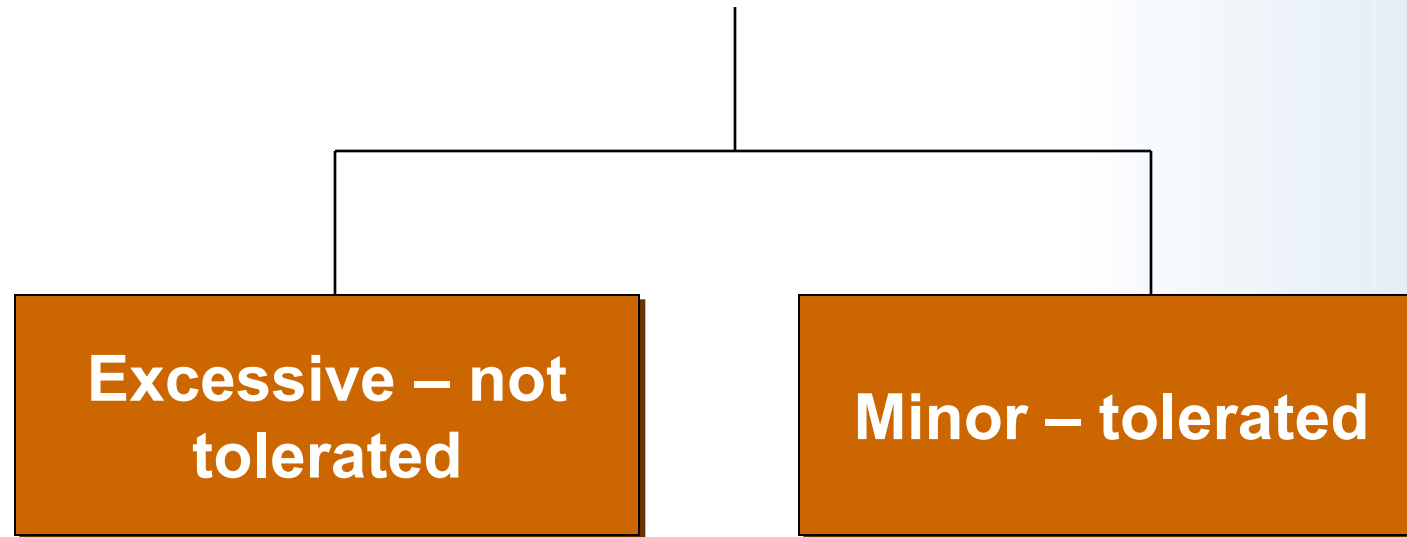
The sunnah uses the word gharar & its derivatives much more extensively than the Qur`an in the sense that several new meanings are added

In commercial transactions, the Prophet s.a.w. in many of his sayings directly prohibited the sale involving gharar (uncertainty) & jahalah (ignorance)

Thus, the prohibition of gharar is made conclusive by the sunnah / hadith of the Prophet s.a.w.

E.g.: prohibition of gharar sale (sale contract affected by gharar), prohibition of sale of fish in the sea, bird in the air, unborn animals, lost items, etc.

TYPES OF GHARAR



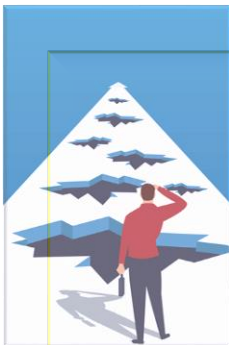
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Only major /excessive gharar affects validity of contracts – will render the contract void / voidable, depending on degree of uncertainty



Gharar affects trading & exchange contracts (mu`awadat); not charitable & unilateral contracts



In banking & finance – gharar can be triggered e.g. – in sale contract if the asset is uncertain / vaguely identified; the trading of a securitised debt which is unconfirmed / not established, sale of insurance policy etc.

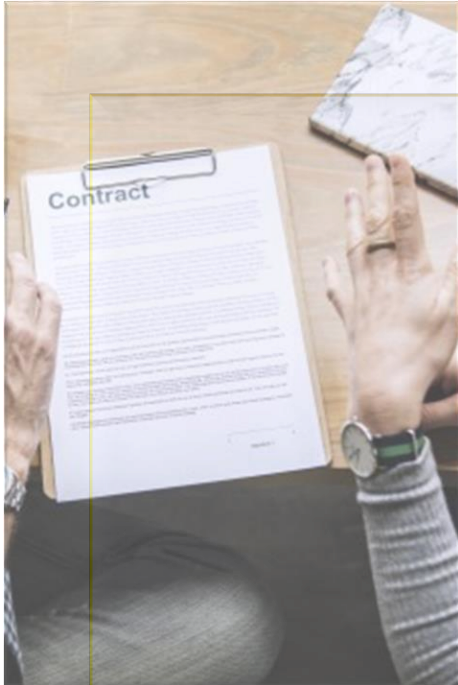
OTHER THINGS TO BE AVOIDED...

Transactions involving the prohibited commodities, e.g., pork and liquor

- Surah al Maidah (5:3)
- Surah al Maidah (5:90)

Transactions involving gambling or maysir/qimar

- Surah al Maidah (5:90)



ESSENTIAL CONTRACTS & THE APPLICABLE PRINCIPLES

SALE: AN OVERVIEW

Sale is a bilateral contract

The purpose is the exchange & transfer of ownership

The exchange of one commodity for another, one of which is called the object & the other the consideration (compare FOREX & barter trading)

Transfer of ownership is the direct effect of a valid & enforceable sale (compare legal ownership & beneficial ownership)

Since the result of sale is transfer of ownership; and to avoid unlawful gain, sale requires more strict requirements.

COMMON SALE CONTRACTS IN IF

Bay` al-
Murabahah

Bay` Bithaman
Ajil (BBA)

Bay` al-`Inah

Tawarruq

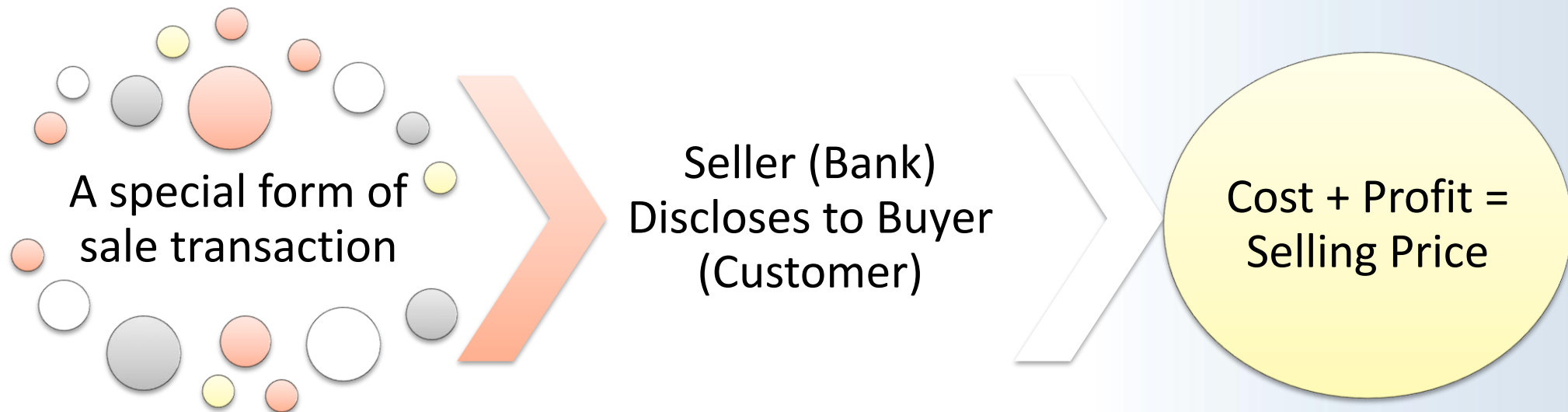
Bay` al-Dayn

Bay` al-Salam

Bay` al-Istisna`

BAY' AL-MURABAHAH

- ❑ Derived from the word '*ribh*' – means increase or profit
- ❑ Implies – the notion of increasing the price of things
- ❑ Main feature – transparent – disclosure of Seller's cost price & profit margin
- ❑ Considered as a type of “trust sale” (bay` al-amanah) with “strict liability”



BAY' BITHAMAN AJIL (BBA)

Refers to mode of payment – all sales that have deferment in payment

Al Qur'an 2:283 allows both deferred payment & deferred delivery sales

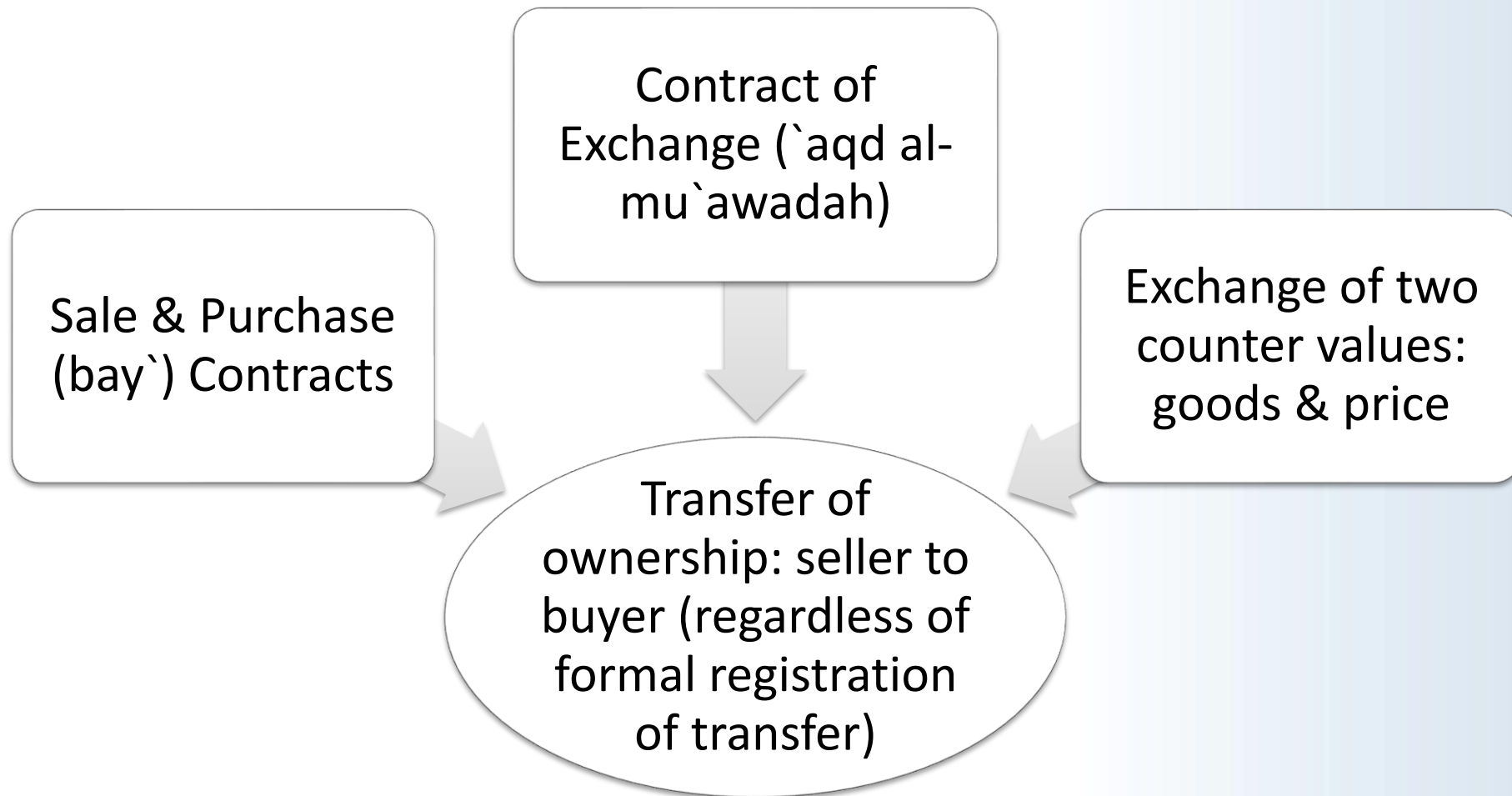
See Article 245 of Mejelle:

- “A sale for a deferred payment or for payment by instalment is good.”

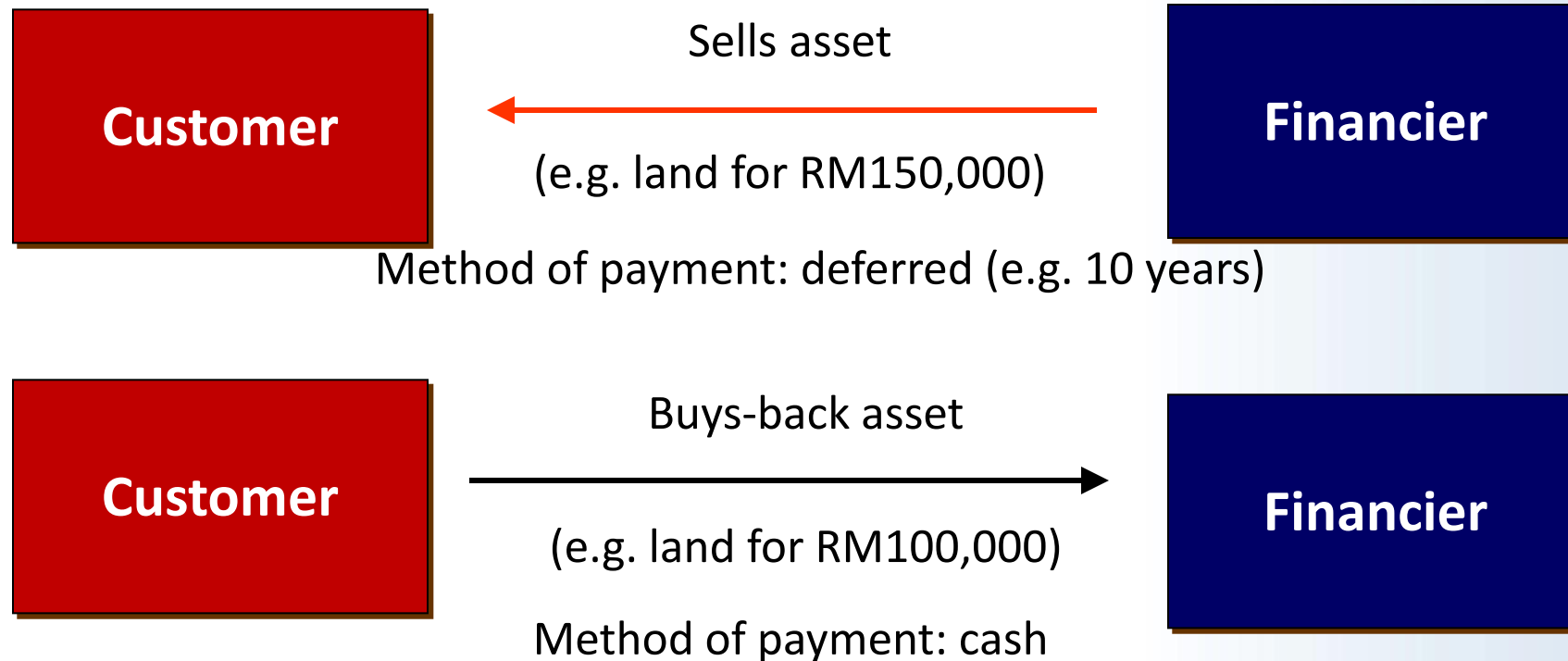
When price is deferred – time for payment must be known & fixed. Article 246 of Mejelle:

- “It is necessary to make the time known and fixed in the case of the payment of the price being deferred, or by instalment.”

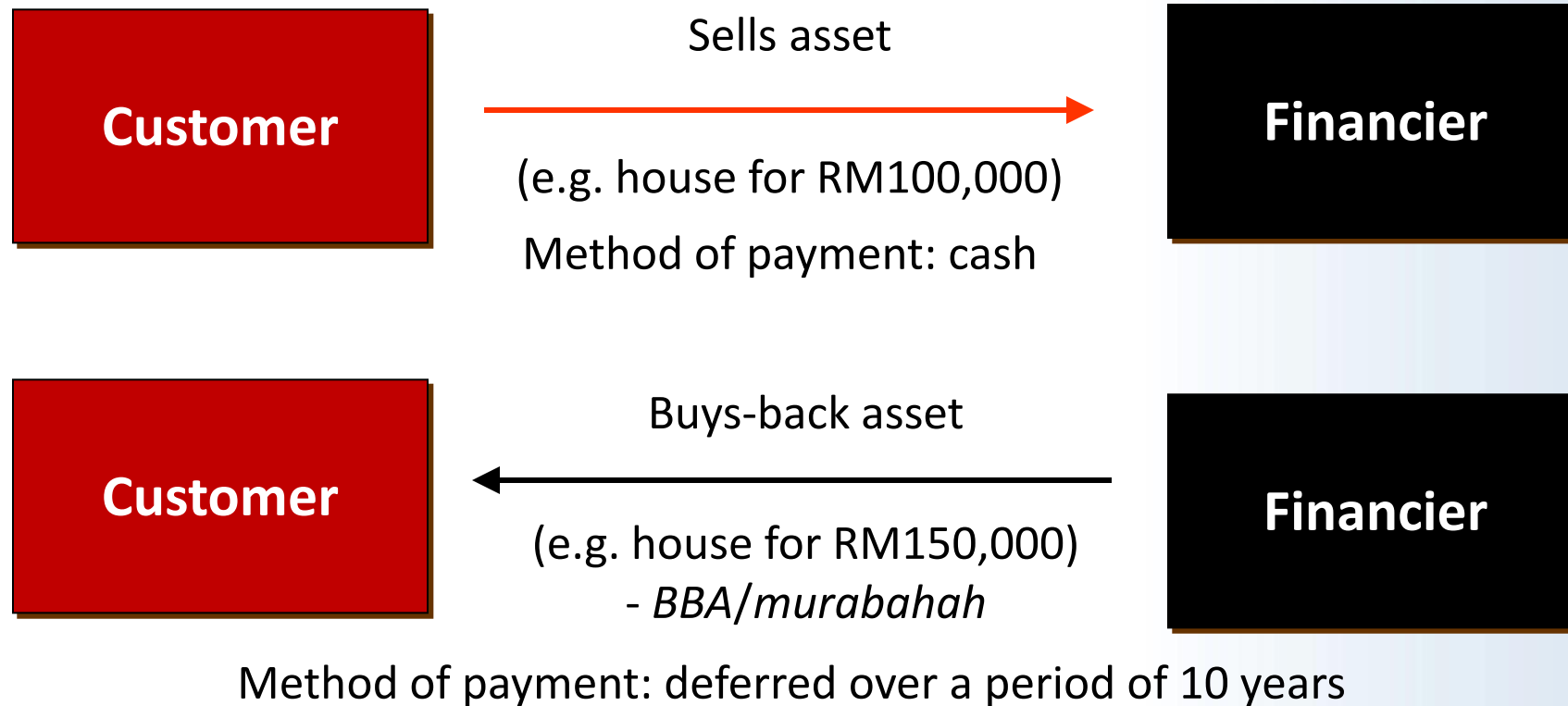
GENERAL PRINCIPLES IN MURABAHAH & BBA



BAY' AL `INAH (Modus Operandi-1)



BAY' AL `INAH (Modus Operandi-2)



THE CONTROVERSIES ON BAY' AL `INAH

Transactions between two parties only, on the same asset



Assumption that the apparent sale & purchase transactions are fictitious



Parties are not interested in the transfer of ownership of property, but in the transfer of cash between them to be paid at a later time with a mark-up



Majority scholars disapproved the practice as it is considered

two sales in one (prohibited in a hadith)

hilah to circumvent prohibition of riba

TAWARRUQ



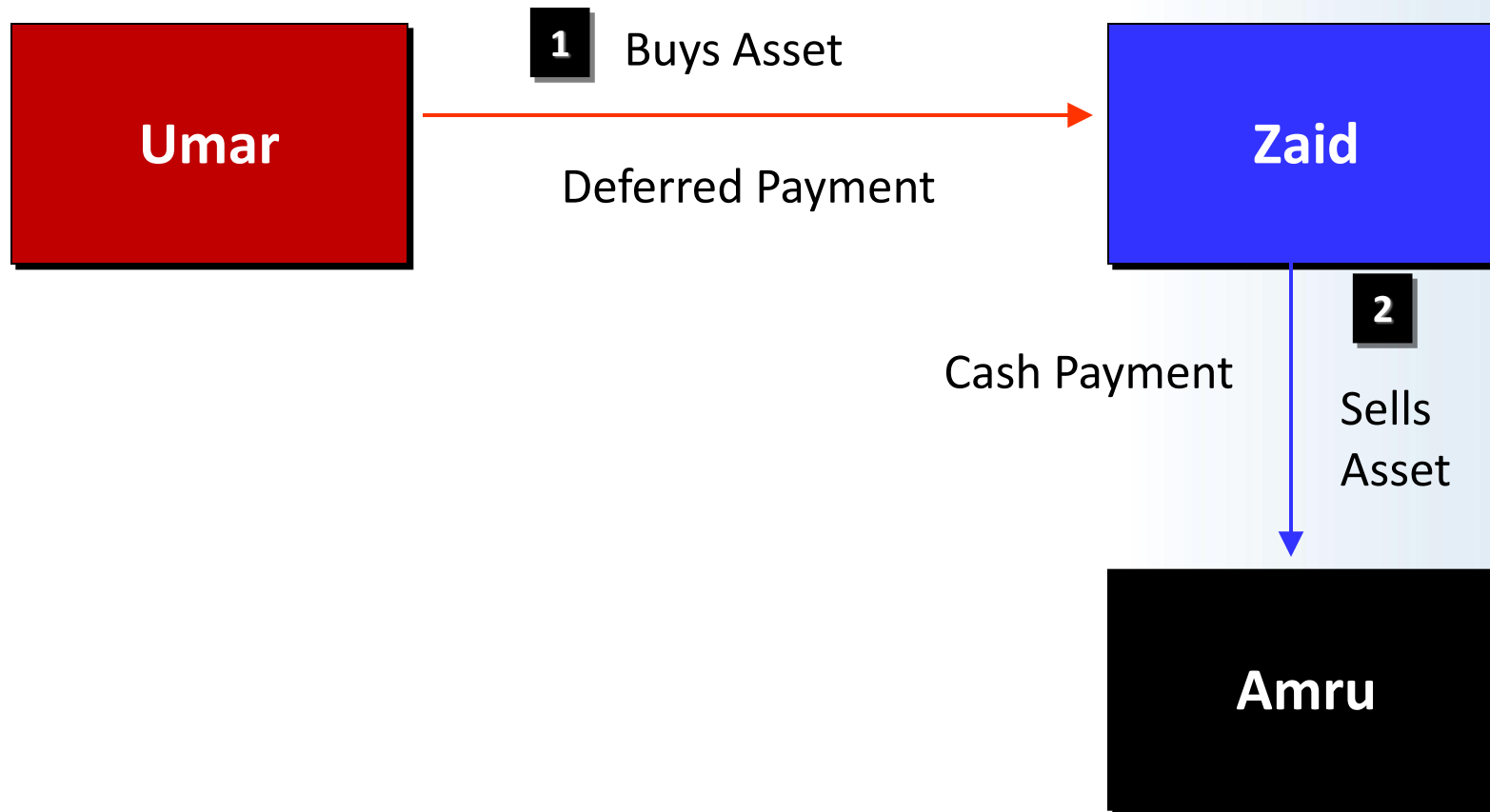
Tawarruq refers to a mu`amalah with two stages of transactions. At the first stage, the buyer will purchase an asset on credit from the original seller, and at the second stage, the buyer will then sell the asset on cash basis to a third party.

It is named as tawarruq because the buyer purchased the asset on credit with no intention of utilising or benefiting from it, rather to sell it to obtain cash.

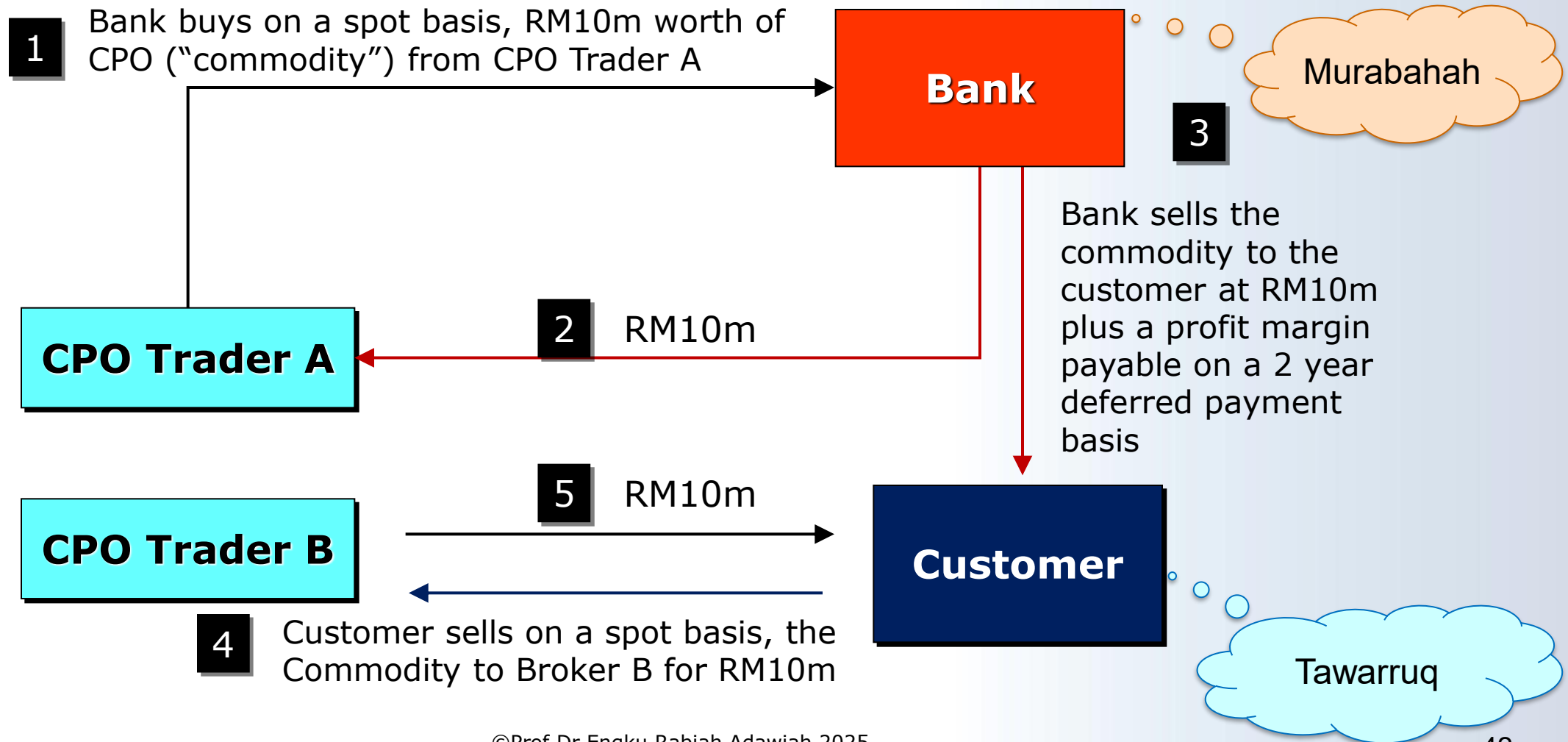
Tawarruq, which is also known as commodity murabahah (CM), is widely used in deposit products, financing, asset & liability management as well as risk management.

TAWARRUQ

TAWARRUQ – ORIGINAL FORM



FINANCIAL TAWARRUQ / COMMODITY MURABAHAH



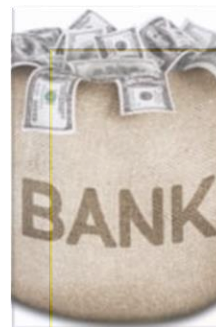
COMMODITY MURABAHAH + TAWARRUQ FEATURES

- Many IFIs use murabahah contract with tawarruq arrangement to allow for “cash financing”
- However, this practice has been criticized as being synthetic & not genuine (hilah) by some contemporary scholars
 - e.g. the Majma` al Fiqh al Islami in its 17th meeting
 - Though in an earlier meeting, Majma` al Fiqh had approved tawarruq in principle (15th meeting) – they consider financial / organized tawarruq as not approved (17th meeting)
- SAC of BNM’s view?

PREVIOUS BNM RESOLUTIONS ON TAWARRUQ



The SAC, in its 51st meeting dated 28 July 2005, has resolved that financing product based on the concept of tawarruq is permissible



The SAC, in its 51st meeting dated 28 July 2005, has resolved that deposit product based on tawarruq is permissible

BASIS OF THE RULING

The aforesaid resolution is based on the following textual provisions & views relating to permissibility of tawarruq:

i. Allah SWT says:

“...whereas Allah has permitted trading and forbidden riba usury...” (Quran: 2:275)

Based on general meaning of the above verse, scholars are of the view that tawarruq is allowed since it is a kind of trading activity. It may be conducted for the purpose of obtaining cash, with either the purpose is known by all related parties or not. It may also be conducted due to pressing need or as a common practice of certain parties or institutions.

ii. Fiqh maxim: “According to the original method of ruling, mu`amalah is permissible, except when there is a provision prohibiting it.”

iii. Contemporary scholars allow the application of tawarruq based on the views of Hanafi, Hanbali and Syafi`i schools that permit the application of tawarruq.

RELOOKING TAWARRUQ / CM

Reviewing tawarruq – both from conceptual & practical perspectives

Shariah: Principle-based vs Rule-based

Regulatory: Prudential & Systemic implications

Commercial / Financial impact



Still work in progress



RELOOKING TAWARRUQ VIS-À-VIS MAQASID & IMPACT

From the Quranic perspective, sale is the most significant alternative to riba (Quran-2:275)



Issue: Why is sale 'opposite' to riba; and how can sale replace riba in many ways?

- Exchange of counter values
- Win – win situation
- Fair and just distribution of risk and return
- Fair and just distribution of resources/wealth

Is this observable in Tawarruq/CM? What is the real behaviour & impact of Tawarruq/CM?

BAY` AL SALAM

This contract is an exception to the general rule that subject matter of contract must exist at the time of contract

The contract is allowed only when there is reasonable certainty that the goods will be ready & available for delivery at the contractually agreed time

Payment of price has to be made in advance at the time of contract

Amount & quantity of goods must be precisely determined at the time of contract

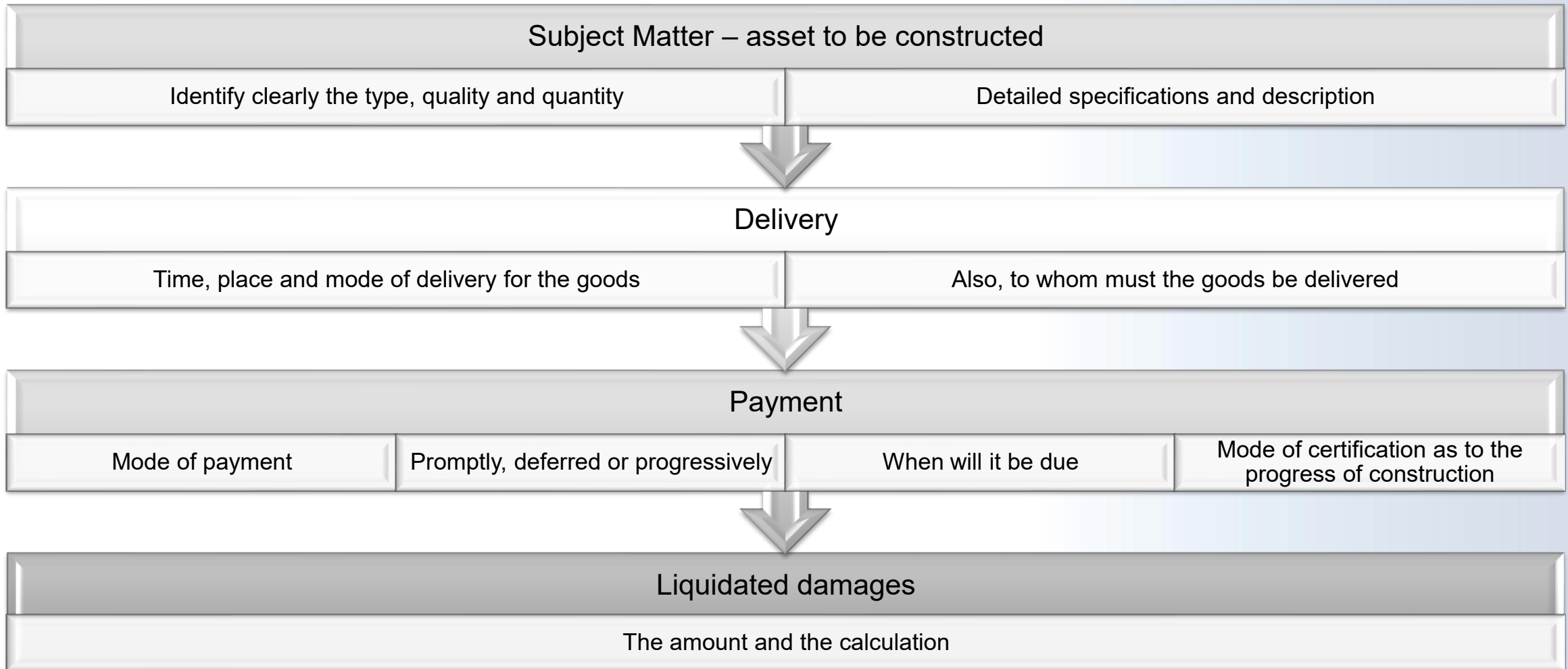
The time, place & mode of delivery must also be prescribed at the time of contract

All of these rules are to minimise the uncertainty involved in a *salam* contract

BAY' AL ISTISNA'

- ❑ This contract is an exception to the general rule pertaining to the existence of the subject matter at the time of contract
- ❑ This contract involves manufacturable goods only (commodities that cannot be manufactured e.g. fruits, grains etc are not suitable)
- ❑ Payment of the price is flexible – need not be advanced at the time of contract only
- ❑ Proper description of the goods ordered should be made
- ❑ Time, place and mode of delivery of both the goods and price should be specified at the time of contract
- ❑ This contract is suitable to finance the purchase of property which is still under construction

IMPORTANT TERMS & CONDITIONS IN ISTISNA'



BAY' AL-DAYN

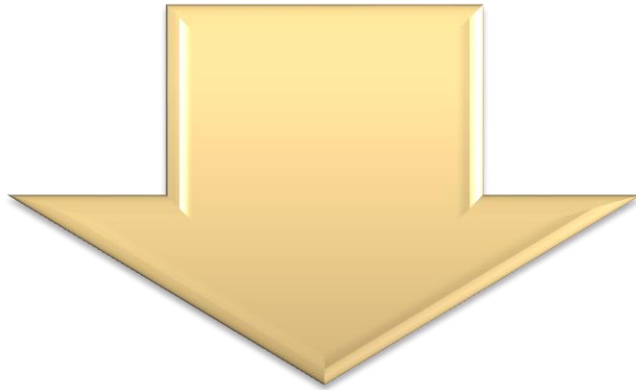
General

- ❑ Meaning: a sale of debt / future receivables for cash
- ❑ The debt must already be established (thabit) & admitted by the debtor.
- ❑ The debt must be Islamic in origin, be it civil, family or criminal.

Legitimacy?

- ❑ Generally speaking, the scholars accepted sale of debt in the following:
 - Sale of debt to the debtor
 - Sale of debt to a 3rd party for spot & face value
- ❑ Sale of debt to a 3rd party **not at face value** has no direct endorsement in classical fiqh

ISSUES IN BAY' AL-DAYN?



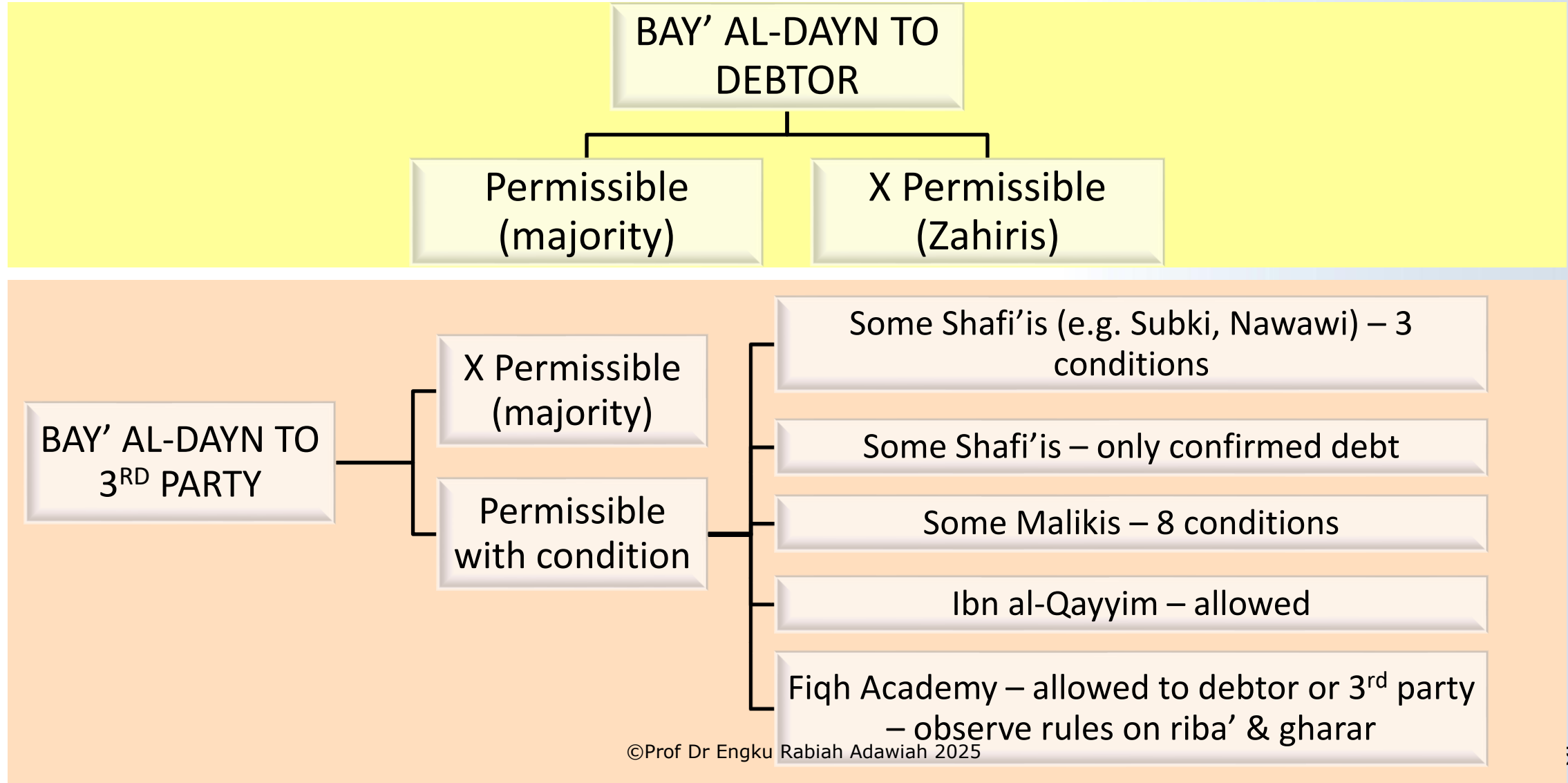
WHO? Sale of debt
to the debtor? Or a
3rd party?



HOW? Sale at
discount? Or at
cost price?



IS BAY' AL-DAYN PERMISSIBLE?



SALE OF DEBT AT DISCOUNT (DA` WA TA`AJJAL)

Da` wa Ta`ajjal (ضع وتعجل): debt discounting for early / accelerated payment

Consensus – Permissible if debt has matured

Majority – X Permissible if debt has not matured

Ibn Abbas – Permissible based on ra'fah & takhfif (lifting the burden)

AHADITH SUPPORTING DEBT DISCOUNTING



Ibn 'Abbas related that when the Prophet SAW directed Bani Nadhir to evacuate from Madinah, it is said: "Oh Prophet of Allah, you ask them to evacuate, but they still have debts in the liabilities of people which are not due yet". The Prophet replied: "Give discount & ask for an earlier payment".



It is reported that while Ka'ab was discussing with Ibn Abi Hadrad on payment of his debt to Ka'ab in a mosque, they did not realise that they had raised their voice that caused Rasulullah SAW who was in his house to hear their discussion. Rasulullah then came out from his house to meet them & said: "Oh Ka'ab. Give discount on part of your debt." Ka'ab replied: "I have already given". Rasulullah SAW then asked Ibn Abi Hadrad to pay the discounted debt."

ARGUMENTS AGAINST DEBT DISCOUNTING BASED ON THE 2 HADITH



1st Hadith is not authentic



2nd hadith: the debt was due already



The message is narrower than what it is claimed for



The nature of debt discounting is different

BAY` AL DAYN WITH DISCOUNTING?

Shariah Advisory Council of SC

- ❑ Islamic debt is as good as asset (haq maliy) & thus, it can be sold at either mark-up or mark-down provided it is sold on spot / cash basis
- ❑ The practice of sale of debt at a discount is supported by the hadith on “give a discount for early payment”

Other Scholars

- ❑ Debt is just a payment & thus, it is monetary in form
- ❑ Money for money exchange requires spot & equal exchange
- ❑ The hadith on “discounting” does not apply to a creditor giving a discount to a third party

IJARAH (LEASE) CONTRACT

Ijarah contract – a form of exchange contract (‘aqd al mu‘awadah) – usufruct vs rent.

Ijarah – a contract that results in the transfer of the right to use (usufruct).

Ownership of the asset remains with the owner/lessor.

In fiqh (Islamic jurisprudence) – ijarah also covers hire contract.

In practice – ijarah can be applied as operating lease, financial lease i.e. lease with option to purchase, or forward lease.

TYPES OF IJARAH

1st Type: Ijarah al-Manafi' (Ijarah for Usufruct) – Lease of usufruct from specific goods or asset

- Eg: lease of house, property
- BNM PD: Lessor leases property to Lessee for an agreed price (ujrah)

2nd Type: Ijarah al-A'mal (Ijarah for Service) – hiring for work or service

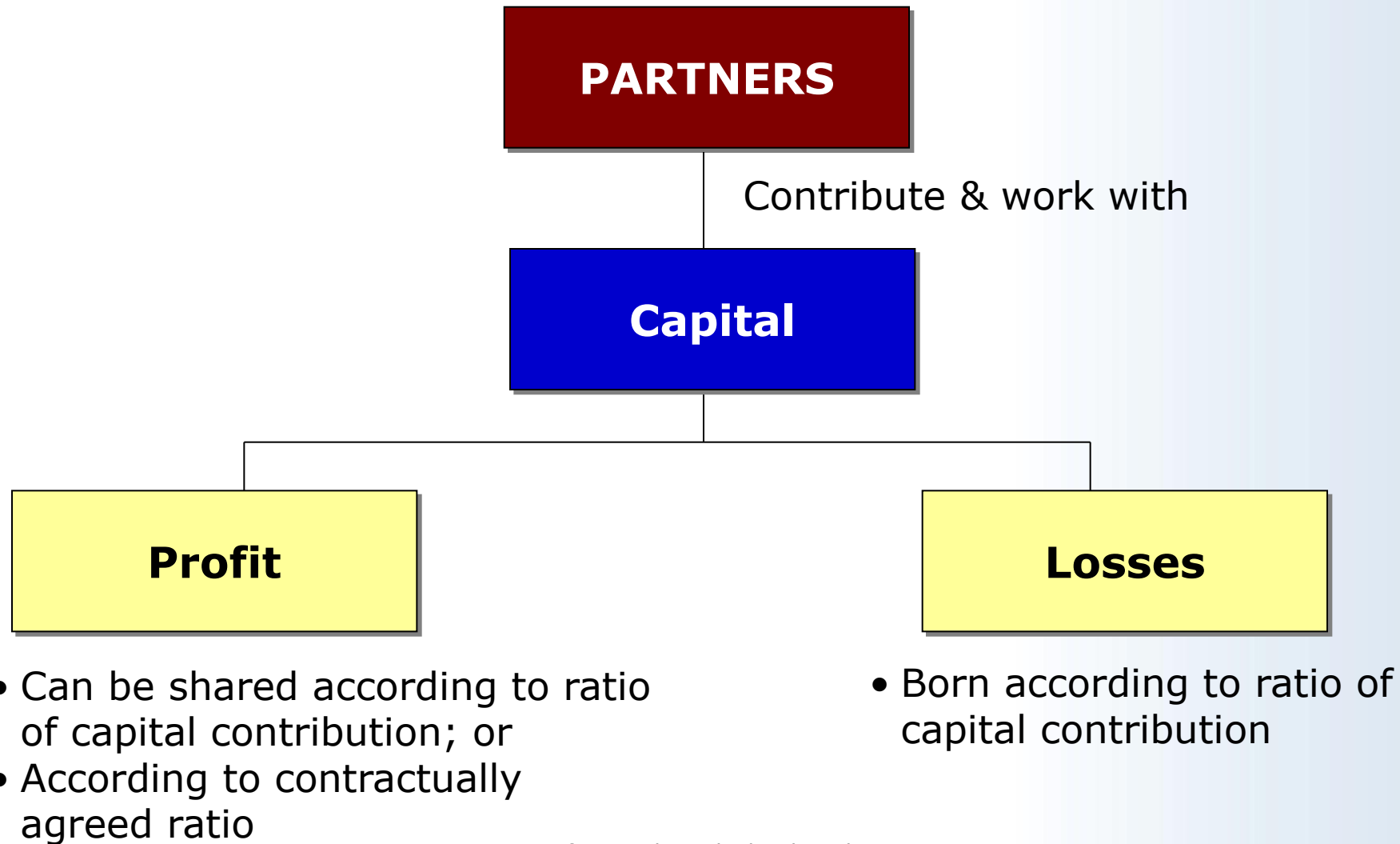
- Eg: consultants, lawyers, accountants,
- BNM PD: Employer employs employee for some valuable services.

3rd Type: Ijarah mawsufah fi Dimmah – lease of a described but non-existent asset – asset which is still under construction

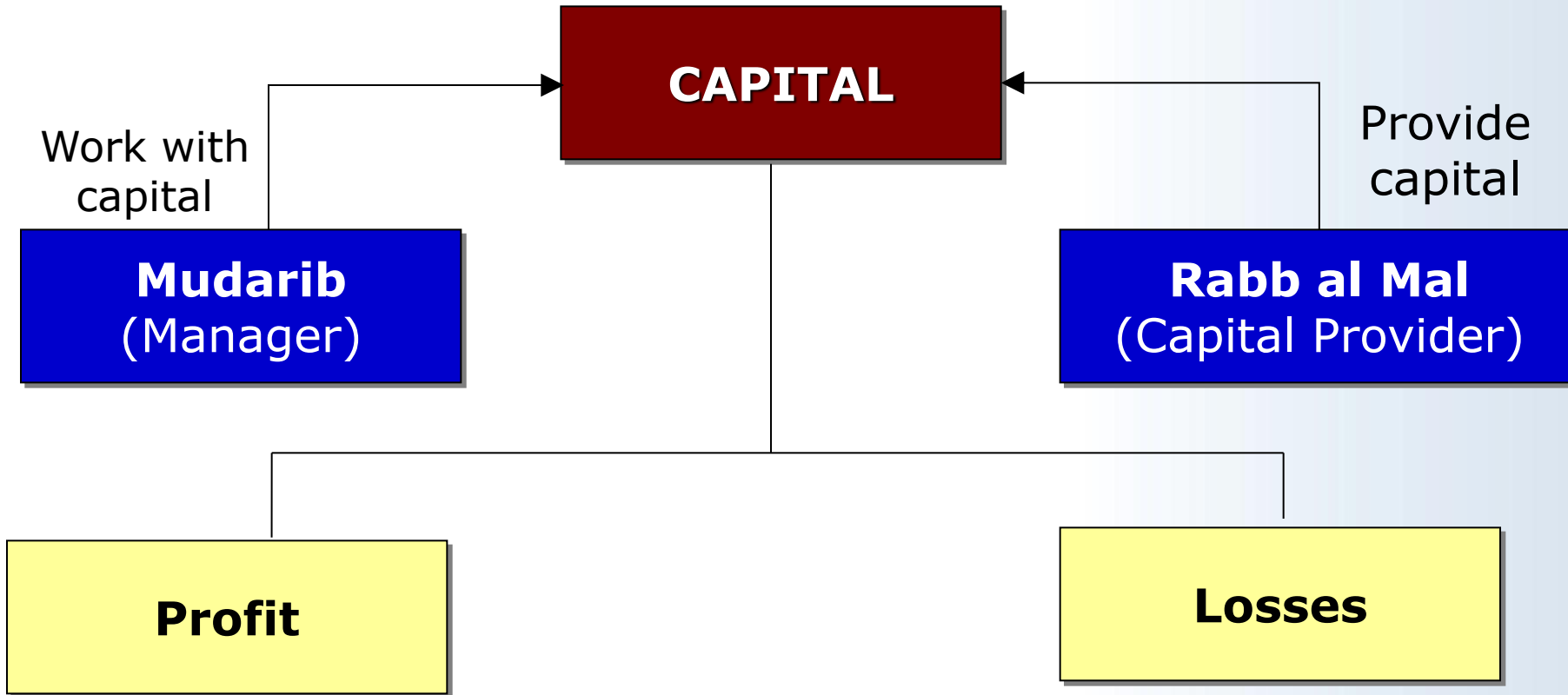
MUSHARAKAH AND MUDARABAH

- ❑ Partnership contracts – presuppose the contribution to capital, and the subsequent sharing of the profits and losses
- ❑ The distribution of profits and losses can be made based on the ratio of capital contribution
- ❑ Alternatively, the profits can also be shared according to a ratio agreed in the contract between the parties
- ❑ However, losses must always be based on the ratio of capital contribution
- ❑ The maxim says: “profits are shared according to what has been agreed upon by the parties at the time of the contract, and losses are to be borne according to the ratio of capital contribution”.
- ❑ The relationship between the partners is mainly based on the principle of agency (*wakalah*)

MUSHARAKAH



MUDARABAH



- Shared between *mudarib* + *rabb al mal*
- Profit sharing according to a contractually agreed ratio
- Profit sharing cannot be a fixed amount/a fixed percentage of capital contribution

- Born solely by *rabb al mal*
- *Mudarib* will only be personally liable if the loss is caused by his negligence



Q & A

Wassalamu alaykum warahmatullah