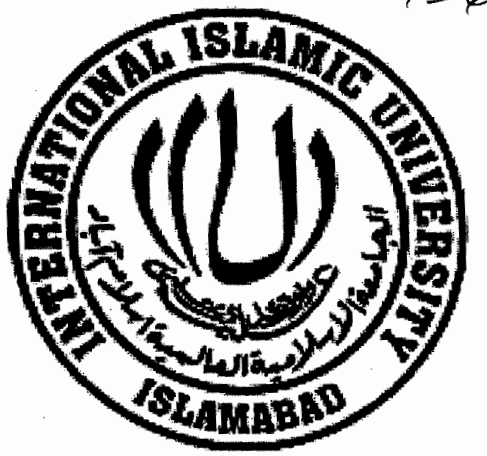
ISLAMIC BANKING IN PAKISTAN SHARIAH APPRAISAL OF THE BANK OF KHYBER ISLAMIC BANKING DIVISION OPERATIONS



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2009

FINAL APPROVAL

It is certified that we have read the dissertation submitted by Hussain Ahmad entitled "Islamic Banking in Pakistan: *Shariah* Appraisal of the Operations of the Bank of Khyber Islamic Banking Division" as a partial fulfillment for the award of degree of LLM (Corporate Law). We have evaluated the dissertation and found it up to the requirement in its scope and quality for the award of degree.

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FACULTY OF SHARIAH & LAW
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ISLAMABAD PAKISTAN
2009

Dedication

To my Late Mother who
gave me Great Care,
Compassion and Endless
Love
Throughout my Life
and to my Late Father who
Sacrificed Everything
To show me the Light of the
Day

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On my family side, I am most grateful to my beloved brothers and sisters, who always support me with their invaluable prayers, continuous encouragement and moral support.

May Allah S.W.T. reward them all in this world and Hereafter...!

THESIS STATEMENT

Islamic banks and financial institutions have shown great growth and success in Pakistan. This success of the Islamic banks is due to the enthusiasm of the Muslim depositors, who wish to invest their money in instruments and channels that are permissible under the *Shariah*. However, it is not clear to a common Muslim, that whether different modes of finance presently practiced by the Islamic banks are in conformity with *Shariah* or they are only legal artifices (*Heelah*). It is due to this reason that a need is felt to critically examine the practices of the Islamic bank in light of the principles of *Shariah*. For this purpose, the Bank of Khyber Islamic Banking Division was opted as a case study.

HYPOTHESIS

1. The operations of the Bank of Khyber Islamic Banking Division are *Shariah* compliant.

2. The operations of the Bank of Khyber Islamic Banking Division are not *Shariah* compliant.

3. The operations of the Bank of Khyber Islamic Banking Division are partially *Shariah* compliant.

OBJECTIVES OF THE STUDY

The main and foremost objective of this study is to analyze the procedures, agreements, terms and conditions of the various modes of finance practiced by the Bank of Khyber Islamic Banking Division and then make their *Shariah* appraisals in light of the basic principles of *Shariah* as expounded by the Muslim jurists. Further, to indicate howfar these terms and conditions of the various modes of finance of the Bank are similar to and different from the basic principles of Islamic law as developed by the earlier jurists. Therefore, an attempt would be made through this study to pin point the basic *Shariah* principles of the various modes of finance practice by the Bank of Khyber Islamic Banking Division. Once these *Shariah* principles have been identified and their operation fully understood, an effort would be made to make *Shariah* appraisals of the Bank operations in the light of these *Shariah* principles. If the operations of the Bank do not conform to the Islamic principles, an attempt would also be made to recommend proper solution in light of the *Shariah* principles that may legalize these modes and enable the Bank to function smoothly. Also, an attempt would be made to review and assess the present state of the Islamic banking and finance.

ABSTRACT

The title of this study is Islamic banking in Pakistan: *Shariah* appraisal of the Bank of Khyber Islamic Banking Division operations. The main objective of our study is two-fold. First, to introduce the general concept and salient features of Islamic banking and financial system. Second, to study the operations of the Islamic Banking Division of the BoK on both liability and asset sides and to examine and analyses them in the light of *Shariah*.

To achieve this objective, in chapter one, the meaning of Islamic banking and finance, the development of Islamic banking in Pakistan have been discussed. The study critically examines how the structure and practices of Islamic banking differ from those of conventional banking.

In chapter two, history of the BoK and its Islamization has been thoroughly studied. The structure and mechanism of the *Shariah* Supervisory Committee and Islamic Banking Division of the BoK have also been especially highlighted.

Chapter three deals with the capital and deposits scheme of the BoK Islamic Banking Division. It is followed by the discussion on the profit distribution mechanism of the Bank of Khyber Islamic Banking Division, its *Shariah* appraisal and recommendations.

The last chapter is devoted to the study of the practices of the Bank of Khyber in utilization of the funds. The modes such as *Ijarah*, *Murabahah* and Diminishing *Musharakah* in both classical *Fiqh* and contemporary Islamic Banking have been critically examined with special reference to BoK practices. Finally, recommendations have been suggested to make the BoK's operations more compliant to *Shariah* principles.

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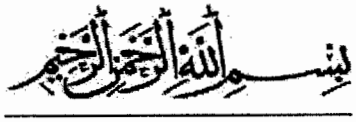
4. Practices of the Bank of Khyber Islamic Banking Division in Utilization of Funds



(In the name of Allah, the Most Compassionate, the Most Merciful)

Chapter No.1

Islamic Banking and Finance

Introduction

The Muslim jurists have identified five main purposes of the Islamic *Shariah*, known as *Maqasid al-Shariah*. They are: preservation and protection of i) religion ii) life iii) progeny iv) intellect and v) property. In Islam preservation and protection of wealth is one of the fundamental interests of man. Property of every person is sacred and inviolable. There are various modes for the preservation and protection of property in *Shariah*, such as prohibition against theft, usurpation, embezzlement, bribery, and all other un-Islamic means of acquiring wealth. Similarly, those transactions are also prohibited, which bring undue and unjustified profit to one party at the cost of other party. The primary principle of Islamic financial system is the prohibition of *Riba* (usury). Islam considers *Riba* as a mean of exploitation of the masses. Its basic goal is the general economic improvement of the public at large rather than of few groups. Islamic economic spells out the measures necessarily to be taken for ensuring social justice and therefore draws lines of demarcation between lawful and unlawful means. Islam expounds rules and regulations governing economic activities and ultimate ends being pursued.

Islamic banking has been in existence for the last three decades. According to some reports the number of Islamic banks and financial institutions has now reached to more than two hundred around the globe. They have seen rapid international growth in both Muslim and non-Muslim countries. In some countries Islamic banks and financial institutions get support from their respective governments, while in others, they have been established in private sector. In Pakistan, the Islamization of the financial and banking system started in 1977. Presently, there are full-fledged Islamic banks as well as Islamic banking branches of the conventional banks in Pakistan. Some of these banks have shown great success. This success of the Islamic banks is due to the enthusiasm of the Muslim depositors, who wish to invest their money in instruments and channels that are permissible under the *Shariah*. However, it is not clear to a common Muslim, that whether different modes of finance presently practiced by the Islamic banks are in conformity with *Shariah* or they are only legal artifices (*Heelah*). It is due to this reason that a need is felt to crtitically examine the practices of the Islamic bank in light of the priciples of *Shariah*. For this purpose, the Bank of Khyber Islamic Banking Division was opted as a case study.

The aim of this research is to study the procedure, agreements, terms and conditions of the various modes of finance practiced by the Bank of Khyber Islamic Banking Division and then make their *Shariah* appraisals in light of the basic principles of Islamic law as expounded by the Muslim jurists. Further, to indicate howfar these terms and conditions of the various modes of finance of the Bank are similar to and different from the basic principles of Islamic law as developed by the earlier jurists. Therefore, an attempt would be made through this study to pin point the basic *Shariah* principles of the various modes of finance practice by the Bank of Khyber Islamic Banking Division. Once these *Shariah* principles have been identified and their operation fully understood, an effort would be made to make *Shariah* appraisals of the Bank operations in the light of these *Shariah* principles. If the operations of the Bank do not conform to the Islamic principles, an attempt would also be made to recommend proper solution in light of the *Shariah* principles that may legalize these modes and enable the Bank to function smoothly. Also, an attempt would be made to review and asses the present state of the Islamic banking and finance.

1.1 What Is Islamic Banking?

The fundamental function of a modern bank, inter alia, is to serve as an intermediary between those who have capital resources but cannot invest on the one hand, and those who can invest but do not have capital on the other hand. The term conventional bank is also used for the word bank. The conventional banks use the interest rate mechanism to act as financial intermediary between savers and investors. In contemporary world, the banks emerged as organization that engaged in various functions i.e. receiving, collecting, lending, paying, transferring, investing, dealing, exchanging, and servicing money and claim to money both domestically and internationally.[1] The term 'Islamic banking' has been defined as: "Banking in consonance with the ethos and value system of Islam and governed, in addition to the conventional good governance and risk management rules, by the principles laid down by Islamic *Shariah*." (Masri, 1981)[2]

International Association of Islamic Banks describes Islamic banking in terms of religious and spiritual functions to be performed by the Islamic banks. It defines Islamic banking in the following words: "The Islamic bank basically implements a new banking concept in that it adheres strictly to the rules of Islamic *Shar'iah* in the fields of finance and other dealings. Moreover, the bank functioning in this way must reflect Islamic principles in real life. The bank should work towards the establishment of an Islamic society. Hence, one of its primary goals is the deepening of religious (Islamic) values among the people."[3]

Thus, we may say Islamic banking is based on Islamic economic principles and the principles of *Shariah*. It is interest free and asset-backed banking and also called *riba*-free banking. The basic and foremost philosophy of Islamic banking is risk sharing and should be completely free from *riba*, which is strictly prohibited in *Shariah*. It avoids all the prohibited activities such as *riba*, *gharar*, financing of *haram* trades and businesses,

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[1] Woelfel, Charles J. Encyclopedia of Banking and Finance, Chicago, 1993, p. 69.
[2] Fuad Al-Omar and Muhammad Abdul Haq, Islamic Banking Theory, Practice and Challenges, p. 21.
[3] IAIB (International Association of Islamic Banks), Directory of Islamic Banks and Financial Institutions, Jeddah, 2001 p. 20.

etc. Goods and services are sold and capital is invested by taking risk to earn *halal* profits in Islamic banking. Islamic banking not only stay away from *riba*-based transactions, but also keep away from unethical and immoral practices and participate actively in achieving the goals and objectives of Islamic economic system.[4]

1.2. Development of Islamic Banking in Pakistan

The first modern experience with Islamic banking was made in Egypt without projecting the name of Islam. This pioneering effort led by Mr. Ahmad Al Najjar through the establishment of the Mit Ghamr Savings Bank in the Egyptian town Mit Ghamr of the Nile Delta in 1963. This experiment was successful and lasted until 1967, by which time there were many branches of the bank in different parts of the Egypt. Although, the bank made a good start and initial results were more than encouraging, it suffered a setback owing to changes in the political atmosphere. Nevertheless, the project was revived in 1971 under the name of Nasser Social Bank. This was the first Islamic bank in an urban setting based in the capital city Cairo of Egypt. The seventies witnessed the emergence of several Islamic banks in various Muslim countries around the world. In recent years, there has been great interest shown in Islamic banking, which has led to the establishment of several full-fledged Islamic banks. An international financial institution, namely, Islamic Development Bank was also set up for the purpose of promoting economic development and social progress in member countries and Muslim communities in accordance with the principal of *Shariah*. Apart from it several local Islamic banks are also operating in different parts of the world.

Pakistan got independence on 14th August, 1947 in the name of Islam. It is due to this reason, that since its independence, the people of Pakistan demanded for the enforcement of complete *Shariah* in the country, including the elimination of *Riba* from the financial system. On 1 July 1948, the first Governor of the State Bank of Pakistan, Mr. Zahid Hussain on the occasion of the opening of the State Bank of Pakistan (SBP) stated that competent economists' well acquainted with the basic principles and requirements of Islam must subject banking practices to careful scrutiny on scientific lines. He also declared that the proposed research organization to be established by the SBP would devote special and constant attention to this most important aspect of our ideology. The founder of Pakistan, Quaid-e-Azam Mohammad Ali Jinnah, while delivering his inaugural address on the same historical occasion said:[5]

> ....."I shall watch with keenness the work of your Research Organization in evolving banking practices compatible with Islamic ideals of social and economic life. The economic system of the West has created almost insoluble problems for humanity and to many of us it appears that only a miracle can save it from disaster that is now facing the world. It has failed to do justice between man and man and to eradicate friction from the international field. On the contrary, it was largely responsible for the two world wars in the last half century, The Western world, in spite of its

[4] For understanding the objectives and functions of Islamic banking see, Kamal Sayyed Tayel, *al-Bunuk al-Islamiah*, p. 54; Gharib al-Jamal, *al-Masarif wa Buyut al-Tamwil al-Islamiyyah*, p. 25; Ibadi, *Mawqifal al-Shariah min al-Masarif al-Islamiyyah al-Muasirah*, pp. 178-179.

[5] S.A. Meenai, Money and Banking in Pakistan, op. cit. pp. 252-53.

advantages of mechanization and industrial efficiency is today in a worse mess than ever before in history. The adoption of Western economic theory and practice will not help us in achieving our goal of creating a happy and contented people. We must work our destiny in our own way and present to the world an economic system based on true Islamic concept of equality of manhood and social justice. We will thereby be fulfilling our mission as Muslims and giving to humanity the message of peace which alone can save it and secure the welfare, happiness and prosperity of mankind." .....

It is clear from the above that struggle for the elimination of *riba* from the financial and economic system of Pakistan and the need for ordering economic system in accord with the Islamic injunctions was publicly voiced right from the first year of the independence of Pakistan. The first Constituent Assembly of Pakistan passed a resolution called the 'Objectives Resolution' of 1949, in which it is clearly stated that the Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the Holy Qur'an and the Sunnah. The State Bank of Pakistan set up an 'Islamic Economic Section' within the Research Department in 1952 to carry out research work in the field of Islamic economic.[6]

In March 1963, the Council of Islamic Ideology (CII) for the first time in the history of the country examined the issue of *riba* on the basis of an official reference made by the Ministry of Finance. The question was whether or not interest in the form in which it appears in public transactions is in agreement with principles and concepts of Islam. The Advisory Council of Islamic Ideology in its decision on the issue on January 13, 1964 agreed that *riba* is forbidden, but was in disagreement as to whether interest in the form in which it appears in public transactions would also be covered by *riba* specified in the Holy Quran and Sunnah of the Prophet (PBUH). However, there was unanimity among the members of the Council on the point that a system without interest should be evolved for the accomplishment of the Islamic requirement of social justice and concept of human brotherhood. The Council strongly recommended that without delay efforts should be taken in the direction of establishing an economy free from *riba*.[7] The CII framed a questionnaire on December 10, 1966 at Dhaka, which sought views on the Quranic definition of *Riba'* applied to simple interest. The Advisory Council of Islamic Ideology took the following historic decisions on December 23, 1969.

i. That under the present banking system any increase received or paid in addition to the principal sum was *riba*' irrespective of the fact whether the transactions were between individuals, organizations, or the governments.

ii. That the discount allowed on short time loans issued by Treasury was *riba*.

iii. Interest paid on Saving Certificates was *riba*.

iv. Prizes paid on prize bonds were *riba*.

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[6] S.A. Meenai, Money and Banking in Pakistan, p. 253.

[7] The Bank of Punjab, Strategic Issues in Islamic Banking, Ferozsons (Pvt.) Ltd., 1995, pp. 3-4

v. Interest paid on Provident Fund and Postal Life Insurance was *riba*; and

vi. Interest charged on loans provided to government employees and local bodies was *riba*'.[8]

Here it is necessary to remind, that the CII mandate was restricted initially to the examination of the meaning of *Riba'* and identifications of its various forms existing in the contemporary economic system of the country. Thus, it considered the various aspects of the issue and gave its opinions and recommendations during the period 1960-1977. However, the works of the Council remained mostly theoretical and were never used for Islamization of the financial system of the country. Special provisions were also inserted in the Constitution of the Islamic Republic of Pakistan, 1973. According to Article 38(f) the Constitution, 1973, "The State shall eliminate *riba*' as early as possible". Similarly, in Article 227 of the Constitution, 1973, it is stated that "All existing laws shall be brought in conformity with the injunctions of Islam as laid down in the Holy Qur'an and Sunnah, and no law shall be enacted which is repugnant to such injunctions". However, the process for the elimination of *riba'* and Islamization of the financial system received a new momentum in September 29, 1977, when the then President of Pakistan set a three years time limit for the elimination of *riba*' from the economy. The CII was given the task to recommend a practical plan for elimination of *riba* from the financial system and prepare a blueprint for an Islamic Financial System.[9]

On October 13,1977, the Council in its meeting held in Islamabad set up a Panel of Economists and Bankers to assist in the preparation of blue-print and recommend ways to remove interest from the economy as well as suggest ways for replacing the interest-based instruments. The said Panel submitted an Interim Report in November 1978 to the CII. The Council recommended on the basis of this Interim Report that a beginning may be made immediately with the elimination of interest from the operations of three specialized institutions, namely, National Investment (Unit) Trust, Investment Corporation of Pakistan, and House Building Finance Corporation.[10] The then government accepted these proposals. In June 1979, Government announced its decision with effect that interest was eliminated from the operations of National Investment (Unit) Trust and House Building Corporation. While in case of Investment Corporation of Pakistan, interest was eliminated from its Mutual Funds operations only. Its other operations were made interest-free subsequently. A scheme of Interest-free loans to small farmers was also launched from 1st July, 1979. Meanwhile, necessary amendments were made in the legal framework of financial and corporate system of the country to remove the legal hindrances. A new financial instrument called Participation Term Certificates (PTC) was introduced in June 1980 to replace the interest-based debentures. The PTC is transferable corporate instruments based on the criteria of profit and loss sharing. The *Mudarabah* Companies and *Mudarabah* (Floatation and Control) Ordinance, 1980 was promulgated in June 1980 in order to regulate financing on the basis of *Mudarabah*.[11]

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[8] Ibid

[9] IPS Islamabad, Experience in Islamic Banking, A Case Study of Islamic Bank Bangladesh, p. 17

[10] Dr. Ziauddin Ahmad, The Present State of Islamic Financial Movement, 1985, p. 26

[11] Ibid.

The Panel of Economists and Bankers presented its Final Report to the Council (CII) in February 1980. The Report contained recommendations for elimination of interest from domestic transactions in all sectors of the economy and all types of financial institutions. On June 15, 1980, the Council adopted this Report after some modifications and substitutions in light of the *Shariah* and finally submitted it to the President. The Report dealt with the problems and strategies relating to elimination of interest from specialized financial institutions, central bank, commercial banks, and government transactions. The Report recommended that elimination of interest may be made gradually under a phased program. It laid down a 'Plan of Action' with an order of priority for elimination of interest from the deferent sectors. It recommended elimination of interest from Government transactions in the first phase, followed by elimination of interest from the assets side of the operations of the commercial banks and other financial institutions, culminating finally in deposits of the banks becoming interest-free. The Report emphasized that the ideal Islamic techniques for replacing *Riba* in the banking and financial fields are profit/loss sharing and *Qard/Qard Hashanah*. The Report also recommended some other comprehensive strategies for elimination of *riba* from the financial system and making compatible with the injunctions of Quran and *Sunnah*. It also discussed some possible hindrances and difficulties in the way of Islamization of the financial system and recommended strategies for their solution.[12]

State Bank of Pakistan (SBP) constituted six working groups in April, 1979, for examining all aspects of elimination of interest from different sectors of the economy. The working groups have submitted their report in November/December, 1979. The Pakistan Banking Council constituted a Superior Task Force for devising the necessary procedures in order to introduce the system of interest-free banking in the nationalized commercial banks of Pakistan.[13] State Bank of Pakistan started the process of conversion into interest-free system in January, 1981 and planned to be completed in two main phases:

Phase 1

This phase started from January 1, 1981. SBP issued Circular 1, according to which interest-free banking was allowed to work side by side with interest-based banking. For this purpose, amendments were made in banking laws of the country. Banks were directed to open Profit and Loss (PLS) deposit counters, side by side with interest bearing counters, with effect from July 1, 1981. As a result, on January 1, 1981, the nationalized commercial banks opened for the first in the history of the country special counters in their 7,000 domestic banks branches in order to accept voluntary deposits from their customers on the basis of Profit and Loss Sharing (PLS).[14] The public response to the banks' PLS deposit scheme was highly encouraging. The banks received Rs. 92.6 million in PLS deposits on the very first day of the scheme. These deposits were steadily growing and by 30th June, 1981 the balances of PLS deposits accounts had reached Rs. 3,186.5 million, out of which Rs. 2,295.5 million (72 %) was in PLS saving deposits and Rs. 891 million (28%) in PLS term deposits. In fact, the return on such deposits has been

[12] Ibid p. 27
[13] The Bank of Punjab, Strategic Issues in Islamic Banking, p. 5
[14] Ibid

somewhat higher than the interest rates allowed on interest-based deposits. The favorable return on PLS deposits further encourage the general public, and by 31st December, 1981, PLS deposits had reached Rs. 6,489.2 million.[15]

It was mandated that funds mobilized through the PLS deposits will not be used for any investment which were against *Shariah*. Thus, an opportunity was provided on voluntary basis to those, who would like to refrain from interest income, yet they can share in the profit and losses of the banks through this new Profit and Loss (PLS) accounts. There was steady growth in PLS deposits. By the end of March, 1985, PLS deposits accounted for 35.7 per cent of the total return bearing deposits of the banking system. [16]

Phase II

The SBP launched a program of complete shifting over of the entire interest based banking system to a non-interest based system. On June 20, 1984, the SBP issued BCD Circular 13, which made the following provisions:

(a) As from July 1, 1985, no banking in Pakistan would accept any interest bearing deposits and all deposits would be on the basis of participation in profit and loss of the banking company except deposit received on current account on which no interest or profit would be given by the banking company.
(b) As from April 1985, all finances provided by a banking company to any entity including individuals would be only in the 12 modes specified in the Circular.[17]

Foreign banks were also not allowed to accept any interest-bearing deposits. All existing deposits in a bank were treated to be on the basis of profit and loss sharing. However, the above-mentioned instructions of the SBP were not made applicable to foreign currency deposits in Pakistan and lending of foreign loans, which continued to be governed by the terms of the loan.[18] A new law, called the Banking Tribunal Ordinance, 1984, was promulgated. The main purpose of this law was to protect the banks against undue delays and defaults in repayment by parties obtaining finance from them. According to the provisions of the said Ordinance, the Tribunals are required to dispose of all cases within 90 days of the filling of the complaint. The High Court was made appellate authority to hear appeal against the decision of Tribunal.[19]

The State Bank of Pakistan termed this "Shift over to Islamic Modes of Financing." However, unfortunately in practice most of these modes contain provisions, which either violate the injunctions of *Shariah* or can at best be termed as second line fixed return techniques. The two important areas namely, the foreign transactions and the government's own fiscal and monetary operations were excluded from the process of Islamization by the then Government. Thus, interest would continue to be paid on all amounts borrowed from foreign countries.[20]

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[15] D.M. Qureshi, Interest-Free Banking, The Institute of Bankers in Pakistan, p. 232
[16] Dr. Ziauddin Ahmad, The Present State of Islamic Financial Movement, p. 28
[17] The Bank of Punjab, op. cit, p. 7.
[18] Muhammad Ayub, Islamic Banking and Finance Theory and Practice, (Pub. SBP), p. 6
[19] Dr. Ziauddin Ahmad, The Present State of Islamic Financial Movement, p. 29
[20] Dr. Shaid Hasan Siddiqui, Journal of Islamic Banking & Finance, Oct. Dec. 2003, p. 43

On June 25, 1980, the then Government excluded the Jurisdiction of the Federal Shariat Court from entertaining any fiscal issues including interest. The relevant Article 203-B (c) of the Constitution, 1973 gave the definition of 'law' as, "includes any custom or usage having the force of law but does not include the Constitution, Muslim Personal Law, any law relating to the procedure of any Court or Tribunal or, until the expiration of 'ten' years for the commencement of this Chapter, any fiscal law or any law relating to the levy and collection of taxes and fees or banking insurance practice and procedure". The Government by making successive amendments to the Constitution had kept these laws out of the jurisdiction of the FSC for the period of ten years. Thus, no petition could be filed in the FSC in this regard. On June 26, 1990, after expiration of the prescribed ten years, the jurisdiction of the FSC was restored over fiscal laws.[21] The FSC disposed of 115 petitions challenging the legitimacy of interest in 20 fiscal laws besides three suo moto Shariah notices, after it was mandated to challenge fiscal laws on 25 June, 1990. The FSC admitted the first ever petition in this connection challenging interest on December 11, 1990. After this petition a number of other petitions were filed as discussed above.[22]

The FSC announced its historic judgment on December 14,1991. The Court declared that the provisions of interest in a number of fiscal laws come under the definition of *Riba* and thus these provisions were repugnant to the *Shariah*. The Court also declared that the mark-up system as in vogue in Pakistan under the banner of Islamic system of banking is against the injunctions of Islam as it is nothing, but interest. The Court further held, that interest, whether simple or compound for productive or consumptive purposes is covered within the definition of *Riba*. The Court declared that Government operations require equal amount of cleansing and that no exception can be given to protect the transactions with the foreigners or in foreign currency. The Court held that laws protecting such transactions are violative of Islamic injunctions. The Court fixed June 30, 1992 as the day when this judgment would come into effect, after which these legal provisions would be null and void. [23]

The Islamization process of the financial system took an historic step forward with the above ruling of the FSC. This ruling put pressure on the then Government to take appropriate action by that date to amend or substitute these laws in the light of the *Shariah*. However, the Government, which defended the concerned laws during the hearings, moved an appeal in the Shariat Appellate Bench (SAB) of the Supreme Court. The SAB automatically stayed the operation of the judgment.[24] Meanwhile, in 1991, the Parliament enacted the Enforcement of Shariat Act, 1991. According to Section 8 of the said Act, the Government constituted a Commission headed by the Governor of the State Bank of Pakistan, and comprising members of Parliament, *Ulema* experts on finance, banking and law and retired government functionaries. The Commission was reconstituted in 1997. The combined works of these Commissions was submitted to the government in August 1997. The work of the Commissions proposed a comprehensive strategy for the elimination of interest from the economy.[25]

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[21] Dr. Shaid Hasan Siddiqui, op. cit., p. 43

[22] Ayub, Muhammad , Islamic Banking in Pakistan: An Appraisal in Histrocial Prospective, p. 99

[23] Federal Shariat Court Judgment on Interest (Riba), PLD Publishers Lahore 1992

[24] The Bank of Punjab, op. cit., p. 20

[25] IPS Islamabad, Experience in Islamic Banking, A Case Study of Islamic Bank Bangladesh, p. 21

The SAB of the Supreme Court delivered its judgment on December 23, 1999 rejecting the appeals. The SAB also directed in its judgment that laws involving interest would cease to have effect finally by June 30, 2001. The Appellate Court held that all prevailing forms of interest fall within the definition of *Riba*, which is strictly prohibited by Holy Quran. The SAB declared that the present interest-based financial system of Pakistan is against the injunctions of Islam and order to bring it in conformity with *Shariah*. It has to be subjected to radical changes. It also directed the Government to set up, within specified time frame, a commission for transformation of the financial system and two task forces to achieve the said objectives. The Court indicated in its judgment some measures, which needed to be taken, and the infrastructure and legal framework to be provided in order to have an economy conforming to the Injunctions of Islam. However, the SAB of the Supreme Court gave exemption for dealing with foreign parties on the basis of interest.[26]

The Government of Pakistan, in line with directives of the SAB, set up Commission for Transformation of Financial System (CTFS) in the State Bank of Pakistan in January 2000. One Task Force was set up in the Ministry of Finance to suggest the ways to eliminate interest from Government financial transactions. Another Task Force has been set up in the Ministry of Law to suggest amendments in legal framework to implement the Court's Judgment. The CIFT constituted a Committee for Development of Financial Instruments and Standardized Documents in the State Bank to prepare model agreements and financial instruments for new system. [27]

The first Interim Report of the CTFS was submitted in October 2000. The Report identified a number of prior actions, which were needed to be addressed to prepare the ground for transformation of the financial system. The second Interim Report of the CTFS was submitted in May, 2001. The Report identified major *Shariah* compliant modes of financing and their essentials. The Report also proposed a draft seminal law captioned "Islamization of Financial Transaction Ordinance, 2001", model agreements for major modes of financing, and guidelines for conversion of products and services of banks and financial institutions. The Commission submitted its final report by joining together the above two Interim Reports to the Government in August 2001. In addition to above, the Commission also dealt with major products of bank and financial institutions, both for asset and liability side. For instance, Letters of Credit or Guarantee, Bills of Exchange, Term Finance Certificates (TFC), State Bank's Refinance Schemes, credit cards, interbank transactions, underwriting, foreign currency forward cover, and various kinds of bank accounts. The Commission proposed that all deposits, except current accounts, would be accepted on *Mudarabah* principle. The Commission also approved the concept of Daily Product and Weightage system for distribution of profit among various kinds of liabilities/deposits. The CTFS suggested that its recommendations concerning the modes of financing, their essentials, and guidelines for conversion of bank's services and products be circulated among banks, financial institutions, etc. to help them prepare the adoption of the new system, when the proposed law is promulgated. According to the Commission prior and essential works for introduction of *Shariah* compliant financial system briefly included creating legal infrastructure conducive for working of Islamic financial system, launching a massive education and

[26] PLD, (2000), Supreme Court Judgement on Riba, Lahore: PLD Publishers.
[27] Muhammad Ayub, Islamic Banking and Finance Theory and Practice, p. 6

training programs for bankers and their clients and an effective campaign through media for the masses at large to create awareness about the Islamic financial system. The Report of the Task Force of the Ministry of Law discussed the Case History of the movement for elimination of *Riba* from economy. It proposed two Ordinances namely, 'Prohibition of *Riba* Ordinance' and the 'Financial Transactions Ordinance' The Report of the said Task Force also proposed draft amendments in various laws or provisions of laws.[28]

As mentioned above, the deadline for the implementation of the Judgment of the SAB of the Supreme Court was June 30, 2001. The Government-owned UBL filled civil *Shariat* Review Petition No. 1 of 2000 in the SAB of the Supreme Court. The Learned Bench of the Supreme Court on June 14, 2001 allowed extension till June 30, 2002 in the implementation of the Judgment of the apex Court, dated November 23, 1999. On June 24, 2002, the *Shariat* Appellate Bench of the Supreme Court set aside the Judgment of the FSC, dated November 14, 1991 and its own Bench Judgment dated December 23, 1999 and remitted the case to FSC for determination afresh.[29] The then Finance Minister of Pakistan in his budget speech for the FY02 stated that; "Government is committed to eliminate *Riba* and promote Islamic banking in the country. For this purpose a number of steps are under ways, which are:

1. A legal framework is designed to encourage practice of Islamic banking by banks and financial institutions as subsidiary operations of their main operations;

2. Consultations and exchanges are undertaken with brother Islamic countries and renowned institutions of Islamic learning such as Middle Eastern countries and *al-Azhar* University of Egypt, to learn more about their experiences and practices;

3. Amendments in HBFC Act are being made in line with the directives of the Supreme Court. With these changes, HBFC would be fully *Shariah* complaint institution, which will play an effective role both in promotion of Islamic financing method but also in the development of the important housing sector;

4. *Shariah* compliant modes of financing like *Musharaka* and *Mudarabah* will be encouraged so that familiarity and use of such products is enhanced and their operation at a wider scale made possible;

5. The Transformation Commission established in the State Bank of Pakistan will continue to function and its recommendations whenever finalized will be considered by the government for appropriate action.

It is Government's intention to promote Islamic banking in the country while keeping in view its linkage with the global economy and existing commitments to local and foreign investors."[30]

A Committee has been constituted in the Institute of Charter Accounts, Pakistan (ICAP), wherein the SBP is also represented, for developing of accounting and auditing

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[28] M. Ayub, Islamic Banking and Finance Theory and Practice, p. 6

[29] Dr. Shaid Hasan Siddiqui, journal of Islamic Banking & Finance, Oct. Dec. 2003, pp. 44-45

[30] See for details Dr. Shaid Hasan Siddiqui, journal of Islamic Banking & Finance, Oct. Dec. 2003, pp. 44-58; Ayub, Muhammad, Islamic Banking and Fiance Theory and Practice, pp. 5-6.

standards for Islamic modes of financing. The Committee is reviewing the standards prepared by the Bahrain based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) with a view to adopt them to the Pakistan specific circumstances and if considered necessary, to propose new accounting standards. The SBP has also reviewed its forms of financial statements for banks in the light of AAOIFI Standards. A new Islamic Banking Division has been established in Banking Policy Department of SBP for regulating and promotion of Islamic banking. Existing Prudential Regulations of the SBP for banks have been reviewed by SBP for their application to Islamic banks. A meeting was held on September 4, 2001 under the Chairmanship of the President of Pakistan, attended by officials of the Ministries of Finance and Law, Governor State Bank of Pakistan, Chairman and some members of the Council of Islamic Ideology and the Chairman of the CTFS and the two Task Forces. It was decided in the meeting that the shift to interest free economy would be in a gradual and phased manner and without causing any disruptions. It was also agreed that the SBP would consider:

1. Setting up of subsidiaries by the commercial banks for the purpose of conducting *Shariah* compliant transactions.

2. Specifying branches by the commercial banks exclusively dealing in Islamic products, and

3. Setting up a new full-fledged commercial bank to carry out exclusively banking business based on proposed Islamic products.

The above historical review of Islamic Banking shows that during the past three decades, considerable progress has been made in the field of Islamic Banking and Finance in Pakistan.

1.3 Current Status of Islamic Banking in Pakistan

The State Bank of Pakistan has established Islamic Banking Department (IBD) on 15th September 2003. The IBD has been entrusted with the task of promoting and developing the *Shariah* Compliant Islamic Banking as a parallel and compatible banking system in the country. The SBP is following the three-pronged strategy for promotion of Islamic Banking in Pakistan. The three-pronged strategy of the State Bank of Pakistan is:

a. Setting up subsidiaries by the commercial banks for the purpose of conducting *Shariah* complaint transactions.

b. Specifying branches by the commercial banks exclusively dealing in Islamic products; and

c. Setting up a new full-fledged commercial bank to carry out exclusively banking business based on proposed Islamic products.[31]

[31] www.sbp.org.pk last visited Decenber 2009.

A. Islamic Banking through Full-fledged Commercial Bank:

In line with Part III of the Strategy, the SBP issued detailed criteria on December 1st, 2001 for establishing of full-fledged Islamic commercial banks in the private sector. Al-Meezan Investment Bank received the first Islamic commercial banking license from the SBP in January, 2002 and the Meezan Bank Limited (MBL) commenced full-fledged commercial banking operations from March 20, 2002. Those interested in establishing Scheduled Islamic Commercial Bank may apply to the Islamic Banking Department, State Bank of Pakistan. The SBP has set up, inter alia, broad criteria for setting up Scheduled Islamic Commercial Bank in its IBD Circular No. 02 of 2004. The proposed bank must commence operations within six months of the grant of permission. They must open at least five branches within a period of twelve months from the date of permission The proposed bank shall have a minimum paid up capital of Rs. 1,000 million and shall also at all times maintain minimum capital adequacy ratio of 8% based on risk weighted assets.[32]

B. Islamic Banking through Subsidiaries:

For part I of the strategy, a new clause (aa) was inserted in Sub Section 1 of Section 23 of the Banking Companies (Amendment) Ordinance, 2002, which provides that banks could form subsidiaries for "carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the Holy Quran and *Sunnah*." The SBP issued Circular No 01 on January, 2003 outlining detailed instructions on setting up of subsidiaries and Stand-alone branches for Islamic Banking by existing commercial banks. The criteria for subsidiaries are almost similar to the prescribed criteria for setting up scheduled Islamic commercial bank as discussed above. The banks interested in establishing a subsidiary for Islamic banking may apply to the Director, Islamic Banking Department, State Bank of Pakistan. The SBP has set up broad criteria for setting up an Islamic banking subsidiary by existing scheduled commercial banks its IBD Circular No. 02 of 2004. The subsidiary must commence operations within six months of the grant of permission and shall be subject to the prevalent banking and other laws, rules and directives issued by the SBP from time to time.[33]

C. Islamic Banking through Stand-alone Branches:

For part II of the Strategy, the SBP issued on January 1, 2003 operational details and other guidelines for opening of stand-alone branches of Islamic banking by existing commercial banks. The guidelines include enlisting eligibility criteria, licensing requirements, etc. The bank is required to set up Islamic Banking Division (IBD) at the Head Office/Country Office in Pakistan. The bank would also appoint a *Shariah* Advisor/*Shariah* Supervisory Committee consisting of *Shariah* scholar(s) of repute to advice the IBD on matters pertaining to *Shariah*. The bank shall insure that proper systems and controls are in place in order to insure segregation of funds and to protect the interest of depositors. The bank shall insure proper maintenance of records for all transactions for disclosure of assets, liabilities, expenses and income of IBB(s). The IBD

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[32] For detailed criteria visit www.sbp.org.pk

[33] www.sbp.org.pk information downloaded on 30th June, 2009.

will also comply with statutory liquidity and cash reserve requirements determined by the SBP.[34] The preceding discussion makes it clear, that the GoP/SBP introduced Islamic banking practices in parallel with the conventional banking system in Pakistan. "The SBP is itself committed to promote Islamic banking in Pakistan on parallel basis. The SBP strategy provides for three institutional options: an independent and dedicated Islamic bank; an Islamic banking subsidiary of a conventional bank; or a dedicated Islamic banking branch of a conventional (bank) with all safeguards to insure integrity and purity of Islamic banking operations."[35]

The SBP has got an encouraging response in its efforts to promote Islamic Banking in Pakistan and a number of institutions have come to the market to start operation in Islamic Banking as per the three-pronged strategy of the SBP. The increasing branch network of the Islamic banks indicates, that the Islamic banking sector continued to growth in the country. Presently, there are six full-fledged operational Islamic banks in Pakistan, as at 24th February, 2007. The total number of branches of these full-fledged Islamic banks is 237 as at September 30, 2008.[36] Meezan Bank Limited (MBL) commenced full-fledged commercial banking operations from March 20, 2002. It has now one hundred and seventeen branches in different parts of the country.[37] Al-Baraka Islamic Bank is a foreign/multinational bank based in Bahrain. It has opened its first branch in Pakistan at Lahore in 1991 to introduce *Shariah* Compliant Banking. It has now twenty operational branches in different parts of the country.[38] BankIslami has opened its first operational branch on 7th April, 2006 at its SITE, Krachi. Presently, BankIslami has fourty operational branches, which are located in different cities of the country. Emirates Global Islamic Bank, an Islamic Commercial Bank, commenced operations on February 16th, 2007. It is incorporated in Pakistan. Currently, it has twenty five operational branches.[39] First Dawood Islamic Bank Ltd. has started its operation 24.04.2007. Currently it has fourteen branches. Dubai Islamic Bank (DIB) was incorporated in 1975 in Dubai (UAE). It is a full-fledged Islamic Bank. DIB has established 'DIB Pakistan Limited', a subsidiary in Pakistan. Currently, it has twenty one branches in different parts of the country.[40]

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[34] Ibid
[35] Extract from the 'Affidavit' filed by the Deputy Governor of the SBP in SC.
[36] www.sbp.org.pk information downloaded on 30th June, 2009.
[37] http://www.meezanbank.com information downloaded on 30th June, 2009.
[38] http://www.albaraka.com.pk information downloaded on 30th June, 2009.
[39] http://www.egibl.com information downloaded on 30th June, 2009.
[40] www.sbp.org.pk information downloaded on 30th June, 2009.

Number of Licensed Islamic Banks and Islamic Banking Branches of Conventional Banks as at September 30. 2008.[41]

	Bank's Name	No. of Branches
A) Full Fledge Islamic Banks		
1	Meezan Bank Limited	117
2	Albaraka Islamic Bank	20
3	Bank Islami Pakistan Limited	40
4	Dubai Islamic Bank Pakistan Limited	21
5	Emirates Global Islamic Bank Limited	25
6	First Dawood Islamic Bank	14
Total of A		**237**
B) Islamic Banking Branches of Conventional Banks		
1	MCB Bank Ltd.	8
2	The Bank of Khyber	17
3	Bank Alfalah Limited	35
4	Habib Metropolitan Bank Ltd.	4
5	Standard Chartered Bank (Pak.) Ltd.	8
6	Bank Al Habib Ltd	3
7	Habib Bank Ltd	1
8	Soneri Bank Limited	4
9	Prime Commercial Bank Ltd.	2
10	Askari Bank Ltd.	16
11	National Bank of Pakistan	3
12	United Bank Limited	5
13	ABN AMRO Bank N.V	1
14	The Royal Bank of Scotland	3
Total of B		**110**
A+B		**347**

Murabahah has remained the most favored mode of finance of all the Islamic banking institutions (IBI's) in Pakistan. It is almost 40 % of the total financing done by the IBI's in the quarter ending December 2006. The second most widely used mode of Finance is *Ijarah* Financing. It makes almost 30% of the total financing. Diminishing *Musharakah* share is 29.4 %. Around ninety percent of financing comes through these three modes of financing. Total assets of IBI stood at Rs. 235 billion showing an increase of 11%.[42]

[41] Ibid

[42] www.sbp.gov.pk last visited on 25th March, 2009.

Modes of Financing[43]

Rs. In '000'

	Sep-2006	Dec-2006	% Change
Murabahah	20,627,469	26,505,838	28%
Ijarah	17,618,377	19,633,599	11%
Musharaka	351,535	533,029	52%
Diminishing *Musharaka*	6,549,520	10,597,750	62%
Salam	2,365,729	464,755	-80%
Istisna	642,547	899,919	40%
Qarz/Qarz-e-Hasna	6,874	7,486	9%
Others	5,000,131	7,099,640	42%
Total	53,162,182	65,742,016	24%
Amount of Non performing Finances	916,340	820,391	-10%
Provision against Non Performing Finances	541,368	604,809	12%
Net Non performing Finances	374,972	215,582	-43%
Gross Financing	53,162,182	65,742,016	42%

1.4 Islamic Banking Vs Conventional Banking

The term 'Islamic finance' has been defined by Professor Khurshid Ahmed as: "Islamic economics is a systematic attempt to study the economic problem and man behaviour in relation to it from an Islamic prospective. It is also an effort to develop a framework for theoretical understanding, as well as to design appropriate institutions and policies, pertaining to the process of production, distribution and consumption, that will enable optimal satisfaction of human needs, enabling man to serve higher ideals in life."[44]

In Islam, economic aspect is one of the most important parts of human life while not being the whole of it. So, one cannot study its economic system, in isolation without a knowledge of the conceptual framework of the whole Islamic system. Thus, Islamic economics makes it very clear that economics is not to be studies in isolation from other aspects of social life. Economic phenomena and economic behavior are to be studied in the context of the totality of human life. The Islamic economic system deals with motives as well as behavior institutions and policies. This approach is distinctive feature of Islamic economic. Everything in this world is created for the benefit and welfare of mankind. In the Holy Quran there are about 20 out of 500 verses, which explicitly discuss economic issues. The main versus dealing with economic issues are concerned with the subject of taxation and *Riba*. However, many versus in Holy Quran have been used in the process of deduction by analogy as a basis of economic rules. The underlying principles of Islamic economy aim at establishing a just society wherein everyone will behave responsibly and honestly, and not fighting for getting as big a share of something without regard to honesty, trust and responsibility.[45]

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[43] Ibid.

[44] Khurshid Ahmed, Anthology of Islamic Banking, Institute of Islamic Banking and Insurance London, p 33.

[45] Tantawi, Muhammad Sayyid, *Mu' amalat al-Bunuk al-Sha'iyyah*, Cairo 1997, p. 92.

Islamic banks have certain traits prescribed by their specific nature, drawing their principles and rules from *Shariah*, which considers that wealth is owned solely by Allah Almighty (SWT) and is mandated by man acting as His vicegerent. The core fundamental features of Islamic financial system are as follows: (i) the prohibition of *Riba* (usury or excessive interest) and the removal of debt-based financing from the economy; (ii) sharing in profit and loss, the provider of financial funds and the entrepreneur share business risk in return for shares of profits and losses; (iii) the prohibition of *Gharar*, encompassing the full disclosure of information and removal of any asymmetrical information in a contract; (iii) investment in permissible things, the exclusion of financing and dealing in sinful and socially irresponsible activities and commodities such as gambling and the production of alcohol; (iv) Asset-backed financing materiality, a financial transaction needs to have a 'material finality', that is a direct or indirect link to a real economic transaction; (v) morally directed economy; (vi) Worked-based System; (vii) Distributive Justice; (viii) Prohibition of Making Money from Money; (ix) Prohibition of Extravagancy; (x) Paying of *Zakat*; (xi) Prohibition of Monopoly and (XII) Prohibition of Injustice and Exploitation.

The similarities between Islamic and conventional banking systems lie in the fact that although the former controlled by the *Shariah*, essentially perform the same functions as those performed by the later; that is they act as administrator's of the economy's payments system and as financial intermediaries. They are needed in both systems for the same reason- for the exploitation of imperfectness in financial market. These imperfections include imperfect divisibility of financial claims, imperfect information, transaction costs of search and acquisition, diversification by the surplus and deficit units, and existence of expertise economies of scale in monitoring transactions.[46] The major functions of a conventional bank may be classified as:

1. Deposit creation
2. Financing
3. Agency services
4. Issuing LC's, LG's
5. Advisory services
6. Other related services

Financial intermediaries in an Islamic bank, which operates in accordance with the principles of Islamic *Shariah*, can reasonably be expected to exhibit economies of scale with respect to these costs, as do a conventional bank. Many of the services handled by the conventional banks and not related to interest, such as LC's, collections, foreign exchange, financial advising etc. are performed by Islamic banks. Some Islamic banks handle a large percentage of its money in the commodities markets. If it is considered that banks and financial institutions measure their success in terms of Return on Assets (ROA), the commodity transaction can be developed to achieve the goals of the parties

[46] Iqbal, Zubair and Mirakhor, Abbas, Islamic Banking, Washington D.C. p. 3.

concerned-the Islamic bank, the conventional bank and the client of the conventional bank.[47]

On the other hand, due to the nature of operations, there are a lot of differences between Islamic and conventional banking. While comparing the two banking systems, one will observe that the most important departure of Islamic banking system from the conventional banking system is the prohibition of *Riba*, and the concentration on *bai'* or selling and buying activities. The main purpose of Islamic banking is avoidance of *riba*, which is *haram* and prohibited in *Shariah* and enabling a *halal* and pure earning for the customers, employees and shareholders of an Islamic bank. Thus, one may say, that a conventional bank earns the major profit of its revenues and expenses on the basis of interest, while an Islamic bank earns the same on the basis of profits arising from trade and business. Again, the former actually participate in production and commerce by taking an equity stake, whereas the latter's interest in commerce and production is limited to the interest it can get in addition to receiving the principal. From this prospective the major differences between Islamic and conventional banking systems are as follows:

a) A conventional bank finances its customers based on the contract of loan where the bank is the creditor and the customer is the debtor. Thus, it is creditor-debtor relationship. On the other hand, the relationship between Islamic banks and their customers is not that of debtors and creditors, but one of participation in risks and rewards. This basic assumption leads to the following:

    1. There is no previously fixed return on the funds invested with the bank. Similarly, there is no previously fixed return on funds provided by the Islamic banks. The returns is decided, for both sides, in the light of the profit realized from the transactions in the ratio of capital participation or agreed ratio of profit-sharing.

    2. There is no liability on the Islamic banks, who is *Mudarib* (manager of funds) to owners of deposited funds (*Rab al-Maal*), except in the case of current account, to return their funds in full on demand, if the bank has not been negligent in investing funds. These funds share profit or loss resulting from the transactions, they are invested in. This is the motivating force, which compels the Islamic banks to employ its resources with more prudence and efficiency.

b) An Islamic bank is said to make a legitimate profit from its trading activity as it involves risk and efforts as compared to a conventional bank, which merely finances the customer at a fixed interest rate. In an Islamic bank it is run by a contract of sale i.e. a deferred sale contract on which the bank itself, or the bank appoints the customer to purchase the goods needed and later sells them to the client with a mark up (cost plus an agreed profit margin). The payment will be made in installments over a specific of time.

c) The nature of Islamic bank is not merely lending the money as practiced by a conventional bank; rather it is involved in buying and selling the commodity/property. Thus, the selling price, which is a cost price plus profit margin,

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[47] Qasim, M. Qasim, Islamic Banking, New Oppertunites for Copperations between Western and Islamic Financial Institutions", in Butterwords (eds.) Islamic Banking and Finance, London, 1986, pp. 19-20.

is the contracted amount. In conventional banking practice, interest is regarded as the price of the loan. For instance, if the asset is worth of Rs. 100,000/- and the interest rate is at ten percent, therefore, the price of the loan to be paid by the customer is Rs. 110,000/-

d) Profit margin imposed by an Islamic bank in some modes of finances i.e. in *Murabahah* or cost plus profit is fixed at the time of contract and must be agreed upon by the customer. Once, it is agreed upon and stipulates in the contract, it becomes and remains fixed throughout the duration of the agreed period of repayment. As a result, even if the client does not pay on time, the bank can not ask for a higher price due to delay in settlement of dues. While interest rate, which is also prefixed at the time of contract either would be unchangeable or would change according to the Base Lending Rate (BLR) that constantly monitored by the central bank.

e) Under Islamic banking system, no penalty is charged for late payment of installments. In order to get the Islamic type of finances, a customer needs to open an account with the bank and to deposit some amount of money in the account so that the deposited money could be set off in case of late payment. Nevertheless, if one has been a good paymaster to the extent that such security deposit has never been used, one is entitled to the dividends on the basis of profit and loss sharing principles. Furthermore, this deposit is merely for security reasons and it will be refunded at the end of repayment period. On the contrary, it is the usual practice of every conventional bank to charge penalty for late payment. There will be the compound interest. The longer the delay the bigger would be the compounding effect.

f) In Islamic financing, no money advanced to the clients by the bank. Instead, the bank in *Murabahah* for example, itself purchase the commodity required by the clients. Since these transactions cannot take place unless the clients assure the bank of their willingness to purchase a commodity, therefore, it is not possible at all, unless the bank creates inventory. In this way, assets always back finances in an Islamic bank.

g) Islamic banks face a risk not faced by the conventional banks. Although both have to take risks, capital adequacy, liabilities and asset matching risks, currency fluctuation and liquidity risks, the risk under Islamic banking system is higher. Islamic banks are organized mainly on the basis of profit earning arrangements permitted by Islam and both profit and loss are possible in every single deal. While in the case of lending at interest by the conventional banks, the risk of loss is borne entirely by the borrower (the client) but the lender (the bank) safeguards itself against any possibility of loss. However, some risks to which conventional banks are subject do not exist in Islamic banks. For instance, interest rate risk, since interest is prohibited in Islamic bank operations.

h) The focus of financial accounting is different in Islamic banking. While in Islamic banks the emphasis is on asset allocation, and return from investment and trade. In

conventional banks, it is on interest rate spread, provision of loan portfolios and maturities of the liabilities.[48]

i) Islamic banks cannot remain aloof about the nature of the activity for which the facility is required. They cannot finance for any purpose, which is prohibited in *Shariah*. While conventional banks are not bound by any religious restrictions. Rather, these banks may advance loans for any profitable purpose. For instance, a gambling casino can borrow money from a conventional bank to develop its gambling business.

j) Unlike conventional banks, which pool together capital fund and investors' funds, an Islamic bank keeps the two segregated, in order not to mix up the profit earned on its own funds (capital) plus current account balances, repayment of which is guaranteed, with the profit earned on investor's funds, which are accepted on a profit and loss sharing basis. This enables the bank to calculate correctly the profit due to investors.[49]

k) Islamic banks do not provide finance by offering cash loans, as is the case with conventional banks, but through participation (*Musharakah*) or through some other form of Islamic instruments like *Murabahah*, *Ijarah*, etc. A significant portion of their activities is trading, i.e. they buy goods needed by their clients and sell them at an agreed profit to the customer against ready cash or on deferred payment basis.[50]

l) Islamic banks are multipurpose banks, as they play the role of commercial banks and investment banks, as well as development banks. They operate in the short term like commercial banks, and in the medium and long term investment development banks like non-bank financial institutions, depending upon the structure of their resources. [51]

m) While the role of the conventional banks is to attract financial resources and to lend them on interest, so as to make profit, the emphasis of Islamic banks is on using their financial resources to develop the society as a whole. Profit is, no doubt, kept in sight, but that is not the main objective of their financing. The emphasis is on achieving the socio-economic objectives of the society without transgressing the injunctions of the *Shariah*. [52]

n) While, conventional banks are satisfied with the traditional review by certified auditors, Islamic banks are subjected to additional reviews by the religious supervisory boards to ensure that funds are being raised and invested in ways that conform to Islamic principles[53].

o) Whereas the Islamic banking system is value-oriented, the conventional system is value-neutral.

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[48] Al Omar, Fuad and Abdel Haq, Mohammad, Islamic Banking: Theory, Practice and Challenges, London, 1996, p. 105.
[49] Zafar Ahmad Khan, Islamic Banking and Its Operations, Institute of Islamic Banking & Insurance London, p. 5.
[50] Ibid.
[51] Ibid
[52] Ibid
[53] Ibid

Islamic bank is different from conventional bank in terms of its mission and objectives. An Islamic bank must reflect Islamic principles in real life. It should work towards the establishment of an Islamic society and deepening of religious spirit among the people.

Chapter No. 2

Islamization of the Bank of Khyber

2.1 Historical Review of the Bank of Khyber

The Bank of Khyber (BoK) was established in 1991 as a provincial commercial bank through an Act XIV of the North West Frontier Province (NWFP) Assembly. The Bank commenced its operations in November 1991 and was designated as a scheduled bank by the State Bank of Pakistan in 1994. The Bank offers full commercial facilities and is also actively involved in development activities. The purpose for establishment of BOK was geared towards meeting the banking and finance requirements of the business community of NWFP in particular and of Pakistan in general through the setting up of a commercial bank having its head office in the provincial capital.[54] The vision of the Bank is "gradual conversion into Islamic banking to develop and promote true Islamic economic system"[55] and the mission of the Bank is "to increase shareholders' value and provide excellent service and innovative products to customers through effective corporate governance, friendly work environment, and contributing towards an equitable socioeconomic growth."[56] According to the Bank of Khyber Act, 1991, the main objectives for establishment of the bank are to:

- Mobilize private savings and public funds for diverting the same to productive channels and ensure their availability;
- Promote industrial, agricultural and other socio-economic processes through the active participation of private as well as public sectors in the province;
- Help under developed areas and create employment opportunities specially in the rural areas of the province. Further to guide and assist the people of NWFP serving overseas to effectively and profitably invest their savings in the province as well as other parts of Pakistan;
- Create a diversified and sound portfolio for utilization of otherwise idle funds and their investments in the existing as well as new ventures especially in the pioneering of high-tech, agro-based, export-oriented and engineering projects to ensure maximum returns; .

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[54] Prospectus, The Bank of Khyber, p. 13, Dated: December 30, 2005.
[55] The BoK, Annual Report 2006, p. 3.
[56] Ibid, p. 4,

- Participate and seek the share of the Province in the capital market of Pakistan by way of subscription through the locally pooled resources in the leading stock exchanges of the country and eventually paving the way for the establishment of a stock market in the province; and

- Develop and promote Islamic modes of financing with a vision to convert itself into full fledged Islamic Bank[57]

The Bank of Khyber operates mainly in the North West Frontier Province (NWFP) of Pakistan in both rural and urban settings, and is headquartered in Peshawar. The NWFP constitutes 9.6% of Pakistan's land mass and accounts for 13.6% of its population. It is an agriculture-based economy with almost 62% of the population considered poor. BoK reached scheduled bank status in 1994, which enabled it to open branches outside NWFP, became a member of the clearinghouse, and to engage in trade finance activities directly. BOK's microfinance operations started in 1995, aimed at the provision of microcredit to small and medium enterprises. In 1997 BoK extended its operations to rural areas, providing smaller loans to micro-enterprises and individual clients through its cooperation with NGOs and Rural Support Programs (RSP). In 1999 BoK created its micro finance Unit as a separate profit centre, developing specific products and BoK knowledge of micro finance practices. BoK is the first formal and structured initiative by a commercial bank in Pakistan to broaden its client base and reach the micro-enterprise market. The activities of the Bank of Khyber include financing of long-term projects, micro-business and rural development, which distinguish it from other commercial banks.[58] The Bank of Khyber has 29 branches all over the country having Head Office in Peshawar. Out of these 29 branches 23 are in NWFP, 2 in Sindh, 1 each in Punjab, Baluchistan, Azad Jammu & Kashmir and Federal Capital.[59]

According to Section 8 of the Bank of Khyber Act, 1991, which can be read as " Government shall be the major shareholder of the Bank, but shall not, except for such time till shares of the Bank are floated to the public, hold more than fifty-one percent of the shares issued by the Bank."[60] The provincial government is its major shareholder, holding 87% of the capital. In pursuance with Section 8 of the Act, 1991, the Governing Board of Directors (BoD) of the Bank has passed a circular resolution on 6th December 2005, whereby the Board has resolved that, "The Government of NWFP shall bring its shareholding to 51% in the Bank of Khyber within one year of formal listing on the exchange. The reduction in the shareholding of the Government of NWFP shall be phased-out either through offer for sale to general public or by finding some strategic investors that if the sale is made to strategic investors, the offer price of one share shall not be less than the weighted average market price of the previous three months as prevailing at Karachi Stock Exchange (Guarantee) Limited from the date of an offer made to the strategic investors." The Government's shareholding in the Bank of Khyber will be 65% after the public offer.[61]

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[57] The Bank of Khyber (Amendment Act, 2004) NWFP Act No. V of 2004.
[58] www.bok.com.pk last visited on 30th September, 2009.
[59] Prospectus, The Bank of Khyber, p. 13, Dated: December 30, 2005.
[60] The Bank of Khyber (Amendment) Ordinance, 2002 NWFP Ordinance No. II of 2002.
[61] Prospectus, The Bank of Khyber, p. 14, Dated: December 30, 2005

2.2 Islamization of the Bank of Khyber

The ex-MMA Government in the NWFP through an amendment in the Bank of Khyber Act, 1991 made it obligatory that this bank should gradually but completely eliminates interest and perform all banking functions in accordance with the *Shariah*. For this purpose the following amendment were made in the Bank of Khyber Act, 1991:[62] In Section 8 of the Act, 1991 clause (f) was added, which is read as "develop and promote Islamic modes of financing with a vision to convert itself into a full fledged Islamic Bank." In Section 19 of the Act, 1991, an amendment was made to the effect that "in addition to the role that may be assigned to it to function as principal banker/treasury to Government, the Bank would carry on and transact, Islamic banking, commercial banking and investment business within the Province and subject to approval of the competent authority under the law for the time being in force; at any place/places in and outside Pakistan hereinafter specified." In Section 19 of the Act, 1991 clause (qq) was added, which is read as "to undertake Islamic banking either by opening of new branch or by conversion of its existing branch or by establishing of a subsidiary for Islamic banking or by adoption of any other mode provided under the Companies Ordinance, 1984, in accordance with the policy of the Sate Bank of Pakistan for the time being applicable."

A new Section namely Section 19.A was added to the Act, 1991. The section is read as "*Shariah* Supervisory Committee. For purpose of Islamic banking, there shall be constituted by the Board a *Shariah* Supervisory Committee, comprising of eminent *Ulema* and Scholars, well versed in *Shariah* with particular reference to Islamic economics, banking and financing. The Board shall appoint one of the members of the Committee to be its Chairman. The number of members of the Committee, including the Chairman, shall not be more than seven and less tan five. The Committee constituted under section 19.A performs the following functions;

A) Guide and advise the Board on matters concerning the financial arrangements and transactions to be made or undertaken or proposed to be made or undertaken by the Bank or on behalf of the Bank, in so far it relates to the conduct of Islamic banking by the Bank, in order to ensure that such financial arrangements and transactions are not in conflict with the injunctions of Islam as laid down in the *Holy Quran* and *Sunnah*;

B) Guide and advise the Bank on process of the conversion of the Bank and its operations from conventional banking modes and practices to Islamic banking modes;

C) Submit at least a quarterly report on the operations of the Bank to the extent of its Islamic Banking that it had remained in conformity with the injunctions of Islam and served Islam's socio-economic objectives and values;

D) Design, develop and approve instruments and products to facilitate the dealings and operations of the Bank in accordance with the injunctions of Islam;

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[62] The Bank of Khyber (Amendment) Ordinance, 2002 NWFP Ordinance No. II of 2002.

E) Suggest and recommend the smooth switch-over of the existing branches of the Bank to Islamic modes and opening of new branches in line with the Sate Bank's policy of Islamic banking;

F) Organize and oversee such training and orientation programs, seminars and workshops for personal of the Bank as may be needed for the purpose of Islamization and improvement of the operations and the performance of the Bank;

G) Lay down its rules of business;

H) Form sub-committees for its assistance; and

I) Perform such other functions, as may be assigned to it by the Board.[63]

The decisions of *Shariah* Supervisory Committee so far it relates to the determination of the rules and principles of *Shariah* relevant to the operation, modes of financing and transactions of the Bank are final and binding. The Bank of Khyber has taken the first step towards Islamic banking and for this purpose an Islamic Banking Division (IBD) has been established to complete the necessary regulatory and operational formalities thereby paving the way for conversion of all branches of BoK into Islamic Banking Branches (IBB's). So far, the Bank has converted following branches into I.B.B.

a) Hayatabad Branch
b) Quetta Branch
c) Bannu Branch
d) Nowshera Branch
e) Timergara Branch
f) Hangu Branch
g) Tank Branch
h) Mingora Branch
i) Quetta Branch
j) Charsadda Branch[64]

2.3 The *Shariah* Supervisory Committee of the Bank of Khyber Islamic Banking Division

In order to establish *Shariah* Supervisory Committee for the purpose of Islamic banking in BOK, the Government of NWFP formed a *Shariah* Supervisory Committee to guide and supervise BOK for its stage wise conversion into a full-fledged Islamic Bank. In addition to it, the Committee reviews the activities and approves the products and services offered by the BOK's IBB's to ensure that all their activities are *Shariah* compliant. All of the Islamic Banking Division's products and transactions are carried out in full compliance with *Shariah* Supervisory Committee's pronouncements. *Shariah* Supervisory Committee plays a vital role in guiding, supervising the implementation and compliance of Islamic *Shariah* principles in all activities of BOK-IBD.[65]

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[63] Section 19.A of The Bank of Khyber (Amendment) Ordinance, 2002 NWFP Ordinance No. II of 2002.
[64] Prospectus, The Bank of Khyber, p. 18, Dated: December 30, 2005
[65] Ibid

The *Shariah* Supervisory Committee comprises of well renowned scholars and economist of national/international repute with a strong background in law and economics. Currently Professor Khurshid Ahmad, as Chairman of the *Shariah* Supervisory Committee, heads the Committee. Other members are as follows:

1. Maulana Muhammad Taqi Usmani
2. Dr. Mahmood Ahmad Ghazi
3. Mufti Ghulam-ur-Rehman
4. Dr. Shahid Hassan Siddiqui
5. Professor Muhammad Abbas

2.4 The Bank of Khyber Islamic Banking Division (IBD)

The BOK has established Islamic Banking Division in January 2003. The aim and target of the IBD is to gradually convert the BOK into an Islamic Bank in accordance with the clause (qq) of Section 19 of The Bank of Khyber Act, 1991, which is reproduced as "to undertake Islamic banking either by opening of new branch or by conversion of its existing branch or by establishing of a subsidiary for Islamic banking or by adoption of any other mode provided under the Companies Ordinance, 1984, in accordance with the policy of the Sate Bank of Pakistan for the time being applicable." In order to achieve this target, the Islamic Banking Division has devised an action plan for expansion and conversion of the Bank and to develop Islamic Banking business in various areas. According to this action plan BOK had converted many of its branches to Islamic Banking Branches as listed above.[66]

Apart from branch expansion, the IBD is planning to start accepting deposits on *Shariah* compliant modes from the conventional banking branches of BOK, as permitted by SBP. Disbursement of funds under Islamic financing modes through other branches of the Bank is also expected to commence in the near future. Presently, the Bank's Islamic Banking Branches are offering credit facilities, which include *Ijarah*, *Murabahah*, *Musharakah* and Diminishing *Musharakah*. The branches invest their idle funds through the Bank's Treasury in the Capital Markets, and also place funds with other Islamic Banks.[67]

[66] Prospectus, The Bank of Khyber, p. 18, Dated: December 30, 2005
[67] Ibid

Chapter No. 3

DEPOSITS AND PROFIT SHARING MECHANISM OF THE BANK OF KHYBER ISLAMIC BANKING DIVISION

3.1 Sources of Funds

There are two main sources of fund of the Bank of Khyber Islamic Banking Division, namely equity and deposits.

1. Equity

The shareholders of the Bank of Khyber Islamic Banking Division provide this part of the capital of the Bank. Presently, the Government of NWFP holds 51 % of the shares of the BOK. The remaining 49 % shares of the Bank are held by the general public. In other words, 51 percent of the capital is contributed by Government of NWFP, while the remaining 49 percent is contributed by the general public.

2. Deposits

Currently, the Islamic Banking Division of the BOK is offering the following deposits schemes to the customers:

a) Current Accounts
b) Interest Free PLS Accounts
c) Riba Free Certificates

3.1.1 Current Accounts

The current account of the BOK IBD is based on the concept of *Qard-e-Hasanah*. Under this scheme, the Bank is liable for loss even without negligence. The Bank is eligible to use the deposits for further investment. The funds received in current accounts are not used in any interest-based activities. The Islamic Banking Branches (IBB's) of the BOK provide almost all those services to the holders of current accounts, which are provided by the other conventional banks to their current account holders. The minimum balance to open current account with IBB of the Bank of Khyber is Rs. 500.[68]

[68] www.bok.com.pk last visited on June 30th, 2009.

Salient Features of Current Account

The salient features of the current account of the Bank of Khyber Islamic Banking Division are described in the following lines:

1. It is based on the concept of *Qarz-e-Hasanah.*
2. The account holder can withdraw his deposits at any time without giving any notice to the Bank.
3. The Bank has the right to utilizes the funds in current accounts i.e. invest it.
4. The depositors are not entitled to any profits.
5. The depositors are not liable for any losses in case of current account deposits.

3.1.2. Interest Free Profit & Loss Accounts

The deposits in the Profit and Loss Saving (PLS) Accounts are accepted on the basis of *Musharakah.* The minimum required balance to open Interest Free PLS Account with the Bank is Rs. 500. The Bank then invests these deposits along with its contributions in a pool that consists of *Murabahah, Ijarah* financing, Diminishing *Musharakah* and *Musharakah* financing. The profits earned on these accounts are calculated every month, but it is disbursed six monthly in January and July of every calendar year. Every customer is eligible for the profit without the condition of any minimum balance.[69]

Salient Features of Interest Free Profit & Loss Accounts

The Interest Free PLS Account of the Bank of Khyber Islamic Banking Division has the following salient features:

1. It is a normal saving account product of the Bank.
2. The deposits are accepted on the basis of *Musharakah* principle of Islamic finance.
3. It is similer to conventional partnership.
4. All partners have equity stake including the Bank.
5. All deposits are invested in *Shariah* compliant business approved by the *Shariah* Supervisory Board (SSC) of the IBD.
6. All the partners share in the financing business.
7. Minimum required balance to open this Account is Rs.500/-
8. Minimum average deposit for eligibility of profit is Rs.5, 000 /-

[69] www.bok.com.pk last visited on June 30th, 2009.

9. Profit announced every month, but credited in January and July of every calendar year.
10. Profits are calculated by using weightages for each type of deposit.
11. Profit rates and weightages are derived and announced on a monthly basis.
12. If at anytime during the month the minimum deposit falls below Rs.5, 000, then no profit is paid to the Account Holder.
13. Profit is calculated on individual accounts, and not on multiple accounts grouped together, of the same Account Holder

3.1.3. *Riba* Free Certificates (RFCs)

RFCs are deposit certificates. It is a certificate of *Riba* free investment like a conventional term certificate. This is based on the concept of *Musharakah.* It is available for five tenures. They are:

a) Six months
b) Twelve months
c) Two years
d) Three years, and
e) Five years.

The minimum investment for RFCs is Rs. 10,000/-. Profits rates are announced every month, but are paid in January and July of the calendar year. All deposits are invested in *Shariah* compliant business approved by the *Shariah* Supervisory Board of the IBD.[70]

Salient Features of *Riba* Free Certificates
The RFC's of the Bank of Khyber Islamic Banking Division has the following salient features:

1. They are called RFSc.
2. It is a certificate of *Riba* free investment
3. It is just like a conventional term certificate
4. The deposits are accepted on the basis of *Musharaka* principal of Islamic finance.
5. They are issued for five tenures, namely, six months, one year, two years, three years, and five years.

[70] Ibid

6. Minimum opening required deposit is Rs. 10,000/-
7. Profit rates announced every month.
8. Profits are paid in January and July
9. Profit is calculated on a daily product basis
10. All deposits are invested in *Shariah* compliant business approved by the *Shariah* Supervisory Board of the IBD.

3.2 Profit Sharing Mechanism of The Bank of Khyber Islamic Banking Division

The profit sharing mechanism of the Islamic Banking Division of the Bank of Khyber is almost similar to the profit distribution mechanism of other Islamic banking institutions in Pakistan and around the world. The customers deposits along with the IBD (BOK) contribution go into a pool of funds based on *Musharakah*. The IBD as the partner (*Musharik*) invests these funds in *Shariah* compliant businesses approved by the *Shariah* Supervisory Board (SSC) of the IBD. The relationship between the depositors and the Bank is that of partners (*Musharkeen*) in funds. The partners share in the financing businesses. The accrued profit from the investment of the Pool Funds is shared among the funds providers on the basis of respective weightages assigned to different types of deposits by the Bank. The Bank's income from other sources, such as service charges, proposal examination fees, etc. is not divided among the depositors. The income allocable to equity holders of the Bank come from the following three sources:

a) Management Fee
b) Income from other Sources
c) Income allocated to Equity from distributable income.

The profit applicable on deposits and RFC's is based on weightages after the following deductions are made from the income of the Pool of *Musharakah*: a) Actual Administration Cost, b) Management fee based on pre-declared percentage of the total profit not exceeding thirty percent. The Bank declares the percentage of management fee at the beginning of each month, c) Stabilization reserve. In calculating the profit applicable to interest free PLS Saving Accounts, the Bank deduct an amount as a contribution to a Stabilization Reserve, which is used to cover unexpected losses or reduction in profit for any month in a manner provided by the Shariah Supervisory Board of the IBD.

System of Weightage

The Bank has assigned specific weightages to all the partners in the *Musharakah* Pool of the IBD. Different weightages have been assigned to various types of depositors. The system of weightages is used to accommodate a variety of depositors with varying tenures and amounts. The depositors also continuously close their accounts or decrease their balances with the Bank. To solve this problem, the Bank assigns a weightages to a

specific deposit based on its amount and the tenure, so as to create a balance in profit returns to the various deposit categories. The Bank can change weightages on need basis. However, the weightage of the Bank can not be higher than double the maximum weightage allowed to any depositor group. In nutshell, the system of wieghtages adopted by the BoK IBD has the following characteristics:

a. Weightages are declared before start of any period for which a pool is created.

b. Weightages are decided by the management of the Bank. For this purpose the management may adopt any criteria to decide weightages of different classes of depositors/investment such as PLS depositors, RFC holders, etc.

c. Criteria set for determining weightages shall be uniformly.

d. PLS deposits can be divided into categories on the basis of amount of deposits such as below 10 Million, upto 50 Million, etc.

e. Weightages of equity cannot be more than two times of highest weightages of any class of deposits or RFCs.

f. Weightages of all deposit classes and categories as well as equity shall be declared before start of every related period.

g. In case, the Bank cannot contribute his equity as declared by the Bank at start of a period, his weightages shall have to be reduced in proportion to the shortfall in required equity at the time of applying the weightages to the equity.

h. Bank can apply a lower weightages as compared to the declared weightages for equity at the time of profit distribution.

i. Weightages of any class or category of deposit including equity cannot be negative.

j. In case of loss weightages shall be ignored.

k. Special weightages shall not be allowed to any particular customer to shift more profit to that customer as it is against social justice.

l. Weightages and other terms of a Pool once declared or accepted by the customer, can not be changed before liquidation of a Pool.

m. Weightages should be displayed on notice board of Islamic banking branches (IBB's) as well as on website of BoK at the start of a period.

Category	Weightage
a) Interest Free PLS Saving Account	
Less Than 1 Million	1.000
I Million Upto 5 Million	1.030
5 Million Upto 10 Million	1.060
10 Million and above	1.090
b) *Riba* Free Certificates (RFC's)	
RFC's 6 Months Maturity	1.090
RFC's 1 Year Monthly	1.158
RFC's 1 Year Quarterly	1.168
RFC's 1 Year Six Monthly	1.178
RFC's 1 Year Maturity	1.192
RFC's 5Year Monthly	1.910
RFC's 5 Year Quarterly	1.920
RFC's 5 Year Six Monthly	1.930
RFC's 5 Year Maturity	1.984
Equity	3.968
Management Fee	30 %

Basis of Profit Calculation

The minimum average balance required for profit sharing is Rs.5000/-. Average balance is calculated on the basis of daily product. For the first month of money deposit, average balance is calculated on the basis of number of days from the date of deposit to end of month and not the total number of days of month. The profit is payable on the basis of daily product. The tire of deposit and rates applicable are decided on the basis of monthly average of daily products. The depositors share profits and losses on the basis of daily product of balances at the day end in the account during the tenure of the Pool i.e. from start till its constructive or actual liquidation whichever is earlier. The *Musharakah* Pool of the IBD comprising of:

a) Saving Account Holders – Amount Tier Wise

b) RFC's Depositors – Maturity Profile Wise

c) Equity of the Bank

Pool for RFC's and Saving Account

The Bank has a single Pool of asset for both RFC's and Saving Accounts, which is working on the principle of *Musharakah* as discussed above. All funds of Pool are invested in any *Shariah* compliant business which is declared before start of any period

Statement 'A'

Statement of Average Remunerative Liabilities

S. No.		Average
1.	PLS Savings Deposits(Rs.5, 000/- to Rs. 999,999/-)	31,369,359
2.	PLS Savings Deposits (Rs. 1,000,000 to Rs. 4,999,999/	27,907, 398
3.	PLS Saving Deposits (Rs. 5,000,000/- to Rs. 9,999,999/-	-
4.	PLS Saving Deposits (Rs. 10,000,000/- and Above	-
5.	RFC 6 Months	59,236,500
6.	RFC 1 Year	5,503,333
7.	RFC 1 Year	-
8.	RFC 2 Years	200,000
9.	RFC 2 Years	-
10.	RFC 2 Years	-
11.	RFC 3 Years	-
12.	RFC 3 Years	-
13.	RFC 3 Years	-
14.	RFC 5 Years	10,680,000
15.	RFC 5 Years	-
16.	RFC 5 Years	-
	Total Average Deposit Base	134,896,590
17.	Equity (10 % of earning assets and Pool's SLR)	60,000,000
18.	Borrowing from BOK	30,000,000
		224,896,590
19.	Current Account (Balancing Figure)	5,215,439
		230,112,029

Utilization of Funds

The use of the funds invested is ascertained by grossing up: a) average *Murabahah* Balance based on those allocated at the beginning of the month b) average *Ijarah* Balance based on those allocated at the beginning of the month c) average placement through treasury d) 11 % of the average deposits mobilized are added for the purpose of Statutory Liquidity Requirement (SLR) e) Balance, if any, is treated as kept in a non-earning current account. Statement 'B' shows the total investment of the BoK IBD for the year 200Y.

Statement 'B'

Statement of Average Fund Employed

1	*Murabahah* Financing	185,588,920
2	*Ijarah* Investment	5,684,484
3	Treasury Investment	24,000,000
	Total Earning Assets of the Pool	215,273,404
4	SLR@ 11 % of Average Deposit Base	14,838,625
		230,112,029

All placements of the funds by the Islamic Treasury are in the companies which fulfil the criteria of Dow Jones Islamic Index. An approved list of companies is maintained in which the Islamic Treasury is allowed to invest. Similarly, an approved list of Islamic banks is maintained where Islamic Treasury can place its idle funds. The return from earning assets of the pool (*Murabahah*, *Ijarah*, Diminishing *Musharakah*, *Musharakah*, and Placement through Treasury) is calculated. Net return is calculated by deducting proportionate administration cost at actual and management fee upto a maximum of 30 % of the return on earning assets. Stabilization Reserve is deducted to arrive at distributable income. This ratio cannot exceed $1/10^{th}$ of the Gross Distributable Income. It can be applied at a lower ratio at the discretion of the Management. The Bank has discretionary power to waive both the administrative expenses and management fee fully or partially. The rate are calculated and declared monthly as the Pool is constructively liquidated at end of each month and created simultaneously. The rates are declared and paid where required within five working days of the constructive liquidation. In case of actual liquidation, Bank may calculate actual profit and loss and distribute profit in reasonable time period. Income from all earning assets of the Pool during the life of the Pool is added up. Any income which may be considered doubtful is immediately transferred to a specific reserve where it remains placed till its clearance from SSC. The net distributable income is distributed among depositors and equity as per weightages declared before start of a period. Higher profit rates or any extra benefit as a gift is not allowed to any customer. Income on termination of *Ijarah* or loss is treated as profit or loss of the Pool to which the asset relate. The holders of current accounts are not eligible for profit. So any profit accruing to current accounts goes to the Bank (shareholders). Statement 'C' shows the profit generated from investment in the financial year 200Y.

Statement 'C'

Break up of Pool Income

1	Profit on *Murabahah* Financing	931,756
2	Profit on *Ijarah* Investment	85,732
3	Profit from Treasury Investment	508,175
	Total Income	1,525,663
4	Admin Expenses	960,514
5	Management Fee	76,283
6	Stabilization Reserve	-
7	Provisions against NPLs	-
	Net Distributable Income	488,866

Profit Rates Declaration Sheet

S #	Deposit	Average Balance	Weight-age	Weighted Av. Deposit	Income Allocated	Rate	Rate Rounded
1	PLS Saving Dep. (5,000/- to 999,999/-	31,369,359	1.000	31,369,359	67,742	2.59%	2.60%
2	PLS Saving Dep. (Rs. 1 M to Rs.4,999,999/-	27,907,398	1.030	28,744,620	62,074	2.67%	2.70%
3	PLS Saving Dep. (Rs. 5 M to Rs.9,999,999/-	-	1.060	-	-	0.00%	0.00%
4	PLS Saving Dep. (Rs.10 M and Above	-	1.090	-	-	0.00%	0.00%
5	RFC 6 Months	59,236,500	1.090	64,567,785	139,433	2.82%	2.80%
6	RFC 1 Year (6 Months)	5,503,333	1.178	6,482,926	14,000	3.05%	3.10%
7	RFC 1 Year (Maturity)	-	1.200	-	-	0.00%	0.00%
8	RFC 2 Years (6 Months)	200,000	1.300	260,000	561	3.37%	3.40%
9	RFC 2 Years (Yearly)	-	1.350	-	-	0.00%	0.00%
10	RFC 2 Years (Maturity)	-	1.380	-	-	0.00%	0.00%
11	RFC 3 Years (6 Months)	-	1.430	-	-	0.00%	0.00%
12	RFC 3 Years (Yearly)	-	1.480	-	-	0.00%	0.00%
13	RFC 3 Years (Maturity)	-	1.500	-	-	0.00%	0.00%
14	RFC 5 Years (6 Months)	10,680,000	1.700	18,156,000	39,208	4.41%	4.40%
15	RFC 5 Years (Yearly)	-	1.750	-	-	0.00%	0.00%
16	RFC 5 Years (Maturity)	-	1.750	-	-	0.00%	0.00%
17	Borrowing from BOK	30,000,000	1.060	31,800,000	68,672	2.75%	2.80%
18	Equity	60,000,000	0.750	45,000,000	97.177	1.94%	1.90%
TOTAL		**224,896,590**		**226,380,690**	**488,866**		

Sharing of Loss between the Bank and the Pool

The Bank follows the following policy in case of loss: General Stabilization Reserve or any other reserve shall be used to meet the specific loss causing the declaration of loss. The Bank management may absorb the administrative expenses wholly or partially for the period. The Bank may also reduce the weightages of equity upto zero. However, equity cannot be given negative weightage. In case of loss the Bank ignores weightages for distribution of loss. The declared loss is meet from the previous periods profit kept under profit payable for individual depositor/RFC holder. The Bank declare reasons for incurring such loss in the press note, circular to branches and declared on the web site. Full details of the loss are provided to a customer on demand. In case, a depositor desires to close his account after declaration of loss. He will be allowed to close as per term and conditions of Account. IBD shall calculate the loss and after vetting of the *Shariah* Advisor, shall declare the same with approval of the Managing Director. A depositor shall not share any profit or be liable for any loss if he closes his account before liquidation of the Pool. The Bank obtains *Takaful* cover of all assets which are in ownership of the Islamic Banking.

3.2.1 *Shariah* Appraisal of Bank of Khyber Islamic Bank Division Profit Sharing Mechanism

The Council of Islamic Ideology of Pakistan in its Report (2002) remarked that for the purpose of profit/loss distribution, the respective capital contributions of the parties, utilized for different periods, would be brought to a common denominator by multiplying the amounts with the number of days during which each particular item such as equity capital of the firm, its current cash surpluses, suppliers' credit as well as the finance provided by the bank were actually deployed in the business. In other words, the calculation of the respective capital contributions of the parties would be made on daily product basis. However, in no case the highest multiple to be used for calculating the daily product can exceed the total number of days covered by the accounting period. This is because it is in this period that the funds will have effectively contributed to the operating results of the firm.[72]

The Council stated on another occasion that distribution of profits/losses of banks would be computed by setting off the administrative expenses, payments due to the State Bank and other banks in respect of the accommodation provided by them, provision for taxes, and appropriation for reserves from the total earnings. The amount so arrived at would be distributed among capital and reserves and savings and fixed deposits while holders on current account deposits would share neither in the profit nor in the loss, if any.[73] However, according to Syyid Tahir, in principle, in a *Mudarabah* personal expenses of the *Mudarib* –the working partner- are his personal responsibility. And, only those expenses are admissible as costs of the *Mudarib* that are payable to third parties in lieu of *Mudarabah* operations. This principle also applies to working partners in the framework of *Musharakah*. A corollary of the principle is that banks should not claim their overhead expenses as costs in the management of *Mudarabah* or *Musharakah* based deposits. Of course, they can address their concerns in this regard through claim a higher

[72] CII, op. cit. pp. 27-28.
[73] CII, op. cit. pp. 67-69.

percentage of profits for themselves. Moreover, if need be, they can seek interest-free loans from the *Mudarabah* or *Musharakah* pools in order to meet contingencies, and adjust these loans against their share of profits.[74]

The calculation of the profit/loss would be made on the basis of daily product of the amounts. These daily products would be assigned different weights so as to ensure an edge for capital and reserves and long-term deposits. The weights would be described by the State Bank of Pakistan. The period of fixed deposits would be six months and its multiples. Profits/losses would be computed and distributed at 6 monthly intervals.[75] However, according to Sayyid Tahir, conflict with the *Shariah* is not resolved for the following reasons:

a. There always remain the possibility of profits belonging to one group of depositors being passed to another, and losses of one category of deposits shifted to another. This issue cannot be ignored as either trivial or irrelevant on grounds of no objection from the depositors. The *Shariah* is divinely ordained code of acceptable conduct. Where the lines are clearly drawn by Allah (SWT) and His Prophet (SAWS), there is little room for human discretion (*al-Hujuraat* 49:1).

b. Application of the daily-product method along with reduction in the period in the calculation of profits and losses may lessen the above problem. But reliance on the daily product method needs review for the following reasons: Firstly, it is well-known that *Ijtehad* in the sense of taking a new position is admissible when the *Shariah* is silent on a matter. Thus, one could make recourse to daily product method if the *Shariah* were silent on principles for settlement of accounts. But, as noted above, this is not the case here. Secondly, the daily product formula applies ex post facto. Thus, a depositor cannot form an opinion about his actual share, in percentage terms, at the time of entering into the contract. In this sense, the daily product arrangement has *gharar*. Thirdly, the principle of consent (*An-Nisaa'* 4:29) of the actual owners-----depositors in the present case------- needs to be respected in both letter and spirit in the design of any settlement arrangement. This, in turn requires, that there should be some arrangement for bringing into the picture the depositors' point of view after profits actually arise, not before. The daily-product method misses this point.

The same view is also expressed by Ahmad El Tegani in his article titled "Distribution of Proft in Islamic Banking: A Case Study of Faysal Islamic Bank of Sudan". According to him with regards to profit distribution of the Bank, the first problem is, how can the Bank determine the actual profit of every holder of an investment account? The Bank's money is invested in various products. Some of these may be completed before the end of the financial year, and their profit known. However, some of them are not, so the Bank can not determine the profits from these uncompleted projects. The right of every holder of an investment account to withdraw part or all of his money at any time, also makes it difficult for the Bank to determine the actual profit for any financial year. The second problem is that the Bank cannot use all the money available for investment, either because the regulations do not allow them, or because funds available for investment are larger than the Bank's investment portfolio. Third, it is

[74] Sayyid Tahir, "Unresolved Issues in Islamic Banking and Finance: Deposit Moblization", op. cit., p. 96.
[75] CII, op. cit. pp. 67-69.

difficult for the Bank to determine how much of the invested money is its own, and how much belongs to the holders of the investment accounts.[76]

According to Syyed Tahir, the above problems are avoided if investment of the deposits in different categories and their accounts are separately maintained. In passing, it may be mentioned that the *Fiqhi* principle of *Al-Kharaj bi Zaman* warrants that the Banks also shoulder the obligations for *Shariah* compliance, as proposed above, in order to justify their entitlement to profits allowed to them by virtue of economic of scale. Notwithstanding, the above, however, a disaggregated approach to management of funds has its own advantage. For example, separate handling of deposits in different categories and the maintenance of separate accounts for them will reduce the chances of bank failure and improve banking stability.[77] The CII has given the following hypothetical exercise for the illustration of profit/loss distribution among the equity holders and savings and fixed deposits holders.[78]

1.	Bank's Capital Reserves	200
2.	Bank's Total Earning	1000
3.	Administrative Expenditure, Payments due to State Bank, and Other Banks Provision for Taxes and, Appropriation for Reserves	300
4.	Distributive Profit	700

[76] Ahmed, El Tegani A., "Distribution of Profits in Islamic Banking: A Case Study of Faysal Islamic Bank of Sudan (FIBS)", J. KAU: Islamic Economics, Vol. 8, pp. 15-32 (1996).
[77] Sayyid Tahir, "Unresolved Issues in Islamic Banking and Finance: Deposit Mobilization", op. cit., pp. 93-95.
[78] CII, op. cit. pp. 67-69.

Profit Distribution would be as follows:

Particular	Amount	Period of Deployment	Product of I & II	Weights	Weighted Daily product	Share Profits (Amount)
	(I)	(II)	(III)	(IV)	(V)	(IV)
1. Capital & Reserves	200	180 Days	36,000	1.00	36,000	119.7
2. Saving Deposits	200	90 Days	18,000	0.30	5,400	17.9
3. Fixed Deposits						
(I) 3-6 Months	200	180 days	36,000	0.30	10,800	35.9
(ii) 6 Months to 1 year	200	180 Days	36,000	0.40	14,400	47.9
(iii) 1-2 Years	200	180 Days	36,000	0.60	21,600	71.8
(iv) 2-3 years	200	180 Days	36,000	0.70	25,200	83.7
(v) 3-4 years	200	180 Days	36,000	0.80	28,800	95.7
(vi) 4-5 years	200	180 Days	36,000	0.90	32,400	107.7
(vii) 5 Years and Above	200	180 Days	36,000	1.00	36,000	119.7
				Total	**210,600**	**700.0**

In case of loss the respective shares in losses would work out as follows:

1. Bank's Total Earnings: 100
2. Administrative Expenditure: 300
3. Total Loss: 200

Particulars	Amount	Period of Deployment	Product of I & II	Share in Loss
	(I)	(II)	(III)	(IV)
1. Capital & Reserves	200	180 Days	36,000	23.53
2. Saving Deposits	200	180 Days	18,000	11.76
3. Fixed Deposits:				
(I) 3-6 Months	200	180	36,000	23.53
(ii) 6 Months to I Year	200	180 Days	36,000	23.53
(iii) 1-2 Years	200	180 Days	36,000	23.53
(iv) 2-3 Years	200	180 Days	36,000	23.53
(v) 3-4 Years	200	180 Days	36,000	23.53
(vi) 4-5 Years	200	180 Days	36,000	23.53
(vii) 5 Year and Above	200	180 Days	36,000	23.53
		Total	306,000	200.0

3.2.2. Recommendations

1. The State Bank of Pakistan should exempt Islamic banks including the Bank of Khyber Islamic Banking Division from statutary reserves due to policy prospective, because they do not utilize the discount window and the last resort function of the central bank, and they do not participate in multiple deposit creation. The negative effect of the reserve ratio reveals the opportunity cost of holding reserves. In fact, since deposits in Islamic banks are treated as shares, and accordingly their nominal values are not guaranteed, holding reserves hurts Islamic banks and their depositors in two ways. Firstly, holding reserve requirement reduce the amount of funds available for investment and hence the expected returns. Secondly, reserves do not yield any return to the banks, and therefore, depositors are uncompensated for that part of their deposits.

2. The Bank should have a clear policy with regard to basis for allocating expenses to equity holders and various classes of deposits for determination and appropriation of profit as well as for profit sharing ratio and weightages for distribution of profit among various categories of deposits and periodicity for changing the same. The Bank should display the applicable profit sharing ratio and weightages for each type of deposits in the branches and website of the Bank for information of the general public. This policy statement should be vetted by the *Shariah* advisors and approved by BOD regarding the policies and procedures to safeguard the interest of the profit and loss sharing based deposit holders. The areas to be covered under the policy for profit and loss distribution may include the followings:

a) Identification and determination of pool of assets.

b) Related income and the basis of such determination together with method for allocation of profit and loss between the PLS depositors and the Bank.

c) Policy on the priority for investment of the Bank's owns funds and those of PLS depositors.

d) Basis for allocating expenses to equity holders and various classes of depsoitotrs for determination and appropriation of profit.

e) Profit sharing ratio and weightages for distribution of profit and policy for charging provisions non-performing assets in compliance with Prudential Regulations.

f) The Bank may invest their surplus funds in shares of such companies whose primary business is not prohibited under *Shariah.*

g) In case a portion of non-*Shariah* compliant income exists, the income of the Bank from dividends shall need to be purified and the Bank's share of non-*Shariah* compliant income shall be donated to charity.

h) The Bank should follow the regulatrory limits prescribed by the SBP in Preduential Regulations in terms of their aggregate exposure in shares.

3. The Bank should also have a clear policy with regard to identification and determination of pools assets and related income and the basis of such determination together with method for allocation of profit/losses between the PLS depositors and the Bank (as *Musharik*), whether or not the Bank participates in the investment with its own funds. Also, it should a clear policy on the priority for investment of own funds and those of PLS depositors. This policy statement should be vetted by the *Shariah* advisors regarding the policies and procedures to safeguard the interest of the profit and loss sharing based deposit holders.

4. The Bank reports all deposits as its liabilities, and all its advances (bank investment) as assets in its balance sheet. This principle may be adopted for deposits acquired on loans, such as demand deposits, but not for investment deposits mobilized on partnership basis. The reason is that ownership of funds under *Musharakah* rests with the depositors. The Bank shares this ownership just for operational purposes. Since their ownership is not transferred to the Bank, such deposits are not liability of banks in the traditional sense. By the same token, any investment made from such deposits is assets of the Bank alone. Thus, the investment deposits and financing from them should be off-balance sheet items for the Bank, and only their share of profits should appear in the Bank income statement.

Chapter No.4

Practices of the Bank of Khyber Islamic Banking Division in the Utilization of Funds

The practices of Islamic banking branches of the BOK with regard to assets mark a more significant departure from conventional banking branches than their practices with regard to liabilities. This is so for obvious reasons. CBB's usually resort to lending on interest in order to satisfy a variety of financing requirements. This mode of financing is not available to IBB's because of the prohibition of *Riba* (interest). Therefore, Islamic Banking Division has developed financing techniques of *Ijarah, Murabahah* and Diminishing *Musharakah*. They are approved by the Shariah Supervisory Committee of the BOK IBD. The customers can be financed on the basis of any one of these modes of finance. The Islamic Banking Division of the Bank of Khyber uses the following financing techniques in the uses of its funds:

1. *Ijarah*
2. *Murabahah*
3. Diminishing *Musharakah*

4.1. *Shariah* Principles of *Ijarah*

Definition

Literal Meaning:

The word '*Ijarah*' is derived, from the Arabic word '*ajar*', which means 'reward' It means "possession of a usufruct for a consideration"[79] or 'to give something on rent'.[80] The Malikis mostly confines the word "*Ijarah*" contract to the human usufruct and the moveable objects other than vessels and animals. They call the contract on usufruct of land, houses vessels the word "*Kira*", so they said that "*Ijarah*" and "*Kira*" have the same meaning.[81]

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[79] *Al-Mabsut* 15/74, 1st Edition.
[80] Syed Sabiq, *Fiqh al-Sunnah*, vol. 3, p. 198; al-Dardir, Ahmad, *al-Sharah al-Saghir*, volume 4, Page 6.
[81] Al-Dardir, Sydi Ahmad, *al-Sharh al-Kabir* (Beirut, *Darul Fekr Le Tabahah Wa Nashr Wa Tawzeeh*) volume 4, p. 2.

Technical Meaning:

The word *Ijarah* is used for two different situations. In the first place, it means to employ the services of a person on wages given to him as consideration for his hired services. The person hired for services is called *ajir*, who is either *ajir khas*, the employee or *ajir mushtarak*, i.e. independent contractor. *Ajir khas* renders services for one person, while *ajir mushtrak* works for a large number of people i.e. tailor, ironsmith, etc. The second type of *Ijarah* relates to the usufructs of assets and properties, and to the services of human beings. *Ijarah* in this sense means to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him. The lessor is called *'Mu'jir*, the lessee is called '*musta'jir* and the rent payable to the lessor is called *ujrah*.[82]

The above is a brief definition of *Ijarah* which combines almost intentions of jurists regarding definitions presented by them which reflect the nature and some features of *Ijarah*. The jurists have formulated various definitions of *Ijarah* keeping in view its different principles. The Hanafis have defined it a contract which enables possession of particular intended usufruct of the leased asset (*Ayn*) for a consideration. Some jurists stipulated that the usufruct from the leased asset should be intended while others explained that what is meant by it is considerable intentions in light of *Shariah* and reasoning and not mere intention.[83] The Malikis have defined the term *Ijarah* as "a contract which relates to permissible usufructs for a particular period and a particular consideration not arising from usufruct".[84] The Shafie School of *Fiqh* have defined it as "a contract for a defined intended usufruct liable to utilization and accessibility for a particular recompense".[85] While, Hanbali school of *Fiqh* defined it as "a contract for a particular permissible usufruct which is taken gradually for a particular period and a particular consideration".[86]

***Manfahah* (Usufruct) of the Leased Asset**

This is the objective of the contract of *Ijarah*. It may be in the form of the services of a man or benefit of an animal, etc. The usufruct should be such, which is permissible under the *Shariah* and can be maintained in its original shape. All those things, which sale is prohibited in *Shariah*, their lease is also prohibited in Islam.[87] The subject matter of *Ijarah* is either lease of usufructs of a particular assets or lease of usufructs described on liability. The lease of an asset is the lease of the usufruct of a particular asset such as: property, animal, or human benefit. The lease described on liability is set for a described usufruct "benefit" while being on liability like renting a car described on specifications, as to say: "It should be on your liability to rent me the car". The Hanbali jurists set a condition-which is one of the two opinions by Shafite jurists – that rental shall be advanced in case of lease described on liability to avoid sale of debt for debt.[88]

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[82] Justice Taqi Usmani, An Introduction to Islamic Finance, pp. 157-158.
[83] Kasani, *Badai al-Sanai*, vol. 4, p. 174.
[84] Ibn Qudamah, al-Mughni, vol. 5, p. 398.
[85] Shirbini, *Mughni, al-Muhtaj*, vol. 2, p. 332.
[86] Bahuti, *al-Rawd al-Murbi*, p. 214.
[87] Ibn Qudamah, *al-Mughni*, vol. 6, p. 129.
[88] Ibn Rushd, *Bidiat Al-Mujtahid*, 2/249, *Minhaj Al-Talibeen* 3/68.

However, if it generally stated without mentioning the liability, then it becomes lease of an asset (*Ayn*).[89]

Conditions of Usufructs

The jurists have prescribed the followings rules and conditions for the usufruct of the contract of *Ijarah.*

a) The *Ijarah* should be affected on the usufruct rather than utilizing the leased asset (*Ayn*). The jurists unanimously agreed upon this point.

b) The usufruct should be of the objects that are liable to valuation in terms of money and intended to be utilized according to contract. It shall not be contracted on permissible things without pricing because spending money that way is a kind of extravagance.

c) The article of lease should be physically fit for hire.

d) The capacity to possess the corpus of the leased property, in order that benefit may be taken from its usufruct. This capacity includes the ability of the lessor to own the leased asset and the ability of the lessee to own the usufruct; thereby means to benefit from it.[90]

e) It is necessary for a valid contract of lease that the corpus of the leased property remains in the ownership of the lessor, and only its usufruct is transferred to the lessee. Thus, the lease cannot be affected in respect of money, fuel, eatables, etc., because their use is not possible unless they are perished. Also, because the purpose of the contract of *Ijarah* is the usufruct. While in this case the purpose is original corpus of the leased asset and not its benefit.[91] If any thing of such nature is leased out, it will be treated as a loan and all the rules regarding the transaction of loan shall accordingly apply. In this, any rent charged on lease shall be considered as an interest charged on a loan.[92]

f) If the subject matter of lease is land, it should be specified that whether it is for cultivation or construction of building.

g) The object of *Ijarah* should have a valuable use. Thus, things have no usufruct al all cannot be leased. For instance, the lease of a pregnant animal and a land which is not suitable for cultivating is not permissible.[93]

h) The subject matter of *Ijarah*, namely, the usufruct should be known and identified. There should not be any vagueness and uncertainty about the usufructs, which may lead to discord and dispute between the parties.[94] The lessor should specifically

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[89] *Al-Mughni*, 6/8.
[90] Al-Ramli, *al-Muhtaj Ala Sherh al Minhaj*, volume 5 page 270.
[91] Ibid, volume 5 page 269.
[92] Taqi Usmani, An Introduction to Islamic Finance, p. 157.
[93] Al-Bahoti, *Kashaf-ul-Qanah Han Matn al-Iqnah*, volume 3, page 565.
[94] Ibn Rushd, *Bidayat al-Mujtahid*, 2/180, 223.

mention the subject matter. An unspecified thing should not be leased out. For instance, if a lessor says: "I rented you one of my these two houses." In this case, the contract would be invalid, because the subject matter is not known and unidentified.[95] The description of the identification of every thing is different as per its specific nature. However, in general it should be specified and quantified. The jurists have described it as the location (*Mahal*) of the subject matter of the lease. The specification of the subject matter can either be made in the agreement or left to the custom of the area. The quality of the subject matter should also be described i.e. description of its type, weight, and location. In case of a house for residence, its period should also be specified. [96] This condition shall be fulfilled in rent also, because ambiguity in both of them lead to dispute, and this is matter of consensus among jurists.[97]

i) All the liabilities arising from the ownership shall be borne by the lessor, because the corpus of the leased property remains in the ownership of the lessor. However, the liabilities emerging due to the use of property shall be borne by the lessor.[98]

j) It is a condition for the accuracy of the lease that the usufruct to be capable of being utilized according to *Shariah* and reality e.g. the renting out of stray animal is not allowed, as the subject matter of lease is something that can be actually delivered.

k) It is a condition that usufruct shall be permissible, neither a required piety nor a prohibited sin. In other words, the purpose and object of the contract of lease should be lawful. Thus, it is not allowed to hire a house for the purpose of gambling.

Ujra (Rental)

This is the considerations given in exchange of the usufruct of the leased asset or services of a man. In other words, it is a payment in consideration of the usufruct owned. It is counterpart of price in the contract of sale and thus all its governing principles also apply to it. Any thing which is valid as price in a contract of sale may be taken as rent in a lease contract. Consensus of jurists (*Jamhoor*) said: The conditions of *Ijarah* are the same conditions of price.[99] The rent should be made known according to the saying of the prophet (PBUH): "He who hires a worker must inform him of his wages". If the wages is of a type which can be converted into a debt described on liability like Rupees, *Dinar*, things estimated by measure of capacity, or by measure of weight, or things estimated by enumeration which closely resembles each other, it is necessary that its kind, description, and amount be clearly sated. If there is any ambiguity (*Jahala*) in wage in a manner that leads to dispute the contract of lease is void, and if the usufruct is used an equivalent price should be paid[100], a matter that is assessed by experts.

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[95] Kasani, *Badai Sanai*, vol. 4, p. 180.
[96] Al-Kasani, Alla Uddin, *Badi al-Saniah Fi Tarteb al-Shariaeh*, 3rd Edition, (Beriut: Darul al-Kitab al-Arabi, 1974), volume 4, page 181.
[97] Ibn Rushd, *Bidayat al-Mujtahid*, 2/223, *al-Fatawa al-Hindiah* 4/41, *al-Hidayah* 3/35, *al-Mughni*, 5/375.
[98] Taqi Usmani, An Intriduction to Islamic Finance, p. 157.
[99] *Al-Mughni* 5/327, *Al-Fatawa al-Hindiah* 4/42, *al-Sharh al-Sageer* 4/59, *Nihaiat al-Muhtaj* 5/322.
[100] *Al-Fatawa al-Hindiah* 4/42.

Conditions for the validity of *Ujra*

a) The rental must be determined at the time of the contract for the whole period of lease. It is allowed that various amounts of rent are fixed for different phases during the lease period, provided that the amount of rent for each phase is specifically agreed upon at the time of affecting a lease. However, if the rent for the subsequent phase of the lease period has not been determined or has left at the option of the lessor, the lease is not valid. Also, the determination of rental on the basis of the aggregate cost incurred in the purchase of the asset by the lessor is not against the rules of *Shariah*, provided that both parties agree to it and all other conditions of a valid lease are fully complied.[101]

b) The lessor can not increase the rent unilaterally and condition in lease agreement to this effect is void.[102]

c) *Ujra* may be on the spot or deferred. It is necessary for the validity of the *Ujra* that it should be clearly defined, specified, quantified and also be watched. In case the *Ujra* is deferred, it should be specified with respect to its nature, quantity and quality. The rent paid out of the leased property should be a lawful thing and known. [103]

d) The *Ujra* or any part thereof may be payable in advance before the delivery of the asset to the lessee. However, in this case the amount so collected by the lessor shall remain with him as 'on account' payment and shall be adjusted towards the rent after its being due.[104]

Termination of *Ijarah* Contract

The contract of *Ijarah* cannot be terminated unilaterally and without the mutual consent of both the parties, because according to the consensus of the jurists, *Ijarah* is an irrevocable contract, when the lessor is able to benefit from the leased asset.[105] However, the basic objective of leasing is to avail the beneficial interest of an asset by acquiring it against a predetermined rate of rent. Therefore, the lessee goes on evaluating the quantum of benefit; he can drive out of the transaction of *Ijarah*. On the other hand, the lessor too binds himself to allow the lessee benefit from the asset so long as the asset itself does not lose intrinsic value, otherwise the ownership of the lessor will be of no advantage. Therefore, to safeguard the interest of both the contracting parties, the *Shariah* has expounded the following events, which lead to the termination of the lease agreement.

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[101] Usmani, Muhammad Taqi, op. cit., p. 161.
[102] Usmani, Muhammad Taqi, op. cit., p. 162.
[103] Al-Ramli, *Nehayat al-Muhtaj Ela Sharhah al Minhaj*, volume 5 page 266.
[104] Usmani, Muhammad Taqi, op. cit., p. 162.
[105] Ibn Qudamah, *al-Mughni*, vol. 6, p. 20. Also see Taqi Usmani, op. cit., p. 173.

a) End of Term

If the term of *Ijarah* is specified and the term expired, *Ijarah* winds up. Some times there is a reason to extend the period of *Ijarah* e.g. *Ijarah* on an artificial land where crops are not yet collected or a vessel in the sea or a plane in the air and the term expired before it landed down.[106]

b) Right of Revocation

Each of the parties to the contract of leasing is at liberty to mention terms and conditions deemed necessary for securing their individual interests. However, every or any term can be made part of the contract only when both the lessor and lessee give their clear individual consent. All such terms once agreed upon will be binding on the parties during the period of lease. Therefore, any lease contract which contains the right of revocation before the expiry of the period of agreement can be revoked by exercising the right of revocation. In such an event the rights and liabilities of the partners will be determined on the basis of beneficial interest derived till the time of revocation of the lease contract.[107]

c) Defect in the Leased Asset

The lessee enjoys another right to exercise for the termination of lease agreement, if at any point of time; it was found that the asset leased out possessed a defect, which may possibly damage his beneficial. *Shariah* protects the interest of both the parties to the agreement. Therefore, contracts executed but subsequently found under concealment of facts or fraud will be voidable and can be revoked instantly. For instance, "A" leased out a house to "B" for residential purposes for a period of three years at rental value of Rs. 200,000/- P. A. "B" paid the lease amount and occupied the house. Later on, it was found that the roof of the house was percolating and was not suitable for residence during rainy days. The lessee has the discretion either to get the house repaired at the cost of the lessor or revoke the lease contract and claim back the lease amount left over.[108] Ibn Qudamah says that: If a lessee leased an item and found an unknown defect to him, in that item, he may rescind the contract, as a generally accepted opinion.[109] Here, the Hanafis goes to the extent that the contract of *Ijarah* can be revoked even in those cases, where the defect is out of the subject matter of the lease. For instance, when the *Uzar* is in the lessee himself i.e. an ailment, which prevent him to benefit from the subject matter of the lease or some one takes on lease a shop for business, but his *Mall* (goods) destroy.[110]

d) Rescission for an Excuse:

The Hanafi jurists are of the opinion that *Ijarah* contract may be rescinded in case of occurrence of an excuse for one of the parties or the leased asset (*Ayn*). The contract would not be binding and may be rescinded, since there is need for it in case of an

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[106] *Al-Mohadhab* 1/403,404. *al-Fatawa al-Hindiah* 4/416. Al-Ikhtiar 2/58, Al-Halabi edition.

[107] Azam K M, "Economics and Politics of Development –An Islamic Prospective", 1988, Royal Book Company, Karachi, (1st Edition).

[108] Al-Bahoti, *Sharhe Muntahe al-Iradat*, vol. 2, p. 373.

[109] *Al-Mughni* 6/30, Al-Manar Edition. *Al-Sharah Al-Sagheer* 4/49.

260 Qazi Zada, Shamsu Udin Ahmed, *Nataij al-Afkar Fi Kashf al-Ramoz wa al-Asrar*, 1st Edition, (Egypt: *Maktabah* wa *Matbahah* Mustfa al-Babi al-Halbi,1970), vol. 9, p. 147.

excuse, because if the contract would binding in this case, then the excuse party would bear damages for honoring a contract with which it is not bound. In this respect Maliki consider that if the leased asset (*Ayn*) or its usufruct is usurped or an unjust order which is beyond jurisprudence is inflicted to close the leased shops, the lessee has the right to rescind or sustain *Ijarah*[111] However, the majority of the jurists do not believe in rescission of *Ijarah* for an excuse, because *Ijarah* is one of the two types of sale, so the contract would be binding and since the contract was concluded by agreement of its parties, it would not be rescinded unless by their agreement. Shafit stated that no party is entitled to rescind *Ijarah* for an excuse, whether it is for the usufruct of the asset (*Ayn*) or liability, since the excuse would not render the leased asset defected.[112]

According to Hanafis, the excuse may be from the part of the lessee, for example he is bankrupted or intending to travel or changes his occupation or craft, such as from farming to trading. The bankrupt would not benefit from using the shop for trading, and if he is compelled to engage in trading this will render damaged. And if the contract is sustained while there is a necessity for the lessee to travel to an other place, this will bring about damage to him. The excuse may be on the side of the lessor, such that if he is grossly indebted and no way to settle such debts without selling the leased asset (*Ayn*) such as means of transport, real estate, etc. In this case he has the right to rescind *Ijarah* contract.[113]

e) ***Iqala* (Termination of *Ijarah* due to rescission of the Transaction)**

As rescission of the contract (*Iqala*) is permissible according to Prophet's (PBUH) saying: "That who rescinds the sale contract (*Iqala*) because he feels repented, Allah will forgive him in custody". Therefore, it also permissible in lease, because it represents a sale of usufructs.[114]

f) **Death of the lessor/lessee**

The jurists have differed on the issue that whether the death of any party will affect the validity of the contract of *Ijarah* or not. According to Hanafi school of thought death of any of the contracting parties will terminate the *Ijarah* contract. While, according to the majority of jurists the death of any of the parties does not affect the contract of lease.[115] However, the contract of *Ijarah* will not be affected by the change of the ownership of the lessor through sale, gift, inheritance, etc.[116] Here, it may be noted that contract of lease entered into by authorized agent (*Wakeel*) will continue to be binding on the principal parties inspite of the death of the agent.

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[111] *Al-Sharah al-Sagheer* 4/51, Darul Maarif edition.
[112] *Al-Mohadhab, p.* 405.
[113] Abu Ghuddah, Dr. Abdul Sattar, *Ijarah* (Lease), pp. 67-68.
[114] For details see, Abu Ghuddah, Dr. Abdul Sattar, *Ijarah* (Lease), p. 72.
[115] Ibn Rush, *Bidayat al-Mujtahid,* vol. 2, p. 288.
[116] Al-Bahoti, *Sharhe Muntah al-Iradat*, vol. 2, p. 376.

g) Destruction of leased asset

Destruction of the leased asset during the lease period will cause termination of the contract automatically because the fulfillment of the objective has become impossible. In this case no benefits can be drawn from the leased asset (*Ayn*) such as: the vessel if destroyed entirely and become sheets of timber and the house if destroyed and turned into rubble. The jurists are agreed upon this issue. But if the benefits expired there seems to be some difference.[117]

h) Contravention of the binding condition

If the lessee contravenes any term of the agreement, the lessor has a right to terminate the lease contract unilaterally. However, if there is no contravention on the part of the lessee, the lease cannot be terminated without mutual consent of both the parties, because as we have mentioned that *Ijarah* is an irrevocable contract, when the lessor is able to benefit from the leased asset. All the jurists agree on this point.[118]

Ijarah in Islamic Banks

Leasing (*Ijarah*) is emerging as a popular technique of financing among Islamic banks. *Ijarah* is not originally a mode of financing. It is simply a transaction meant to transfer the usufruct of a property from one person to another for an agreed period against an agreed consideration. However, certain financial institutions have adopted leasing as a mode of financing instead of long term lending on the basis of interest.[119] The primary advantage of *Ijarah* over the conventional forms of borrowing to finance equipment is that the ownership of the asset remains with the lessor. The financing is largely unrelated to the size of assets and the capital base of the lessee and depends principally on the ability of his cash flow to service payments of lease rentals.[120]

1. *Ijarah wa Iqtina* (Hire-Purchase)

It is a combination of leasing movable or immovable property with granting the lessee an option of eventually acquiring the object of lease.[121] This term refers to a mode of financing adopted by Islamic banks. It is a contract under which the Islamic bank finances equipment, a building other facility for the client against an agreed rental together with an undertaking from the client to purchase the equipment, the facility. The rental as well as the purchase price is fixed in such a manner that the bank gets back its principal amount along with some profit, which is usually determined in advance.[122] This type of financial lease contract requires full amortization of the asset value throughout the contract term. It is also called capital lease, which means that total contracted rental payments shall cover the entire cost of the asset and produce a reasonable return into the lessor's (the bank) invested capital. [123] All expenses related to the use, maintenance and ownership of the asset are bear by the lessor i.e. real estate taxes and insurance premium.

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[117] *Al-Mughni* 6/76 Al-Manar edition 4/49-50; *Minhaj Al-Talibeen* 3/77.
[118] Ibn Qudamah, *al-Mughni*, vol. 6, p. 20. Also see Taqi Usmani, p. 173.
[119] Taqi Usmani, p. 163.
[120] Dr. Ausaf Ahmad, Contemporary Practices of Islamic Financing Techniques, p. 45.
[121] Nabi A. Salih, Unlawful Gain and Legitimate Profit in Islamic Law, p. 122, quoted by Mansuri, p. 238.
[122] Dr. Ausaf Ahmad, Contemporary Practices of Islamic Financing Techniques, p. 45; Mansuri, op. cit. p. 238.
[123] *Ijarah* (Lease) by Dr. Abdul Sattar Abu Ghuddah p. 83 (Pub. by AlBaraka Banking Group)

Generally, this type of financial lease contract is irrevocable. However, if the lessee is willing to terminate the contract before the pre-agreed period, then he shall pay all the remaining rentals payments at once and buy the leased asset. In addition to reasonable return to the lessor, the entire value of the leased asset is amortized during the term of lease period. This type of lease contract includes an option for the lessee to purchase the asset for an agreed upon lower price or even without any payment (*Hiba*) at the end of the lease period. In this way, the lease transaction ends by the lessee owing what he has leased. Therefore, it is also sometimes called lease ending to ownership-*Ijarah Muntahia Bittamleek.*[124]

2. Direct Leasing

Under this scheme of financing the bank purchase a real asset and leases it to the client. The period of lease is determined by mutual agreement according to the nature of asset. The physical position of the asset and its right of use is transferred to the lessee during the period of lease, while the asset remains in the ownership of lessor. The period of lease ranges from few days to few months depending upon the type of asset in question. The lessee in return pays monthly or annual rental fee. After the expiry of lease period the asset revert to the lessor.[125]

4.1.1. *Ijarah*'s Practice of Bank of Khyber Islamic Banking Division

The customer submits an Application Form and other documents at the BOK's IBB with request of entering into a transaction with him to provide his requirements of equipment on *Ijarah Wa Iqtina basis*. The concerned branch processes the application and determines that whether the applicant qualifies on the prescribed credit approval criteria established by the Bank. The branch requests some of the client identification documents along with financial statements to verify his ability to pay back the proposed finance amount and experience in the field of the required equipment, etc. prior to entering any commitment with him. The concerned section at the Branch enters customer's record in the system and generates the proposal. A credit summery is generated to check the customer's eligibility. If the customer fails to pass any of the prescribed criteria, then the concerned section of IBB inform the customer accordingly and file the rejected application. In case, the branch is satisfied with the financial stability of the client, it refers the proposal with its recommendation to IBD for further necessary action. The branch verifies the customer's address. The customer CIB report is obtained from SBP in all cases of Rs.500,000/- and above.[126]

At this stage, the IBB contacts with the customer's designated car dealers in order to obtain quotations, invoice of the vehicle, and other related documents. The quotation, credit summary, disbursement schedule and other necessary documents are submitted to IBD for approval. The *Shariah* Advisor of the IBD gives *Shariah* clearance on the documentation. The approval of each designated case is sanctioned through a designated committee of the IBD. In case, the designated committee of the IBD disapproves the

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[124] *Ijarah* (Lease) by Dr. Abdul Sattar Abu Ghuddah pp. 83-84.

[125] Dr. Ausaf Ahmad, Contemrary Practices of Islamic Financing Techniques, p. 45; Mansuri, Islamic Law of Contract and Business Transaction, p. 238.

[126] *Ijarah* Mnual of the Bank of Khyber Islamic Banking Division, p. 9.

case, then the customer is informed of the decision through letter and the file is closed with the file of rejected application. In case of approval, IBD deliver the sanction advice and other documents to the concerned IBB for preparation of "Agreement to Lease", Application Form, Attachments and a Documents Checklist.[127] The IBB contacts the customer and informs him about the execution of the Lease Agreement. At this stage, the branch requests the customer for the cheques of security deposits, non-refundable processing charges covering BOK's (i. Cost of legal documents, ii. Cost of CIB report, iii. Cost of address verification) and documentation and registration charges[128]

However, it is also allowed to obtain cheque for documentation and registration upon delivery of the lease asset. The Branch gives a cheque receipt to the customer. The customer is asked to submit 36 or 48 or 60 (as the case may be) post dated cheques for rentals as per the term of the Lease Agreement. These rentals are not charged to income of the BOK during the period between disbursement and delivery of the vehicle and are treated as an advance towards the Lease Agreement to be executed upon delivery of the vehicle. Customer is required to submit the executed documents to the Branch. The concerned section of the Branch prepare and move the disbursement sheet to the Operations Department of the Branch for preparation of pay order after completion of documentation and clearance of the customer cheques.[129] A pay-order is issued under a covering letter "Purchase Order" to the car dealer mentioning that the vehicle, etc. is BOK's asset and should not be handed over to the customer without express written permission of BOK. It also contains instructions for the registration of the vehicle.[130]

The cheque for documentation charges received from the customer is deposited upon delivery of the vehicle. The dealer arrange for the registration of the vehicle in the BOK's name and intimate the vehicle's engine and chassis number to BOK. At this stage, the vehicle particulars are sent for insurance to reputable companies offering protection under the Islamic concept of *Takaful*. The BOK as an owner of the leases asset obtains insurance of the asset either directly or through the customer appointing him as an agent of the Bank. The cost of insurance is bear by the Bank. However, the Bank adds this cost to the total cost of the leased asset and accordingly charges rentals from the customer.[131] The concerned section of the Branch prepares the "Lease Agreement", which is to be accepted and signed by the customer. At this stage, the Branch requests the customer for a cheque of documentation charges covering vehicle registration charges, govt. taxes and dealer's service charges.[132] The Branch gives a cheque receipt to the customer. According to the Lease Agreement, the first rental of the lease shall be of a higher amount comprising of the advance accumulated till that date and normal rental for that month. However, rest of the rentals till the life of the lease remains the same. Dealer delivers the vehicle to customer upon receipt of "Delivery Order" from BOK and gets a Vehicle Acceptance Letter signed by customer. The original registration receipt along with all other relevant documents and a spare key are submitted to IBB. The Branch retains the

[127] Ibid, pp. 9-10.
[128] Ibid, p. 10.
[129] Ibid, pp. 10-11.
[130] Ibid.
[131] Ibid, p. 11.
[132] Ibid, pp. 12-13.

original registration book and a copy of the first page of the registration book is given to the customer.[133]

Premature Termination

If the customer wants to terminate the *Ijara*h Agreement pre-maturely, he is required to contact the concerned Branch of the Bank with the request for premature termination. The Branch intimates the pre-mature termination sale price to the customer as per the Lease Termination Schedule and the System. The Branch forwards the customer's application to IBD for processing of premature termination. The customer pays the termination amount to the Branch through cross cheques. After clearance of the check, the Branch processes the termination. The Branch raise sale invoice of the vehicle in the name of the customer and hand over the vehicle documents to the customer. The customer signs a Vehicle Acceptance Letter to confirm receipt of the vehicle.[134]

Normal Termination of the Lease Agreement

The BOK offers the vehicle for sale at the pre-agreed Lease Terminal Value to the customer upon completion of the Lease Agreement period and payment of all dues by customer. In case, customer agrees to purchase vehicle, the Bank raises an invoice to customer. Customer either pays through a cheque or instructs the Bank to adjust the security against the purchase price of the asset. In case, customer pays invoice amount through cheque, the Bank return the customer's security deposit through a cheque. The customer signs a Vehicle Acceptance Letter to confirm receipt of vehicle.[135]

Return of Vehicle

The customer has also been given the option to return the vehicle upon completion of the Lease Agreement time period. In this case, the Bank appoints a surveyor of the insurance company to inspect the vehicle and intimate the current condition and value of the vehicle and cost required for repair and maintenance. The Branch deducts the cost of repair and maintenance work from the Customer' security deposit and pay the balance amount to the customer. The customer is makes liable for the repair and maintenance work. The Bank then sold the vehicle in the open market.[136]

Insurance Cost

As the ownership of the asset remains with the BOK, therefore the Bank obtains the insurance of the asset either directly or through the customer by appointing him as an agent of the Bank. In the later case, the Bank and the customer signs an Insurance Agency Agreement under which the Bank appoint the customer its agent to obtain insurance of the asset from the company of its choice offering Islamic *Takaful* services and which is also from the approved list of the BOK. The Bank adds the insurance cost to the total aggregate cost of the asset and accordingly charge the rentals from the

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[133] Ibid, p. 13.
[134] Ibid, pp. 14-15.
[135] Ibid, p. 15.
[136] Ibid, p. 16.

customer.[137] In case of increase in insurance cost, the Bank and the customer may agree to revise the rentals for the next period during the currency of the lease agreement.[138]

Salient Features of the Lease (*Ijarah*) Agreement of the Bank of Khyber Islamic Banking Division

The lessee executes a Demand Promissory note in favour of the lessor for the entire amount of the lease rentals. The security deposited by the lessee (the customer) with the lessor (the Bank) can be applied in the absolute discretion of the lessor in respect of any rent in default under the Lease at any time or from time to time. The lessee is only entitled to the return of the said deposit after deduction of any cost, charges, and expenses at the end of the term of the Lease.[139] The Lease Agreement can be terminated through the mutual consent of both the parties. In this case, the lessee is bound to discharge all his outstanding dues to the satisfaction of the lessor. The lessor shall not charge lease rentals after the leased asset has been destroyed or returned to the lessor without ant fault of the lessee.[140] The leased assets shall be delivered to the stated place by lessor. The whole costs connected with delivery shall be born by the lessor.[141]

The lessor can revise the lease rentals with the consent of the lessee, when any cost relating to the lease is increased and which is borne by the lessor, i.e. insurance cost, etc. provided that every 18 months from the commencement of the Lease and at the end of each successive 18 months period thereafter, the lessor may negotiate the lease rentals with the lessee. If the parties fail to agree upon the revised lease rentals, the lessor may terminate the Lease.[142] The lessee is responsible for all ordinary maintenance and repair works, which keeps the lease assets in good working conditions. The lessor is responsible for all the major repairs, which arise due to the accidents and damages occurring without the negligence of the lessee.[143] The lessee agrees to pay to the lessor the cost of repair or replacement of the lease asset or any part thereof due to any damage arising out of the misuse of the lease assets.[144]

The leased assets, where applicable, is registered in the name of the lessor under the relevant laws pertaining to registration of such assets. Title, ownership and right of property in the leased assets leased remain vested in lessor and the lessee agrees not to do or perform any act prejudicial thereto. Notwithstanding such registration, it is understood and agreed between the parties that lessor is not liable or responsible for the infraction of or non-compliance with any relevant rules and regulation, whatsoever relating to the operation or use of leased assets.[145] Payment of all taxes incidental to usage and ownership including the road tax, if applicable, is the sole responsibility of the lessee, and it is understood this payment has been factored in the lease rental. It is further provided

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[137] Ibid, p. 16.
[138] Ibid, pp. 16-17.
[139] Ibid, p. 20.
[140] Ibid, p. 20.
[141] Ibid, p. 21.
[142] Ibid, p. 22.
[143] Ibid, p. 22.
[144] Ibid, p. 23.
[145] Ibid, p. 23.

that if lessee is not in default under this lease, the lessor will, upon request, furnish the lessee a letter of authority for this purpose.[146]

The lessee agrees to return the leased asset at the end of the agreed lease period or any extension thereof or upon earlier termination of lease in good operating condition and working order free from any physical damage.[147] The lessor is not required to comply with the terms of this Agreement, if prevented from so doing by acts of God, or the state's enemies, viz., major strikes, substantial destruction to the plant, and shall not be liable for any loss or damages sustained by the lessee and resulting there from. All repairs, replacements, or substitution of the parts or components of the leased assets necessitated due to normal usage is at the lessee's expenses, and title thereto shall vest and remain in lessor.[148] The lessee undertakes that where any amount is required to be paid by the lessee under the principal documents on a specified date and is not paid on that date, or any amount is payable by the lessee under the Principal Documents within one week of a demand from the lessor and is not paid by it within one week of the said demand being made and such amounts to be recovered through litigation or otherwise, the lessee shall pay a sum of to be calculated at the rate of 20 percent per annum or fraction thereof of the amount outstanding to the lessee to be used by the lessor for the purpose of charity approved by the Shariah Supervisory Board of the lessor (the Bank).[149] The Agreement is governed and construed in accordance with the Pakistani law and the recognized principles of Islamic *Shariah* as may be determined by the *Shariah* Supervisory Board of the Bank.[150]

4.1.2 Case Study of Car *Ijarah*

A customer namely, Mr. 'A' came to the BOK IBB with the request for consumer car financing on the basis of *Ijarah*. The concerned section of the Branch informed him about the related required documents, which include but not limited to Undertaking to *Ijarah*, identification documents, bank statements, account number., proof of business and its name and address, proof of income i.e. last pay slip, etc, utility bills, two reference letters, experience, phone number, residential address, personal guarantee of 'A' and quotation of the desired car. He agreed with the same and submitted all the required documents. The concerned section perused all the given documents and reach to the conclusion that he qualifies the credit approval criteria established by the IBD (BOK). His clear CIB (Credit Information Bureau) Report was obtained from the State Bank of Pakistan. The Brach prepared a proposal of the car *Ijarah*, which contains details about inter alia, complete profile of the client, particulars of the car, etc. The total cost of the car was calculated as Rs. 1400000/-. The tenure of the car *Ijarah* was proposed for three years, which composed of rental payments of 36 monthly instalments. The Branch sent the proposal to IBD for approval along with all the necessary documents.

The concerned section of the IBD perused all the documents and prepared a comprehensive proposal of the car *Ijarah*. The credit worthiness of the customer was

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[146] Ibid.
[147] Ibid, p. 24.
[148] Ibid.
[149] Ibid.
[150] Ibid.

declared as good. The instant car *Ijarah* proposal was also referred to *Shariah* Advisors of IBD for giving *Shariah* Clearance Certificate. The *Shariah* Advisor has examined the proposal and all the relevant documents and concluded that there is nothing adverse against the *Shariah* in instant proposal. The security deposit was fixed as 30 percent of the proposed Car *Ijarah* financing amount by the Bank. The car was exclusively owned and registered in the name of BOK. The rental was fixed as 18 percent per annum of the credit amount advanced by the Bank to the client. The IBD of the Bank after complete perusal of the available record recommended his proposal to the concerned Credit Committee of the Bank on the following Terms and Conditions:

1. Demand promissory note of *Ijarah* rentals for the whole period.
2. The rentals shall not exceed 1/3rd of the net verifiable income of the customer.
3. The vehicle shall be brand new.
4. Commercial use of vehicle is strictly prohibited.
5. The facility of *Ijarah* shall be governed by the rules and regulations of *Shariah*, the Government of Pakistan and the State Bank of Pakistan presently enforced or as amended from time to time.
6. Execution of *Ijarah* Agreement along with ancillary agreements. Disbursement is subject to execution of all necessary agreements, documents, completion of all the required formalities, and clear Consumer CIB Report.
7. Post dated cheques to be obtained from the client for recovery of rentals as per schedule prepared at the time of delivery of vehicle.
8. The leased asset shall be comprehensively insured in favour of the Bank from a company listed on approved panel of the Bank as the loss payee. Insurance premium shall be paid by the Bank.
9. If the client fails to pay any rental beyond the period as stipulated in *Ijarah* Agreement/ or Rental Schedule, then an event of default will occur and resultantly repossession process will be initiated at the cost and risk of the client.
10. Any other term and condition, which may be stipulated by BOK from time to time if permissible under *Shariah*.

The concerned section of Bank approved the instant car *Ijarah* proposal on the above mentioned terms and conditions. The IBD of the Bank after approval of the proposal issued Sanctioned Letter in favour of the customer. The IBD delivered the Sanctioned Letter along with all other documents to the concerned Branch for preparation of Agreement to Lease, Application Form on prescribed format of the Bank, attachments, and a documents checklist. The Branch prepared all the documents and informed the customer about the same for execution. The customer was asked to submit 30 percent of security deposits. He was also asked to submit personal guarantee of two persons. A total of Rs.39,695.3/- was fixed as monthly rentals. The Branch also requested him for the

following cheques: a) Security deposit amounting to Rs.420,000/- (30%), b) Non-refundable processing charges of Rs.2500/-

The customer has deposited the prescribed amount in the account and submitted cheques with the Bank. He was also asked to submit 36 post dated cheques for rentals of Rs.39,695.3/- each. The customer has executed Undertaking to Purchase, Undertaking for the above-mentioned Terms & Conditions of the Sanction Letter and submitted the same to the Branch. After completion of documentation and clearance of the customer cheques, the Branch prepared and moved the preparation sheet to the concerned section for preparation of Pay-Order. The Pay-Order was prepared and issued to the concerned car dealer with remarks that the car is BOK's asset and should not be handed over to the customer without express written permission of BOK. The car was delivered to the dealer's show room. The dealer arranged for registration of the car in the name of BOK and intimated the car's engine and chassis numbers to the Bank. The particulars of the car were sent to the Insurance (*Takaful*) company for insurance of the car. The insurance company after insurance of the car sent original insurance policy along with the premium payment receipt to the Branch. The concerned section of the Branch asked the client to execute the Lease Agreement. He has signed the "Lease Agreement". He was also asked to submit cheque for car registration charges amounting to Rs.20000/-.

The customer has deposited the prescribed amount in the Account and submitted cheques with the Bank. The concerned section of the Branch issued Delivery Order to the dealer. The dealer upon receipt of Delivery Order delivered the car to the customer on September 1st, 2004 and got the car acceptance letter dully signed by the customer. The Lease Agreement was given effect from the date of delivery of the car i.e. September 1st, 2004. The dealer has submitted a spare key and the original registration receipt along with all other related documents to the Branch. The Branch has given the copy of the first page of the registration book to the customer and retained the original registration book. The details of the monthly rentals can be easily understood through the following table:

Rentals

S. #	Due Date	Rentals	Principal	Takaful	Profit of BOK	Terminal Value
1	October 1st, 2005	39,695.3	20,740.7	3,447.2	15,507.4	1,499,945
2	Nov. 1st, 2005	39,695.3	21,051.2	3,498.6	15,145.4	1,473,546
3	Dec. 1st, 2005	39,695.3	21,366.4	3,550.9	14,778.0	1,446,797
4	January 1st, 2005	39,695.3	21,686.3	3,603.9	14,405.1	1,419,695
5	Feb. 1st, 2005	39,695.3	22,010.9	3,657.7	14,026.7	1,392,233
6	March 1st, 2005	39,695.3	22,340.4	3,712.3	13,642.6	1,364,408
7	April 1st, 2005	39,695.3	22,674,9	3,767.7	13,252.7	1,336,215
8	May, 1st 2005	39,695.3	23,014.4	3,823.9	12,857.0	1,307,649
9	June 1st, 2005	39,695.3	23,358.9	3,881.0	12,455.4	1,278,705
10	July 1st, 2005	39,695.3	23,708.6	3,938.9	12,047.7	1,249,377
11	August 1st, 2005	39,695.3	24,063.5	3,997.7	11,634.0	1,219,661
12	Sep. 1st, 2005	39,695.3	24,423.8	4,057.4	11,214.0	1,234,352
13	October 1st, 2006	39,695.3	24,789.4	3,449.2	11,456.6	1,294,513
14	Nov. 1st, 2006	39,695.3	25,160,6	3,500.7	11,034.0	1,174,281
15	Dec. 1st, 2006	39,695.3	25,537.2	3,553.0	10,605.1	1,143,649
16	Jan. 1st, 2006	39,695.3	25,919.5	3,606.0	10,169.7	1,112,613
17	Feb. 1st, 2006	39,695.3	26,307.6	3,659.8	9,727.8	1,081,167
18	March 1st, 2006	39,695.3	26,701.4	3,714.5	9,279.4	1,049,306
19	April 1st, 2006	39,695.3	27,101.2	3,769.9	8,824.2	1,017,024
20	May, 1st 2006	39,695.3	27,506.9	3,826.2	8,362.2	984,316
21	June 1st, 2006	39,695.3	27,918.7	3,883.3	7,893.3	951,176
22	July 1st, 2006	39,695.3	28,336.7	3,941.3	7,417.3	917,599
23	August 1st, 2006	39,695.3	28,760.9	4.000.1	6,934.3	883,578
24	Sep. 1st, 2006	39,695.3	29,191.5	4.059.8	6,444.0	884,948
25	October 1st, 2007	39,695.3	29,628.5	3,585.4	6,481.4	850,558
26	Nov. 1st, 2007	39,695.3	30,072.1	3,638.9	5,984.3	815,715
27	Dec. 1st, 2007	39,695.3	30,522.3	3,693.3	5, 479.7	780,413
28	January 1st, 2007	39,695.3	31,443.0	3,748.4	4,967.7	744,645
29	Feb. 1st, 2007	39,695.3	31,913.7	3,804.3	4,447.9	708,406
30	March 1st, 2007	39,695.3	32,391.5	3,861.1	3,920.4	671,689
31	April 1st, 2007	39,695.3	32,876.4	3,918.8	3,385.0	634,489
32	May, 1st 2007	39,695.3	33,368.6	3,977.3	2,841.6	596,798
33	June 1st, 2007	39,695.3	33,868.2	4,036.6	2,290.0	558,610
34	July 1st, 2007	39,695.3	34,375.2	4,096.9	1,730.2	519,919
35	August 1st, 2007	39,695.3	34,889.8	4,158.0	1,162.0	480,718
36	Sep. 1st, 2007	39,695.3		4,220.1	585.3	420,000
	Total	**1,429,029.3**	**980,000.0**	**136,640.0**	**312,389.3**	

The customer has regularly paid the monthly rentals, until he has paid the last monthly rental i.e. September 1st, 2007 of Rs.39, 695.3. The Lease Agreement between the Bank of Khyber and 'A' came to an end on September 1st, 2007. The customer came to the Bank and informed about the deposit of the last rental in favour of the Bank. The

BOK has offered the said car for sale at the pre-agreed terminal value to the customer i.e. Rs.420, 000/-. The customer has agreed to purchase the car on the pre-agreed terminal value. The Bank has given him the option to deposit the sale amount in the Bank's Account or to adjust the security deposit amount of Rs.420, 000/-. The customer has given instructions to the Branch for adjustment of his security deposit amounting to Rs. 420,000/-. The Branch has raised an Invoice to the customer amounting to Rs. 420,000/-. The customer has agreed on the same sale price and signed the Acceptance Letter. In this way at the end of the *Ijarah* Agreement period, the customer became the owner of the car.

4.1.3. *Shariah* Appraisal of the Bank of Khyber Islamic Banking Division's *Ijarah Wa Iqtina*

Ijarah as a Mode of Financing

In fact, *Ijarah* is not originally considered as a mode of finance. In other words, it was not popular in profit oriented business of the modern times. It was mere a process of handing over an asset by one person to another with permission to use the asset for a specific period of time for an agreed consideration. However, in recent time the financial institutions and Islamic banks adopted *Ijarah* (leasing) as a mode of finance and use it in place of interest based transaction. This type of lease is generally known as the financial lease as distinguished from the operating lease and many basic features of actual leasing transaction has been dispensed with therein. As leasing is a lawful transaction according to *Shariah* and it has a considerable market, therefore it is felt by the modern Islamic economists and jurists that leasing to be appropriate in using as interest free mode of finance. This transaction of financial lease may be used for Islamic financing, subject to certain conditions. It is not sufficient for this purpose to substitute the name of 'interest' by the name of 'rent' and replace the name of 'mortgage' by the name of 'leased asset'. There must be a substantial difference between leasing and an interest-bearing loan. That will be possible only by following all the Islamic rules of leasing.[151]

The Council of the Islamic Fiqh Academy has described certain conditions for the permissibility of a valid form of *Ijrah wa Iqtina* transaction. They are the presence of two contracts that are totally separate and independent with respect to time of their conclusion and in which the sale contract succeeds the lease contract, or the presence of a promise that would enable the lessee to become the owner at the end of the contract period. In this connection, Option and Promise stand on equal footing with regard to their *Shariah* rulings.The Council also stated that there should be a genuine desire from the two parties to conclude the lease contract and not just to use it as a mere veil for the sale contract. The leased asset should be guaranteed by the owner (lessor) and not the lessee. The lessor should bear any damage that is not caused by misuse or negligence of the lessee. In this sense, the lessee has to bear nothing even if such damage has made the leased asset completely useless. In case the contract includes insurance of the property, then it should be made according to the Islamic methods and at the expense of the lessor only. The contract should be subjected to *Shariah* rulings on *Ijarah* throughout the lease period, whereas *Shariah* rulings on ownership should be observed when ownership of the

[151] Usmani, Muhammad Taqi, op. cit., pp. 163-164.

property is shifted to the lessee. The cost of maintenance, excluding operational expenses should be borne by the lessee throughout the lease period.[152] The *Shariah* Board of the Jordan Islamic Bank has also given a ruling on the permissibility of the lease ending on ownership. The Board described the following conditions for the soundness of the *Ijarah Wa Iqtina* contract: 1) The length of the lease must be rendered precise, and all of its terms must be continued to be met throughout the life of the lease. 2) The amount of each instalment payment must be determined exactly. 3) The ownership of the subject must be transferred to the lessee by means of its being gifted to him. In this manner the promise made earlier between the owner and the lessee may be fulfilled. [153]

Agency of Client

The OIC Council of Islamic Fiqh Academy in its third session (11 to 16 October 1986) resolved that the appointment by the bank the client as its agent for the purchase in the name of the bank of equipments and tools of given specifications and price with the intention for the bank to lease the purchase item to this client after the later has received them is a valid agency appointment. The Council however recommended that it is preferable that the purchasing agent be different from the beneficiary client, if this condition can be easily met. The Council held that the lease agreement should be implemented after actual acquisition and possession of the leased asset and should be entered into by a separate contract than the agency contract or the promise.[154]

Advance Rentals

The acceptance of advance payment of rental is permissible from *Shariah* point of view. However, it should be based on the justification that it is an advance payment of the rental value and not the profit value of the lease, because the lease payment is an indivisible whole. So it shall not be divided into principal and profit. In case of *Ijarah*, all the payment is considered rental which may be advanced partially or wholly (which is a part of the overall rental). Also, it may be installed or deferred till the lease usufruct is used.[155] According to the *Shariah* Board of the Kuwait Finance House, if the lessee returns the item owing to compelling circumstances, the remainder of the lease payment must be returned because the lease will be considered to have been dissolved for valid reasons. According to *Shariah*, *Ijarah* may be legally invalidated by compelling circumstances. If the lessee returns the item simply because he wants to return it, then if the bank agrees to such a return, the remainder of the lease payment must be returned to the lessee because a mutual dissolution of the lease, much like *Iqalah*, has taken place. If, however, the lessee stipulates that the item must remain in his name until the completion of the leased period, and that it not be leased to another, then the remainder will not be returned and the item will remain at the disposal of the lessee until the lease expires.[156]

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[152] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 253-155.

[153] Jordan Islamic Bank, *al Fatawa al Shar 'iyah*, vol. II, p. 636, translated by Yusuf Talal DeLorenzo, 'A Compendium of Legal Opinions on the Operations of Islamic Banks, Vol. 1, p. 40 (Pub. Institute of Islamic Banking and Insurance London, UK, 2001)

[154] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 23-24.

[155] Abu Ghuddah, Dr. Abdul Sattar, *Ijarah* (Lease) op. cit., p. 38.

[156] Kuwait Finance House, *Fatawa Shar 'iyah*, Question 230, p. 221, Translated by Yusuf Talal, op. cit. p. 19

The Commencement of Lease

Generally a forward sale is not allowed in *Shariah*. However, the contract of *Ijarah* unlike the contract of sale can be affected for a future date. This is an exception to the general rule. It is allowed on the condition that the rent will be payable only after the leased asset is delivered to the lessee. The lease agreement should not contain any provision with effect that the lease commences on the very date on which the price is paid by the bank, irrespective of whether the lessee has affected payment to the supplier and taken delivery of the asset or not, because it may mean that the lessee's liability for the rent starts before the lessee takes delivery of the asset, which is not allowed in *Shariah*. In real sense, it amounts to charging rent on the money given to the customer, which is nothing but interest, pure and simple. Accordingly, the correct way is that the rent be charged after the lessee has taken delivery of the leased asset and not from the day the price has been paid.[157]

The *Shaiah* Board of the Kuwait Finance House has given a legal opinion with effect that payments are required of a lessee from the time of taking possession of the item leased from the lessor. The payments will be due as soon as possession of the leased asset is taken.[158] The responsibility of rent payment does not arise from payments of the amount financed either in advance or later on. Before delivery of the leased asset (in part or entirely), there is nothing to justify the right to receive payments. This is because the lease contract is a contact that is subject to time, and no rent will be due merely because of the contract, but rather as a result of the subject of the lease being made available. It is not lawful from the *Shariah* prospective to take any amount from the lessee for the period preceding delivery of the leased item. Nor will the lessee be held liable for any amount until after delivery of the item. [159]

Different Relations of the Parties

When the lessee has been appointed as agent to purchase the asset intended to be leased, there are two separate relations between the bank and the customer which comes into operation one after the other. In the first phase, the client is an agent of the bank to purchase the lease asset on the latter's behalf. At this stage, the relation of the lessor and lessee has not yet come into operation and the relation between the parties is nothing more than the relation of a principal and his agent. The client cannot be held liable for the obligations of the lessee at this stage. The customer is responsible to carry out the functions of an agent only.[160] In the second stage, the relation of the lessor and lessee comes into operation from the date when the customer takes delivery of the leased asset from the supplier. Unlike *Murabahah*, in case of *Ijarah*, the parties need not effect the lease contract after taking delivery of the lease asset. If, the bank while appointing the client as agent has agreed to lease the asset with effect from the date of delivery, the lease will automatically starts on that date without any additional procedure. The reason for

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[157] Usmani, Justice Yaqi, op. cit., pp. 164-165.
[158] Kuwait Finance House, *Fatawa Shar 'iyah*, Question 225, pp. 218-219, quoted by Yusuf Talal, op. cit. p. 53.
[159] *Majmu 'at Fatawa al Hay 'ah al Shar 'iyah*, Decision no. 112, quoted by Yusuf Talal, op. cit. p. 54.
[160] Usmani, Justice Taqi, op. cit., p. 165.

this is that in *Ijarah*, the asset remains under the risk and ownership of the lessor throughout the leasing period and the ownership has not been transferred.[161]

Expenses Consequent to Ownership

The bank as owner of the asset purchases the lease asset from the supplier through appointing the customer as agent. Being the owner of the leased asset, the bank is liable to pay all the expenses incurred in the process of the purchase of the asset and its import to Pakistan from a foreign country. Accordingly, the bank is liable to pay the freight, custom duty, etc. Of course he can include all these expenses in his cost and can take them into consideration while fixing the rentals. Any provision in the lease agreement to the contrary is not in conformity with the principles of *Shariah*.[162]

Maintenance of the Leased Asset

It is not permissible to stipulate that maintenance should be carried by the lessee, because this results into ambiguity of rental, so *Ijarah* would be void by this condition as agreed by all schools of jurisprudence. If this happens and the lessee took the possession of the leased asset, he will be entitled for estimated equivalent charge and has the right to reimburse his expenses on the asset and a similar expense for supervision, provided he has done so with the lessor permission, otherwise he would be a donor.[163] The owner is responsible for maintenance related to the object that is leased, and on which the continued performance and usufruct of the object is customarily understood to depend, so long as there is no written agreement to the contrary. It is, however, lawful for the lessor and lessee to agree that the lessee will be responsible for normal maintenance costs other than those related to the continued performance and usufruct of the leased equipment, so long as these costs are regular and customarily such that ignorance of the same will not lead to dispute..... the owner will be responsible for maintenance essential to the continued operation or usufruct, while the lessee will be responsible for every thing else.[164] In case the lessor gave the lessee permission in the contract or afterward to make certain repairs on the leased asset, he may undertake such repairs and may revert to the lessor to reimburse his expenses unless the latter did not stipulated not to revert to him. However, if the lessee undertook the maintenance of the leased asset without the lessor's permission, the former has no right to revert to him and hence he is considered as a donor.[165]

The leased asset is trust in the hands of the lessee, which should not be guaranteed except in case of transgression or default. The accessories of the leased asset are also a trust. If any of the items needed for enablement of the usufruct is defected, no guarantee is needed. The lessor is committed to refurbish the leased asset and repair any defects which hamper its usufruct. If the lessor refused, then the lessee has the right to rescind the contract, unless if the property has leased as it is, as per the opinion of the majority of

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[161] Usmani, Justice Taqi, op. cit., pp. 166-167.
[162] Usmani, Justice Taqi, op. cit., p. 167.
[163] *Al-Fatawa Al-Hindiah* 4/443, *Kashf al-Gina* 4/16, *Nihayat Al-Mohtaj* 5/264, 265, *Hashiat Al-Dosogi* 4/47, *Al-Sharh al-Sagheer* 4/63, Usmani, Justice Yaqi, An Introduction to Islamic Finance, p. 167.
[164] *Majmu 'at Fatawa al Hay'at al Shar 'iyah*, Al-Rajhi Bank, Decision No. 11; Kuwait Finance House, *Fatawa Shar 'iyah*, Question No. 241, pp. 228-229, quoted by Yusuf Talal, op. cit. p. 23
[165] Quoted by Abu Ghuddah, Dr. Abdul Sattar, *Ijarah* (Lease), op. cit., pp. 47-49.

jurists.[166] According to Malikis and some Hanafi, the lessee is not compelled to repair any leased asset in general. The lessee has the option to either live in the house and pay the full rental or leave. If the lessee pays certain repair expenses without permission or delegation of the lessor, he would be considered as donor. The option may be given to the lessor at the end of the contract either to pay repair expenses or to demolish the same if possible[167], provided that the lessor has not stipulated in the lease contract that he should not be reverted to in that respect. However, if the lessee maintained the leased asset (*Ayn)* without the lessor's permission, the former would be a donor and hence has no right to revert to the later.[168] In case of the lessee default, which is considered by the lessor as major default but not in contradiction with the purpose of the contract, in this the lessee will be considered as transgressor and he should guarantee any damages incurred by the leased asset.[169]

Al-Braka Third Fiqh Symposium issued *Fatwas* regarding the maintenance of the leased asset with effect that the lessor is not obliged to make structural or improvement repairs unless if conditional in the contract. The lessor is obliged to make necessary repairs to enable the lessee of usufruct, in case a defect occurred after the contract date or has been existing at the time of contract but not known to the lessee. However, if the defect was existing before the contracting and known to the lessee, the lessor is not obliged to rectify it unless stipulated in the contract. In case the lessor undertakes the repairs as stipulated in above paragraph, the lessee in this case has no right to rescind the contract. However, if the lessor did not perform the repairs, he will not be compelled to do so and the lessee may rescind the contract. As a major principle in this respect is that the lessor may not stipulate on the lessee to make maintenance for any defects of the leased asset. If the contract includes any such condition, it would be void due to ambiguity. However, the following cases are excluded:

A. Operating Maintenance:

Which is a requirement for smooth use of the leased asset (*Ayn*) continuously, such as oil for machinery and equipment.

B. Periodical Maintenance:

Which is necessary for sustaining the capability of the leased asset to provide usufruct.

C. Establishment Maintenance:

Which is described and quantified in the contract or common practice, whether that maintenance is mere work or with specified parts and materials, because such items are considered as rentals which are due consideration.

According to Dr. Hussain Hamid Hasan, maintenance works may be divided into following categories. I) Maintenance required for proper operation of machinery or equipment i.e. by applying equipment operation instructions along with requirements for revision and follow up of readings of temperature water, oils, etc. meters. In additions to

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[166] *Hashiat Ibn-Abdeen* 5/66, *al-Mohazab* 1/401, *Sharh al-Dor* 2/300.
[167] *Hashiat al-Dosogi* 4/45, *Al-Sharh al-Sagheer* 4/70,71, *Sharh Al-Dor* 2/300.
[168] Abu Ghuddah, Dr. Abdul Sattar, *Ijarah* (Lease), op. cit., p. 46.
[169] Abu Ghuddah, Dr. Abdul Sattar, *Ijarah* (Lease), p. 47.

their inspection to verify its properness during operation hours and their calibration, if needed. All these works are the responsibility of the lessee, because they necessary for the utilization of the leased asset usufruct and not for enabling of its usufructs. They are also necessary for optimum usufruct and not its source or origin, and that is within above stated controls and based on some branches of jurisprudence in which jurists stipulated similar duties on the lessee and per common practice in this respect. ii) Preventive Maintenance: which include specific works which should be done on specific dates, in which certain parts of the equipment are calibrated and some replaced, even if they are still proper to use. These are the responsibility of the lessee as per the contract in general, because they fall within what is required for utilization of usufruct and not for enabling usufruct, or necessitated for optimum usufruct and its source or origin based on some branches of jurisprudence and common practice. iii) Maintenance which include repair or replacement of major machinery or equipment parts, which frequently would not be defected unless for unexpected casual accidents and need expensive costs and highly technical experience. These are the responsibility of the lessor as being considered as necessary for enabling usufruct and not for utilizing usufruct or a necessity the origin of usufruct or its optimum use. They could be based on jurisprudence cases on which necessary maintenance for proper operation and preventive maintenance are based. Obliging the lessee to undertake the first two types of maintenance is not in contradiction of the contract requirements, because the *Ijarah* contract is considered as usufruct of the lessee of the leased asset (*Ayn*) in consideration of rental. However, maintenance works and which party should perform it, this is part of the contract provisions and consequences in general i.e. in absence of condition. These are the rights and obligations which the *Ijarah* contract parties may agree in a matter which satisfy their interests, provided that such arrangement are not contradictory to *Shariah*. If they abstain from such arrangements, the provisions and consequences of the contract should be applied according to *Sharaih*.[170]

Permission to Re-Lease (Sub-Lease)

All the schools of Islamic jurisprudence are unanimous on the permissibility of sub-lease. However, the opinions are different in case the rent charged from the sub-lessee is higher than the rent payable to the owner. Imam Shafi and some other scholars allow it and hold that the sub-lessor may enjoy the surplus received from the sub-lessee. This is the preferred view in the Hanbali School as well. On the other hand, Imam Abu Hanifah is of the view that the surplus received from the sub-lessee in this case is not permissible for the sub-lessor to keep and he will have to give that surplus in charity. However, if the sub-lessor has developed the leased property by adding something to it or has rented it in a currency different from the currency in which he himself pays rent to the owner/the original lessor, he can claim a higher rent from his sub-lessee and can enjoy the surplus. Although the view of Imam Abu Hanifah is more precautious which should be acted upon to the best possible extent, in cases of need the view of Shafai and Hanbali schools may be followed because there is no express prohibition in the Holy *Quran* or in the

[170] See for details discussion, Abu Ghuddah, Dr. Abdul Sattar, *Ijarah* (Lease), op. cit., pp. 49-52.

Sunnah against the surplus claimed from the lessee. Ibn Qudamah has argued for the permissibility of surplus on forceful grounds.[171]

The Albaraka Banking Group has given the following *Shariah* opinion (*Fatwa*) on sub-lease.[172] It stated that the lessee owns the usufruct and in principle any one who owns the usufruct is able to benefit from it for himself and for other. So it is permissible for the lessee to sub-lease the leased asset. The problem is that it restricts the ownership of usufruct. It is similar to ownership of the asset (*Ayn*) just like some one who sold a commodity to another and said: "Do not sell it to any one else". Hence the usufruct is now owned by the lessee and restrictions violate s principle of ownership, which in turn violates requirements of the contract except in case of damage.[173] There is no logic behind the owner of the leased asset to stipulate that the lessee should use the usufruct himself, unless damage occurs to the lease asset. It is permissible to rehire the leased asset for similar, lower, or higher pay whether re-hiring takes place after or before the first lessor receives the asset. It is permissible for some one who rented the service for another to re-hire it to some one else for the same, lower, higher pay as lessor of the worker's service is entitled to its usufruct, so he may transfer it to another. The said *Fatwa* is the one stated by the consensus of Muslims jurists (*Jamhoor*) and comes in the context of opinions of schools of *Fiqh* and their approved reference books.[174] The *Shariah* Board of the Jordan Islamic Bank has also given a *Fatwa* with effect that it is lawful to lease something for a certain amount of rent and then to sub-lease it to another for the same amount as the rent in the original lease, or for more, or less, as long as the original lessor has no objections and custom allows it.[175]

Default Obligation Amount

The Bank can not add the penalty amount to its income. The reason is that what amount becomes due, is a debt payable by the lessee and is subject to all the rules prescribed for a debt. A monetary charge from a debtor for his late payment is exactly the *Riba* prohibited by the Holy Quran. Therefore, the Bank can not charge an additional amount in case the lessee delays payment of the rent. However, in order to avoid the adverse consequences resulting from the misuse of this prohibition, the bank may resort to the said arrangement. This fund may be credited and disbursed for charitable purposes including advancing interest free loans to the needy persons. The amount payable for charitable purposes may vary according to the period of default and may be calculated at percent per annum basis. This arrangement may serve a strong deterrent for the lessee to pay rent promptly and does not compensate the bank for his opportunity cost of the period of defualt.[176] The OIC Council of Islamic Fiqh Academy, in its twelfth session (23 to 28 of September 2000) concerning 'Penalty Provision' resolved that it is permissible to include the Penalty Provision in the original contract. The Penalty Provision shall be become null and void

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[171] Usmani, Justice Taqi, op. cit., pp. 176-177.

[172] The Second Fiqh Symposium of the Kuwait Finance House, Item 3, quated by Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), p. 74.

[173] Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), op. cit., pp. 75-76.

[174] See for details *Al-Insaf* by al-Mirdawi 6/49. *Al-Mughni* by Ibn Qudammah 5/477. *Mughni Al-Muhtaj* by Al-Shirbini 2/350. *Hashiat Ibn Abideen* 6/28.

[175] Jordan Islamic Bank, *al Fatawa al Shar 'iyah*, Vol. II, pp. 36-37 quoted by Yusus Talal, op. cit. p. 38.

[176] Usmani, Justice Taqi, op. cit., pp. 171-172.

when the lessee proves that his failure to meet obligations was due to reasons that fall out of his control. [177]

The *Shariat* Appellate Bench of the Supreme Court of Pakistan has also observed in respect of leasing: "The correct position according to *Shariah* is that once the lessee has enjoyed the usufruct of the leased asset for the period of lease, the amount of rent has become a debt due on him and it will be subjected to all the rueles relevant to a loan or debt, and as mentioned in the case of mark-up, if the lessee is unable to pay on account of his poverty, he will have to be given further time according to the clear Quranic command, and if he is purposely delaying the payment, he will be subjected to punitive steps. But his delay will not be taken as an automatic source of return to the lessor,....."[178]

Promise to buy the Leased Asset

Any express or implied condition that title of the asset will pass on to the lessee at the end of the lease period is not in accordance with the *Shariah* principles. This is because one transaction cannot be tied up with another transaction so as to make the former a pre-condition for the other. The lessee promise the lessor to buy the leased asset by the end of the lease period and after payment of all rental payment installments agreed on during this period. The jurists have two different opinions regarding whether promise is binding or no. The consensuses of jurists (*Jamhoor*) opine that it is not binding. While according to Imam Malik, Ibn Al-Qasim and Sahnoon, the promise is binding if the promissee entered into an obligation due to this promise.[179]

The OIC Islamic Fiqh Academy has also suggested that there can be a unilateral promise to gift or sell the asset at the end of the lease period subject to the following conditions: Firstly, the agreement of *Ijarah* itself should not be subjected to signing this promise of sale or gift but the promise should be recorded in a separate document. Secondly, the promise should not be binding on both parties because in that case it will be a full contract ascribed to a future date, which is not allowed in the case of sale or gift.[180] The bank promise to sell for a specific price or *Ijarah* term, or return the commodity to the lessor. According to Dr. Abdul Sattar this disposition is not prohibited as it is equivalent to the type of *Ijarah* tied up (connected) with a promise to sell for an actual price. But here it becomes more flexible for the lessee, as it empowers him to select between the two choices by the end of *Ijarah* term: purchase the leased asset, or return the commodity to the owner.[181]

There is no objection to state in *Ijarah* contract that the ownership of the leased asset shall be transferred after payment of rental instalments to the lessee. However the sale contract shall be concluded in due time i.e. upon payments of all instalments and this contract can not be concluded on the onset of lease as the sale contract can not be tied up

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[177] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 251-252.
[178] FSC, 'Judgement on *Riba'*, op. cit.
[179] Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), op. cit., p. 100.
[180] Quoted by Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), op. cit., p. 103; *Majmu 'at Fatawa al Hay'at al Shar 'iyah,* Al-Rajhi Bank, Decision No. 11; Kuwait Finance House, *Fatawa Shar 'iyah,* Question No. 241, pp. 228-229, quoted by Yusuf Talal, op. cit. p. 23; Also see, Muhammad Ayub, op. cit. p. 97.
[181] Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), op. cit, p. 104.

to the future and no objection to make a promise to sell in due time.[182] It is lawful to issue an offer in which a time is specified for the sale of something for a certain price. The one making the offer will be considered legally bound to (honour) the offer for the duration of the time specified; and the other party may accept or refuse during the same period. This principle was adopted by the jurists of the Maliki School.[183]

Estimation of Rent in *Ijara Wa Iqtina* Contract

According to Dr. Sami Hommod, that although in case of *Ijarah wa Iqtina* he considers all payments as rents, however, in fact it is part of the price. Consequently upon rescission, it should be calculated or deducted from that rent. It should be stated that part of it is a consideration of usufruct and the other part should be returned to its owner in case the contract is rescinded at any stage. Otherwise, it would be taking something illegally.[184] An other member of the Academy, in regard to the rent as being more than the estimated equivalent price, opined that it is related to estimated equivalent price. Hence if it is revoked, we revert to the estimated equivalent price and then any increment would not be a right entitled for the owner, because he will be disposed of consequences by certain conditions. These conditions if they do not contradict the subject matter of the contract, it is then approved. Otherwise, it would be rejected and the contract itself would continue as sound and proper.[185] This is an example of difference between rent and estimated equivalent price and damages inflicted on the lessee if the leased asset (*Ayn*) was not possessed by him.

According to Dr. Abdul Sattar, the above mentioned opinions in rent researches, regarding permissibility of its repetition by different magnitudes according to certain circumstances such as period, place, quantity of work, the worker, the distance, and quantity of carriage, etc. This could be a reasonable basis for using the principle of repetition in the period of *Ijarah*.[186] In case the *Ijarah* extended to include the whole agreed upon contract period, the rent would be as such (considering agreed upon distribution of the total price, leased asset (*Ayn*) cost and profit on periodical terms) because since the lessee has owned the leased asset (*Ayn*), he would not bother for the distribution mechanism, as all are entitled. [187] If the period of *Ijarah* is terminated before its due date for any reason (*Shariah* accepted excuse for rescission, or by mutual consent, or by violation of *Ijarah* conditions) the *Ijarah* would be as such (considering a just estimation of rent within the limit of estimated equivalent price). Consequently, the lessee will not pay more than the equivalent of usufruct during the period of usufruct.[188]

If the contract of *Ijarah* does not full fill the above mentioned requirements of *Sharaih*, then the consensus of jurists (*Jamhoor*) consider the contract incorrect and null and void, as it is prohibited. The prohibition necessitates non-existence of the contract

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[182] Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), op. cit., p. 109.
[183] *Majmu 'at Fatawa al Hay'at al Shar 'iyah*, Al-Rajhi Bank, Decision No. 11; Kuwait Finance House, *Fatawa Shar 'iyah*, Question No. 241, pp. 228-229, quoted by Yusuf Talal, op. cit. p. 23.
[184] Islamic Fiqh Academy Magazine 5/2676, discussion by Dr Sami Mohmood quated by Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), op. cit., pp. 110-111.
[185] Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), op. cit., p. 111.
[186] Ibid., p. 112.
[187] Ibid.
[188] Abu Ghuddah, Dr. Abdul Sattar in his book "*Ijarah*" (Lease), op. cit., p. 112.

from the point of view of *Shariah*, whether prohibition is due to deficiency in the principal contract or due to a description inherent or emergent to it. The prohibition results in no effect and the use by the lessee is not permissible and does not result in identical rent, but he shall pay the equal rent whatsoever if he receives the subject of the contract or used the usufruct or time has elapsed for the use of the asset. Because, lease is like sale and usufruct is just like an asset and the invalid sale is like the correct one in terms of stability of the exchanged item, it is so in *Ijarah* and it is so according to opinion of Shafie.[189] The rent payment must be exactly known, with regard to the amount and the due date. An indication of the same, by saying that it should represent so much profit, is not acceptable. This may be no more than an indication of how rent is to be calculated, and there is nothing wrong with that. Even so, it is essential that the rent be specified in the contract itself, far removed from any mention of profit.[190] .

Variable Rentals

Some contemporary scholars have allowed in long-term lease to tie up the rental amount with a variable bench-mark which is well-known and well-defined leaving no room for any dispute. For instance, according to them it is permissible to provide in the lease contract that in case of any increase in the taxes imposed by the government on the lessor, the rent will be increased to the extent of the same amount. Accordingly, it is allowed by them that the annual increase in the rent is tied up with the rate of inflation. For instance, if there is an increase of 5 percent in the rate of inflation, it will result in an increase of 5 percent in the rent as well. Some Islamic banks use the rate of interest of a particular country (like LIBOR) as a bench-mark to determine the periodical increase in the rent.[191] The clause of the Bank's Lease Agreement about the periodical increase in rent may be criticised on the ground that the variation of the amount of the rent being unknown leading to *Jahalah* and *Gharar*, which are not permissible in *Sharaih*. It is one of the essential requirements of the *Shariah* that the consideration in every contract must be known to the parties when they enter into the contract. The consideration in the contract of *Ijarah* is the rent charged from the lessee and therefore it must be known to each party right at the beginning of the contract of lease. If we tie up the rental with the unknown elements, then the amount of rent will remain unknown as well. This is the *Jahalah* or *Gharar* which renders the contract invalid.

However, according to Justice Taqi Usmani, one may say that *Jahalah* has been prohibited for two reasons. Firstly, that it may lead to dispute between the parties. If we see to this transaction, it will become clear that this reason is not applicable here, because both the parties have agreed with mutual consent upon well defined criteria for determining the rent. Accordingly, whatever amount is determined based on the said criteria will be acceptable to both the parties. Thus, there is no question of any dispute between the parties. The second reason for the prohibition of *Jahahah* is that it renders the parties susceptible to an unforeseen loss. It is possible that the Bank's cost may increase or remain constant or goes down below the previously agreed level. In this case it equally possible that the lessor or lessee may suffer. In this case it may be suggested

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[189] *Nihait Al-Muhtaj* 5/264. *Minhaj Al-Talibeen* and *Hashiat Al-Qaliobi* 3/86, and *Al-Muhazab* 1/399.
[190] *Majmu 'at Fatawa al Hay 'ah al Shar 'iyah,* Decision no. 112, quoted by Yusuf Talal, op. cit. p. 54.
[191] Quoted by Usmani, Justice Taqi, op. cit., pp. 169-169.

that the relation between rent and the agreed criteria for the increase of rent may be subjected to a limit or ceiling in order to meet the risks involved in such possibilities. For instance, it may be provided that in the Lease Agreement that the rental amount after a given period will be changed according to the change in the increase in Bank's cost but it will in no case be higher than 15 percent or lower than 5 percent of the previous monthly rent. This arrangement will mean that if the increase in the Bank's cost is more than 15 percent, the rent will be increased only upto 15 percent. Conversely, if the decrease in the rate of Bank's cost is more than 5 percent the rent will not be decreased to more than 5 percent. According to Justice Usmani, this is moderate view which takes care of all the aspects involved in the issue.[192]

Termination of Lease Agreement

The lessor has the right to terminate the lease agreement unilaterally, if the lessee contravenes any term of the agreement. However, the lease agreement cannot be terminated without the mutual consent, if there is no contravention of any condition by the lessee. Accordingly, the lessor cannot be given unrestricted power to terminate the lease agreement unilaterally whenever he wishes, according to his sole judgement, because this is contrary to the principles of *Shariah*. In case of termination of the lease agreement, there should be an express provision with effect that the rent of the remaining period shall not be paid by the lessee. Any condition contrary to this is against the principles of *Shariah*, equity and justice. The leased asset should be taken back by the lessor and the lessee should be asked to pay the rent as due upto the time of termination. In case the termination has been effected due to the misuse or negligence of the lessee, he can then also be asked to compensate the lessor for the loss caused due to his misuse or negligence. However, he cannot be compelled to pay the rent of the remaining period.[193]

According to the *Shariah* Board of the Kuwait Finance House, if the lessee returns the item owing to compelling circumstances, the remainder of the lease payment must be returned because the lease will be considered to have been dissolved for valid reasons. According to *Shariah*, *Ijarah* may be legally invalidated by compelling circumstances. If the lessee returns the item simply because he wants to return it, then if the bank agrees to such a return, the remainder of the lease payment must be returned to the lessee because a mutual dissolution of the lease, much like *Iqalah*, has taken place. If, however, the lessee stipulates that the item must remain in his name until the completion of the leased period, and that it not be leased to another, then the remainder will not be returned and the item will remain at the disposal of the lessee until the lease expires.[194]

Insurance of the Leased Asset

The bank being the owner of the leased asset obtains the insurance of the asset either directly or through the customer by appointing him as an agent of the bank. In the later case, the bank and the customer signs an insurance agency agreement under which the

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[192] Usmani, Justice Taqi, op. cit., pp. 168-171.
[193] Ibid, pp. 173-174.
[194] Kuwait Finance House, *Fatawa Shar 'iyah*, Question 230, p. 221, Translated by Yusuf Talal, op. cit. p. 19

bank appoint the customer its agent to obtain insurance of the asset from the company offering services under Islamic mode of *Takaful*. The bank may add the insurance cost to the total aggregate cost of the asset and accordingly charge the rentals from the customer.[195]

Normal Termination of the Lease Agreement

The lease agreement should not contain any express or implied condition with effect that the leased asset shall be transferred to the lessee at a nominal token price or free of any charge. Any agreement containing provisions contrary to this is against the principles of *Shariah*. It is well settled rule of Islamic jurisprudence that one transaction cannot be tied up with another transaction so as to make the former a pre-condition for the other. The actual position in *Shariah* is that the leased asset shall be the sole property of the lessor and he shall be at liberty after the expiry of the lease period to take the asset back or renew the lease or lease out the leased asset to another person or sell to the lessee or any other person. The lessee cannot compel the lessor to sell the leased asset to him at nominal price nor can any such condition be imposed in the lease agreement on the lessor. [196]

Some contemporary jurists keeping in view the needs of the Islamic financial institutions have suggested an alternative. According to them, the agreement of lease should not contain a condition of sale or gift at the end of the lease period. Contrary, the lessor may enter into a unilateral promise to sell the leased asset to the lessee at the end of the lease period. The lessor will be bound by his promise. According to them, the principle is that a unilateral promise to enter into a contract at a future date is allowed whereby the promissor is bound to fulfil the promise, but the promisee is not bound to enter into the contract. This means, that the promisee has the option to purchase the leased asset, which he may or may not exercise. However, if the lessee excerise his option to purchase the leased asset, the lessor cannot refuse it, because he is bound by his promise. Accordingly, these scholars propose that the lessor after entering into the lease agreement can sign a separate unilateral promise whereby he undertakes that if the lessee has paid all the rental amounts and want to purchase the asset at a specified mutually acceptable price, he will sell the leased asset to him for that price. Similarly, it is allowed by these scholars that instead of sale, the lessor signs a separate promise to gift the leased asset to the lessee at the end of the leased period and after full payment of all outstanding rent. This arrangement is called *Ijarah wa Iqtina*. It has been allowed by large number of contemporary scholars. According to Justice Taqi Usmani, the validity of this arrangement is subject to two conditions. Firstly, the agreement of *Ijarah* should not be subjected to signing this promise of sale or gift but the promise should be recorded in a separate document. Secondly, the promise should be unilateral and binding on the promisor only. It should not be a bilateral promise binding on both parties, because in this case it will be a full contract effected to a future date which is not allowed in the case of sale or gift.[197]

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[195] Usmani, Justice Taqi, op. cit., p. 174.
[196] Ibid, pp. 174-175.
[197] Usmani, Justice Taqi, An Introduction to Islamic Finance, pp. 175-176.

4.1.4 Recommendations

The contract of *Ijarah Wa Iqtina* practiced by the BoK IBD is deduced from various provisions of *Ijarah* such as determination of rent and incurrence of the owner (the lessor) of the liability arising from the contract such as his obligations towards maintenance and all burdens of ownership. It also includes many points which need to be clarified to avert ambiguity of contract (*Gharar*). Such deviations from *Shariah* guidelines disqualify this form of *Ijarah* for their underlying intentions and transferred it to mode comparable to usurious (*Riba*) mode, because it awards the Bank returns without shouldering the guarantee. Therefore, the following recommendations are made with regard to *Shariah* observations in the mode of *Ijarah Wa Iqtina* practice by the BoK IBD:

1. The contract should be better be denominated as (*Ijarah* with Purchase Price) instead of (*Ijarah* with Purchase Option). This is because option in Islamic *Fiqh* gives the option holder freedom of choice either to purchase or not. Accordingly, it is not permissible to seize the security amount paid at the start of lease contract if he refused to purchase. This is due to the fact that the advance amount is considered in effect as trust which is not permitted to dispose of. So it should be return to him as per his request

   The cash amount paid at the time of contracting in order to confirm seriousness of the client to purchase the property is contradicting with the principle of option in *Fiqh*. This contradiction would be cleared if we use the mode of purchase promise instead of purchase option. In case of purchase promise the cash amount may be requested from the promisor to confirm his seriousness. This amount is considered in effect as a trust which is permitted to dispose of and so it is not part of the price. Also, this amount would be guaranteed by the party holding its rights of gain and loss. In case the client fails to honour his promise, the cash amount may be confiscated if it is stipulated in the contract, which should only be deduced in proportionate to actual damage realized due to forbearance. In case the property was sold with less than the original invested amount, it is permissible to deduct the equivalent of the realized loss from the deposited cash amount. However, no amount should be deducted if the total original invested amount is realized upon the sale of property.

2. The contract states that in case the lessee exercised the purchase option, the lessor would convey the leased asset ownership to him, at the pre agreed terminal value. The terminal value should not be pre fixed. It should be left to the market price of the leased asset, if the customer excerise the option to purchase the leased asset. This is for the reason that the leased asset may not be of the amount as agreed in terminal avalue and may be less than that or high.

3. It has been observed that some of the clients entered into the *Ijarah* transaction with Bank just for the liquidity requirement. Therefore, the management of the Bank should consult the *Shariah* advisors and *Shariah* auditors of the Bank in every case, who should make insure that just for liquidity requirement *Ijarah* transaction is not allowed. They should also make insure that recoveries of rentals are made only after

the delivery of the vehicle, because it is a unanimous opinion of all the *Shariah* scholars that it is not allowed to recover rentals before delivery.

4. The term 'revision of rent' is mentioned in the Lease Agreement, without specifying the details of this rent. This contradicts with the properness of compensation (*Moawada*) contracts including *Ijarah*, wherein the rent should be fixed and specified in magnitude or by setting a standard which could be applied at the time of entering the contract to evade any further dispute.

5. The contract should clearly mention all those liabilities to be incurred by the lessor with respect to the maintenance of the leased asset. So, that the liability of the lessor should not be disavowed and overburdened on the lessee. The lessee may bear the liabilities arising from operation and periodical maintenance, because these are consequences of use, which is permissible. All expenses other than expenses related to normal wear and tear of the *Ijarah* asset should be borne by the Bank and may be included into the list price of *Ijarah* asset.

6. It is stated in the contract that the lessor has the right to rescind the *Ijarah* contract in case of the lessee default. In this case the contract should clearly state that the lessor would not entitle for the rent of up to the end of the remaining period of the contract. Because he has no right in the rent of the property after the date of rescission.

7. The contract should clearly state that the lessor is liable for the contract provisions which has been entered between the lessee and the property dealer. Because the property was possessed for the benefit of the lessor and so he is responsible for the obligations arising from such ownership.

8. The Shariah advisors should make insure that the purchase promise should be independent of the *Ijarah* contarct. There is no objection that entering the promise and signature of *Ijarah* contract could be done simultaneously. The *Ijarah* contact should not be linked to the property sale contract, because they are two separate contracts.

9. A phrase stating that: (without violating Islamic *Shariah* regulations) should be added in the clause relating to the governing law of the contract. It has particular importance in *Ijarah* ending with ownership contract, because courts and laws which may be referred to may not observe *Shariah* requirements and only give due consideration to mere legal points of law.

4.2. *Shariah* Principles of *Bai' Al-Murabahah*

Definition

Literal Meaning:
It is pertinent to define the two terms, *Bai* (sale) and *Murabahah* individually for the proper understanding of the definition of the term *Murabahah*. In *Shariah* 'sale' is defined as "an exchange of a useful and desirable thing (*Mall*) for similar thing by mutual consent in a specific manner."[198] Some jurists have added to this definition the words "for the alienation of property."[199] While, the term *Murabahah* is derived from Arabic word '*Ribh*' meaning an agreed upon profit. *Bai-Murabahah* means sale for an agreed upon profit.

Technical Meaning:
Bai Murabahah is a particular kind of sale where the seller expressly mentions the cost of the sold commodity he has incurred, and sells it to another person by adding some profit thereon.[200] *Murabahah* is a contract between a buyer and seller under which the seller sells certain specific goods permissible under Islamic *Shariah* to the buyer at a cost plus an agreed upon profit payable on the spot or on some future date in lump sum or by installments. It is also permissible to fix the profit in percentage i.e. ten percent of the cost.[201] It is a type of sale that Islamic jurisprudence considers as a trust contract, because the seller and the buyer do not negotiate the price, but rather agree on a certain profit margin added to the cost, as faithfully declared by the seller.[202] A definition of *Murabahah* published by the *Dar Al-mal Al-Islami* in the daily Sharq Al-awsat, dated 07/06/1984[203].

> "*Al-Murabahah* is a contract by virtue of which a customer wishing to purchase some equipment or goods requests the Islamic Organization (the bank) to purchase these goods (for him). After the Organization (the bank) takes possession (of goods), it sells them to him at their value plus what it has spent in procuring them in addition to a reasonable profit agreed upon by the both parties along with their agreement regarding the terms of repayment".

Thus, we may say that *Murabahah*, in its original Islamic connotation, is simply a sale. The only feature distinguishing it from other kinds of sale is that the seller in *murabahah* expressly tells the purchaser how much cost he has incurred and how much profit he is going to charge in addition to the cost. If a person sells a commodity for a lump sum price without any reference to the cost, this is not a *Murabahah*, even though he is

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[198] Kasani, *Badai, al-Sanai*, vol. 5, p. 133.
[199] Shirbini, *Mughni al-Muhtaj*, vol. 2, p. 2: Ibn Qudamah, *al-Mughni*, vol. 3, p. 559.
[200] Ibn Rushd, Abul al Walid Muhammad, *Bidayat al-Mujtahid wa Nihayah al Muqtasid*, vol II, p. 213.
[201] Dr. Tahir Mansuri, Islamic Law of Contract and Business Transaction, Shariah Academy, p. 214.
[202] IDB, IRTI, Financing Trade in an Islamic Economy, p.19. Also available on www.irti.org
[203] Quoted by Al-Kaff, Syed Hamed Abdul Rehman, *Al-Murabahah* in Theory & Practice, p. 14, (Islamic Research Academy Karachi, Date not given).

earning some profit on his cost because the sale is not based on a "cost-plus" concept. In this case, the sale is called "*Musawamah*".

Conditions of *Murabahah:*

The ordinary *Murabahah* is permissible under the teachings of the Holy Quran, Sunnah, and reasoning.[204] The validity of *Murabahah* depends on some conditions which should be dully observed to make it compatible with the injunctions of Islam. *Murabahah* being a sale contract should fulfill all the essential conditions necessary for a valid sale. In the following lines some general conditions for a valid sale are described.

General Conditions for a Valid Sale:

1. The subject of sale must be existing at the time of sale. Thus, a thing which has not yet come into existence cannot be sold. If a non-existent thing has been sold, though by mutual consent, the sale is void according to *Shari'ah*. For instance, if some one sells the unborn calf of his cow to another person. The sale is void in eye of *Shariah*.

2. The subject of sale must be in the ownership of the seller at the time of sale. Thus, what is not owned by the seller cannot be sold. If he sells something before acquiring its ownership, the sale is void. For instance, A sells to B a car which is presently owned by C, but A is hopeful that he will buy it from C and shall deliver it to B subsequently. The sale is void, because the car was not owned by A at the time of sale.

3. The subject of sale must be in the physical or constructive possession of the seller when he sells it to another person. "Constructive possession" means a situation where the possessor has not taken the physical delivery of the commodity, yet the commodity has come into his control, and all the rights and liabilities of the commodity are passed on to him, including the risk of its destruction. For instance, A has purchased a car from B. B, after identifying the Car has placed it in a garage to which A has free access and B has allowed him to take the delivery from that place whenever he wishes. Thus the risk of the Car has passed on to A. The car is in the constructive possession of A. If A sells the car to C without acquiring physical possession, the sale is valid. However, there are two exceptions to the conditions mentioned above provided by *Shariah*. They are: (i) *Bai' Salam* (ii) *Istisna'*.

4. The sale must be instant and absolute. Thus, a sale attributed to a future date or a sale contingent on a future event is void. If the parties wish to effect a valid sale, they will have to effect it afresh when the future date comes or the contingency actually occurs. For instance, A says to B on the first of January: "I sell my car to you on the first of February". The sale is void, because it is attributed to a future date.

5. The subject of sale must be a property of value. Thus, a thing having no value according to the usage of trade cannot be sold or purchased.

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[204] See for details Abu Ghuddah, Dr. Abdul Sattar, *Al-Bai al-Muajal*, pp. 17-18, IDB IRTI, Also available on www.irti.org.

6. The subject of sale should not be a thing which is not used except for a *haram* purpose, like pork, wine etc.

7. The subject of sale must be specifically known and identified to the buyer. It means that the subject of sale may be identified either by pointation or by detailed specification which can distinguish it from other things not sold. For instance, there is a building comprising a number of apartments built in the same pattern. A, the owner of the building says to B, "I sell one of these apartments to you"; B accepts. The sale is void unless the apartment intended to be sold is specifically identified or pointed out to the buyer.

8. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance. For instance, A sells his car stolen by some anonymous person and the buyer purchases it under the hope that he will manage to take it back. The sale is void.

9. The certainty of price is a necessary condition for the validity of a sale. If the price is uncertain, the sale is void. For instance, A says to B, "If you pay within a month, the price is Rs. 50. But if you pay after two months, the price is Rs. 55". B agrees. The price is uncertain and the sale is void, unless anyone of the two alternatives is agreed upon by the parties at the time of sale.

10. The sale must be unconditional. A conditional sale is invalid, unless the condition is recognized as a part of the transaction according to the usage of trade. For example, A buys a car from B with a condition that B will employ his son in his firm. The sale is conditional, hence invalid.[205]

However, there are certain conditions which are more relevant to the transaction of *Murabahah.* Therefore, in the following lines, we will discuss those conditions, which are more relevant to the transaction of *Murabahah*. They are elaborated under the following headings:[206]

1. Disclosure of Original Price:

It is necessary for a valid *Murabahah* that the purchaser should have knowledge of the original price of the commodity. It means that the seller should disclose price of the commodity. If the price is not disclosed in session of contract and contract parties leave the session (*majlis*), the contract will be void.

2. Fixation of Profit:

The profit to be added to the original cost should be clearly mentioned in the contract of *Murabahah.*

[205] Usmani, M. Taqi, op. cit., pp. 97-101.
[206] Zuhayli, *al-Fiqh al-Islami wa Addillatuhu*, vol. 4, pp. 704-706.

3. Ascertainment of Price:

The certainty of price is a necessary condition for the validity of *murabahah*. It is valid only, where the exact cost price can be ascertained. If the exact cost price is uncertain, then the commodity cannot be sold on *Murabahah*. Instead, it will be sold without reference to the cost. This situation may arise in cases, where a person has purchased two or more things in a single transaction, and he does not know the price of each object individually.

4. Validity of First Contract:

The first contract should be a valid contract. If the first contract is irregular (*fasid*), then the second is not permitted on the basis of *Murabahah*. Because, *Murabahah* is resale of a thing with the addition of profit, and the irregular sale is not allowed with the stated price. It is allowed only with the legal value i.e. the market price.

5. Existing of the Subject Matter:

The subject of *Murabahah* contract must exist at the time of sale. According to *Shariah* a non-existing thing cannot be sold, though by mutual consent and the sale would be void.[207]

6. Ownership of the Seller:

The subject matter of the contract of *Murabahah* must be in the ownership of the seller at the time of sale. Thus, if the seller sells something before acquiring its ownership, the sale is void.[208]

7. Possession of the Subject Matter by Seller:

The subject matter of sale must be in the physical or constructive possession of the seller where he sells it to the other person.[209]

8. Instant and Absolute Sale

The sale must be absolute and instant. Thus, where a sale is attributed to future date or contingent on a future event, then it is void.

9. Valuable Subject Matter:

The subject matter of *Murabahah* must be valuable property. Thus, if a thing has no value according to the usage of trade cannot be sold or purchased.

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[207] Taqi Usmani, op. cit., p. 97.
[208] Ibid.
[209] Ibid, p. 98.

10. Lawful Subject Matter:

All commodities which may be the subject matter of sale with profit can be subject matter of *Murabahah*, because it is particular kind of sale. Conversely, *Murabahah* is not possible on things that cannot become the subject of sale. For example, it is not possible in exchange of currencies. The subject matter of the contract of *Murabahah* should not be a thing, which is used for *haram* purposes i.e. wine, etc.[210]

11. Delivery of the Subject Matter:

The delivery of the sold commodity to the buyer should be certain and should not depend upon a contingency or chance.

12. Absolute and Unconditional Sale:

The sale must be absolute and unconditional. According to *Shariah* a conditional sale is invalid, unless the condition is recognized according to the usage of the trade as a part of the transaction.

13. Fixation of Deferred Payment Time Period:

The general rule in sale transactions is the cash payment. Therefore, it is necessary to conclude in the contract of *Murabahah* about the deferment of the sale price. If the contract of *Murabahah* does not mention about the time of the payment of the commodity price, then the reversion would be made to custom (*Urf*).[211] It is a condition for the validity of the valid *Murabahah Muajjal* agreement to fix the time period, the payment of the price of the commodity is contingent upon it. Thus, the deferment of sale price is not permissible into an indefinite period, because it leads to tussle between the parties. Also, the non-fixation of time period leads to non-compliment of those contracts, whose compliments are obligatory.[212] The deferment may rather be in the from of mentioning specific dates or specific time or mentioning time period from the date of contract i.e. twenty years, or deferment to a specific *Eid i.e. Eid-ul-Fitar* according to the consensus of jurists.[213]

Modern Application of *Murabahah*

As, we mentioned above, in ordinary *Murabahah* sale, there are two parties to it, the seller and the buyer. The seller is an ordinary trader who buys a commodity without depending on a prior promise of purchase, then he displays it for *Murabahah* sale for a price and a profit to be agreed upon. However, *Murabahah* sale connected with a promise, there are three parties to it, the seller, the buyer and the bank as an intermediary trader between the buyer and the seller. The bank here does not purchase unless the buyer specifies its desire and a prior outstanding promise to purchase. The *Bai' Murabahah* involves purchase of a commodity by a bank on behalf of a client and its resale to the latter on cost-plus-profit basis. Under this arrangement the bank discloses its cost and profit margin to the client. A simple *Murabahah* is one where there is cash payment and

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[210] Ibid, pp. 145-146.
[211] *Al-Kafi*, Ibn Abdul Bar, 726/2.
[212] *Al-Mawsoha Al-Fiqhiyah*, 33/2, (Published by Ministry of Trusts and Islamic Affairs since 1981).
[213] Al-Kasani, *Badi Saniah*, 181/4, Ibn Qudammah, *al-Mughni*, 318/4, *al-Mawsoha al-Fiqhiyah*, 33/2.

Murabahah Muajjal is one on deferred payment basis. However, in practice the mode of *Murabahah Muajjal* is used by the Islamic banks and financial institutions. The reason is that the customer basically needs finance. Therefore, he approaches the bank, which buys the commodity on cash price and then sells it to the customer on deferred price along with profit margin.[214] It is used by Islamic banks to provide finance in various and diverse sectors e.g. in consumer finance for purchase of consumer durables, such as cars and households appliances, in real estate to provide housing finance, in the production sector to finance the purchase of machinery, equipment and raw materials, It is also used in domestic trade, agriculture, transportation, international trade, etc. *Murabahah* contract is also used to issue letter of credits and to provide financing to import trade. *Murabahah* has become one of the most popular financing techniques among the Islamic banks. It has been estimated that seventy to eighty percent of the total finance provided by Islamic banks is through *Murabahah.*[215]

4.2.1 *Murabahah's* Practice of the Bank of Khyber Islamic Banking Division

The client approaches IBB of BOK for availing the *Murabahah* financing facility. The concerned section of the Branch explains him the concept of the *Murabahah* financing, its process and the required documents of the proposed purchase asset. The client and the Bank agree on the terms and conditions of the *Murabahah* facility, such as amount, tenor, rate, security, etc.[216] The Bank and the client execute Master *Murabahah* Facility Agreement (MMFA) and Agency Agreement. The MMFA is an "Agreement to *Muarabahah*" between the client and the Bank, which sanction a master limit to the customer. In other words, it is a Unilateral Promise by the client to purchase the proposed commodity after the Bank has acquired the asset. This Agreement also serves the purpose to define the legal framework within which the Bank and the customer will undertake business with each other.[217] The Bank usually provides goods on the basis of *Murabahah* financing to its customers through any one of the following modes. The Bank may either directly buy the goods from the supplier and then sell to the customer or may appoint a third party as agent to purchase the goods required by the customer. The Bank may also appoint the customer himself as the agent (*Wakil*) of the Bank to buy the required goods for the Bank.[218]

In case, the Bank appoints the customer as its agent (*Wakil*) to select and procure specified goods for the Bank, then "Agency Agreement" is executed by the client. Under the "Agency Agreement" the Bank appoints the customer as its agent (*Wakil*) to select and procure specified goods for the Bank. The most important reason for appointing the client as agent is that no disputes arise about the quality and price of the goods and the goods are according to the consent of the customer. The agent is liable to take every possible measure to select and procure genuine goods under the Agency Agreement. Any problem arising due to the selection of goods is the responsibility of the agent. As soon as the agent completes the purchasing process of the specified goods, ownership risk of the specified goods transfers to the Bank. The Agency Agreement of the Bank also

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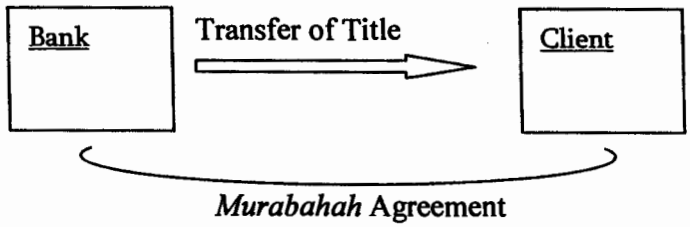
[214] Abu Ghuddah, Dr. Abdul Sattar, *al-Bai al-Muajal*, p. 37, IDB IRTI.
[215] Dr Ausaf Ahmad, Development and Problems of Islamic Banks, op.cit., pp. 45-47.
[216] Manual of *Murabahah*, The Bank of Khyber Islamic Banking Division, p. 6.
[217] Ibid.
[218] Ibid.

contains an exhaustive list of the goods that may be purchased by the agent.[219] After the agent completes the procurement process of the goods, disbursement is made by the Bank. The Bank may make disbursement in either of two ways: a) direct payment to supplier or b) indirect payment via agent.

In order to verify that the customer has really purchased the concerned goods, the client is required to submit purchase evidence in the form of bills, sale invoice along with Declaration. The total cost of the goods also includes the charges of sales tax, transportation and handling besides its original cost and profit of the Bank. It is necessary that the purchase evidence must conform that the goods have been acquired after the Agency Agreement and before the Declaration date. The most important thing is that the goods must be in existence in their original form at the time of signing of Declaration (Execution of Sale).[220] The Bank accepts the said Declaration after all the above-mentioned conditions have been fulfilled. The title and ownership of the goods are transferred to the client. The client pays the total price of the goods in the number of instalments as agreed between them. The price of the goods includes original price of the goods, expenses of the Bank and profit of the Bank.[221]



Salient Features of the Master *Murabahah* Facility Agreement of the Bank of Khyber Islamic Banking Division

Payments

The customer is bound to abide by the terms of the Declaration and the payment schedule and in consideration of the sale of the asset shall make payments to the Bank on demand all expenses (including legal and out of pocket expenses) incurred by the Bank in connection with preparation, execution, performance or enforcement of this Agreement or any related document.[222] The customer shall pay to the Bank within three days of the Bank's first demand all stamp, documentary, registration or other like duties imposed on or in connection with this Agreement and the security documents or any other documents and shall indemnify the Bank against any liability arising by reason of any delay or omission by the customer to pay such duties. The customer shall pay all the payments in full to the Bank under this Agreement and without any set off or counter claim whatsoever and free and clear of any deduction or withholding on the due date to a current account of the Bank. The customer shall be liable for all taxes, fees, and expenses

[219] Ibid.
[220] Ibid.
[221] Ibid.
[222] Ibid.

incurred by the Bank or levied by any authority or government in respect of any transaction under this Agreement other than the corporate income tax of the Bank.[223]

Penalty

The customer shall pay to the Bank an amount calculated at the rate of twenty (20) percent per annum for the amount of the contract price, part thereof or any other amount due for each day of delay beyond the relevant payment date or due date by which the contract price, any part thereof or any other amount due remains unpaid in case of default in payment of the contract price, any part thereof or any other amount due hereunder, which will be utilized by the Bank for charitable and religious purposes.[224]

Setoff

The customer authorizes the Bank to apply any credit balance to which the customer is entitled or any amount which is payable by the Bank to the Customer in partial or total satisfaction of any due sum or payable from the customer to the Bank under this Agreement.[225]

4.2.2 Case Study of the Bank of Khyber Islamic Banking Division *Murabahah* Financing

A customer namely, Mr. 'B' came to the BOK IBB for availing the *Murabahah* financing transaction facility. He planned to build a hospital on a 15 *Marlas* land for which he needed raw materials. Therefore, he requested to the Bank for the Master *Murabahah* Finance (MMF) limit of Rs.3.000 Million for purchase of cement, steel, and other raw materials. The concerned section of the Branch explained to him the product of *Murabahah* financing, its procedure and the requirements of the proposed purchase asset. The required documents included execution of Master *Murabahah* Facility Agreement (MMFA), Agency Agreement. identification documents, bank statements, Account No., proof of business and its name and address, proof of income i.e. last pay slip, etc, utility bills, two reference letters, experience in business, phone no. and residential address. The security offered for the proposed amount included registered mortgage of Rs. 200,000/- and agriculture land measuring 22 Kanals having force sale value (FSV) of Rs.6.035M and personal guarantee of the customer and owner of the agriculture land. He also submitted a registered deed of Irrevocable General Power of Attorney (IGPA) in favour of the Bank to sell, auction, transfer, and lease out or rent out the property offered as security.

The customer submitted all the relevant documents. The concerned section of the Branch perused all the given documents of the customer. The Branch made an independent inquiry and scrutiny of the informations provided by the customer. A credit worthiness report of the customer and his guarantors was also made. The concerned Branch reached to the conclusion that he qualifies the credit approval criteria established by the Bank. The clear CIB report of the customer was also obtained from SBP. The concerned section of the Branch prepared a proposal, which contained inter alia a brief profile and history of the client, MMF limit, tenor, ratio of the Bank profit and details

[223] Ibid.
[224] Ibid, p. 14.
[225] Ibid.

about the given security. The Brach recommended MMF limit of Rs. 3.000 Million for the purchase of proposed raw materials. The tenor of the *Murabahah* facility was fixed as three years, which composed of 36 equal monthly instalments. The Branch recommended a profit rate of 18 %. The concerned section of the Branch after complete perusal of the given record recommended his case to the IBD of the Bank along with all the relevant documents.

The concerned section of the IBD perused the record and prepared a comprehensive proposal of the proposed *Murabahah* facility. The credit worthiness of the customer was declared as good. The IBD proposed MMF facility limit of Rs. 2.000 Million for the purchase of prescribed raw materials for the period of three years, consisting of 36 equal monthly instalments. The profit rate was proposed as 18 percent per annum. The instant *Murabahah* facility proposal was also referred to *Shariah* Advisors of the IBD for giving *Shariah* Clearance Certificate. The *Shariah* Advisors of the IBD has examined the proposal and all the relevant documents and concluded that there is nothing adverse against the *Shariah* principles in instant proposal. The concerned section of the IBD after getting *Shariah* clearance has recommended the instant proposal of Master *Murabahah* Facility limit of Rs. 2.000 Million to the concerned section of the Head Office for approval. The concerned section of the Bank approved the instant *Murabahah* facility in favour of the said client with a MMF limit of Rs. 2.000 Million for a period of three years at the profit rate of 18 percent per annum on the above-mentioned Terms and Conditions. The IBD issued Sanctioned Letter in favour of the customer after approval of the instant proposal and delivered the same along with other documents to the concerned Branch for preparation of MMFA, Agency Agreement, Application Form on prescribed format of the Bank, attachments, and a documents checklist.

The Branch prepared all the documents and informed the customer about the same for execution. The MMFA sanctioned a master limit of Rs.2.000 million to the customer for the purchase of prescribed raw materials. The Agency Agreement was also executed between the client and the Bank. The Bank appointed the customer as its *Wakil* to select and procure prescribed goods for the Bank. The Agency Agreement also contained an exhaustive list of the goods that was purchased by the agent.The customer negotiated the specification, quantity, and per unit price of the specified raw materials with the original supplier as the Bank's agent. He informed the Bank immediately after completing the procurement process of the raw materials. The total cost of the goods was declared as Rs. 2.000 million, which included the charges of sales tax, transportation and handling. The client sends a "Draw Down/Order Form" and requested the Bank to disburse the funds for the purchase of the raw materials and also submitted Summery Payment Schedule. The Bank credited the requested amount of Rs. 2.000 Million to the client Account with the Bank. This amount was drawn by the client against cheques in the name of the original supplier.

The customer submitted a Declaration immediately upon receipt of goods along with Bills and sale invoices of the said raw materials. The declaration stated that he has acquired the goods acting as Bank's agent. He also offered through the same declaration to purchase the goods from the Bank on a deferred payment basis. The Bank accepted the said declaration. The title and ownership of the said goods were transferred to the client. The sale price of the goods included original price of the goods, expenses of the Bank and profit of the Bank at the rate of 18 percent per annum. He also submitted post dated

cheques as per repayment schedule. The details of the monthly instalments can be easily understood through the following table:

Master *Murabahah* Monthly Installments

S. #	Due Date	Amount	Profit of BOK IBD	Principal
1	October 1st, 2002	72,250	29,909	42,341
2	November 1st, 2002	72,250	29,276	42,974
3	December 1st, 2002	72,250	28,633	43,617
4	January 1st, 2002	72,250	27,981	44,269
5	February 1st, 2002	72,250	27,319	44,931
6	March 1st, 2002	72,250	26,674	45,603
7	April 1st, 2002	72,250	25,965	46,285
8	May, 1st 2002	72,250	25,273	46,977
9	June 1st, 2002	72,250	24,570	47,680
10	July 1st, 2002	72,250	23,857	48,393
11	August 1st, 2002	72,250	23,134	49,116
12	September 1st, 2002	72,250	22,399	49,851
13	October 1st, 2003	72,250	21,654	50,596
14	November 1st, 2003	72,250	20,897	51,353
15	December 1st, 2003	72,250	20,129	52,121
16	January 1st, 2003	72,250	19,349	52,901
17	February 1st, 2003	72,250	18,558	53,692
18	March 1st, 2003	72,250	17,755	54,495
19	April 1st, 2003	72,250	16,941	55,309
20	May, 1st 2003	72,250	16,113	56,137
21	June 1st, 2003	72,250	15,274	56,976
22	July 1st, 2003	72,250	14,422	57,828
23	August 1st, 2003	72,250	13,557	58,693
24	September 1st, 2003	72,250	12,679	59,571
25	October 1st, 2004	72,250	11,788	60,462
26	November 1st, 2004	72,250	10,884	61,366
27	December 1st, 2004	72,250	9,967	62,283
28	January 1st, 2004	72,250	9,035	63,215
29	February 1st, 2004	72,250	8,090	64,160
30	March 1st, 2004	72,250	7,130	65,120
31	April 1st, 2004	72,250	6,157	66,093
32	May 1st, 2004	72,250	5,168	67,082
33	June 1st, 2004	72,250	4,165	68,085
34	July 1st, 2004	72,250	3,147	69,103
35	August 1st, 2004	72,250	2,113	70,137
36	September 1st, 2004	72,250	1,065	71,185
	Total	**2,601,000**	**601,000**	**2,000,000**

Mr. B has regularly paid the monthly installments of prescribed amounts, until he has paid the last monthly installment i.e. September 1st, 2004 of Rs.72,275/-. Thus, during

the period of three years, the client has paid the total sale price of the goods amounting to Rs.2,601,000/- in 36 equal monthly installments as agreed between them.

4.2.3. *Shariah* Appraisals of Bank of Khyber Islamic Banking Division *Murabahah* Financing

Murabahah as a Mode of Finance

Muslim bankers in their quest of a viable Islamic system of finance that would replace the illicit practices of interest financing introduced the instrument of *Murabahah*. However, *Murabahah* as inherited from Islamic Jurisprudence was not tailored to readily fit the needs of bankers and other financial institutions for a substitute finance technique. Originally *Murabahah* was not conceived as a mode of finance, since it was not necessarily concluded on the basis of deferred payment. *Muarabah* sale for cash was the rule rather than exception. The shift to credit *Murabahah* or *Muarabahah* deferred with price is a first requisite for its transformation into a technique of finance.[226] When first introduced this financing technique was termed "*Murabahah* Sale for the Orderer of Purchase". But with the passage of time, the usage tended to prefer to it the much shorter term of "*Muarabaha*".[227]

According to Justice Taqi Usmani, *Murabahah* is originally not a mode of financing. It is only designed to escape from interest and not an ideal instrument for carrying out the real economic objectives of Islam. Accordingly, this instrument should be used as a transitory step taken in the process of Islamization of the economy and its use should be confined only to those cases where *Mudarabahah* or *Musharakah* are not workable.[228] According to Dr. Shahid Hassan Siddque, the mode of *Muarbahah* can not be expected either to remove the injustices of the interest-based system or to contribute to the achievement of the socio-economic objectives which Islam seeks to achieve.[229]

Agency of Client

According to the above prescribed procedure, the Bank may appoint the customer as its agent to purchase the *Murabahah* goods on behalf of the Bank. The *Shariah* Council of *Dar al Mal al Islami* has given a *Fatwa* with effect that an agent may not lawfully purchase, by means of *Murabahah*, the same goods he purchase on behalf of the Bank, because such a transaction involves several dubious elements, and ill serves the concept of *Murabahah* sales. The bank should seek out another party to act as its true agent. [230]

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[226] IDB, IRTI, "Financing Trade in an Islamic Economy", p. 19. Also available on www.irti.org

[227] Dr. Sami Hassan Ahmed Hamoud, *Tatweer al-Amal al-Mashrafiya Bima Yattafiq al-Shariyah al-Islamiyah,* pp. 430-434.

[228] Usmani, Justice Taqi, An Introduction to Islamic Finance, pp. 104-105.

[229] Siddiqui, Dr. Shahid Hassan, Article "Islamic Banking: True Modes of Financing".

[230] *Shari' ah Council of the Dar al Mal al Islami*, March 10, 993, at Jeddah, quoted by Yusuf Talal, p. 159.

Increase in Sale Price due to Defer Payment:

In practice the BOK IBD affect *Murabahah* on the basis of deferred payment. The Bank while selling the commodity on credit takes into account the period in which the price is to be paid by the client and increase the price accordingly. The higher the price of the commodity would be, the longer the maturity of the *Murabahah* payment. Accordingly, the price in a *Murabahah* transaction is always higher than the market price. The client would have to pay much less than he has to pay in *Murabahah* transaction on deferred payment basis, if he has sufficient money to purchase the same commodity from the open market on cash payment. Thus, a question arises as to whether there would be two addable margins over and above the actual price of the commodity in question: one against the mutually agreed profit at 2% or 3% and the other against the period of time granted for installment?

There is difference of opinions among the jurists that whether the cash value and the installment (credit) value of the commodity would be the same and one in both cases or there would be a difference. This is a vital important question for the bank, because the second margin, if any, if declared interest would turn the whole operation into an interest-generating deal in which the bank would be charging interest against the time granted. According to the consensus of jurists (*Jamhoor*), it is permissible to sale a commodity on increase price in case of deferred (credit) payment than its cash payment. They based their arguments on verses from the *Holy Quran*, *Sunnah* and reasoning. The only condition is that at the time of actual sale, one of the two options must be determined, leaving no ambiguity in the nature of transaction. For instance, the seller says "if you purchase the commodity on cash payment, the price would be Rs.111/- and if you purchase it on credit of six months, the price would be Rs.121/-." The purchaser shall have to select either of the two options. He should say that he would purchase it on credit for Rs.121/-. [231] In its sixth session, the learned Council of the Islamic Fiqh Academy of the Organization of Islamic Conference resolved that it is permissible to fix an increase price for a commodity sold on deferred payment, as compared to its cash price. It is also permissible to mention different prices for cash and deferred sales. Even the deferred prices can vary according to the different periods specified for payments, and such variance can be expressly disclosed by the seller to the customer. But the sale can not take place until the parties agree to contract a particular mode of payment and specify whether the payment is in cash or deferred. Therefore, if the sale takes place without specifying a single particular mode of payment, leaving it uncertain whether the buyer shall pay in cash or in installments, the sale is not valid according to *Shariah*.[232] The Council in its seventh session (9 to 14 May, 1992) reiterated its view with regard to increase in deferred price than cash price through Resolution No. 62/2/7, concerning Installment Sale in the following words: "The installment sale is permissible in *Shariah*, even if the deferred price exceeds the spot price. It is permissible for the two parties to a debt to agree on the fact that all installments shall be due for payment if the debtor refuses to any one of the installments owned to him, as long as he is not insolvent"[233]

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[231] See for details, Ibn Qudamah, *al-Mughni* 4:290, al-Sarakhsi, *al-Mabsut*, 13:8, *Al-Dasuqi*, 3: 58, *Mughni-al-Muhtaj* 2:31, Abu Ghuddah, Dr. Abdul Sattar, *Al-Bai al-Muajal*, pp. 19-24; Taqi, op. cit.,p. 117.

[232] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 103-104

[233] Ibid., pp. 135-136

A *Fatwa* with similar effect is also issued by the Jordan Islamic Bank. The *Fatwa* states that according to the *Shariah*, it is lawful to apply a scale of direct proportion on profits that is based on the payment period and the nature of the goods to be sold. This, however, is provided that the "purchase pledger" knows how much profit he will have to pay for.[234] Dr. Yousuf Al-Qardhawi is one of those jurists who consider the addition of some amount of money to the actual prices of goods against the deferred payment as lawful. To quote him:

> "Both the bank and its client have opted to abide by their promises and to shoulder the consequences of going back on their commitments. Moreover, the copy (of their agreement) states: the value (of the goods in question) agreed between the bank and its client is a "Delayed Value". Mostly, in the determination of (delayed) value the repayment period is taken into consideration as done by anyone who sells (on the basis of) delayed payment."[235] He further states on page 64 of the same books: "Here the prices offered are not two: one cash price and another price for delayed payment as interpreted by Sammak and those who approve his stand point. It is only one fixed known price as it is clear from the form filled up by the orderer of the goods. He states therein the specifications, value, period, (of repayment) and mode thereof..... And that is, of course, after verbal discussion."[236]

The *Shariat* Appellate Bench of the Supreme Court of Pakistan in its judgement on *Riba* has observed: "*Murabahah Muajjal* is a transaction of sale affected on the basis of deferred payment. One of the basic conditions of this transaction, like any other sale, is that the price is fixed at the time of the original contract of sale. The price may include a margin of mark-up (profit) added on the cost incurred by the seller. To determine the amount of mark-up, the seller may take different factors into consideration including the deferred payment, but as already explained, once the price is fixed, it will be attributable to the commodity and cannot be increased or decreased unilaterally, because as soon as the sale is accomplished, the price of the commodity become a debt payable by the purchaser."

Justice Taqi Usmani is also of the view that deferred price of the commodity may be different from its cash price. According to him, when money is exchanged for money, no excess is allowed, neither in cash transaction, nor in credit, but where a commodity is sold for money, the price agreed upon by the parties may be higher than the market price, both in cash and credit transaction. Time of payment may act as an ancillary factor to determine the price of the commodity, but it can not act as an exclusive basis for and sole consideration of an excess claimed in exchange of money for money.[237]

On the other hand, there are some jurists, who prohibit any difference between the cash and deferred prices of the commodity. Among these jurists are, Zain Al-Abideen Ali Ibn Al-Hussain, Al-Nasir (from Zaidis jurists), Al-Mansoor Bi Allah, Al-Hadawiah and Imam Yahya. According to Dr. Abdul Sattar Abu Ghuddah, this prohibition is not communicated from any other jurists except the above mentioned jurists. In

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[234] *Fatawa* of the Jordan Islamic Bank: Vol. I, pp. 28-30, quoted by Yusuf Talal, op. cit. p. 4.
[235] Al-Qardhawi, Dr. Yousuf, *Islam Aur Ma'ashi Tahaffuz*, pp. 36-37, second edition, 1984, (Dar Al-Ilm, Kuwait).
[236] Ibid, p. 64.
[237] Usmani, An Introduction to Islamic Finance, p. 116.

contemporary jurists, who follow the opinion of prohibition are: Abdul Rehman Abdul Khaliq (discussed the issue in details in his booklet, '*Ba'ai Muajal*') and Nizamu Ddin Abdul Hameed. The later expressed his opinion in the meeting of the Council of OIC Islamic Fiqh Academy, in which the above given Resolution No. 51 was passed about the permissibility of the difference in cash and deferred prices of the commodity.[238]

They argue that the increase of price in a credit sale, being in consideration of the time given to the purchase, should be treated analogous to the interest charged on a loan, because in both cases an additional amount is charged for the deferment of payment. On this basis, they argue that the *Murabahah* transaction, as practiced in the Islamic bank, are not different in essence from the interest based loans advanced by the conventional banks. Justice Taqi Usmani rebuts this argument by saying that Islam has treated money and commodity differently. Since money has no intrinsic utility, but is only a medium of exchange which has no different qualities, the exchange of a unit of money for another unit of the same denomination cannot be affected except at par value and any excess on either side is without consideration, hence not allowed in *Shariah*. This rule is applicable to both spot and credit transaction of money. While, the case of the normal commodity is different. Since they have intrinsic utility and have different qualities, the owner is at liberty to sell them at whatever price he wants, subject to the forces of supply and demand. If the seller does not commit a fraud or misrepresentation, he can sell a commodity at a price higher than the market rate with the consent of purchaser. If the purchaser accepts to buy it that increase price, the excess charged from him is quite permissible for the seller. Thus, when a seller can sell his commodity at a higher price in a cash transaction, he can also charge a higher price in a credit sale, subject to the condition that he neither deceives the purchaser, nor compels him to purchase, and the buyer agrees to pay the price with his free will.[239]

Another argument is that the increase of price in a cash transaction is not based on the deferred payment, therefore it is permissible. While in a sale based on a deferred payment, the increase is purely against the time which makes it analogous to interest. Justice Taqu Usmani also rebuts this argument by saying that any excess amount charged against the late payment is *Riba* only where the subject matter is money on both sides. But if a commodity is sold in exchange of money, the seller, when fixing the price, may take into account different factors, including the time of payment. A seller being the owner of a commodity which has intrinsic utility may charge a higher price and the purchase may agree to pay it due to various reasons.[240]

According to Syed Hamed Abdul Rehman Al-Kaff, the addition of some amount of money to the actual prices of goods against the deferred payment is exactly what has been happening at the advent of Islam-during the Pre-Islamic Period- which was forbidden and declared unlawful in the most unequivocal terms.[241] Ibn Al-Arabi in an attempt to repudiate the claim of those who believe that the Pre-Islamic interest was confined only to the debts-interest and did not cover and included sales-interest (interest generated by sales on the basis of deferred payment) said: The second problem: our learned men said: interest literally means an addition and it is inevitable for an addition to

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[238] Abu Ghuddah, Dr. Abdul Sattar, *Al-Bai Al-Muajal*, p. 21.
[239] Usmani, An Introduction to Islamic Finance, p. 114.
[240] Usmani, op.cit., pp. 114-115.
[241] Al-Kaff, Syed Hamed Abdul Rehman, *Al-Murabahah* in Theory & Practice, op. cit., p. 22.

become apparent to have something to add to. For this reason, they differed among themselves whether (the verse is general in prohibiting all types of interest or particular which could not be explained except by other (s)? It is true that (the verse) is general because (the Arabs) used to conclude sales deals and charge interest. Interest was something known to them. A person used to conclude a sale deal with another person (the value being repayable) upto a certain time. When that time arrived he would say: would you repay or increase (the amount)? It means whether you would increase my money due from you and exercise patient upto another period (for repayment). Because of that Allah, the Almighty prohibited the interest.[242] The Islamic *Fiqh* Academy of India in its third seminar considered the issue of *Muarbahah* and after arrived at the conclusion that it will not be proper to quote, at the time of making the deal, two separate sale-prices one for down payment sale and the other for credit sale, or to link the sale price with the length of payment period at the time of making the deal. The Bank should show the sample of commodity offered for sale and should clearly inform the buyer about the period and the number of installments fixed for the payment and the quantum of profit to the Bank, which will be the purchase price for the buyer from the Bank.[243]

The Late Shaikh Mohammad Abu Zohra stated: "Arguments about the lawfulness of deferred payment price being more than cash".[244] However, one thing is clear that no such provisions can be added in the contract of *Murabahah* with effect that profit will be subjected to review each year. Once the sale has been completed, and the price plus costs and the profit have been specified, it will be not lawful to increase or decrease anything unless it be to decrease the amount of an instalment in return for its early payment.[245]

Payment of Sale Price in Installments:

In most of the *Muarabahah* transactions by the Islamic banks, the sale price is divided on different instalments periods to be paid by the purchaser. While, in original *Murabahah* transaction, the price is to be paid by the purchaser on deferred basis and at once time. The ancient Muslim jurists are also of the same view with regard to the payment of the sale price. Accordingly, if the sale price can be paid at once on deferred basis, likewise it is valid that the same sale price can be distributed on different instalment periods to be paid by the purchaser for the saying of the Holy Prophet (PBUH): ((Muslims should abide by their conditions except the one which validate the impermissible (*Haram*) or invalidate the permissible (*Halal*)).[246]

Promise to Purchase:

One of the important issues in *Murabahah*, which has been subject of discussion among the contemporary *Shariah* scholars is that the bank can not enter into an actual sale at the time when the client seeks *Murabahah* financing from him, because the required commodity is not owned by the bank at this stage and one can not sell a commodity not owned by him, nor can he effect a forward sale in *Shariah*. The bank is therefore bound

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[242] Ahkamul al-Quran, vol. 1, P. 241, quoted by Al-Kaff, Syed Hamed Abdul Rehman, *Al-Murabahah* in Theory & Practice, pp. 23-24.
[243] Available on www.ifa.com last visited on 25/07/2008.
[244] Quoted by Al-Kaff, Syed Hamed Abdul Rehman, *Al-Murabahah* in Theory & Practice, p. 26.
[245] *Fatawa* of the Shariah Board, Faisal Islamic Bank of Bahrain, p. 16, quoted by Yusuf Talal, op. cit. p. 34.
[246] Abu Ghuddah, Dr. Abdul Sattar, *Al-Bai al-Muajal*, p. 16.

to purchase the commodity from the supplier, and then it can sell it to the client after having its physical or constructive possession. On the other hand, if the client is not bound to purchase the commodity after the bank has purchased it from the supplier, the bank may be confronted with a situation where he has incurred huge expenses to acquire the commodity, but the client refuses to purchase it. In some cases, the commodity may be such that it has no common demand in the market and is very difficult to dispose of. In this case, the bank may suffer unreasonable loss.[247] Some of the contemporary jurists have offered solution to this problem by asking the client to sign a promise to purchase the commodity when it is acquired by the bank. Instead of being a bilateral contract of forward sale, it is a unilateral promise from the client which binds himself and the bank. Being a one-sided promise, it is distinguishable from the bilateral forward sale.[248]

The Bank of Khyber Islamic Banking Division has also adopted a similar provision in its *Murabahah* Financing Agreement. This solution is subjected to an objection that a unilateral promise creates a moral obligation but according to *Shariah* it can not be enforced by the courts of law. Thus, a question arises that whether a one-sided promise is enforceable in *Shariah* or not. In order to answer this question we will examine it in the light of the original sources of the *Shariah* and in last we will give the opinions of some contemporary scholars and OIC Fiqh Academy regarding this issue.

The Muslim jurists have different views on the subject. According to consensus of jurists (Imam Abu Hanifah, Imam al-Shafi'i, Imam Ahmad and some Maliki jurists) fulfilling a promise is a noble quality and it is advisable for the promisor to observe it, and its violation is reproachable, but it is neither mandatory (*wajib*), nor enforceable through courts.[249] While, according to Samurah bin Jundub (the well known companion of the Holy Prophet (PBUH)), Umar Bin Abdul Aziz, Hasan Al-Basri, Sa 'id bin Ashwa, Ishqah bin Rahwaih and Imam al-Bukhari fulfilling a promise is mandatory and a promisor is under moral as well as legal obligation to fulfil his promise. According to them, promise can be enforced through courts of law.[250] The same is the view of some Maliki jurists, and it is preferred by Ibn al-Arabi and Ibn-al-Shat and endorsed by al-Ghazzali, the famouns Shafi jurist, who says the promise is binding, if it is made in absolute terms. The same is the view of Ibn Shubrumah.[251] A third view is attributed to some Maliki jurists. They say that in normal conditions, promise is not binding, but if the promisor has caused the promise to incur some expenses or undertake some labour or liability on the basis of promise, it is mandatory on him to fulfil his promise for which he may be compelled by the courts.[252]

According to some contemporary scholars, the jurists who have accepted the binding nature of a promise have done so only with regard to unilateral gifts or other voluntary payments, but none of them has accepted the binding nature of a promise to effect a bilateral commercial or monetary transaction. However, according to Justice Taqi

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[247] Usmani, Justice M. Taqi, pp. 120-121.
[248] Ibid, p. 121.
[249] See *Al-Azkar Le Nawai*, p. 282, *Umdat-ul-Alqari*, 12:121, *Marqat al-Mafateh* 4: 653, *Fath-ul-Ali Almalik* 1:254, quoted by Usmani, pp. 121-122.
[250] See *Sahih al-Bukhari, Shahadat*, where this view is reported from all the aforesaid jurists, quoted by Usmani, pp. 121-122.
[251] *Al-Qurtabi, Al-Jameh Le Ahlam al-Quran*, 18:29, *Al-Ghazzali, Ahyah Uloom al-Din*, 3:133, Ibn Hazam, *al-Mahali*, 8:28, quated by Usmani, p. 122.
[252] *Al-Qarafi, A-Furooq*, 3:133, *Fath-ul-Ali Almalik* 1:254, quoted by Usmani, p. 122.

Usmani, this notion does not seem to be correct, because the Maliki and Hanafi jurists have allowed *Bai bil Wafa* on the basis of binding promise. *Bai bi Wafa* is a special kind of sale whereby the purchaser of an immovable property undertakes that whenever the seller will give him the price back, he will resell the house to him. He concludes the discussion on the binding nature of the promise by stating that if repurchase by the seller is made a condition for the original sale, it is not valid transaction, but if the parties have entered into the original sale unconditionally, but the seller has signed s separate and independent promise to repurchase the sold property, this promise will be binding on the promisor and enforceable through courts of law. The binding nature of the promise in this case has been admitted by both *Maliki* and *Hanafi* jrists.[253] He further states that the jurists who hold the promises to be binding do not restrict it to the promises of gift, etc. The same principle is applicable, according to them, to the promises whereby the promsior undertakes to enter into a bilateral contract in future. In light of the injunctions of the *Holy Quran* and *Sunnah* about the fulfilment of the promises, it is evident that fulfilling of a promise is obligatory.[254]

In reply to the question that whether or not a promise is enforceable in courts of law in commercial dealing Justice Taqi Usmani states in commercial dealing, where a party has given an absolute promise to sell or purchase something and the other party has incurred liability on that basis, then the promise should be enforced and there is nothing in the Holy Quran or *Sunnah* which prohibits the making of such promises enforceable.[255] The client promises to the Bank that he will purchase the commodity after the later acquires it from the supplier. This promise will be binding on him and may be enforced through courts. This promise does not amount to actual sale. It will be simply a promise and the actual sale will take place after the commodity is acquired by the bank for which exchange of offer and acceptance will be necessary.[256]

The Council of the OIC Islamic Fiqh Academy has also made the promises in the commercial dealings binding on the promisor under some conditions. , In its fifth session (10 to 15 December, 1988) concerning 'Discharging of Promise' in *Murabahah* transaction resolved that according to *Shariah*, a promise (made unilaterally by the purchase orderer or the seller), is morally binding on the promisor, unless there is a valid excuse. It is however legally binding if made conditional upon the fulfilment of an obligation, and the promisee has already incurred expenses on the basis of such a promise. The binding nature of the means that it should be either fulfilled or a compensation be paid for damages caused due to the unjustifiable nonfulfilling of the promise. Mutual promise (involving two parties) is permissible in the case of *Murabahah* sale provided that the option is given to one or both parties. Without such an option, it is not permissible, since in *Murabahah* sale, mutual and binding promise is like an ordinary sale contract, in which the prerequisite is that the seller should be in full possession of the goods to be sold.[257]

A resolution was passed by the Second Conference on Islamic Banking held in *Kuwait* in regard to *Murabahah* sales and reservations about compulsion. The test of the

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[253] Al-Hattab, *Tharir-al-Kalam*, p. 239, Beirut, 1404.
[254] Usmani, An Introduction to Islamic Finance, pp. 123-124.
[255] Ibid, p. 125.
[256] Ibid, p. 126.
[257] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 86-87

resolution states that "The conference resolves that a mutually agreed upon promise to transact a *Murabahah* sale to a buyer, following purchase and possession of goods (by a bank) for a specified amount of profit in accordance with prior agreement is lawful, on condition that the bank will be responsible for loss or damage before delivery, and what accrues from the return of the merchandise if a return becomes necessary. The promise and its biding nature safeguard the transaction and bring it stability, and therefore serve the interests of both. Thus, it is lawful for the bank to insist on such a promise, and every bank has the right to follow the advice of its own Shariah Board or Supervisory Committee.[258]

Possession of Goods by the Bank

One of the conditions for a *Murabahah* transaction is that the Bank must have a good title and should take possession (Physical or Constructive) of the goods before selling them to the client. The jurists consider it sufficient in respect of the condition of 'possession' that the supplier from whom the bank has purchased the item, sets it aside for the bank and hands it over to any person authorized by the bank. To put in simple words, the commodity must be in seller's risk, even though for a short period.[259] The commodity will be separated in a way that distinguished it from the other goods kept in the warehouse. The buyer will be liable for the merchandise, which will be a trust with the supplier in his warehouse.[260]

The OIC Islamic Fiqh Academy in its sixth session (14-20 March, 1990) resolved in respect of forms of 'Possession' that: "Just as the possession of commodity may be physical, by taking the commodity in one's hand or measuring or weighting the eatables, or by transferring or delivering the commodity to the premises of the buyer, the possession may also be an implied or constructive possession which takes place by leaving the commodity at one's disposal and enabling him to deal with it as he wishes. This will be deemed a valid possession, even though the physical possession has not taken place. As for the mode of possession, it may vary from commodity to commodity, according to its nature and pursuant to the different customs prevalent in this behalf."[261]

The *Shariah* Board of the Jordan Islamic Bank has also given a *Fatwa* with effect that authorizing the seller by the bank to carry out the *Murabahah* sale process is lawful.[262] The *Shariah* Board of the Faisal Islamic Bank of Bahrain has also given a similar *Fatwa*, which states that it is lawful for the bank to purchase goods from the dealer in order to resell the same to its client by means of *Murabahah* sale. After the goods have been sold to the client, the Bank may authorize the dealer to deliver the goods to the client, but only after the goods have been sold to the bank and the bank has taken legal possession of them such that the goods have become the bank responsibility. However, if such legal possession has not taken place, and the bank has not become liable for the goods, it will not be lawful. This is because the Prophet (PBUH) prohibited

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[258] The First Albarakah Seminar, Fatwa no. 8, *al Fatawa al Shar 'iyah li Majmu al Baraka*: *Fatwa* 73, pp. 98-101, Jordan Islamic Bank, *al Fatawa al Shar 'iyah*, quoted by Yusuf Talal, pp. 100-101.
[259] Usmani, op. cit. pp. 106-107.
[260] *Fatawa* of the Kuwait Finance House: Question no. 115, pp. 115-116, quoted by Yusuf Talal, p. 82.
[261] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 107-108.
[262] See *Fatawa* of the Jordan Islamic Bank: Vol. 1, pp. 28-30, quoted by Yusuf Talal, op. cit. pp. 63-64.

one's profiting from that for which one is not liable.[263] The *Murabahah* sale asset must be registered in the name of the Bank prior to its sale to the client, because according to the opinions of classical jurists in regard to *Murabahah* sale, the bank is not considered the owner unless the property is registered in its name in order to sell it to the purchase pledger. Any other agreement will not be acceptable. For instance, it is not allowed that the Bank instructs the dealer to register the commodity in the name of the client prior to its registry in the name of the Bank.[264]

Default Obligation Amount:

In interest-based loans, the amount of loan keeps on increasing according to the period of default. But, it is a settled principle in Islamic finance that if the client defaults in payment of the money on due date, the money can not be increased. This restriction is sometimes exploited by dishonest clients who deliberately avoid to pay the price at its due date, because they knew that they will not have to pay any additional amount on account of default. In order to tackle the problem of default by the customers, according to Justice Taqi Usmani the real solution to this problem is to develop a system where the defaulters are dully punished by depriving them from enjoying a financial facility in future. However, this may be only where the whole banking system is based on Islamic principles, or the Islamic banks are given due protection against the defaulters. Therefore, upto a time when this goal is reached, the proposal one adopted by BOK IBD may be followed.[265] He states that this proposal is based on a ruling given by some Maliki jurists who say that if a debtor is asked to pay an additional amount in case of default, it is not allowed by *Shariah*. However, in order to assure the creditor of prompt payment, the debtor may undertake to give some amount in charitable in case of default. This is in fact a sort of *Yamin* (vow) which is a self imposed penalty to keep oneself away from default. Normally such 'vows' create a moral or religious obligation and are not enforceable through courts. However, some Maliki jurists allow to make it justiceable.[266]

He further states that there is nothing in the *Holy Quran* or *Sunnah*, which prohibit making this 'vow' enforceable through courts of law. Therefore, in cases of genuine need, this view can be acted upon.[267] However, he cautions that this proposal is meant only to pressurize the debtors on paying their dues on due date and not to increase the income of the bank, not to compensate the bank for its opportunity cost. Thus, no part of the penalty amount forms part of the income of the bank in any case, nor it can be used to set-off any liability of the bank. The amount of penalty may be either any amount wilfully undertaken by the debtor or it can also be determined on per cent per annum basis. Being a vow of charitable act, it was originally permissible for the client to give the stipulated amount to any charity of his own choice. However, in order to assure that he will pay, the charitable account or fund maintained by the bank is specified in the proposed undertaking. This specific undertaking does not violate any principle of *Shariah*. It is necessary that the bank maintains a separate fund or at least separate

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[263] *Fatawa* of the *Shari 'ah* Board, Faisal Islamic Bank of Bahrain, p. 15, quoted by Yusuf Talal, op. cit. p. 83.
[264] *Al Fatawa al Shar 'iyah*, Jordan Islamic Bank, vol. 1, p. 97.
[265] Usmani, p. 137-138.
[266] Al-Hattab, *Tahrir-al-Kalam*, p. 176, Beirut 1404 quoted by Taqi Usmani, op. cit., p. 138.
[267] Taqi Usmani, op. cit., p. 138.

account for this purpose and the amounts credited to that account must be spent in well defined charities known to the client/debtor.

The Council of the OIC Islamic Fiqh Academy, in its twelfth session (23 to 29 September, 2000) concerning 'Penalty Provision' resolved the followings: "A Penalty Provision in legal terminology is a condition agreed to by the two parties of a contract as to how compensation stipulated for one of them in case of default or delay from the part of the other can be assessed. The Council confirms its previous resolutions regarding penalty provisions including the following: Its Resolution No. 51(2/6) on Instalment Sale which stipulates that "When the purchaser delays payment of due instalments no additional charge should be imposed on him whether by virtue of a predetermined condition or otherwise. Such a practice amounts to commitment of prohibited usury. It is permissible to include a Penalty Provision in all financial contracts except when the original commitment is a debt. Imposing a Penalty Provision in debt contracts is usury in the strict sense. Consequently, it is impermissible, for instance, to make a Penalty Provision in Instalment Sale on a debtor who delays repayment of outstanding instalments, whether due to insolvency or payment evasion. The Penalty Provision shall become null and void when the concerned partner proves that his failure to meet obligations was due to reasons that fall out of his control, or when he proves that no loss has been incurred by his partner as a result of his breach of the contract. The Council recommended vide the same resolution convening of a specialized seminar to work out the conditions and arrangements that could enable the Islamic banks to guarantee collection of their outstanding dues."[268]

The Supreme Court of Pakistan has observed in case of default by the client: "If the purchaser has delayed the payment despite his ability to pay, he may be subjected to different punishments, but it cannot be taken to be source of further 'return' to the seller on percent annum basis" The Supreme Court judgement also states that: "The legislature can also confer a power on the Court to impose penalty on a party who makes a default in meeting out his liability or who is found guilty of putting up vexatious pleas and adopting dilatory tactics with a view to cause delay in decision of the case and in discharging liabilities and from the amount of such penalty a smaller or bigger part depending upon the circumstances can be awarded as solatium to the party who is put to loss and inconvenience by such tactics. The amount of penalty can be received by the State and used for charitable purposes and in the projects of public interest including the projects intended to ameliorate economic conditions of the section of society possessing little or nothing i.e. needy people/peoples without means".[269]

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[268] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 251-252

[269] *Shariat* Appellate Bench (SAB), Supreme Court of Pakistan, 'Judgment on *Riba*'; *Shariat* Law Reports, Lahore, February 2000.

Compensation for Breach of Promise to Buy:

According to the provisions of the 'Order Form' of the Bank of Khyber, which are read as "We shall immediately acquire the asset from you on the basis of *Murabahah* failing which we undertake to compensate you for any actual loss suffered (not being opportunity cost) by selling the assets to a third party."

The Council of the OIC Islamic Fiqh Academy, in its twelfth session (23 to 29 September, 2000) resolved that it is permissible to include the Penalty Provisions in the Original Contract or make it as a separate agreement that succeeds the contract and precedes the occurrence of the anticipated loss. It is permissible to include a Penalty Provision in all financial contracts except when the original commitment is a debt. Imposing a Penalty Provision in debt contracts is usury in the strict sense. The loss that may be compensated includes actual financial loss incurred by the partner, any other material loss and the certainly obtainable gain that he misses as a result of his partner's default or delay. It does not include moral loss. The Penalty Provision shall become null and void when the concerned partner proves that his failure to meet obligations was due to reasons that fall out of his control, or when he proves that no loss has been incurred by his partner as a result of his breach of the contract. The Court may, if so required by one of the two parties, adjust the amount of the compensation, subject to a reasonable justification, or when the compensation proves to be exaggerated."[270] A pledge to purchase is binding. The advance received from the client in return to his binding agreement to buy the goods from the bank and to be timely in repaying the instalments can be used to recompense the bank for its expenses. If there is a remainder, after the bank is recompensed, it will be returned to the client. If the advance is insufficient as recompense, the rest should be paid by the purchase pledger. [271]

Demand Promissory Note

This is taken for the purpose to recover costs in case the client fails to live up to his responsibilities, so as to protect the interest of the bank. The Demand Promissory note should not be taken until after a debt has been established as the result of a contract of *Murabahah* between the bank and its clients, or any other such contract in which a financial responsibility is initiated. [272]

Securities against *Murabahah* Price

The OIC IFA in its sixth session (14-20 March 1990) resolved that the seller has no right to secure the ownership (of the sold commodity) after the sale has taken place. However, it is permissible for him to impose a condition that the buyer shall mortgage the sold commodity with the seller to secure his right of receiving the deferred instalments of the price".[273] Justice Taqi Usmani has described some basic rules about the security documents in case of *Murabahah* facility. He states that the security can be asked rightfully where the transaction between the parties has created a liability or debt. Thus,

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[270] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 251-252
[271] *Fatawa* of the *Shariah* Board, Faisal Islamic Bank of Bahrain, p. 33, quoted by Yusuf Talal, p. 22.
[272] *Fatawa* of the *Shariah* Board, Faisal Islamic Bank of Bahrain, p. 34, quoted by Yusuf Talal, p. 23.
[273] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., p. 104.

no security can be claimed from a person who has not incurred a debt or liability. The procedure of *Murabahah* financing comprises of different transactions carried out at different stages. The client does not incur a debt in the earlier stages of the procedure. The relationship of creditor and debtor comes into existence only after the asset is sold to the customer by the Bank on credit. Therefore, the proper way in a *Murabahah* transaction would be that the Bank asks for security after it has actually sold the commodity to the customer and the price has become due on him, because at this stage the client incurs a debt. However, it is also allowed that the customer furnishes a security at earlier stages, but after the *Murabaha* price is determined. In the later case, if the security is possessed by the bank, it will remain at its risk. It means that if it is destroyed before the actual sale to the customer, the bank will have to pay the market price of the mortgaged asset and cancel the *Murabahah* agreement or sell the commodity required by the client and deduct the market price of the mortgaged asset from the price of the sold commodity.[274]

Justice Usmani further states that it is also allowed that the sold commodity itself is given to the bank as a security. Some contemporary Muslim jurists are of the opinion that this can only be done after the customer has taken delivery of the commodity and not before. In other words, it means the customer shall take its delivery, either physical or constructive from the bank, then give it back to the bank as mortgage, so that the transaction of mortgage is distinguished from the transaction of sale. However, Justice Usmani states that after studying the relevant materials, it can be concluded that the earlier Muslim jurists have put this condition in cash sales only and not in credit sale. Thus, it is not necessary that the customer takes delivery of the sold property before he surrenders it as mortgage to the bank. The only requirement would be that the point of time whereby the commodity is held to be mortgaged should necessarily be specified, because from that point of time, the commodity will be held by the bank in a different capacity which should be clearly earmarked. Otherwise different capacities of the parties will be mixed up giving rise to dispute and rendering the security invalid.[275] However, the *Shariah* Council of the *Faisal* Islamic Bank of Egypt has given a *Fatwa* with effect that pledging of the *Murabahah* commodity as collateral for the remaining payments is not lawful.[276]

It is lawful from the *Shariah* prospective that the bank seeks surety (*Kafalah*) from a purchase orderer in *Murabahah* sales, guaranteeing against the loss. It is a voluntary sort of contract, and may be entered into before any right is established.[277] According to Justice Taqi Usmani, the bank in a *Murabahah* transaction can also seek from the customer to furnish a guarantee from a third party. The bank may have recourse to the guarantor, who would be liable to pay the amount guaranteed by him, in case of default in the payment of price at the due date.[278]

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[274] Usmani, Justice Taqi, A n Introduction to Islamic Finance, pp. 125-129

[275] Ibid, pp. 125-129

[276] Meeting of the *Shariah* Council of the Faisal Islamic Bank of Egypt: June 1, 1981, quoted by Yusuf Talal, op. cit. p. 19.

[277] *Al-Fatawa al-Shar 'iyah li Majmu 'a al Barakah: Fatwa* 74, p. 102; Jordan Islamic Bank, *al Fatawa al Shar 'iyah*, vol. II, p. 30, quoted by Yusuf Talal, op. cit. p. 18; *Fatawa* of the Kuwait Finance House, no. 276, pp. 263-264, quoted by Ysuf Talal, op. cit. p. 80.

[278] Usmani, Justice Taqi, An Introduction to Islamic Finance, pp. 129-130

Rebate on Earlier Payment

In some cases the debtor may want to pay earlier the debt than the specified date. In this case he wants to earn a discount on the agreed deferred price. Now the question is whether it is allowed to allow him a rebate for his earlier payment? This question has been discussed by the classical jurists in detail. The majority of the Muslim jurists, including the four recognized schools of Islamic jurisprudence do not allow it, if the discount is held to be a condition for earlier payment. While some earlier jurists have held this arrangement as permissible.[279] However, according to the majority, if the earlier payment is not conditioned with discount and the creditor gives a rebate voluntarily on his own, it is permissible. This view is also adopted by the Council of the Islamic *Fiqh* Academy, in its seventh session (09-14 May, 1992) concerning 'Instalment Sale' resolved that to reduce a deferred debt with the aim of accelerating its repayment, whether at the request of the creditor or of the debtor (pay less but ahead of time) is permissible in *Shariah* and does not fall within the province of *Riba*, if it is not base on advanced agreement and as long as the relationship between the creditor and the debtor are bilateral. If there is a third party between them, the reduction is not permissible as it will then be subject to the ruling on discount of commercial papers.[280] According to Justice Usmani in a *Murabahah* transaction affected by an Islamic bank no such rebate can be stipulated in the agreement nor can the client claim it as his right. However, it is not objectionable, if the bank give the customer a rebate on its own, especially where the client is a needy person. For instance where the purchaser is a poor farmer and he has purchased a tractor or any other agriculture inputs on the basis of *Muarahahah*, then the bank should give him a voluntary discount.[281]

The *Shariah* Board of the *Faisal* Islamic Bank has also given a *Fatwa* with similar effect that it will be lawful to decrease the amount of an instalment in return for its early payment. This will be in accordance the principle "Pay now and Pay less," which was derived from the Prophet's (PBUH) ruling in regard to the Jews of Banu Naidr, when they were banished. For they said to him, "We are owed debts which have not yet fallen due." And he, (PBUH), told the debtors, "Pay now, but Pay less." For this reason, there is nothing wrong legally with decreasing the instalment amount in return for its early repayment, but one condition that this not be made a condition for the client by the bank.[282]

No Roll-Over in *Murabahah*

In conventional banking based on interest, if a client can not pay the debt at the due date for any reason, he may request the bank to extend the facility for another term. If the bank agrees, the facility is rolled over on the terms and conditions mutually agreed at that point of time, whereby the newly agreed rate of interest is applied to the new term. Actually it means that another loan of the same amount is re-advanced to the borrower. While in *Riba* free Islamic banking, the *Murabahah* transaction can not be rolled over for a further period and the period of payment can not be extended on an additional mark-up

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[279] Ibn Qudamah, *al-Mughni* 4:174-175. Usmani, *Bahoos Fi Qazaya Fiqhiyya al-Muasirah*, p. 25.
[280] Resolutions and Recommendations of the Council of Islamic Fiqh Academy, op. cit., pp. 135-136
[281] Usmani, Justice Taqi, An Introduction to Islamic Finance, p. 143.
[282] *Fatawa* of the *Shariah* Board, Faisla Islamic Bank of Bahrain, p. 16, quoted by Yusuf Talal, p. 35

charged from the customer. Because this practice will means that another separate *Murabahah* is booked on the same commodity, which is totally against the well settled principles of *Shariah*. Once the commodity is sold to the buyer, its ownership is passed on to the client. It is no more the seller property. The seller can claim only legitimately the agreed price, which has become a debt payable by the buyer. Thus, there is no question of affecting another sale on the same commodity between the same parties. The roll over in *Murabahah* is interest simple and pure, because it is an agreement to charge an additional amount on the debt created by the *Murabahah* sale.[283]

The *Shariat* Appellate Bench of the Supreme Court of Pakistan in its judgment on *Riba* has observed that "to determine the amount of mark-up in *Murabahah*, the seller may take different factors into consideration including the deferred payment, but once the price is fixed, it will be attributable to the commodity and cannot be increased or decreased unilaterally, because as soon as the sale is accomplished, the price of the commodity become a debt payable by the purchaser. If this debt is evidenced by a promissory note or bill of exchange it is not different from note or a bill evidencing a loan, and no return, whatsoever, can be charged over that note or bill, because it will amount to charging interest on the debt. .....after a sale is affected on the basis of mark-up, and the price is evidenced by a promissory note or a bill of exchange, including the original mark-up, no further return on the note or the bill is permissible in *Shariah* on the basis of the original mark-up."

Calculation of Cost in *Murabahah*

The transaction of *Murabahah* contemplates the concept of cost plus profit. Therefore, it can be concluded only where the seller can only ascertain the exact cost he has incurred in acquiring the commodity he wants to sell. On the other hand, if the exact cost can not be ascertained, then no *Murabahah* can be possible. In the later case, the sale can be affected on the basis of *Musawamah* (i.e. sale without reference to cost) and not on the basis of *Murabahah*.[284] All of the various expenses incurred in the purchase of goods must be added to the capital cost of purchasing the goods, so that the total of these represents the price of the goods to the bank. Thereafter, a margin of profit may be added.[285] In determining the profit margin, consideration must be given to the agreement reached by the two parties on an exact percentage of the (original) purchase price because *Murabahah* is one of the sales of trust.[286]

The *Murabahah* transaction should be based on the same currency in which the seller has purchased the commodity from the original supplier. If the seller has purchased it for Pakistani rupees, the onward sale to the ultimate purchaser should be based on Pakistani rupees, so that the exact cost may be ascertained.[287] The bank amounts of profit should not be based on the rate of exchange on the date that the *Murabahah* goods are

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[283] Usmani, Justice Taqi, An Introduction to Islamic Finance, pp. 141-141.
[284] Ibid, p. 143
[285] Fatawa of the *Shari 'ah* Board, Faisal Islamic Bank of Bahrain, p. 14, quoted by Yusuf Talal,. p. 55.
[286] Ibn Qudamah, *al-Mughni*, vol. 4, p. 102; Ibn Abidin, *Radd al Muhtar*, vol. 5, pp. 132-135; *Fatawa* of the *Shariah* Board, Faisal Islamic Bank of Bahrain, pp. 27-28, quoted by Yusuf Talal, op. cit. pp. 21-21; *Fatawa* of the Jordanian Islamic Bank, vol. 1, pp. 41-43, op. cit. p. 35.
[287] Usmani, Justice Taqi, An Introduction to Islamic Finance, p. 143; Meeting of the *Shariah* Council of the Faisal Islamic Bank of Egpyt: June 1, 1981 quoted by Yusuf Talal, op. cit. p. 29.

received by the client, because they do not know the actual price of the goods or the actual amount required for the transaction.[288] Only those expenses which are regularly incurred in accordance with customary practice can be added to the price of the goods sold by the bank by means of *Murabahah* i.e. those which add value to the goods, and those which are incurred directly. The salaries of bank employees are not to be added as they are a part of the (purchasing process and the) services offered by the bank in exchange for its right to make a profit. With respect to customs, if those who undertake this work are not bank employees (but agents), then whatever is paid to them may be added to the price of the goods. If they are bank employees, however, their salaries may not be added; though the expenses they incur while clearing the goods may be added. Of course, it may be possible to cover all such expenses through increasing the percentage or amount of profit.[289]

The bank will bear expenses for demurrage when these are incurred before the contract between the bank and the purchase pledger, and before the purchase pledger is able to take possession of the goods, even if nothing is known about the charges until after the contract is signed. Such charges, when paid by the bank, may not be added on to the price of the *Murabahah* sale because they are not mutually considered to be expenses that constitute a part of the price. Demurrage charges incurred after the contract, and after the purchase pledger is able to take delivery will be the responsibility of the purchaser. Legally, the contractual connection and its effects and obligations will exist between the bank and the exporter, and not between the exporter and the purchase pledger. This is point that should be explained to the exporter.[290] The Finance House has also given a *Fatwa* with effect that after the agreement, if other costs are incurred, only those costs will be taken, without adding profit; and this may take only if the contract includes provision for unanticipated costs.[291]

Accounting for Profit

The *Shariah* Board of the *Faisal* Islamic Bank has given a *Fatwa* with effect that it is not lawful to account for *Murabahah* transaction until after the goods have arrived and the client has taken possession of the same, or the client has taken possession of at least the bills of lading in accordance with the conditions established for the transaction, and after the full price has been determined, including all expenses. Therefore, it will not be lawful to estimate the profit on partial payment made by the bank either in advance or at later stages.[292] The Board also given a *Fatwa* with effect that it is equitable to account for profit by means of regular entries. The bank accounts for it sprofits periodically from the date the contract is concluded until the last payment is made by the client, adding the profits on monthly basis to the bank's profit and loss account.[293] The *Shariah* Council of the *Dar al Mal al Islami*, Islamabad, Pakistan has also given a *Fatwa* with effect that the most just and equitable method of accounting for profits in *Murabahah* transactions is the method designated "periodic mitigation" by means of which the bank determines its

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[288] *Fatawa* of the Kuwait Finance House, Question 190, pp. 185-186, quoted by Yusuf Talal, op. cit. p. 15.
[289] *Fatawa* of the Kuwait Finance House, Question 143, pp. 142-143, quoted by Yusuf Talal, op. cit. p. 13.
[290] *Fatawa* of the Kuwait Finance House, Question 298, pp. 290-291, quoted by Yusuf Talal, op. cit. p. 14.
[291] *Fatawa* of the Kuwait Finance House, Question 97, pp. 102-103, quoted by Yusuf Talal, op. cit. p. 31.
[292] *Fatawa* of the *Shariah* Board, Faisal Islamic Bank of Bahrain, p. 35, quoted by Yusuf Talal, p. 53
[293] *Fatawa* of the *Shariah* Board, Faisal Islamic Bank of Bahrain, p. 35, quoted by Yusuf Talal, p. 46

profits in a period that begins with the signing of the contract and ends on the date the last installment is paid. The profit may thus be credited monthly to a "profit and loss" account.[294]

Inspection of the Commodity

The Kuwait Finance House has given a *Fatwa* with effect that the merchandise is the property of the Finance House, and it is free to do as it wishes, including its requesting inspection of the merchandise. If it prefers not to have any inspection, it is free to do that as well. Any instructions of the purchase pledger may be considered no more than (informal) promises, as the contract has yet to be completed. But the promiser may, at the time of signing the contract, give a written agreement that the merchandise not be inspected, and that he will be responsible for any faults that may appear in the merchandise.[295]

Rescheduling of Payments in *Murabahah*

In conventional banks, the loans are normally rescheduled on the basis of additional interest. This is not possible in *Murabahah* financing. If the client in *Murabahah* financing is not able to pay according to the dates agreed upon in the *Murabahah* agreement, he sometimes requests the bank for rescheduling the instalments. If the instalments are rescheduled, no additional amount can be charged for rescheduling. The amount of the *Murabahah* price will remain the same in the same currency. Rescheduling must always be on the basis of the same amount in the same currency. However, at the time of payment the customer may pay with the consent of the bank in a different currency on the basis of the exchange rate of the day (i.e. the day of payment) and not the rate of the date of transaction.[296]

There is no legal impediment to granting permission for partial payment of instalments, or to agreeing with clients on the rescheduling of their remaining payments. Such permission, however, is to be given with understanding that nothing extra will be added to the remaining instalment amounts. This is because such excess would be considered *Riba*, and Allah has prohibited *Riba*. The rescheduling of payments and calculation of amounts as penalties for delays in payment to be added to the debt is prohibited because it corresponds to the sort of Riba practiced in Pre-Islamic times, i.e., "Will you pay now, or give me increase?" or an agreement between debtor and creditor to extend the period granted for payment in exchange for an increase in the amount of payment.[297] Rescheduling the remaining instalments is permissible provided that the amount due to the creditor (the bank) remains the same, with no further increase.[298]

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[294] *Shariah* Council of the *Dar al Mal al Islami*, quoted by Yusuf Talal, op. cit. pp. 56-57.
[295] *Fatawa* of the Kuwait Finance House, Question 99, pp. 104-105, quoted by Yusuf Talal, op. cit. p. 32.
[296] Usmani, Justice Taqi, An Introduction to Islamic Finance, pp. 146-147.
[297] *Fatawa* of the Shariah Board, Faisal Islamic Bank of Bahrain, pp. 12-13, quoted by Yusuf Tala, p. 18.
[298] *Shariah* Council of the Islamic Finance House, meeting of August 20-21, 1987 at Geneva, quoted by Yusuf Talal, op. cit. p. 18.

Securitization of *Murabahah*

According to Justice Taqi Usmani, *Murabahah* is a transaction which can not be securitized for creating a negotiable instrument to be sold and purchased in secondary market. The reason is that the purchaser in a *Murabahah* transaction signs a paper to evidence his indebtness towards the bank, the paper will represents a monetary debt receivable from him. Therefore, transfer of this paper to a third party will mean transfer of money. It is a settled principle of *Shariah*, that where money is exchanged for money (in the same currency) the transfer must be at par value. It can not be sold or purchased at a lower or higher price. Accordingly, the paper representing a monetary obligation arising out of *Murabahah* transaction cannot create a negotiable instrument. If the paper is transferred, it must be at par value.[299] The *Shariat* Appellate Bench of the Supreme Court of Pakistan in its judgment on *Riba* has observed that the promissory note or bill of exchange resulting from the credit sale cannot be sold to a third party on a price different from the face value.[300]

The use of Interest-Rate as Benchmark

Most of the Islamic banks determine its mark-up in case of *Murabahah* on the basis of current interest rate. The jurists criticize this practice on the ground that profit based on an interest rate should be prohibited as interest itself. The *Shariah* Board of the *Faisal* Islamic Bank of Bahrain has given a *Fatwa* with effect that there is no legal impediment to setting limits on the extent the bank is willing to finance a client in their original agreement, or to specifying percentages of profit for each and every *Murabahah* deal when the bank receives the client's order, in the understanding that the order represents the client pledge's to purchase.[301]

According to Justice Taqi Usmani, no doubt, the use of interest rate for determining a *halal* profit cannot be considered desirable. It certainly makes the transaction resemble an interest-based financing, at least in appearance, and keeping in view the severity of interest. He states even this apparent resemblance should be avoided as for as possible. However, he further states that one should not ignore the fact that most important requirement for the validity of *Murabahah* is that it is a genuine sale with all its ingredients and necessary consequences. If the transaction of *Murabahah* fulfils all the conditions required for a valid *Murabahah*, then merely using the interest rate as bench mark for determining the profit of *Murabahah* does not render the transaction as invalid, *haram* or prohibited, because the transaction itself does not contain interest. The use of interest has been used only as a benchmark or an indicator.[302]

However, he proposes that the Islamic banks and financial institutions should get rid of this practice at the earliest for the two reasons. Firstly, it takes the rate of interest as an ideal for a *halal* business which is not desirable and secondly, because it does not advance the essential philosophy of Islamic economy having no impact on the system of distribution. Therefore, the Islamic banks and financial institutions should strive for developing their own benchmark. He suggested a proposal for the same. The purpose can

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[299] Usmani, Justice Taqi, An Introduction to Islamic Finance, p. 147.
[300] SAB, The Court Order, Para: 40.
[301] Fatawa of the Shariah Board, Faisal Islamic Bank of Bahrian, p. 12, quoted by Ysuf Talal, p. 105.
[302] Usmani, Justice Taqi, An Introduction to Islamic Finance, p. 119.

be achieved by creating inter-bank market based on Islamic principles and a common pool which invests in asset-backed instruments like *Musharakah*, *Ijarah*, etc. For instance, like the leased property or equipment and shares in business concerns, etc, if the majority of the assets of the pool are in tangible form, then its units can be sold and purchased on the basis of their net asset value determined on periodical basis. These units can be negotiable and may be used for overnight financing as well. The banks having surplus liquidity can purchase these units and when they need liquidity, they can sell them. This arrangement may create inter-bank market and the value of the units may serve as an indicator for determining the profit in *Murabahah* and *Ijarah* also.[303] It is also criticized that Islamic banks utilize the interest rate as a criterion for fixing the profit margin in the *Mudarabah* sales. To be fare there is no known way of avoiding the alleged link up as long as Islamic banks coexist with traditional banks. Still Islamic banks must avoid exceeding the prevailing interest rate or exploiting the clients through accounting methods as employed by some banks.[304]

4.2.4. Recommendations

1. Most of the financing of the Bank IBD is channeled through the *Murabahah* mode of financing.[305] It is appreciable that the *Shariah* Supervisory Committee of the Bank has put a bar with effect that the *Murabahah* financing of the Bank should not exceed 30 percent of the total financing of the Bank. However, the management of the Bank should give due attention in applying this method to the warning given by the Council of Islamic Ideology of Pakistan that "It would not be advisable to use it widely or indiscrimately in view of the danger attached to it of opening a back door for dealing on the basis of interest."[306] The management of the Bank should not assume that *Murabahah* is a universal instrument which can be used for every type of financing. It is basically designed to replace the interest of the conventional banks and is a transitory step taken in the process of the Islamization of the economy. This mode can be used only where the commodity is intended to be purchased by the customer. *Murabahah* cannot work, if the funds are required for some other purpose. In such cases, some other suitable modes of financing, like *Ijarah*, *Musharakah*, etc. can be used as per the nature of the requirement.

2. According to the Resolution No. 109 (3/12) concerning 'Penalty Provision' of the OIC Islamic Fiqh Academy, no penalty can be imposed on the defaulters. Therefore the instant Penalty Clause of the *Murabahah* Agreement should be deleted and instead of it some other measures such as blacklisting of the defaulted customer may be adopted. The practice of blacklisting the willful defaulted customers is adopted by some Islamic banks in the Kingdom of Saudi Arabia. This clause can be read as "In the event of default of payment, the customer will be blacklisted and his name

[303] Usmani, Justice Taqi, An Introduction to Islamic Finance, pp. 119-120.
[304] Homoud, 1994, pp.74-75.
[305] The BoK, Annual Report 2006, p. 65.
[306] Council of Islamic Ideology: "Report on Elimination of Interest from the Economy" Reprinted in Ziauddin Ahmad, etc. al (eds) Money and Banking in Islam, 1983, Institute of Policy Studies, pp. 118-119.

circulated to all other banks operating in Pakistan. In according with the blacklisting rules the names will appear in the black list for a certain period of time even if the customer arranges settlement at a later date."

3. It has been observed, that in some cases the customer gets the *Murabahah* documents for obtaining funds only. Actually they are not interested in purchasing the commodity and never intend to utilize the funds for purchasing of a specific commodity. They are just in need of funds for unspecified purpose. They name a fictitious commodity in order to satisfy the requirements of the formal documents. It is a pseudo transaction in which goods do not in fact change hands to comply the required *Shariah* stipulations. The customer uses the money for whatever purpose they wish after receiving the same from the Bank. This practice is neither in conformity with the *Shariah* principles nor with the requirements of good banking practices. This mark up practice of the Bank is responsible for creating crisis of confidence in the system of Islamic banking and critics have termed it as another from of interest. Therefore, the authority of the Bank sanctioning the facility to the client should be very careful and they have the duty to make insure that whether the client really intends to purchase the commodity, which may be subject to *Murabahah* or he is just pretending the Bank. For instance, the Bank must make insure that the client has taken possession of the goods. Generally the Bank should give funds to the supplier directly instead to the client. However, if it becomes necessary that the customer is entrusted with funds to purchase the commodity on behalf of the Bank, then his purchase should be evidenced by invoices or similar other documents which should be presented to the Bank. In those cases where, either one of the above two requirements is not possible to be fulfilled, the Bank should arrange for physical inspection of the purchase commodity. The Bank may have a right of withdrawal so as to prevent situations in which a client may break the terms of purchase contract with the Bank. No dealings be made with clients concerning whom it is discovered that they had conspired to defraud the Bank for a period of at least six months or until their conditions improves.

4. The *Shariah* auditors of the Bank while conducting *Shariah* audit of the Bank *Murabahah* transactions with regard to their *Shariah* compliance, must make sure that the different stages of *Murabahah* have observed and every transaction is affected at its due time. For instance, it is not allowed to sale the commodity to the client before the commodity is acquired by the Bank from the supplier. Usually this mistake is committed in transactions where all the documents of *Murabahah* are signed at once without taking into account various stages of the *Murabahah*. The *Murabahah* agreement should not be signed at the time of disbursement of money or at the time of approval of the facility. The whole transaction of *Murabahah* will turns into an interest-bearing loan without observing the basic feature of *Murabahah* financing. Thus, the sale of commodity to the client should not be affected before the commodity is acquired from the supplier. The various stages of the *Murabahah* should not be skipped and all the documents should not be signed together. It is to be remembered that *Murabahah* is a package of different contracts and they come into play one after another at their respective stages.

5. It has been observed that some clients effect *Murabahah* on already purchased commodities from a third party. This practice is not allowed in *Shariah* and *Murabahah* can be affected on not yet purchased commodities only. Once the commodity is purchased by the client himself, it can not be purchased again from the same supplier. If the commodity is purchased by the bank from the client himself and is then sold to him, it is buy-back technique, which is not allowed in Shariah especially in *Murabahah*. In those cases, where the client has already purchased a commodity and he approaches the Bank for funds, he either intends to set-off his liability towards the supplier or he wants to use the funds for some other purpose. In both of these cases, the Bank can not finance the client on the basis of *Murabahah*. Therefore, it is recommended that the ideal way is that the Bank itself purchases the commodity directly from the supplier and after taking its delivery, resells it on *Murabahah* basis to the client, because making the client agent to purchase on behalf of the Bank renders the arrangement dubious, except in cases where direct purchase by the Bank is not possible at all. It is further recommended that the Bank should make payment directly to the supplier and physical survey of the goods should be performed on a test basis. Evidence of receipt of goods should also be obtained. For instance to obtain Gate Pas, Weighbridge Slip Stcok record, etc.

6. The *Shariah* compliance officers of the Bank should make insure that the staff of the Bank do not obtain complete set of signed *Murabahah* transaction documents from the customer before actual execution of transaction, because such irregularities leads to non con-compliance of the transaction.

7. It has been observed that sometimes the Bank takes the constrictive possession, while the customer actually receives the delivery of the goods. There is risk that *Murabahah* transaction may be executed prior to the procurement of goods, which will render the *Murabahah* transaction as being mere financing rather than trading. Therefore, it is recommended that physical survey of the goods should be performed on a test basis. As an alternative, evidence of receipt of goods including third party evidence should be ensured.

8. In certain cases, the Bank receive declaration of the purchased goods after significant delay, so there is risk that goods might already have been used/sold by the customer. Therefore, it is recommended the *Murabahah* transaction should be executed as soon the goods purchased by the customer.

9. Any difference in quantities of commodity being purchased under *Murabahah* as per Declaration and the invoices creates a conflict within *Murabahah* documentation. Therefore, the quantities as per "Declaration" should be similar to that of invoices presented unless a transaction involves joint purchases with customer. Where a transaction involves joint purchases, the client must give a letter indicating clearly the amount purchased for himself.

10. In certain cases, the Bank promises to give rebate to the customer if he settles the transaction before the actual repayment date. In such cases, the Bank should not agree to give rebate to the clients in the beginning of transaction and in every case of rebate, the Bank should refer the matter to *Shariah* advisors.

11. Absence of date on invoices and Declaration may arise a question with regard to the permissibility or otherwise of *Murabahah* transaction. Therefore, it is recommended that no invoices with out date shall be accepted and the management should remain vigilant to avoid such weaknesses.

12. The client can not return the goods which are unsold, or exchange them or sale them for cash to the supplier, because there is no formal agreement between the client and supplier of the goods. Any such practice by the customer is against the principles of *Shariah*. Therefore, it is recommended that the proper way is that it is responsibility of the Bank to return the unsold goods, if any such situation occur.

13. The State Bank of Pakistan Islamic Banking Department should bring a binding *Murabahah* Agreement for all the Islamic banks including Bank of Khyber IBD.

14. The State Bank of Pakistan has prescribed the minimum and maximum rates of profits, which could be earned by the Bank in a *Murabahah* financing. It seems that prescribing the minimum is not acceptable from the *Shariah* prospective.

4.3. *Shariah* Principles of *Musharakah*

Definition of *Musharakah* in *Fiqh*:

We shall first define the literal meaning of the *Musharakah* and then turn to the various meanings reflected in the definitions provided by the Muslim jurists.

Literal Meaning:

The word *Musharakah* is derived from the Arabic word *Sharikah*.[307] In the literal sense, the word *Sharikah* is used in two meanings:

a) ***Ikhtilat* (Mixing or Mingling).** Ibn Manzor in *Lisan al-Arab* has defined it the mixing of the shares, that is, the capital contributed. Taj al-Urus has defined it the participation of the partners. Ibn al-Humam has described *Ikhtiliat* as the attribute of the property that is found in a mixed or mingled state, which is "mixing of the shares in such a way that one cannot be distinguished from the other."[308]

b) **The contract of *Sharikah*.** Ibn al-Humam has described the second meaning of *Shirakah* as the agreement of *Sharikah* itself, for the reason that it is the cause of *Khalt*. Accordingly, when the phrase *Sharikah Al-aqd* is used, it serves as an elaboration.[309]

Technical Meaning:

According to Imran Ahsan Khan Nyazee, the meaning assigned to world *Sharikah* by the jurists does not go beyond the literal meanings, because partnership arises either through a contract or through the mixing of capital. It is due to this reason that jurists have divided the types of *Sharikah* into: *Sharikaht al-Ibahah* (common sharing of things); *Sharikat al-Milk* (co-ownership); and *Sharikat al-aqd* (partnership through contract). He further says that a single definition of partnership cannot be found in *Fiqh* literature, that covers all the three types.[310] Abd al-Aziz al-Khayyat feels that the reason for this is the difference between the rules and conditions for the different kinds of *Sharikah*.[311] Therefore, we will first discus different types of *Sharikah* separately in order to understand the technical meaning of *Shirakah* and then in the last, we will give a single definition of *Sharikah*.

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[307] Syed Sabiq, *Fiqh-al-Sunnah*, vol. 3, p. 294 (Cairo: *Maktabah Darr-ul-Turath*).
[308] Syed Sabiq, *Fiqh-al-Sunnah*, vol. 3, p. 294; Kamal al-Din Muhammad ibn al-Humam al-Siwasi al-Iskanadari, *Fath al-Qadir 'ala al-Hidayah Sharh Bidayat al-Mujtahid*, vol. 5 p. 6 (Cairo: Mustafa al-Babi al-Halabi, 1970) (hereinafter referred to as Ibn al-Humam, Fath al-Qadir).
[309] Ibn al-Humam, *Fath al-Qadir*, vol. 5 p. 6.
[310] Nyazee, Imran Ahsan Khan, Islamic Law of Business Organization Partnership, pp. 14-15.
[311] Abd al-Aziz al-Khayyat, *al-Sharikat*, vol. 1, p. 33 (Amman: *Wizarat al-Awqaf*, 1971) (hereinafter reffered to as al-Khayyat, *al-Sharikat*.

Types of *Sharikah*

The jurists have divided *Shirkah* into the following three kinds:

i. ***Sharikat al-Ibahah*** (Common right to acquire ownership)

ii. ***Sharikat al-Milk*** (Proprietary Partnership)

iii. ***Sharikat-ul-Aqd*** (Contractual Partnership)[312]

(i) ***Sharikat al-Ibahah*** (Common right to acquire ownership)

In *Majallah*, *Sharikat al-Ibahah* is defined as the "common right of the people in ownership by acquisition or gathering of things that are *Mubah* (permissible for such acquisition) and are not originally owned by anyone."[313] In other words, it is a form of partnership in which people participate in the common right to own things that are not owned by any one. Today, such a form of *Sharikah*, would be difficult to find. The state owns all those things not owned by the citizens except that are free like air, rain, water.[314]

(ii) ***Sharikat al-Milk*** (Partnership by joint ownership)

Ibn Abidin has defined it as follows:-

> *Sharikat al-milk* is the ownership by a number of persons of an *'ayn'* (ascertained property) or *dayn* (debt not ascertained by weight or measure or other means) through inheritance or through exchange (*bay*) or through other means.[315]

The Majallah defines *Sharikatt al-milk* as "the existence of a thing in the exclusive joint-ownership of two or more persons due to one of the bases of ownership, or it is the joint claim of two or more persons for a debt that is due from (is the liability of) another individual arising from a single cause."[316] Thus, it is a joint ownership of two or more persons in a particular property, which is difficult to divide and distinguish. This kind of *"Sharikah"* may come into existence in two different ways:

a) **Optional Partnership *(Ikhtiari)*:**

It is the relationship of partnership, which comes into existence at the option of the parties e.g. joint purchase or joint acceptance of gift or a bequest, joint seizure of an article in enemy's country in the course of war, etc. For instance, if two or more persons purchase equipment, it will be owned jointly by both of them and the relationship between them with regard to that property is called *"Sharikat-ul-Milk Ikhtiari"*

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[312] Majallah, Article 1045.
[313] Majallah, Article 1045
[314] Nyazee, Imran Ahsan Khan, Islamic Law of Business Organization, Partnership, p. 15.
[315] Ibn Abidin, *Hashiyah*, vol. 4, p. 301.
[316] Majallah, Article 1060.

b) **Compulsory Partnership (*Ghair Ikhtiari*):**

This type comes into operation automatically without any action taken by the parties. For example, after the death of a person, all his legal heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person.[317]

(iii) *Sharikat-ul-Aqd* (Partnership by contract)

The definition of *Sharikat a-aqd* is important for the purpose of our research. It is the same thing as "partnership" in law. However, the jurists have described the different kinds of *Sharikat al-aqd*, for which separate rules have been described. Therefore, we will first describe the various kinds of *Sharikat al-aqd* and then in the last we will give a single definition of *Sharikat al-aqd* as provided by some of the contemporary jurists.

Kinds of *Sharikat-ul-Aqd*

In this section, we will discus the different kinds of *Sharikat al-aqd.* There is difference of opinions among the different schools about the various types of *Sharikat-ul-Aqd.* However, we will prefer to discus for the purpose of our research the different kinds of *Sharikat-ul-Aqd* under the Hanafi jurists.[318] According to them, *Sharikat-ul-Aqd* is further divided into the following three kinds:

a) ***Sharikat-ul-Amwal***

b) ***Sharikat al-a 'mal***

c) ***Sharikat-ul-wujooh***

(a) *Sharikat-ul-Amwal* (Partnership in capital)

It is an agreement between two or more persons to invest some capital into a commercial enterprise and share its profits according to pre-determined ratio.[319] *Majallah* has defined it as, "an agreement between two or more persons for common participation in capital and profits."[320] Ali al-Khafif defines it as; "It is a contract between two or more people for participation in capital and its profits, or for participation in profits without participation in capital."[321] In other words we may call it a "joint commercial enterprise." It is defined by the Malikis as "a permission from each of the participant to the others for transaction in his wealth and on their own behalf, while retaining the right to transact personally (in such wealth)."[322]

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[317] Majallah, Articles 1063-1064.
[318] Nyazee, Imran Ahsan Khan, pp. 41-46, Islamic Law of Business Organization, Partnership.
[319] *Kitab al-Fiqh Ala al-Mazahib al-Arbahah* 3/67.
[320] *Majallah*, Article 1329.
[321] See Ali al-Khafif, *al-Sharikat fi al-Fiqh al-Islami* (Cairo) p. 19.
[322] Al-Khayyat, *Sharikat*, vol. 1, p. 42 as quoted by Imran Ahsan Khan Nyazee in Islamic Law of Business Organization Partnership, p. 18.

(b) *Sharikat al-a 'mal* (Partnership in services):

Al-Kasani, defining the *sharikat al-a mal*, says:

As for the *sharikat al-a mal*, it is participation in work as tailors or as butchers or as something else, by saying that we have become partners to undertake this work so that whatever sustenance is given to us by Allah, the Mighty, the Exalted, as wages will be shared on the following conditions.[323]

Thus, here all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio. For example, if two people agree to undertake tailoring services for their customers on the condition that the wages so earned will go to a joint pool which shall be distributed between them irrespective of the size of work each partner has actually done, this partnership will be a *sharikat-ul-amal* which is also called *Sharikat-ut-taqabbul* or *Sharikat-us-sanai* or *Sharikat-ul-abdan.*

(c) *Sharikat-ul-wujooh* (Partnership in goodwill):

The word has its root in the Arabic word *'Wajahat'* meaning goodwill. Al-Sarakhsi, a famous Hanafi scholar says: "As for *sharikat al-wujuh* (that is, *sharikah* with credtworthiness), which is also called *sharikat al-mafalis* (*sharikah* of the insolvents or those reduced to a financial state of copper coins), it is a partnership of two people with capital upon the condition that they will buy on credit and sell (for cash). It has been called by this name on the grounds that they employ their credit-worthiness, because credit sales are made only to those who have a standing among the people (traders)."[324] Thus, here the partners have no investment at all. They purchase commodities on deferred price, by getting capital on loan because of their goodwill and sell them at spot. The profit so earned is distributed between them at an agreed ratio. Each of the above three types of *Shirkat-ul-Aqd* are further divided into two types:

1) *Sharikat-Al-Mufawada:* (Capital & Labour at par)

Ibn Abidin says: "In the dictionary *mufawadah* means the participation in each thing with equality, but technically it is a narrower meaning, it applies to equality in real estate and goods."[325] Imran Ahsan Khan Nyazee has defined it as, "It is a contract of partnership between two or more persons, with the stipulation of complete equality with respect to capital, profit, and status, for working with their own wealth, or with their labour in another wealth, or on the basis of their credit-worthiness, so that each partner is a surety for the other.[326] Thus, all partners share capital, management, profit, and risk in absolute equals. It is a necessary condition for all four categories to be shared amongst the partners; if any one category is not shared, then the partnership becomes *Shirkat-ul-Ainan.* Every partner who shares equally is a trustee, guarantor and agent on behalf of the other partners.

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[323] Al-Kasani, *Badai al-Sanai*, vol. 7, p. 3531.
[324] Al-Sarakhsi, *al-Mabsut*, vol. 11, p. 152.
[325] Ibn-Abidin, *Hashiyah* , vol. 4 p. 302.
[326] Nyazee, Islamic Law of Business Organization Partnerships, p. 20; See also, S 1331 of the *Majallah.*

2) *Sharikat-ul-Ainan*:

The word *ainan* is derived from the Arabic word '*ainan*' meaning reins of riding animals. It is a contract between two or more persons to work in any trade with determined capital and to share profit and loss with pre-determined ratio. This partnership is allowed in unequal capital. The partner hand over the right of transaction in some wealth to the other and not in the rest. Thus, equality in capital, management or liability might be equal in one case but not in all respect meaning either profit is equal but not labour or vice versa.[327]

A Single Definition of *Sharikat al-Aqd*

Some of the modern jurists have tried to give a single definition of *Sharikat al-aqd*, that would cover more forms. One of such definitions is given by Imran Ahsan Khan Nyazee, in his book, Islamic Law of Business Organization Partnership. He states. "It is a contract between two or more persons for participation in capital and its profits, or participation in transactions in someone else's capital and its profits, or participation in profit without participation in capital or transaction."[328] In the later case, it is called *Mudarabah*. Justice Taqi Usmani has defined it as "a joint enterprise in which all the partners share the profit or loss of the joint venture."[329] Some other definitions of *Sharikat al-aqd* by the contemporary jurists are given below:

"Participation of two or more persons in a certain business with defined amounts of capital according to a contract for jointly carrying out a business and for sharing profit and loss in specified proportions."[330]

"Joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution."[331]

"an arrangement of financing based on the concept of profit or loss sharing in which the parties participate with their money or efforts or skills or combination of all or any of the above."[332]

"two, three or more people combine, contribute capital and agreed to share profits and bear losses in agreed proportions".[333]

In light of the above discussion on *Sharikah* and its different kinds, we may say that the term '*Shirkah*' is more commonly used in the Islamic jurisprudence than the word *musharakah*. All these modes of "Sharing" or partnership are termed as "*Shirkah*" in the

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[327] Muhammad Tahir Mansoori and Abdul Hayi Abro, Arabic book, *Al-Madkhal Li Al-Fiqh Al-Islami*, Shariah Academy IIUI, p. 228.
[328] Imran A K Nyazee, Islamic Law of Business Organization Partnerships, p. 20.
[329] M. Taqi Usmani, An Introduction to Islamic Finance, p. 27.
[330] Siddiqi, Muhammad Nejatullah, Partnership and Profit-Sharing in Islamic law, p. 15.
[331] Meezan Bank Guide to Islamic Banking.
[332] Nawazish Ali Zaidi, Interest Free Banking, The Institute of Bankers in Pakistan, p 234.
[333] K. K. Dewit, Modern Economic Theory, p. 106, ch. 14, Sham Lal Chariteble Trust, Delhi.

terminology of Islamic *Fiqh*, while the term "*Musharakah*" is not found in the books of *Fiqh*. This term has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of "*Sharikah*", that is, the *Sharikat-ul-Amwal*, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes *Sharikat-ul-Aamal* also where partnership takes place in the business of services. Thus, it is evident from this discussion that the term "*Sharikah*" has a much wider sense than the term "*Musharakah*" as is being used today. The latter is limited to "*Sharikat-ul-Amwal*" only while the former includes all types of joint ownership and those of partnership. Since, "*Musharakah*" is more relevant for the purpose of our search, and it is almost analogous to "*Sharikat al-aqd*", we will focus on it in our present research, while describing different *Shariah* rules of *Musharakah*.

Conditions of the Contract of *Musharakah*

There are certain ingredients, which are specifically related to the contract of *Musharakah*. The jurists have necessitated the followings conditions in the contract of *Musharakah*.

Conditions of *Rass al-Mall* (Capital):

It is a necessary condition for the validity of the contract of *Musharakah* that the capital must be present either at the time of the conclusion of contract or at the time of the purchase of the goods. It is not valid to conclude the contract of *Musharakah* on an absent *Mall* or on debt.[334] The same is the view of the Hanafis, who says that the capital in a *Musharakah* must be an ascertained commodity ('*ayn*') and not *dayn*, i.e. wealth that is not present.[335] Similarly, According to Imam Abu Hanifah and Imam Ahmad, it is a condition for valid *Musharakah* that its investment is in the form of currency and no contribution in kind is acceptable.[336] While Imam Shafi has classified commodities into two kinds

i. Dhawat-ul-amthal:

It is a form of commodities which, if destroyed can be compensated by the similar commodities in quality and quantity i.e. wheat, rice, etc.

ii. Dhawat-ul-qeemah:

It is a form of commodities which cannot be compensated by the similar commodities i.e. cattle, etc.

Imam Shafi has allowed *Musharakah* in the first kind (*dhawat-ul-amthal*) and disallowed in the second kind (*Dhawat-ul-qeemah*).[337] While, according to Imam Malik the capital in the form of currency is not a condition for the validity of *Musharakah* and it

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[334] Ibn Rushd, *Bidayat al-Mujtahid*, vol. 2, p. 250, *Kitab-ul-Fiqh Ala al-Mazahib al-Arabahah*, 3/78, *Al-Fitawah al-Hindiah*, 2/306.
[335] See Kasani, *Bada'I 'al-Sana'I* ', vol. 6 pp. 59-60.
[336] Ibn Qudamah, *al-Mughni*, vol. 5, pp. 124-125.
[337] Ibn Qudamah, *al-Mughni*, vol. 5, p. 125

is permissible in goods, if their value is determined on the day the contract is concluded. Some Hanbali jurists also adopt this view.[338]

Mixing of Capital

There is difference of opinions among the jurists about the mixing of the capital of *Musharakah*. According to Shafis, Zaidyah, and al-Shiah al-Jafarayah, the contract of *Musharakah* is not valid without mixing the capital of partners, so that the share of the one partner can not be differentiated from the other.[339] While, according to the majority of jurists, mixing of capital prior to the conclusion of the contract is not necessary. Imam Shafi says, that the meaning of the word *sharikah* is intermingling and this is realized through ownership only. If the two investments are mixed together in a manner that makes them indistinguishable from each other, then the partnership becomes effective through ownership and contractual partnership can be built upon it. If one of the investments is lost before they are intermingled, the loss is borne exclusively by its owners and any projected contractual partnership cannot become effective, because the capital did not undergo the process of mixing.[340]

Management of *Musharakah*

Musharakah is run and managed by the will and equal rights of participation of all the partners. The normal principle of *Musharakah* is that every partner has a right to take part in its management and to work for it. However, the partners may agree upon a condition that the management shall be carried out by one of them, and no other partner shall work for the *Musharakah*. However, if all the partners agree to work for the joint venture, each one of them shall 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 shall be deemed to be authorized by all the partners.[341]

Distribution of Profit

In *Shariah* profit is the joint product of capital investment and business effort. Profit is the fruit of business effort working with capital.[342] According to Hanafi jurists, a partner becomes entitle to the profit in one of three ways:

i. By Capital
ii. By work
iii. By the liability incurred by the partner.[343]

While, according to majority of Muslim jurists, a partner becomes entitles to the profit by capital and labour only. Profits are to be distributed among the partners in business on the basis of proportions settled by them in advance. The share of every party in profit must be determined as a proportion or percentage. Fixed amount cannot be

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[338] Sarakhsi, *al-Mabsut*, vol. 11, p. 177; Ibn Qudamah, *al-Mughni*, vol. 5, p. 125.
[339] Muhammad Tahir Mansuri and Abdul Hayi Abro, op. cit., p. 231.
[340] Sarakhsi, *al-Mubsut*, vol. 11, p. 177, Muhammad Tahir Mansuri and Abdul Hayi Abro, pp. 231-232.
[341] Zuhayli, *al-Fiqh al-Islami wa Addillatuhu*, vol. 4, pp. 415-416, Usmani, Justice Taqi, An Introduction to Islamic Finance, p. 41-42; al-Khafif, pp. 42-44.
[342] Siddiqi, Muhammad Nejatullah, Partnership and Profit-Sharing in Islamic law, p. 27.
[343] Kasani, *Badai al-Sanai*, vol. 6, p. 62-63; Ibn al-Hamam, *Fath al-Qadir*, vol. 5, p. 21.

settled for any party.[344] According to Hanafis, it is lawful that the capital of partners be equal and yet the profit be shared unequally.[345] While Shafi, Malik and Zufar do not accept this opinion. It is not allowed to fix a lump sum amount for anyone of the partners or any rate of profit tied up with his investment. There is a difference of opinion among the jurists, that whether the ratio of profit of each partner conforms to the ratio of capital invested by him. Malik and Imam Shafi are of the opinion, that it necessary for validity of *Musharakah* that each partner gets the profit exactly in the proportion of his investment. While Imam Ahmad is of the opinion that the ratio of profit may differ from the ratio of investment, if it is agreed between the partners with their free will.[346] Imam Abu Hanifah is of the opinion that the ratio of profit may differ from the ratio of investment in normal conditions. "It is valid that the capital investment of the two parties be equal and yet one of them obtain a larger share of profit than the other".[347] However, If a partner has put an express condition in the agreement that he will not work for the *Musharakah* and will remain a sleeping partner throughout the term of *Musharakah*, then his share of profit cannot be more than the ratio of his investment.[348] Thus, it is allowed according to the Hanafis and Hanbalis jurists view that if a partner is not working, his profit share can be established as less than his capital share. According to Muhammad Nejatullah Siddiqi, the view of the Hanafis and Hanbalis jurist is the more forceful and persuasively argued. It will more helpful in extending the scope of joint stock business and in making it easier.[349]

Sharing of Loss

The *Shariah* view loss as diminution of capital and does not consider it as consequence of business effort.[350] Therefore, all the jurists are, unanimously, of the view that the loss shall be borne by the partners according to their capitals based on the saying of *Syedna* Ali ibn Talib that is as follows:

"Loss is distributed exactly according to the ratio of investment and the profit is divided according to the agreement of the partners."

Thus, loss will always be distributed in proportion to capital proper. All Imams agree on this in spite of their belonging to different schools of thought. Any conditions agree to in contravention of this principle would be declared null and void and would not be executed."[351]

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[344] See for details Siddiqi, M. N., Partnership and Profit-Sharing in Islamic Law, pp. 22-23.
[345] Ibn Juzy, *al-Qawanin al-Fiqhiyyah,* p. 284.
[346] Ibn Qudamah, *al-Mughni*, vol. 5 p. 140.
[347] Marghnani, Vol. 2, (*Shirkah*: *Shirakat-'inan*), quoted by Siddiqi, Muhammad Nejatullah, Partnership and Profit-Sharing in Islamic law, p. 28.
[348] Kasani, *Badai al-Sanai*, vol. 6, pp. 162-163, *Al-Hidyah*, volume 2, p. 82, *al-Mughni,* vol. 5 p. 140; al-Jaziri, *Kitab al-Fiqh ala al-Mazahib al-Arba 'ah*, vol. 3, 104-113; Ali al-Khafif, p. 29.
[349] Siddiqi, M. N., Partnership and Profit-Sharing in Islamic Law, p. 29.
[350] Ibid, p. 27.
[351] Ibn Qudamah, *al-Mughni*, vol. 5, p. 147; *Minhaj al-Talibin* p. 56; al-Khafif, p. 55.

Rights and Duties of Partners in *Musharakah*:

The partners have the following rights and duties after entering into a *Musharakah* contract:[352]

a) **Right to sell goods for cash and credit:** The partner has the right to sell the goods of the *Musharakah* for cash as well as for credit. Similarly, he has the right to purchase raw material or other stock for credit or for cash by using funds belonging to *Shirkah* to put into business. This right is conferred upon him by virtue of the contract and he does not need any permission from the other for doing so. Also, since all partners are representing each other in *Shirkah* and all have the right to buy & sell for business purposes. However, he cannot purchase in excess of the capital of *Musharakah*.[353] The value of the goods and services purchased on credit on behalf of the partnership should not exceed the total value of the *Musharakah*. Any credit purchases in excess of this limit can be made only with the permission of other partners. If a partner makes purchase in excess of the capital or accepts any liability without the permission of other partners (i.e. in violation of the memorandum or articles of association) and resultantly bring loss to the business, then other partners will not be liable to the extent of such loss and the loss will be incurred by him only.[354]

b) **Right to appoint agent:** A partner has the right to appoint a person as his agent for the business transaction, if needed.

c) **Right to Merge Joint Capital with Personal Capital in Business:** No partner has the right to mix his personal business with the joint business without the general or special permission of his co-partners.[355]

d) **Right to Deposit:** The partner has the right to deposit money and goods belong to the *Musharakah* as depositor trust where and when necessary; for depositing is one of the customary practices of businessmen.

e) **Right to give Joint Capital on *Mudarabah*:** The partner has the right to give capital in the way of *Mudarabah*, provided other partners have given their permission, because *Musharakah* is designed for profit and *Mudarabah* is a mode of earning profit.[356] According to Imam Abu Hanifah, permission from other partners is not necessary.[357] According to Malikis, a partner has the right to a part of the *Shirakah* capital to any third party on the basis of *Mudarabah*, provided the amount of capital is sufficient to do so, otherwise not.[358] While according to Hanbalis, no partner has

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[352] Zuhayli, *al-Fiqh al-Islami wa Addillatuhu*, vol. 4, pp. 415-416, Muhammad Tahir Mansuri and Abdul Hayi Abro, op. cit. pp. 233-234.
[353] *Badai al-Sanaeh*, 6/680.
[354] Ghazi, Dr. Mehmood Ahmad, Urdu Booklet, (*Islam May Riba Ke Hurmat Awar Bila Sood Sarmaikari*), p, 28, (Pub: Shariah Academy, IIUI); Siddiqi, Muhammad Nejatullah, Partnership and Profit-Sharing in Islamic law, pp. 17-18.
[355] See for details Siddiqi, Muhammad Nejatullah, op. cit., p. 48.
[356] See for details Siddiqi, Muhammad Nejatullah, op. cit., p. 46.
[357] Al-Sarakhsi, Vol. 11, p. 175; Kasani, Vol. 6, p. 69.
[358] Al-Jaziri, Vol. 3, p. 117; al-Dardir, Vol. 2, p. 156.

the right to give a part of the *Shirakah* capital on *Mudarabah* to any third party without the permission of other partners. However, it is not necessary according to them to secure express permission for this. The general permission to make business deals being sufficient.[359]

f) **Right to extent Gift and *Qard*:** A partner does not have the right to gift the property of *musharakah*. However, if one partner for purpose of investing in the business has taken a *Qard-e-Hasana*, then paying it becomes liable on both

g) **Right to Lend *Musharakah* Capital:** A partner in *Musharakah* business does not have the right to lend to party *Musharakah* money; nor he can borrow money from other persons to use in the business without the express permission of the other partners.[360]

h) **Right to mortgage or pledge:** A partner can pledge or mortgage the assets of *musharakah* and also accept such pledges, provided he got the permission of other partners.

i) **Contractual obligations of partners:** Hanafis are of the opinion that all the rights and obligations arising from a contract made by a partner will revert to him. Thus, if the partner has purchase something or hire services, he will alone be sued in connection with claims arising from such transactions. Similarly, he has the right only to sue third parties for all claims connected with the contract he concluded.

Dissolution of *Musharakah*

There are certain elements, through which all kinds of the *Shirakah* contract can be terminated. The contract of *Musharakah* will stand terminated in the following circumstances:

a) **Recession of the contract by either party:** A *Musharakah* is a *Jaiz* (permissible) contract that is also *Ghayr Lazim* (terminable). Every partner has the right to terminate the *Musharakah* at any time after giving his partner a notice that will cause the *Musharakah* to end. All jurists agree on this principle.[361]

b) **Expiration of Fixed Period:** If the *Musharakah* was for a limited period, it will stand terminated by the expiration of that period. Similarly, if the purpose of forming the *musharakah* has been achieved. For example, if two partners had formed a *Shirkah* for a certain project for e.g. buying a specific quantity of cloth in order to sell it and the cloth is purchased and sold with mutual investment.[362]

c) **Death of One Party:** The death of any one of the partners leads to termination of *Musharakah*. Because the underlying contract of *wakalah* become void upon the

[359] Ibn Qudamah, Vol. 5, p. 132.
[360] See for details Siddiqi, Muhammad Nejatullah, Partnership and Profit-Sharing in Islamic law, pp. 64-76.
[361] See for details Siddiqi, Muhammad Nejatullah, Partnership and Profit-Sharing in Islamic law, p. 81.
[362] See for details Siddiqi, Muhammad Nejatullah, Partnership and Profit-Sharing in Islamic law, pp. 86-93.

death of the partner and the *Musharakah* is based upon on *wakalah*.[363] Also, each of the partners is the agent of the other and the death automatically discharges the agent, whether, the later knows about it or no. Any business conducted by the surviving partner after his colleague demise will be strictly on his own account. The heirs of the deceased partner have the option either to draw the share of the deceased from the business or to continue with the contract of *musharakah*.[364]

d) **Insanity of One Partner:** The loss of mental competency of the one of the partners also results in termination of *Musharakah*, provided the insanity is continuous. However, the jurists disagree about the period of insanity. According to Abu Yusuf, the period for this is one month, while according to Muhammad it is a full year. The *sharikah* is not to be considered as terminated during this period.[365]

e) **Loss of Capital:** In case of damage to the share capital of one partner before mixing the same in the total investment and before affecting the purchase, the partnership will stand terminated and the loss will only be borne by that particular partner. However, if the share capital of all partners has been mixed and could not be identified singly, then all will share the loss and the partnership will not be terminated.[366]

f) **Mutual Consent:** The contract of *musharakah* can also be terminated by the mutual consent of the parties.

g) **Apostasy and Emigration to Enemy Land:** When one of the partners decides to migrate to the *Dar al-Harb* (the enemy land) as an apostate, he is assigned the *Hukm* of a deceased person as for as Islamic law is considered. The Hanafis consider this as legal death (*Hukm*).[367] This takes place when judicial order is issued. However, in case when there is apostasy without a judicial order with effect or not the partner migrates to the enemy land, it results in suspension of the *Musharakah*. In other words, it means that if he comes back into the fold of Islam, the contract of *Musharakah* is presumed to continue as it existed prior to the act of apostasy.[368]

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[363] Al-Kasani, *Badai Sanai*, vol. 7, p. 3581.
[364] Ibn Qudamah, a*l-Mughni*, vol. 5, pp. 133, 134.
[365] Al-Kasani, *Badai Sanai*, vol. 7, pp. 3581, 3489; Ibn Qudamah, *al-Mughni*, Vol. 5, pp. 133, 134
[366] *Al-Hidyah*, Vol. 2, p. 610.
[367] Al-Kasani, *Badai Sanai*, vol. 7, p. 3489, al-Marghnani, *al-Hidayah*, vol. 3, p. 12.
[368] Nyazee, Imran Hassan Khan, Islamic Law of Business Organization, p. 123.

Tenure of *Musharakah*:

According to the Hanafi school of thought a person can fix the tenure of the *Musharakah*, because it is an agreement and an agreement should have a fixed period of time. In the Hanbali school of thought the tenure can be fixed for the *Musharakah*, as it's an agency agreement and an agency agreement in this school can be fixed. However, the Maliki School is of the opinion that *Shirkah* cannot be subjected to a fixed tenure. Shafi School like the Maliki considers fixing the tenure to be not permissible. Their argument is that fixing the period will prohibit conducting the business at the end of that period which in turn means that the fixing will prevent them from conducting the business.[369]

Modern Forms and Application of *Musharakah*

Islamic banks use *Musharakah* as a mode of financing. It is considered as an alternative to the riba-based transaction under the Islamic financial system. *Musharakah* is used in the following sector of financing by the contemporary Islamic financial systems.

a) Project Financing:

Islamic banks provide project finance on the basis of *Musharakah*. A typical *Musharakah* transaction may be conducted in the following manner: One, or more customer's approaches the bank for the finance required for a project. The bank prior to any financing gets the evaluation of the project through its experts. The bank if found the project feasible and profit is expected with the addition that the customers have sufficient experience to handle the project, and then the partnership is negotiated. The bank, along with other partners, provides complete finance. All partners, including the bank, have the right to participate in the project. They can also waive this right. The profits are to be distributed according to an agreed ratio, which need not be the same as capital proportion. However, loss must be shared exactly in the same ratio in which different partner provides finance. Here the contract of *Musharakah* terminates with the project completion.[370]

b) Financing of Single Transaction:

Islamic financial institutions provide finances on the bases of *Musharakah* in order to meet day to day needs of small traders. The traders approach the bank with the request to fiancé purchase of certain goods. The bank after evaluation, if considers the transaction profitable, then it finance purchase of required goods on the basis of *Musharakah*. The said goods are then sold in the market and both the parties share the profit in proportion to their investment.[371] The instruments of *Musharakah* can also be used for financing of import and export. If the Letter of Credit has been opened without any margin, then the form of *Mudarabah* is adopted. While, if the L/C is opened with some margin, then the form of *Musharakah* is adopted. The importer and financer according to pre-determined ratio share the sale proceeds of the goods, after they are cleared from the port. Here the

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[369] Al-Kasani, *Badai al- Sanai*, vol 6, p. 99. See also Ibn Qudamah, *al-Mughni*, vol. 5, p. 186, and Sarakhsi, *Almubsut*, vol. 22, p. 133.
[370] Justice Taqi Usmani, pp. 56-61.
[371] Ibid, pp. 61-62.

ownership of the imported goods remains with financier, to the extent of the ratio of his investment.[372]

c) Diminishing *Musharakah* (DM)

The instrument of Diminishing *Musharakah* (DM) is developed in the near past. According to the concept of DM, an Islamic bank and customer develop a joint stock project, which would later lead to the sole ownership of the customer. The partners share profits and losses in the proposed contract according to *musharakah* principles.[373] The DM contract combines the prime characteristics of the sale and sharing contracts: it transfers ownership through sale and does so through profit sharing arrangement.[374] The share of the bank is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share until all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be. Thus, the ownership of the object will pass to the customer upon successful completion of the agreed term.[375] It was approved as a permissible mode of financing by the First International Conference on Islamic Banking, held in Dubai, during 23-25 Jamad al Thani 1399H (1979).[376] The concept of DM is widely used by the Islamic banks for house financing.[377]

4.3.1 Practice of the Bank of Khyber Islamic Banking Division for House Financing on the Basis of Diminishing *Musharakah*

Presently, the Islamic Banking Division of the BOK uses the mode of Diminishing *Musharakah* (DM) for house financing only. According to the prescribed procedure of the Bank, the customer submits an application on prescribed form of "*Pak Ghar* Scheme" duly filled to the nearest branch of the Bank along with all the relevant documents. The application is routed through the IBB for submission to the Islamic Banking Division of the BOK. The client is required to specify the area, where he intends to purchase the house. The customer opens an Account with the concerned branch of the BOK. The customer also provides proof of income i.e., salary slip, income certificate, income tax return, affidavit and audited or un-audited financial accounts, whichever is applicable.[378]

The Branch verifies the income of the client. The affidavit is supported with the proof of income. The customer provides copy of National Identity Card (NIC) with three photographs. The customer also furnishes to the Branch Statement of Account for the last six months, which may be of the BOK or any other bank accounts.[379] The Bank conducts an independent inquiry and scrutiny of the informations provided by the customer. The

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[372] Ibid.
[373] T. Allah Khan & B. Bendjilali, Economics of Diminishing *Musharakah*, p. 49 (Pub. IRTI, IDB)
[374] Ibid, p. 49.
[375] Justice Taqi Usmani, Introduction to Islamic Finance, p. 82,
[376] Abdallah, Ahmad Ali, (1991) "Methods of Financing Houses According to *Shari 'ah*".
[377] Dr. Ahamed Kameel, Alternative in Islamic Home Finance, available at www.iiu.edu.my
[378] Diminishing *Musharakah* Manual of the Bank of Khyber Islamic Banking Division, p. 9.
[379] Ibid.

concerned Branch of the BOK makes a visit report to confirm credentials of the applicant and guarantors, if any. A credit worthiness report of the applicant and guarantors is also prepared. The income of the applicant is verified. The client's request along with Branch recommendation and all other relevant documents are submitted to the IBD of the Bank.[380]

The proposal is processed at IBD of the Bank. The *Shariah* Advisors of the IBD give *Shariah* clearance of the proposal and certify that there is nothing adverse against the *Shariah* principles in the proposal. After the *Shariah* clearance, the proposal is submitted to the relevant credit committee of the BOK for approval and decision. In case of approval, IBD issue a Consent Letter containing Diminishing *Musharakah* Fund (DMF) limit in favour of the client with the terms and frequency of repayments. The concerned Branch of the Bank asks the applicant for acceptance of the Consent Letter. The applicant after accepting the same enters into D.M. Agreement with the BOK for purchase of proposed house. The Bank convey major specification of the house to be purchased under DMF, such as locality, market value, construction quality, current condition, clear title, etc. to the co-owner.[381] After execution of DM Agreement, the client may deposit his portion of investment with the Bank or he may utilize that amount as advance or token money to the vendor to get all formalities completed. Some times the Branch issue a letter to the vendor confirming the sanctioned limit in favour of the applicant.[382] The Branch asks the client to submit a detailed proposal along with all relevant but not limited to the under mentioned documents and informations:

a. Title deed, sale deed, lease deed, possession certificate, transfer deed, *Fard* or mutation, *Aks-e-Shajra*, *Naksha-i-Tasweeree*

b. This contains the specific house, street, sector, and complete mailing address of the proposed house.

c. Non Encumbrance Certificate, Search Certificate

d. Approved Building Plan

e. Valuation Certificate from SBP and PBA approved evaluator.

f. Branch's satisfactory visit report in respect of the proposed house, confirming its accessibility, salability, marketability and assessment of its market and forced sale value in distress. The visit report also comments on the status, nature, quality of construction and soundness of the house.

g. Non Objection Certificate (NOC) to mortgage.

h. Personal Guarantee of the applicant as well as joint applicant, if any and personal guarantee of third party at the discretion of BOK.

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[380] Ibid, p. 10.
[381] Ibid.
[382] Ibid.

i. Pre-mortgage legal opinion from BOK's approved legal advisor[383]

The application along with all requisite documents is submitted to IBD along with Branch's recommendation. The IBD in turn put the proposal before the relevant credit committee for getting approval to utilize the already sanctioned DMF limit for purchase of the proposed house. The IBD issues the Sanction Letter accordingly.[384] The concerned IBB of the BOK issue Sanction Letter to the applicant and get his acceptance thereto and ensure fulfillment of securitization and other formalities in accordance with the Sanction Letter, which include the under mentioned:

1. Unilateral Promise by the client for *Ijarah* Agreement and Sale Agreement for purchase of units of BOK's share in the house.
2. Equitable mortgage over collateral offered as interim security (In cases where interim security is possible)
3. A DM Account is opened with the Branch and the client (co-owner) pays his share of investment in full or amount less Advance. The Bank also deposits its share of investment in the same Account. Disbursement upto purchase price is made to the vendor at the time of purchase of house and the balance amount to be utilized for other direct expenses.
4. A joint ownership is created by virtue of *Musharakah* Agreement (*Shirkat-ul-Milk*). The client also provides undertaking that he will mortgage the house in favour of Bank after its transfer in his name.
5. Demand Promissory note for the value of shares of the Bank in the house.
6. The title of the house is directly transferred in the name of client (co-owner) on the same day of disbursement of purchase price to the vendor and equitable mortgage is created simultaneously.
7. *Ijarah* Agreement is executed on the date of transfer and possession of property by the client as co-owner.
8. BOK's shares are divided into units and are given to the client on rent.
9. Client to promise to purchase Bank's units over the period of facility.
10. Post dated cheques (one for each year for the amount including annual shares to be purchased and annual rent)
11. Mortgage Deed is prepared and property is mortgaged within 7 days or as soon as possible after property is transferred in the name of client (co-owner). Registered mortgage of Rs.50,000/- or 10% of the purchase price of the house, whichever is

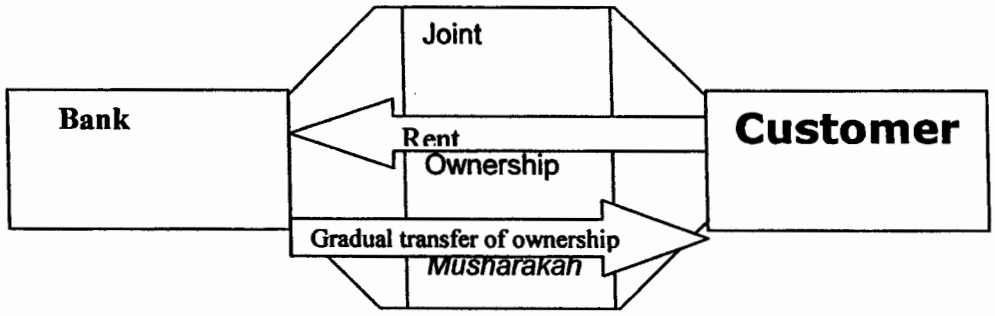
[383] Ibid, pp. 10-11.
[384] Ibid, p. 11.

less and remaining equitable mortgage by way of MODTD to secure the DP note amount of DMF.

12. Registered deed of Irrevocable General Power of Attorney in favour of BOK
13. Mutation and noting in favour of BOK.
14. NOC (Post Mortgage Legal Opinion) from BOK's legal advisor
15. NOC from Credit Administration Department (CAD) of the Bank.
16. Payment by the co-owner to the Bank for purchase of shares is considered as sale of shares and bank will record the sale of shares in its system and a receipt is provided to the customer on request.[385]

Initially, the customer owns the share of the house corresponding to the down payment as a percentage of the total purchase price. The Bank and the customer share the risks and the profits caused by changes in the house's value. Each month, the customer makes a monthly payment to the Bank, of which a component is for the use of home (rent) and another for equity share. At the end of the DM Agreement, the customer owns hundred percent of the house.

Basic Transaction Structure



Salient Features of the Bank of Khyber Islamic Banking Division Diminishing *Musharakah* Agreement

The parties mutually agree to purchase or build the project on the basis of Diminishing *Musharakah* for the project value. The project value is contributed by the parties in the agreed ratio. The project value is divided into project shares and such project shares are held by the parties in proportion to their contribution in project value. The parties are authorized to sell the shares to each other over time at any price as mutually agreed between them. The Bank's and co-owner's share in the project value change with every sale and purchase of the shares among both the parties. The Bankl advise the criteria for selection of the project by the co-owner.[386]

[385] Ibid, pp. 11-12.
[386] Ibid, p. 16.

On behalf of the co-owner and itself, the Bank procures insurance coverage from reputable companies offering protection under *Takaful*. The premium of the insurance cover obtained under this clause has is borne by the parties according to their respective shares in the project.[387] The co-owner agrees to pay the Bank the cost of repair or replacement of the project, or any part thereof, due to any damage arising out of misuse of the project. If there is an event of default as described in the agreement, the Bank may terminate the Agreement and become entitled to the return of the project.[388]

It is understood and agreed that the co-owner has selected the project and ascertained the suitability of the project for his use and that the Bank shall not be liable or accountable to the co-owner for any loss, damage, claim, demand, liability, cost or expense of any nature or kind sustained by the co-owner directly or indirectly resulting from any inadequacy for any purpose, or from loss or interruption of use thereof, or any loss of business or profits consequential upon any defect of the Project of any nature whatsoever.[389] The Agreement is binding upon and be enforceable by the Bank, the co-owner and their respective successors, permitted assigns and transferees of the parties hereto, provided that the co-owner shall not assign or transfer any of its rights or obligations under this Agreement without the written consent of the Bank. The Bank may assign all or any part of its rights or transfer all or any part of its obligations or commitments under this Agreement to any other financial institution or person.[390]

Conditions Precedent

The Bank has subjected its contribution to the project value to the following conditions precendents:

a. Documentary evidence that:

I. This Agreement has been executed and delivered by the co-owner;

II. The co-owner's representatives are duly empowered to sign the Principal Documents for and on behalf of the co-owner;

III. The co-owner has taken all necessary steps and executed all documents required under, or pursuant to, the Principal Documents or any documents creating or evidencing the security in favour of the Bank and has perfected the security as required by the Bank;

IV. The co-owner has executed all contracts and has procured all permissions, licenses and consents necessary for the Project;

1. Certified copy of the memorandum and articles of association of the co-owner;

2. Certified copy of the co-owner's financial statements ;

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[387] Ibid, p. 17.
[388] Ibid, pp. 18-19.
[389] Ibid, p. 19.
[390] Ibid, p. 19.

3. The valuation certificate and project budget;

The obligation of the Bank to contribute its share to the project value is further subjected to the fulfillment of the following conditions:

a. Such contribution shall not result in any breach of any law or existing Agreement;

b. The security has been validly created, perfected and is subsisting in terms of this Agreement;

c. The Bank has received such other documents as it may reasonably request in respect of the Project and their necessity for the conduct of the co-owner's business;

d. No event or circumstance which constitutes or which with the giving of notice or lapse of time, or both would constitute, an event of default shall have occurred and be continuing or is likely to occur;

e. Delivery by the co-owner to the Bank of a true and complete extract of all relevant parts of the minutes of a duly convened meeting of its Board of Directors approving the Principal Documents and granting the necessary authorizations by the Board of Directors; and

f. All fees, commission, expenses required to be paid by the co-owner to the Bank or vice versa have been received by the Bank.

Any condition precedent set forth in this section or any requirement under any other clauses of this Agreement may be waived and or modified by the mutual written consent of the parties hereto.[391] The DM Agreement is governed by and construed in accordance with the Pakistani law and the recognized principles of the Islamic *Shariah* as may be determined by the *Shariah* Supervisory Committee of the Bank.[392]

During the currency of the DM Agreement, in case this Agreement or any provision thereof is finally held by any court, tribunal or authority to be unenforceable or contrary to the injunctions of Islam or not conforming with any of the Islamic modes of financing, as prescribed by the State Bank of Pakistan or any other competent authority or if it is necessary for any other reason whatsoever to amend or modify the terms or any provision of this Agreement, then the parties hereto, whilst acknowledging that the terms and covenants herein contained have been prepared in absolute good faith and in accordance with information and knowledge currently available, agree that upon such happening, they shall forthwith suitably substitute this Agreement or such of its provisions as may have been declared unenforceable or contrary to the injunctions of Islam or not being in conformity with the Islamic modes of financing prescribed by the State Bank of Pakistan or any other competent authority or which are necessary to amend for any other reason whatsoever; provided always that the new terms are in accordance with the directions of the court or tribunal or authority concerned.

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[391] Ibid, p. 21.
[392] Ibid.

Salient Features of the Lease Agreement of the Bank of Khyber Islamic Banking Division for the Purposes of Diminishing *Musharakah*

The lessee shall execute a Demand Promissory note in favour of the lessor for the amount of the lease rentals receivable during the term of the lease and execute post dated cheques for all lease rentals.[393] The lessor may revise the lease rentals in cases where any costs relating to the lease and borne by the lessor, including without limitation insurance costs, are increased, with the consent of the lessee. Provided that every one year from the commencement of the lease and at the end of each successive one year period thereafter, the Bank may renegotiate the lease rentals with the Lessee.[394] The lessee agrees and undertakes that:

a. The lessee shall at all times use, and occupy the project carefully and prudently;

b. The project shall be used for the normal and usual purpose of the business or other use, of the lessee, and except with the prior permissions of the Bank, for no other purpose whatsoever;

c. The lessee shall use project in compliance with all relevant laws, rules, regulations, orders and direction, whether of federal or any provincial government or of any municipal or local authority or of any court, tribunal or other competent authority;

d. The lessee shall not sell, transfer, assign or otherwise dispose of, or sub-lease, let for hire, loan, give on license, or part with possession of, or mortgage, hypothecate, pledge, charge or otherwise encumber, the project;

e. The lessee shall not, without the prior written consent of the lessor, make any alteration, addition, or improvement to the project or change the condition thereof; and all alteration, addition and improvements of whatsoever kind or nature made, including replacement or substitution of any part or component or accessory, shall become part of and an accretion to the project leased hereunder and shall be subject to the terms and conditions of this Agreement;

f. Nothing contained in this article shall release the lessee from his liability for any use of the project or any part thereof, in breach of any of the terms and conditions contained herein or in a manner contrary to any provisions or requirements of the insurance policy or polices intended to cover the Bank's liability as owner of Project, or in contravention of any law, rule, regulation, order, or direction, whether of Federal or any Provincial Government or of any municipal or local authority or of any court, tribunal or other competent authority;

g. The lessee agrees to indemnify, and save harmless the Bank from and against all claims and demands made and all fines or penalties levied or imposed in respect of or arising out of the occupation, use of the Project or any of them.[395]

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[393] Ibid, p. 27.
[394] Ibid.
[395] Ibid, pp. 28-29.

4.3.2 Case Study of the Bank of Khyber Islamic Banking Division Diminishing Musharakah Financing

A customer namely, Mr. 'C' came to the BOK IBB with the request for Diminishing *Musharakah* Facility (DMF) of Rs.8.000 million with BOK investment of Rs. 4.000 Million i.e. 50:50 debt and equity to purchase a house measuring 10 Marlas under Diminishing *Musharakah* financing scheme of the Bank for 10 years. He showed his monthly gross salary of Rs. 50000/- and net salary as Rs.45000/-. The customer filled the application form on prescribed form of "*Pak Ghar* Scheme" and submitted to the relevant Branch of the Bank along with all the relevant documents. He made down payment of Rs. 1.000 million and opened an Account with the concerned Branch of the Bank. The submitted documents included salary slip, income certificate, income tax return, affidavit in support of the proof of income, National Identity Card, three photos and statement of account for the last six months.

The Bank conducted an independent inquiry and scrutiny of the customer's supplied informations and documents and also made a visit report to confirm credentials of the applicant and guarantors. A credit worthiness report of the applicant and guarantors were also prepared. The proposed income of the applicant was verified by the Branch. The customer request along with the Branch recommendation and all other relevant documents were submitted to the IBD of the Bank. The instant proposal was processed at IBD. The *Shariah* Advisors of the IBD gave *Shariah* clearance of the proposal and certified that there is nothing adverse against the *Shariah* principles in the instant DMF proposal. After the *Shariah* Clearance, the proposal was submitted to the relevant credit committee of the BOK for approval and decision along with the recommendation of the IBD. The concerned credit committee of the Bank approved the proposal. The IBD issued a Consent Letter containing Diminishing *Musharakah* Fund (DMF) limit of Rs. 4.000 Million in favour of the said client on the following terms and conditions.

Terms and Conditions:

Nature:	Diminishing *Musharaka* Facility.	
Purchase Price:	Purchase price of the house is Rs.8.000M.	
Total Cost:	Purchase price plus other direct expenses including transfer fee, insurance expense	
Investment Ratio:	Bank	50%
	Client	50%
Period of Facility:	10 Years	
Rental Rate:	15 %	

Unit value: The total cost of the house shall be divided into shares of Rs.1000 each. Fractional units shall be purchased by the client at the time of purchase of house from vendor.

Components of Rentals:

i) Rent of BOK's share

ii) Purchase price of units of BOK's shares.

Period for Purchase: Maximum 10 years of BOK's share are fully purchased in 120 months. In case the client intends to purchase more than 33% shares in one year, the value of shares to be re-calculated on the basis of valuation of house from PBA/SBP approved evaluator.

BOK Shares in Profit and Loss: In case of loss due to natural calamities, Bank's share will be proportionate to BOK's outstanding investment. In case of loss or gain due to market forces, BOK's share in loss will be 20% of outstanding investment. BOK's share in gain will be 10% of outstanding investment. The BOK may at its sole discretion forego its share in the capital gain as per policy of the Bank. While foregoing the share in capital gain, the Bank shall ensure that its net Internal Rate of Return (IRR) is higher 1% to 2% than the prevailing market rate at the time of foregoing such gain.

Selling or transfer of Shares of the property: Any transaction of sale or transfer of shares of the property through General Power of Attorney or any other instrument, which has not been permitted by the BOK in writing, shall be void.

Mode of payment:

Payments with regard to share, rentals, insurance or any other expenses or dues will be made through cross cheques drawn in favour of the BOK or debit authority to be given to BOK. The client has only to deliver post dated cheques for the investment period. In case of debit authority, the client has to make the funds available in his account well before the due date of such payment.

Processing fee: As per schedule of charges of BOK, IBD.

Default Obligation amount: As per schedule of charges of BOK, IBD.

Security:

The following security shall be furnished after the transfer of the title of the house to be purchased under DMF, in the name of the customer (co-owner.)

1. Registered mortgage of Rs.100,000/- and remaining equitable mortgage of residential house measuring 10 Marlas having market value of Rs.8.000M.
2. Irrevocable General Power of Attorney (IGPA) in favour of BOK to sell, auction, transfer, lease out or rent out the property offered as security and to execute any other deed, documents, if the Bank so desires at its own discretion. In case IGPA caries high stamp duty, the mortgage deed must contain relevant clauses of IGPA in order to secure interest of BOK.
2. *Takaful* Policy (Insurance policy) of the above property (Building portion only) offered as security with a Bank clause covering risk of fire, RSD and all other natural calamities from BOK's approved insurance company (*Takaful* company) along-with insurance premium paid receipt.
3. Personal Guarantee of the client.

The concerned branch of the BOK asked the said client for acceptance of the Consent Letter. The client after accepting the Consent Letter entered into Diminishing *Musharakah* (DM) Agreement with BOK for purchase of the said house. The Bank conveyed major specification of the house, such as locality, market value, construction quality, current condition, clear title, etc. to the client (co-owner). The client deposited his portion of investment with the Bank, after execution of DM Agreement. The Branch issued a letter to the vendor confirming the sanctioned limit in favour of the client. The branch asked the client to submit a detailed proposal along with the following documents and informations:

a. Title Deed, Sale Deed, Lease Deed, Possession Certificate, Transfer Deed, *Fard* and Mutation, *Uks-e-Shajra, Naksha-i-Tasweeree.*
b. This contained the specific house, street, sector, and complete mailing address of the proposed house.
c. Non Encumbrance Certificate and Search Certificate
d. Approved Building Plan
e. Valuation Certificate from SBP and PBA approved evaluator.
f. NOC to mortgage.
g. Personal Guarantee of the applicant.

The application and all the relevant documents were submitted to the IBD along with the Branch's recommendation. The IBD putt the proposal before the relevant credit committee for getting approval to utilize the already sanctioned DMF limit for purchase of the proposed house. The IBD issued the Sanction Letter accordingly. The concerned Branch of the BOK issued the Sanction Letter to the customer and got his acceptance thereto and also fulfilled securitization and other formalities in accordance with the Sanction Letter.

Initially, the customer owns the share of the purchased house corresponding to the down payment as a percentage of the total purchase price. The Bank and the customer share the risks and the profits caused by any changes in the house's value. Each month, the customer makes a monthly payment to the BOK, of which a component is for the use of home (rent) and another for equity share. The customer would owns hundred percent of the house after the agreed period of ten years and accordingly DM Agreement would come to an end between the parties.

4.3.3 *Shariah* Appraisals of Bank of Khyber Islamic Banking Division Diminishing *Musharakah*

Diminishing *Musharakah* as a Mode of Finance

The product of diminishing *Musharakah* is a new financing technique as discussed above. Islamic *Shariah* has categorically prohibited *Riba*. In addition, *Gharar* is prohibited on case by case (i.e.*Gharar al-Fahish*-excessive uncertainty prohibited). Keeping in view these two prohibitions, the researchers have the freedom to develop new financial instruments to meet various needs of the Islamic economy. As Hassab (1992) suggested, an effective methodology in this regard is to combine the characteristics of the various permissible modes and develop new instruments. While discussing the implications of the traditional *Mudarabah* and *Musharakah* (M-M) principles in the long run economic prospective, Homoud (1974) confronted the following problem. Since an Islamic bank is a non-biological entity, its life span can be very long compared to human beings. Given this reality, if Islamic banks use the non-terminating M-M contracts in the ongoing enterprise at a larger scale, in a period of say 100 years, they would be controlling a disproportionate amount of the economic resources. They may neither be manageable nor equitable. Thus, he proposed the concept of *Musharakah Yantahi Bi al-Tamlik (Musharakah* which ends in transferring ownership to one party-the entrepreneur). [396] Practically, it may take the form of rent-sharing as was recommended by the CII in its Interim Report on the Elimination of *Riba* and which was adopted by HBFC in 1979.[397] HBFC announced a new scheme in December 2001 for providing finance for purchase/construction of houses and flats, which is based on the concept of diminishing *Musharakah*.[398]

The OIC Islamic *Fiqh* Academy in its 14th Session (6-11 March, 2004) discussed the issue of diminishing *Musharakah* and resolved that it is a new concept, which embodies *Shirakah* between the parties in a joint venture in which one of the partners

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[396] Boualem Bendjilali and Tariqullah Khan, Economics of Diminishing Musharakah, p. 15.
[397] Muhammad Ayub, 'Islamic Baking and Finance Theory and Practice', p. 75.
[398] For details see, Muhammad Ayub, 'Islamic Baking and Finance Theory and Practice', p. 76.

undertakes to buy the shares of other partner gradually irrespective of the fact whether the purchase is from the buyer or from the other party. It is concluded between the parties in which each one of them participate in the capital of *Shirakah* irrespective of the fact whether contribution is in cash or goods after ascertainment of its value. The profit ratio of each partner will be specifed. The loss, if any, will be borne by both parties in proportion to their shares in capital of *Shirakah*. There is a binding promise from one of the partner in DM to own the share of other partner, while there is an option for the other partner. This is occurred each time through the sale contract while owning new unit of share. This may be through the exchange of offer and acceptance. It is permissible for one of the partners to take on lease the share of other partner on a specified lease amount and for a specified period. Each one of the partner is responsible for *al-Syana al-Asasiyah* in proportion to his shares. Diminishing *Musharakah* is permissible, provided that the general principles of *Shirakat* are followed.[399]

In addition to the general principles of *Shirakat*, the Council pin pointed some specific conditions for DM vide the same resolution. It states that one of the parties should not contract to purchase the shares of the party at the price fixed at the time of conclusion of *Shriakah*, because it guarantees the share of the partner. It is necessary that the value of the shares to be determined according to the market price at the day of sale or through mutual agreement at the time of sale. The cost of insurance, al-*Syina*, and entire expenses should be shared by the parties in proportion to their shares, and should not be borne by one of the party.The (profit) share of every partner in *Musharakah* must be fixed as a proportion. No fixed amount can be settled for any party or fixed percentage from the capital of *Musharakah*. There should be a gap between the contracts and attached liabilities of *Musharakah*. There should be provisions with effect to bar the right of one of the parties to take back, what he contributed to the capital of *Musharakah*.[400]

The *Shariah* Board of *al-Barakah* Group has also given a *Fatwa* on the procedure of DM. It states that the bank and the client/partner will jointly purchase the residence in accordance with an agreed upon percentage of shares. The Bank will sell its share to the client/partner on the basis of its sale of the physical property while remaining the rights to usufruct until a time as the client/partner has completed paying the remainder of the price. The Bank will account its earnings from the yearly lease against the usufruct of the property in proportion to amount of the sale price that is actually realized. If the client/partner fails to pay the installments he owes, the Bank will have the right either to proceed with the sale by realizing its right to the remainder through forceful appropriation of the collateral; or it may nullify the sale and maintain possession of the property, if the client/partner agrees to the return of his payments. In legal terms, this would amount to an annulment of the transaction from its beginning. It will be lawful to register the property in the name of the client/partner from the outset. Nor will such a registration in any way nullify the *Musharakah* agreement, especially since the right of the client/partner to freely dispose of the residence will remain conditional until such a time as he assumes full ownership. With regard to leasing, the principle would to be followed is that the lease will be determined annually in accordance with (the terms of) the (*Musharakah*) agreement.[401]

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[399] *Fatwa* is availeble on OIC IFA website www.ifa.org

[400] Ibid

[401] *Fatawa Shar 'iyah*, al-Barakah Group, Fatawa no. 4, pp. 39-43 op. cit. pp. 242-243.

This method of DM was also approved as a permissible mode of financing by the First International Conference on Islamic Banking, held in Dubai, during 23-25 *Jamad al-Thani* 1399H (1979).[402] The international symposium on "Islamic Banking Methods of Financing Houses" jointly organized by Sudanese Estate Bank and IRTI-IDB, held in Khartoum, Sudan during the period 27-29 October 1991 has also recommended the above form of decreasing *Musharakah*. They state that on the basis of partnership agreement, the financing institution and the beneficiary may buy the house which becomes their joint property, according to the rates of their participation to the cost. The financing institution then leases its shares to the beneficiary for a specified periodic rent. The share of the financing institution in the ownership of the house is divided into shares. As the beneficiary buys one of these shares at a specified price, according to the agreed schedule, the total shares of the financing institution decreases. Proportionately, the rental amount is reduced, and the share of the beneficiary in the ownership of the house increases until he has full ownership of the house; at which point both the partnership agreement and the lease contract come to an end.[403]

Creation of Joint Ownership in the Property

According to the BOK IBD's prescribed procedure of DM, a joint ownership is created by virtue of *Musharakah* Agreement (*Shikat-ul-Milk*). As, we discussed above that *Shirkat al-Milk* (joint ownership) can come into existence by different ways including joint purchase by the parties. All the Muslim jurists have expressly allowed this. *Fuqahah* has defined joint ownership as follows: "Property sharing is when more than one person own as asset or a debt through purchase, inheritance, or any other means."[404] According to Justice Taqi Usmani, therefore joint ownership of the house is permissible in *Shariah* and there is nothing that contradicts with Shariah, since it has taken place through a purchase which the two partners made from their own sources.[405]

Giving Share of the Bank to Client on Rent

According to the prescribed procedure of DM, the lessor (the Bank) leases its share of the project to the lessee and the lessee agrees to take on lease from the lessor the share of the Bank in the project for the agreed lease period and upon the agreed terms and conditions.[406] All the Muslim jurists are unanimous on leasing one's undivided share in the property to his partner. However, there is difference of opinions among the jurists on the permissibility of lease, if the undivided share is leased out to a third party. Ibn Qudamah says in this respect: "Leasing of joint property is not permissible except to the partner. Both partners can lease (to a third party) together. This is the view point of Abu Hanifah and Zufarh. That is because only one partner may not be able to deliver the object offered for lease. Therefore, he alone should not offer it for lease. Abu Hafs al-

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[402] See Abdullah (1991) quoted by Boualem Bendjilali and Tariqullah Khan, op. cit. p. 16.
[403] IRTI, Islamic Banking Modes for Building Finances, op. cit. p. 274.
[404] *Tanwir al-Absar, Ma'Rad al-Muhtar*, vol. 3, pp. 264-265 quoted by Usmani op. cit. p. 68.
[405] Usmani, op. cit. pp. 85-86; Usmani, 'Methods of House Building Financing According to *Shariah*', a paper presented in seminar op. cit p. 68; Dr. Ausaf Ahmad, 'Islamic Banking Modes for Building Financing', IRTI p. 41 available on www.irti.org
[406] Manual of DM of the BOK IBD

Akbari considers such leasing as permissible as pointed out to him by Ahmad. This is also compatible with the view point of Malik, al-Shafi, Abu Yousuf, and Muhammad. According to them, if the property offered for sale is known the sale becomes valid and so is the case for leasing. Moreover as a partner is allowed to sell and lease to his partner, he can do the same with a third party."[407] In *al-Dur al-Mukhtar al-Hasfaki* states that "Leasing of jointly owned property is not permissible except to the partner."[408] In the above procedure of the Bank, the property is leased to the partner himself. According to Justice Taqi Usmani, leasing one's share in a jointly owned property to one's partner is permissible as per the general consensus of *Fuqahah*.[409]

Client's Promise to Purchase the Bank's Units of Share

According to the above prescribed procedure of DM, the client makes a unilateral promise to purchase units of BOK's share in the house within the agreed period. All the Muslim jurists are unanimous that the sale of both the land and building of the undivided share can be made. Similarly, it is also allowed by all the jurists unanimously that the sale of an undivided share of a building only can be made to the partner. However, there is difference of opinions among the jurists, if it is sold to a third party. Ibn Abidin says: "If one of the two partners in the building sells his share to a third party, it is not permissible, while it is permissible for him to sell it to his partner."[410] According to Justice Taqi Usmani, therefore, this transaction is also allowed, since in the case of diminishing *Musharakah* the sale is not affected, except with the partner.[411] However, the sale should not be made before the Bank owns its share. Under the principles of *Shariah*, a sale cannot be concluded on the basis of future ownership of the commodity by the seller. The sale contract could be signed on the basis of offer and acceptance after the ownership of the house takes place.[412]

In above procedure of the BOK, the client makes a unilateral promise for *Ijarah* Agreement and Sale Agreement for purchase of units of BOK's share in the house to be purchased. It is a well settled rule in *Shariah* that one transaction can not be made a pre-condition for another. Therefore, each one of the above three contracts viz *Musharakah*, Leasing and Sale contracts are allowed per se. However, they can not be combined into a single transaction. In other words, all of the above transaction can not be combined by making each one of them a condition to the other, because it is not allowed in *Shariah*. A conditional sale is not valid even according to those who permit some conditions on sale like the Maliki *Fuqahah*. Ibn Qudamah considers this type of sale as invalid. According to him it could take one of the three forms. One of which is when a party imposes, as a condition, a further contract to be concluded such as a loan, a sale, or a lease contract. This nullifies the sale and may nullify the condition also because the Prophet (PBUH) said: "It is not permissible to link a sale with a loan or to impose two conditions (contracts) on a sale." According to *Al-Tirmizi* this is a correct *Hadith* and the Prophet (PBUH) has forbidden concluding two sales in one deal and this practice amounts to the

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[407] Ibn Qudamah, *al-Mughni*, vol. 6, p. 137, quoted by Usmani op. cit. p. 68.
[408] Al-Haskafi, *al-Dur al-Mukhtar, Ma'Rad al-Muhtar*, vol. 6, pp. 47-48 quoted by Usmani op. cit. p. 68.
[409] Usmani, op. cit. p. 86; ; Dr. Ausaf Ahmad, 'Islamic Banking Modes for Building Financing', p. 41
[410] Ibn Abidin, *Rad al-Muhtar*, Vol. 3, p. 365, *Kitab al-Shirkah*.
[411] Usmani, op. cit. pp. 86-87.
[412] Usmani, 'Methods of House Building Financing According to Shariah', op. cit p. 66.

same. Ahmad said: "The sale holds true for all that falls under the same meaning as when party says to the other ...provided that you give me your daughter to marry, or that I give you my daughter to marry, that is not acceptable." Ibn Mas'ud said: "Two sales in one deal is usury." The same view was held by Abu Hanifah, al-Shafi, and other *Ulama*. Malik considers such a deal as permissible while the condition is invalid.[413]

The practice of the BoK IBD indicates it does not make these different transactions conditional to each other.There is a one sided promise from the client/partner, to take share of the Bank on lease and pay the agreed rent, and secondly, to purchase different units of the share the Bank at different intervals. Here once again the question arises that whether this promise can be enforced or not in a court of law. This issue is already discussed at length during our discussion on the *Shariah* appraisals of the *Ijarah Wa Iqtina* mode of finance of the Bank in the relevant section for details which may be consulted. This is the case, if the sale is affected unconditionally and the pledge is made after the sale. Some *Fuqahah* are of the opinion that the same ruling would apply, if the pledge is made before the sale and then the sale is affected unconditionally. Judge Ibn Samarach (a Hanafi *Faqeeh*) says: "If an imperfect condition is made by the two parties prior to the contract then the contract followed, the contract is valid, but if the two matters happen simultaneously the contract becomes invalid."[414] On the issue of sale through pledge he says: "Likewise, if they make a pledge prior to the sale, and then they conclude a contract free of the pledge, the contract is valid, and no consideration should be given to the previous pledge."[415] Ibn Abidin has also reported this in his book Rad al-Muhtar in which he says: "As stated in *Jami al-Fusulain,* if an imperfect condition is made prior to the contract and then the contract is concluded, it is valid. Imperfection of the transaction happens, if the two parties agree to make such a condition the basis of the contract."[416] Some recent Hanafi *Fuquahah* were also of the view that a pledge that is independent of the sale contract, and which is imposed as a condition on the deal does not make the contract unacceptable whether such a pledge is made prior or after the contract."[417]

According to Justice Taqi Usmani, if there is just an understanding between the two parties that they will make the lease at such and such date and each contract is finalized at its specified date, free of any condition, then the contract is valid. This would apply to a contract involving more than one deal.[418] A separate and independent promise to purchase does not render the original contract conditional or contingent and accordingly can be enforced through a court of law. He further elaborates that if the sale is without any condition, but one of the two parties has promised to do something separately, then the sale can not be held to be additional or contingent with fulfilling of the promise made. The promise will take effect irrespective of whether or not the promisor fulfils his promise. The sale will remain effective, even if the promisor backs out of his promise. The most the promisee can do is to compel the promisor through courts of law to fulfill his promise and if the promisor is unable to fulfill the promise, the

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[413] Shams al-Din Ibn Qudamah, *al-Sharh al-Kabir,* vol. 4, p. 53 and also al-Muafaq al-Din Ibn Qudamah in a*l-Mughni*, vol. 4, p. 290, quoted by Usmani, op. cit. pp. 69-70.
[414] Ibn Samarah, *Jami al- Fusulain,* vol. 2, p. 237, quoted by Usmani op cit. p. 71.
[415] Ibn Samarah, Ibid.
[416] Ibn Abidin, *Rad al-Muhtar*, vol 4, p. 135.
[417] See al-Faleh Muhammad al-Lalnawi, *Etr al-Hidayah*, quoted by Usmani, op. cit. p. 72.
[418] Usmani, 'Methods of House Building Financing According to Shariah', op. cit. p. 70.

promisee can claim actual damages he has suffered because of the default.[419] Justice Usmani states that the flawless method of decreasing *Musharakah* which adheres to *Shariah*, is that the three contracts should be concluded in their due time and independently. However, it is possible to have an agreement whereby both parties pledge to enter into these contracts, agreeing to buy such a house with their joint funds. Then the financier would lease out to the client for a specific rent; then the client buys the share of the financier in a number of installments until he owns the entire house. Such an agreement is only a pledge between the two parties to make up such contracts, but they shall not be except when they are due and with the mutual consent of both parties. Thus, the contract would be definitive and free of all conditions.[420]

The international symposium on "Islamic Banking Methods of Financing Houses" held in Khartoum, Sudan during the period 27-29 October 1991 by Sudanese Estate Bank and the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) has also stated in its recommendation that in decreasing *Musharakah*, where partnership, leasing and sale are involved, no contract should be provided for in the context of the other. However, both the financing institutions and the client may reach, through promises, an understanding on the entire process. Furthermore, the piecemeal sale of the institution's share to the client should not be concluded in one single step beforehand. Rather the sale of each share part should be concluded at its due time. However, a pledge amounting to final commitment may be given by either party declaring an offer to sell or to purchase according to the Maliki *Fuqahah*. However, such a pledge does not render the sale as completely finalized as the party given pledge remains free to accept the deal or not. Only when the other party gives a confirmed acceptance does the sale become final, an act which takes place when share transfer the share ownership is agreed upon.[421] Justice Taqi Usmani has put the following conditions for house financing on the basis of diminishing *Musharakah*:

a) The agreement of joint purchase, leasing and selling different units of the share of the Bank should not be tied-up together in one single contract. However, the joint purchase and the contract of lease may be joined in one document whereby the Bank agrees to lease its share, after joint purchase to the client. This is allowed for the reason that *Ijarah* can be affected for a future date as explained in the relevant section. At the same time, the client may sign one-sided promise to purchase different units of the share of the Bank periodically and the Bank may undertakes that when the client will purchase a unit of its share, the rent of the remaining units will be reduced accordingly.

b) At the time of the purchase of each unit, sale must be affected by the exchange of offer and acceptance at that particular period.

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[419] For details see Sheikh Muhammad Eleish, *Fat'hal Alie al-Malik*, vol. 1, p. 356, *Masa'il al-Iltizam*; al-Qarrafi, *al-Furooq*, vol. 2, p. 25; Ibn al-Shat, *al-Hashiyah*, vol. 4, pp. 24-25; *Fatwa Khaniya*, vol. 2, p. 138; Ibn Abidin, *Rad al-Muhtar*, vol. 4, p. 135; Usmani, op. cit. pp. 87-89.

[420] Usmani, 'Methods of House Building Financing According to Shariah', op. cit. pp. 73-74.

[421] IRTI, Islamic Banking Modes for Building Finances, op. cit. p. 274.

c) It will be preferable that the purchase of different units by the client is affected on the basis of the market value of the house as prevalent on the date of purchase of that unit, but it is also permissible that a particular price is agreed in the promise of purchase signed by the client.[422]

Value of the Shares

The value of the shares should not remain fixed through the period of contract in the transaction of DM. Otherwise, it would leads to suspicion of *Riba*, because according to vice versa the Bank will ensure the recovery of principle as well as its share in the rent in proportion to its shares. It would have been more appropriate to leave the value of shares to be determined according to the estate market. The BOK should not only reconsider the rent in accordance with the rise and fall in the market price of the real estate. Here the shares (the principle) should also be treated on equal footing as for as changes in the market price of real estates are considered. One can even consider the principle to be more worthy of such adjustment according to changes in the market prices than the rent.[423]

Delayed Payments

The HBFC of Pakistan has a same clause in its contract for providing finance for purchase/construction of houses and flats. In case the partner fails to pay monthly payable rental income within 15 days from the due date i.e. first date of every month, he will have to pay to HBFC an amount caculated @ 2% per month or part thereof worked out for each payment on monthly basis. The amount so realized shall be used for charitable and other permissible purposes and shall not be looked in the income amount of the Corporation.[424] The al-Barakah Group of London also applies such type of penalty against defaulters, which is assessed on the monthly rate of return achieved by al-Barakah Group. The penalty is imposed only when the delay is due to delinquency. This practice is now widely adopted by Islamic banks.[425] This issue of penalty amount is discussed at length during our *Shariah* appraisal of the *Ijarah* and *Murabahah* financing of the BOK in relevant section for details which may be consulted.

The CII of Pakistan has recommended that the penal rates of interest should be replaced by fines in case of delay in repayment, except when it is caused by a genuine loss situation. However, the amount of the fine should not accrue to the banks, as this would tantamount to interest under the *Shariah*, but should be deposited in the Government treasury. Since delays and defaults without genuine causes would not only be a breach of trust but also jeopardize the success of the new system. The Council further recommended that deterrent punishments should be provided to defaulters, which

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[422] Usmani, op. cit. pp. 89-90.

[423] Ahmad Ali Abdallah, "Forms of Investment in Real Estates in Islamic Perspectives", a research paper presented during the Proceeding of a Workshop organized in Khartoum (Sudan) during 27-29 October, 1991, available on www.irti.org in the form of Book titled 'Islamic Banking Modes for Building Financing' pp. 50-51.

[424] Muhammad Ayub, op. cit. p. 278.

[425] Dr. Abdin A. Salamal, 'Housing Finance in Islamic Countries,' A Research Paper Presented during the Proceeding of a Workshop organized in Khartoum (Sudan) during 27-29 October, 1991, available on www.irti.org in the form of Book titled 'Islamic Banking Modes for Building Financing' p. 33.

may include confiscation of property. Such delinquents should also be blacklisted and debarred from any future financial assistance by banks.[426] The *Shariat* Appellate Bench of the Supreme Court of Pakistan has also approved the provision of penalty clause in the contractual agreements.[427]

Transfer of Title of House to Client

According to the DM procedure of the BOK, the title of the house to be directly transferred in the name of client (co-owner) on the same day of disbursement of purchase price to the vendor and equitable mortgage to be created simultaneously.[428] It is a well settled principle of Islamic law that a sale contract will not be valid unless the asset being sold comes in the ownership of the bank and it is forbidden to sell something which is not in one's possession. In view of this rule of *Shariah*, double registration of the house will be required. First in the name of the Bank, at the time of the sale between the vendor of the house and the Bank and the second time in the name of the client when the sale deal between the Bank and the client is signed. Thus, the double registration will increase the final cost of the house. Some contemporary scholars are of the opinions, the practice of the Bank to buy the house and directly register it in the name of the client solve the problem of double taxation. However, some others are of the opinion, that this may not be a much of solution. Dr. Ausaf Ahmad has suggested a solution to solve this problem. He states that in those countries where the Islamic banking system is being enforced on an economy side wise, a plea can be made to the concerned authorities to charge a lower registration fee if the deal is finalized through an Islamic bank. While in those countries, where the previous option is not feasible for any reason, a consensus may be evolved for distribution of registration fee between the buyer and the Islamic bank. [429] The *Shariah* Borad of the AlBarakah Group has given a *Shariah* ruling with effect that registration is a form of documentation that is secured by a pledge (or collateral) which formally establishes ownership in accordance with the conditions agreed to with the client/partner. Placing the responsibility for registration fees, real estate assessment, stamp fees, and other related expenses on the client/partner alone, from the beginning, will also be lawful when the two partners agree to the same; especially since the client/partner is the one who will eventually become the sole owner.[430]

Limited Period *Musharakah*

There is difference of opinions among the classical jurists in regard to legitimacy of fixing a limited period, like one year, for *Musharakah*. According to the *Fatawa Khaniyah*, the fixing of a period for partnership is permissible. Similarly, according to the *Mu 'jam Fiqh al Hanbailah*, the fixing of a period for *Mudarabah* is permissible. However, according to the same opinion in the same work, it is not. The Jordanian Islamic Bank has also given a *Fatwa* with effect that it is lawful to fix a limited period for

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[426] CII, op. cit. pp. 28-29.
[427] *Shariat* Law Reports (SAB), Lahore, February, 2000, (Page 477, Para 25).
[428] Mnual of DM of the BOK IBD
[429] Dr. Ausaf Ahmad, 'Islamic Banking Modes for Building Financing' p. 39.
[430] *Fatawa Shar 'iyah*, al-Barakah Group, Fatawa no. 4, pp. 39-43 op. cit. pp. 242-243.

a *Mudarabah* contract, when this is agreed to the two parties, if the interest of the bank require such limitation.[431]

Guarantee for *Musharakah*

The contract of *Musharakah* is based on both agency and trust. Every partner is an agent when he transacts in the wealth of his partner and is a trustee in it. Under the principles of *Shariah*, a trustee will not be held liable for a trust unless he is fraudulently or culpably negligent in looking after the trust. In *Shariah*, guarantee or surety is the bringing together of the responsibility of the guarantor to that of the guaranteed in honouring a right. Thus, the right will become the responsibility of both and the possessor of the right may seek his due from either. The jurists are in agreement that a guarantee will be lawful after a right has become due. However, according to the Hanafis, Malikis, and Hanbalis, it will be lawful before a right becomes due as well. The *Shariah* Borad of the Faisal Islamic Bank of Sudan has given a *Fatwa* with effect that "...it will be lawful for the Islamic Bank when it enters into a *Musharakah* with one of its partners, to seek a guarantee against loss resulting from negligence or fraud. It will nor, however, be lawful for the bank to seek a guarantee against loss resulting from other than negligence or fraud, because what is lost in that case will not be guarantee for the partner, and therefore may not be guaranteed by the partner."[432] According to AAOIFI standars, in contract of *Musharakah*, no partner can guarantee the other partner's capital, because it is based on the legal principle of *alghurm- bil-ghunm* (the entitlement to return is related to the exposure to risk). However, a partner may request the other partner of *Musharakah* to provide guarantess against the later's negligence or misconduct.[433]

***Takaful* (Insurance)**

According to the provisions of the BoK's IBD *DM* Agreement, the insurance of the assets of the project is arranged jointly from any *Takaful* company. The *Shariah* Board of the al-Baraka Group has given a *Fatwa* with similar effect that with regard to insurance, the original assumption would be that both partners pay the premiums, because the burden falls on the shared property. For the Bank's part, it may be possible for it to cover its costs in the matter when determining the amount of its share in the case.[434]

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[431] *Fatawa* of the Jordanian Islamic Bank, vol. 1, pp. 41-43, quoted by Yusuf Talal, op. cit. p. 34.
[432] *Fatawa Shar 'iyah*, Faisal Islamic Bank of Sudan, Fatwa no. 7, op. cit. pp. 248-251.
[433] AAOIFI, Accounting, Auditing and Governance Standards for Islamic Financial Institutions, p. 203.
[434] *Fatawa Shar 'iyah*, al-Baraka Group, Fatwa no. 4, pp. 39-43, op. cit. p. 242.

4.3.4 Recommendations

1. Since the mode of Diminishing *Musharakah* combines the major attributes of the *Ijarah*, *Musharakah* and sale principles of Islamic financing, therefore extreme care should be taken by the Bank against any violations of the *Shariah* principles. Each and every case should be given to the *Shariah* advisors of the Bank for its scrutiny in light of the *Shariah*, so that each contract is concluded on its proper date.

2. In case of DM based on *Shirakat-ul-Aqd* (business purpose), the Bank agrees to sell the units to the client at face value. It is recommended that in all such transactions, valuations should be done either on market value or any value agreed at the time of sale of units.

3. Normally, *Takaful* cost of the DM assets is borne by the customer. Being the proportionate owner in the DM asset, the Bank has to pay his share in *Takaful* cost with the Bank.

4. In certain cases, repair and maintenance cost is borne by the customer. In such all such cases, the Bank should pay the charges of maintencnace as per its share in the DM asset.

5. Most of the banks using the same accounting treatment as used by conventional banks. In this case Islamic banks consider amount as a liability rather than the asset. While, in case of DM, bank is a partner in the DM asset. Therefore, the Bank should ensure accounting similar to AAOIFI *Ijarah* standard.

6. The financial statement of the Bank shows that the DM mode of finance for house building is one of the less practiced modes of finances by the Bank. The reason behind the reluctance of the Bank to extend funds to the housing sector is the long term nature of investment in this sector coupled with its relatively low rate of return, especially at times of inflation as then it would not pay the Bank to undergo the venture of tying up their capital to an activity of such a low rate of capital turnover.

7. The Government should establish a special court to take prompt action against defaulters, who are willingly avoiding the payment of their dues to the Bank.

8. It has been observed that poor and middle classes of the masses are unable to avail the DM facility of the Bank IBD. Therefore, the Bank should encourage the financing of middle income and poor people in order to allow the largest number of people to own their own houses. It would have social benefits, because this section of the society lacking saving reserves cannot purchase the houses on an outright or 2-3 years instalments basis. The government should also provide subsidies to the Bank in order that these classes of the society also benefit from this scheme.

9. The arrangement may be called 'Diminishing *Musharakah* and *Ijarah'* instead of Diminishing *Musharakah* only.

10. In order to insure *Shariah* compliance, *Ijarah* based transaction would require actual leasing that would be subject to various taxes and levies like General Sales Tax, Sales Tax, Withholding Tax, fees, etc. The overwhelming opinion of the contemporary scholars is that the amendments need to be made in various laws and rules so that *Shariah* based modes do not entail any additional financial burden on the Bank or their clients.

11. The concept of diminishing *Musharakah* is ambiguous to the common man. Therefore, the Bank should make it easy and translate it to the local languages as well for understanding of the common people. The Bank may also use print and electronic media for this purpose. Furthermore, training opportunities about the mode of DM for house financing should be made available for staff of the Bank.

12. The expenses of registration must be shared by the partners as they relate to the property itself in light of the Islamic law about to not sell those things, which are not in one's possession. The Bank of Khyber should not shift the cost of registration fee to the buyer, as it may turn out to be exploitative. Accordingly, the assessment and legal fee should also be bore by both the parties and not only by the client.

13. It may be pointed out here that the financing of real estate is a wide open field for investment. Therefore, it requires further study, research and exchange of knowledge and expertise among Islamic banks to develop the most efficient means for investment in light of the principles of *Shariah*. In other words, Islamic states and financial institutions all over the word should cooperate together and coordinate their efforts, in order to develop modes for house building financing that are compatible with *Shariah*.

Conclusion

This study was designed to know generally about the Islamic banking and financial system and to understand the basic legal principles of the *Ijarah*, *Murabahah* and *Musharakah* as developed by the earlier jurists. The aim of this research was also to investigate the procedures, agreements, terms and conditions of the various modes of finance practiced by the Bank of Khyber Islamic Banking Division (IBD) and then make their *Shariah* appraisals in light of the basic principles of Islamic law. After *Shariah* appraisal of the each mode of finance of the BOK IBD, an attempt was made to give recommendations in light of the *Shariah* principles to the management of the Bank.

Islam has given equal importance to the material life and moral principles and has struck a balance between individual rights, social welfare and obligations. From this prospective, the fundamental Islamic objective of distributive justice is described as the guarantee of fulfillment of basic needs of people in society. The absolute ownership of Allah Almighty and trust ownership of mankind, avoiding of *Riba*, obligation of the payment of *Zakat*, prohibition of the socially harmful economic activities and freedom of trade and profession are adequate elements for such a moral economic system.

The process of Islamization of the financial system in Pakistan was initiated in 1979. At present Islamic banks in Pakistan are working side by side with the conventional banks. There are many prospects for the growth of Islamic banking practices in Pakistan and environment is favourable for this sector. Pakistan is an Islamic country, so there is much space and opportunity available for Islamic banks in Pakistan. The SBP has provided the Islamic banking sector with sufficient legislations and policies, so as to assist this sector and increase its efficiency. The establishment of the Islamic Banking Division of the Bank of Khyber can be cited as an important outcome of the efforts made by the ex-MMA provincial government at the Islamization of the banking system under the control of the provincial government. The Bank of Khyber is originally a conventional Bank mainly operating in the North West Frontier Province of Pakistan. The Bank has established an Islamic Banking Division for offering Islamic banking services to its customers through Islamic banking branches (IBB's). Presently, the IBB's of the Bank offers the Islamic modes of *Ijarah*, *Murabaha*, and Diminishing *Musharakah*.

Although controlled by the principles of *Shariah*, the BOK IBB's essentially perform the same functions as those performed by the conventional banking branches (CBB), but differ them due to the difference nature of their operation. For instance, a) contrary to an IBB's, the bank-customer relationship in CBB's is creditor-debtor or lender-borrower; b) an IBB's makes a legitimate profit or variable return from its trading activities, while CBB's merely finances the customer at a fixed interest rate; etc. Like conventional banking branches, profitability is considered as one of the important objectives of IBB's. However, in line with the main purpose of the existence of IBB's, they are expected to include social and moral aims as well as profit in their objectives. As

for as the utilization of the various Islamic modes of financing is concerned, *Murabahah* has remained the most favored mode of finance of the BOK IBB's. *Ijarah* and Diminishing *Musharakh* are the second and third used mode of financing respectively of the IBB's. The management of the BOK must completely segregate the funds of the IBBs of the Bank and those of the conventional branches in which Islamic products are not offered. The funds of Muslim investors who are very anxious to earn lawful income should not be mixed with those of conventional investors who are not interested in *Shariah* compliant products. There should be separate accounts, books, and computer programs evidencing this complete segregation of funds. The management of the Bank, which is undertaking *Shariah* compliant products, should be fully convinced of the concept and fully committed and dedicated to it. It should be anxious to complement it and comply with the teachings governing it. Unless and until the entire management is committed and convinced, the business activities of the Bank will not be foul free and will not escape irregularities and deviation. The Bank needs to improve its managerial capabilities by training their personal in project appraisal, monitoring, evaluation and performance auditing. It is recommended that the *Shariah* Academy and Faculty of *Shariah* & Law of the International Islamic University Islamabad may organize short term training courses (i.e. of four months) for the staffs of the IBB's of the Bank of Khyber to make them conversant with the Islamic concepts, principles, and command of *Shariah* in regard to the economic system envisaged by Islam.

The Bank of Khyber Islamic Banking Division like other Islamic banks has its own *Shariah* Supervisory Committee and *Shariah* advisors. It has been observed during this research that especially the *Shariah* advisors have hardly any formal training in modern finance. It is a fact that there is due shortage of scholars with dual specialization or at least having working knowledge of modern finance and *Shariah* at the same time. It has also been observed that many managers of the branches of the Bank are not very well trained in the use of Islamic modes of finance. Therefore, it is extremely important that the Bank should have people with the dual right kind of skills and commitment. Some short-term courses either on the job or elsewhere may be arranged for the managers and other employees to prepare them for the needs of Islamic banking. There is also a need to arrange short courses for *Shariah* advisors in economics and finance and similar courses for economists in *Shariah*. The future of the Islamic banking and finance practices of the Bank crucially depends on teaching, training, and research in the desired specialization. The members of the *Shariah* Supervisory Committee and *Shariah* Advisors should have full access to the dealings of the Islamic Banking Branches. It will make ensure that the product it offered is indeed *Shariah* compliant.

The Islamic Banking Division of the BOK has been estalished with the basic goal of avoiding the *Riba* and *Gharar* based transactions of the CBB's. It is due to this reason that most of the times; it has been observed during this study that depositors ask: What is the material difference, from the *Shariah* point of view, between the transactions of the IBB's and CBB's of the BOK? Therefore, steps should be taken so that depositors do not lose trust in the Bank of Khyber Islamic Banking Branches of the Bank. The Bank should not take advantage of the religious sentiments of the Muslims of the area by marketing products that are Islamic in name only. It is hoped that this humble effort will be pursued further in order to establish true Islamic banking system based on the principles of *Shariah*.

It is a fact that at present, the moral fabric in Pakistan and all other Muslim countries is not ideal for smooth functioning of Islamic banking and finance. Therefore, it is direly required to improve the moral culture of the Muslims. Islamic banking and finance is a part of Islamic economic system the very basis of which revolves around justice and morality. Therefore, the moral dimension is an essential component of Islamic banking and finance. All-out efforts needed to be made by the Government and all others for enhancing morality of populace. The CII has also in its report pointed that the elimination of interest is but a part of the overall value system of Islam, and this measure alone cannot be expected to transform the entire economic system in accordance with the Islamic vision. It has, therefore, emphasised the need for reformatory measure at moral building and eradication of false values of life.

It has been observed during this study that the IBB's of the Bank take recourse to excessive use of *Murabaha* and *Ijarah* modes in financing investment. Yet it is not a violation of *Shariah* as long as the *Murabaha* contract is correct from *Shariah* viewpoint and is free from intentional or nominal deception. However, the Bank should make little use of this mode of finance. In order to have a more diversified portfolio, it would be desirable that the predominance of fixed return modes such as *Murabahah* and *Ijarah* on the asset side is gradually reduced over the long run. It is for the reason that Islam disallows the interest system because intrinsically it is a highly inequitable system. The feature that makes the interest based system inequitable is that the provider of capital funds is assured a fixed return while all the risk is borne by the user of these capital funds. Justice demands that the provider of capital funds should share the risk with the entrepreneurs if he wishes to earn profit. The ultimate objective of the Bank should be toward investment-oriented long term financing. According to the Muslim jurists, the real substitute of interest in an Islamic financial system is the mode of profit/loss sharing such as *Mudarabah* and *Musharakah*. While the other techniques like *Murabaha*, *Bai-Muajjal*, *Ijara* and *Ijara wa Iqtina* can not be of equal significance in achieving Islamic socio-economic objectives (Ahmad 1994). Financing techniques like *Murabaha*, *Bai-Muajjal*, *Ijara* and *Ijara wa Iqtina*, which involve a pre-determined return on capital, can not be regarded as commendable substitutes for interest, and should only be used when absolutely needed. In the words of the CII report "It is, therefore, imperative that the use of these methods should be kept to the minimum extent that may be unavoidably necessary under the given conditions and that their use as general techniques of financing must never be allowed. The Council, therefore, recommends that a basic policy decision may be taken to the effect that with the passage of times the operational field of profit/loss sharing should gradually be expanded while that of the other alternatives reduced." (CII, Report).

This study has also taken to notice that *Murabahah* mode of finance of the IBB's is widely misused. As long as *Murabahah* is related to exchange of different goods and its operation is linked with actual economic activity, it must not have any harm for it is profit-oriented business rather than *Riba*-based transaction. But when the customer or bank avoids any participation of actual goods transaction there is no other way to generate income except to indulge *Riba*-based activities. The customer claims that he is performing *Murabahah*, while in practice, there is a fictitious transaction which existing only on paper, to back up credit transactions on mark up basis. In this way, the *Murabahah* is being used as legal artifice (*Heela*). Practically, the goods have not been

sold. The client has received only loans with certain rate of interest instead of the price of his goods.

The study has comprehensively discussed the issue that whether the increase in sale price in lieu of time is lawful or not. The crux of the said discussion is that a number of *Fiqh* scholars are of the view that the increase in price in lieu of time is lawful and valid. Nevertheless, many of the Islamic scholars have emerged critical to this view, arguing that accepting time value in *Murabahah* transactions and then rejecting the same in monetary transactions appears to be inconsistent and illogical.

There seems to be a gap between the ideals and actual practice of the Bank of Khyber Islamic Banking Division. In its reports, booklets, bulletins and posters the Bank IBD express its commitment to make gradual conversion into Islamic banking to develop and promote true Islamic economic system (vision of the Bank). However, the present study shows that a little progress has been achieved so far in that regard. Though this failure is attributed mainly to the pervasive influence of conventional banking system itself, lack of vigilance of the promoters of Islamic banking in realizing the objective is no less to blame. The management of the Bank should identify the shortcomings. Particularly, it has to be seen whether there is any scope to open up alternative avenues to arrest the causes of efficiency erosion. There should be a thorough review of policies that have been pursued by the Bank IBD since its inception, and points of departure have to be identified to redesign their course of action. This is a very crucial issue because of the fact that people at the mass level find very little difference between the banking operations of Islamic Banking Division and that of its conventional counterpart, because of its excessive recourse to *Murabaha* and *Ijarah*. Until and unless a quick change in policy followed by clear actions takes place, the credibility that Islamic banking branches have achieved so far may be tarnished away very soon. The first action that deserves immediate attention is the promotion of the image of Islamic banks as PLS-banks. Strategies have to be carefully devised so that the image of Islamic character and solvency as a bank is simultaneously promoted.

Given the above summary of the study, it is concluded that although profit and loss sharing framework (*Musharakah* and *Mudarabah*) is central to the theory of Islamic banking and finance, however, it is most of the times not practice by the Islamic Banking Division of the Bank. The operations of the IBB's of the Bank can be regarded as successful only if they strictly follow Islamic principles of banking and finance, and at the same time concentrate exclusively on acceptable and profitable economic activities of the country as well as ask deposits from the clients for direct investment in those activities as quasi-investment banks in order to achieve its ethical-social objectives. It is a fact that lending on equity based principle would not only require constant vigilance by the Bank, but also professional staff which would imply higher administrative costs. However, effective and efficient judicial system, honesty and a general high degree of morality, which serve as some of the determining prerequisites of the Islamic system, would definitely increase the yield of real sector and consequently the rate of return. The Muslim investors should give a positive response to the profit and loss sharing modes of finance, as one party show can never be the solution. If the business community starts changing its attitude the process can be accelerated.

It is evident from the research findings (Akkas 1996) that Islamic banking could be the most efficient system if it were allowed to operate as a sole system in an economy.

However, when it starts operation within the conventional banking framework, most of its efficiencies are lost. The study demonstrates that it is not the inherent shortcomings of Islamic banking system that is responsible for its relative inefficiency. Rather it is the continuation of legacies of the conventional banking system that jeopardize an efficient operation and functioning of Islamic banks in the economy. The policy implication is not that Islamic banks should never be floated within the conventional banking framework. Rather it is the conventional banking system whose operational mechanism needs to be reviewed into PLS-system considering beneficial impact of the latter on the economy. Having been considered the pro-efficiency character of Islamic banking and its beneficial impacts on the economy, we may, thus, conclude this thesis by reiterating that, if the management of the Bank of Khyber wishes to promote the real well being of its customers, it must make excessive use of the true Islamic modes of *Musharakah* and *Mudarabah* and make recourse to the fixed income modes of *Murabahah* and *Ijarah* only in those cases, where the prior are not feasible. In addition, all of the conventional branches of the Bank should be converted to IBBs at the earliest, so that the whole operations of the Bank come under the umbrella of Islamic banking.

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GLOSSORY OF ARABIC TERMS

A

Ajr: Refers to commission, fees or wages charged for services.

Ajir Khas: A hired worker who is contracted to perform a specific task in a specific amount of time by one party, such as a cook or a servant.

Ajir Mushtarak: A worker, such as tailer, who offers his services to many and thus may be contracted by several clients at once.

Ajr Mithl: The prevailing rate; the price which is normally paid for a given service.

Al-Amin al-Amm: One who has been entrusted with the property of another for a reason other than safekeeping (*Wadi 'ah*), such as a tenant who rents an apartment or the *Mudarib* in the *Mudarabah* contract.

Amil: Agent who acts to perform a task.

Al-Amin al-Khas: One who has been entrusted with the property of another and is responsible for it, as is the case in the *Wadi 'ah* (safe-keeping) transaction.

Al-Amwal al-Ribawiyah: The six kinds of substances (gold, silver, wheat, salt, and barely) which, then exchange in kind, must be exchanged in equal measure and with immediate transfer of possession. If these conditions are not met, then the exchange is considered to be *Riba*.

Al-Kharaj Bi Daman: The Islamic legal maxim that means entitlement to revenue follows assumption of responsibility. Profits, therefore, are based on the ownership of, and responsibility for, capital.

Adl: A general term which conveys the meaning of justice, equity, fairness.

Amil: One who performs a task, an agent. One who deserves compensation for some task which he does.

Aqar: Immovable property such as land, buildings, trees, and so forth.

Aqd: A central term is Islamic financial law, which means, "contract".

Ard: Land

Ayn: A term used by the classical jurists to refer to currency or ready money. It refers to gold, silver, coins, notes and any other form of ready cash.

Amanah: Trust, with associated meanings of trustworthiness, faithfulness, and honesty. As an important secondary meaning, the term also identifies a transaction where one party keeps another's funds or property in trust. This is in fact the most widely understood and used application of the term, and has a long history of use in Islamic commercial law. By extension the term can also be used to describe the different financial or commercial activities, such as deposit taking, custody or goods on consignment.

Al-Wadia: Resale of goods with a discount on the original stated cost.

Ayah: The term refers to a passage from the Holy Quran.

Al-Wakala: A contract of agency.

Al-Rahn: An arrangement whereby a valuable asset is places as a collateral for a debt. The collateral may be disposed off in the event of a default.

Al-Wadiah: Safe keeping

Awqaf: A religious foundation set up for the benefit of the poor.

B

Bai: Sale; an agreement between two parties (the seller and buyer) to the effect that the ownership of the sale item is transferred from the seller to the buyer in exchange for a price. It is often used as a prefix in referring to different sales-based modes of Islamic finance, like Murabahah, Istisna, and Salam.

Bai Athnan fi Bai: Lit. two sales in one. A type of transaction which was explicitly prohibited by the Prophet (PBUH). The meaning of the expression "two sales in one" is explained by the *Fuqahah* in various ways. Also called "*Safaqatan fi Safaqah*".

Bai Dayn: Sale of debt or receivables. The provision of financial resources required for production, commerce and services through the sale and purchase of trade documents and papers. Bai Dayn is a short-term facility with a year or less maturity.

Bai Inah: The sale and buy-back of an asset for a higher price than that for which the seller originally sold it. A seller immediately buys back the asset he has sold on a deferred payment basis at a price higher than the original price. This can be seen as a loan in the form of a sale.

Bai Wafa: The sale and buy-back of an asset within a set time, when the original buyer agrees to the original seller's repurchase.

Bayat al-Mal: The treasury of the Muslim community; historically, the *Bayat al-Mal* is an institution was developed by the early Caliphs but which soon fell disrepair. The Funds contained in the *Bayat al-Mal* were meant to be spent on the needs of the *Ummah* e.g. supporting the needy.

Batil = null and void

D

Darura: In an emergency, Muslims may disregard aspects of *Shariah* laws in order to save their lives, or to preserve the Islamic community.

Daman: A contract of guarantee whereby a guarantor shall underwrite any claim and obligation that should be fulfilled by an owner of the asset. This concept is also applicable to a guarantee provided on a debt transaction in the event a debtor fails to fulfill his debt obligation.

Dirham: A unit of currency, usually a silver coin, used in the past in some Muslim countries and still used in some Muslim countries today, for example Morocco and the UAE.

Dinar: A gold coin used by Muslim throughout Islamic history. The standard mass of the *Dinar* which is referred to in *Fiqh* is one *Mithqal* (app. 4.25 grams).

Darar: Damage, Harm.

Dayn: Debt; some form of wealth which one is required to pay back to another.

Dhimmah: *Dhimmah* is a basic term in *Fiqh al-Mu 'amalat*, which roughly corresponds to the concept of liability. A debt is said to be "established in someone's *Dhimmah*" if he is in debt to someone else. The *Fuqaha'* also speak about a person's *Dhimmah* "being occupied" and "being cleared".

F

Faqir (Plural= *Fuqara*): A poor person

Faskh: Undoing, dissolving, cancellation. It is a term used by the classical jurists to refer to the dissolution of a contract or agreement. It has been described as the cancellation of a contract, such that affairs return to the state in which they were before the concluding of the contract, without any addition or subtraction. Many of the classical *Fuqaha'* apply the term *faskh* to instances in which a previously valid (*Sahih*) contract is cancelled

voluntarily by the contractual parties such as in *Iqalah*, *Khiyar al-Ayb* (option to return in case of a defect) and *Khiyar al-Shart* (stipulated option of return) and use the term *Infisakh* for cancellation which occur outside of the will of each of the contractual parties, such as the cancellation of a sale contract when the sale item is destroyed, before the seller can handover to the purchaser or the dissolution of certain partnerships i.e. *Sharikah* upon the death of one of the contracting parties.

Fard al-Kifa'i: A collective duty of Muslims. The performance of these duties (for example funeral prayers) by some Muslims absolves the rest from discharging them. This term covers functions which the community fails to or cannot perform and hence are taken over by the state, such as the provision of utilities, or the building of roads, bridges and canals.

Fasid: A forbidden term in a contract, which consequently renders the contract invalid.

Fuduli: A party is described as "*Fuduli*" whenever it transacts (e.g. sells, rents, etc.) with someone else's property without the permission of *Shariah* (e.g. *Wakalah*). Such is the case when a party does not own the property with which it transacts and is not the *Wakil* (authorized representative) or *Wali* (guardian) of the true owner. For instance, if a person were to negotiate and close a deal with a buyer in which he sole some machinery without the owner of the machinery having made him *Wakeel* (authorized representative), the seller would be described as *Fuduli*.

Fatwah (Plural= *Fatawa*) A formal response issued by an expert *Faqih*, called a *Mufti* in response to a question.

Fiqh: Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, *Fiqh* covers all aspects of life, religious, political, social, commercial, or economic. The whole corpus of Fiqh is based primarily on interpretations of the Quran and the *Sunnah* and secondarily on *Ijmah* (consensus) and *Ijtihad* (individual judgement). While, the Quran and the Sunnah are immutable, *Fiqhi* verdicts may change due to changing circumstances.

Fiqh al-Mu'amalat: Islamic commercial jurisprudence or the rules of transacting in a *Shariah* compliant manner.

Faqih (Plural = *Fuqaha*): Muslim jurist; A Muslim who is an expert in *Fiqh*; a Muslim who is knowledgeable of the rules of the *Shariah* and knows how these rules are related to the source texts upon which they are based.

G

Gharar: One of three fundamental prohibitions in Islamic finance (the other two being *Riba* and *Maysir*). It is uncertainty in a contract of exchange as to the existence of the subject matter of the contract and deliverability, quantity or quality of the subject matter.

Gharar is a sophisticated concept that covers certain types of *haram* uncertainty in a contract. It is an exchange in which one or more parties stand to be deceived through ignorance of an essential element of the exchange. Gambling is a form of gharar because the gambler is ignorant of the result of the gamble. The prohibition on *gharar* is often used as the grounds for criticism of conventional financial practices such as short selling, speculation and derivatives.

Gharim (Plural= *Gharimum*) A debtor who does not possess the funds with which to repay his debts. The *Gharimun* are one of the eight groups mentioned in the Quran as legitimate recipients of *Zakah* funds.

***Ghasb*:** The wrongful appropriation of property by force.

***Al-Ghunm bil Ghurm*:** A *Shariah* maxiam that provides the rational and the principle of profit sharing in *Sharikah* arrangement. It means that earning profit is legitimized only by engaging in an economic venture, risk sharing and thereby contributing to the economy.

H

Hadith (Plural = *Ahadith*): A successively transmitted report of an utterance, deed, affirmation, or characteristic of the Prophet Muhammad (PBUH). The *Ahadith* are the source texts by which the *Sunnah* is preserved.

***Hajj*:** There is a duty on every Muslim who is financially and physically able to carry out *Hajj*, the fifth pillar of Islam, at least once in his lifetime. The pilgrimage takes place in the week from the 8th until the 13th day of the 12th Islamic month of *Dhul Hijjah*.

***Haqq Tamalluk*:** A tradable asset in the form of ownership rights.

***Halal*:** The concept of *halal* has spiritual overtones. In Islam there are activities, professions, contracts and transactions that are explicitly prohibited (*haram*) by the Quran or the Quran. All other activities, professions, contracts and transactions are *halal*. This concept differentiates Islamic economics from conventional economics. In western finance all activities are judged on economic utility. In Islamic economics, spiritual and moral factors are also involved – an activity may be economically sound but may not be allowed in Islamic society if it is not forbidden by the *Shariah*.

Hanbali: Islamic school of law founded by Imam Ahmad Ibn Hanbal. Followers of this school are known as Hanbalis.

Hanifite: One of the major Islamic school of law, founded by Imam Abu Hanifa. Followers of this school are known as Hanafis.

***Haram*:** Activities, professions, contracts and transactions that are explicitly prohibited by the Quran or the Sunnah. See Halal above.

Haqq Maliy: *Haqq Maliy* are rights on the financial assets. Examples of such rights are *haq dayn* (debt rights) and *haq tamalluk* (ownership rights).

Hawala: A contract which allows a debtor to transfer his debt obligation to a third party who owes the former a debt. The mechanism of *Hawala* is used for settling international accounts by book transfers, thus obviating the need for a physical transfer of cash.

Hibah: A gift voluntarily donated in return for a loan provided or a benefit obtained.

Hila: A transaction which appears permissible, but is in fact structured in an un-Islamic way.

Haq: Lit. truth, right. *Al-Haq*, the truth, is one of the names of Allah. In the *Fiqh* of financial transaction, the term *Haq* signifies a right which a party possesses, for example the creditors right to payment.

Hukm (Plural= *Ahkam*): In *Fiqh*, the *Shariah* ruling (e.g. obligatory, recommendable, neutral, reprehensible, or forbidden) associated with any action.

I

Ibra: When a person withdraws the right to collect payment from a borrower.

Ikhtilaf: Divergence of opinions among jurists.

Iman: Conviction, faith, or belief; the acceptance and affirmation of Allah, His Books, His Messengers, His Angles, and the Hereafter and Divine Decree.

Iqtisad: Lit. moderation. The term is used in modern standard Arabic to denote the field of economics.

Ijtehad: A faqhi's endeavor to formulate a rule on the basis of evidence found in the Islamic sources.

Ijma: Literally, Consensus; technically, the unanimous consensus of the Muslim legal jurists on a given legal issue, usually as represented by the agreement of the jurists, after the death of the Prophet (PBUH). Ijam has traditionally been recognized as an independent source of law, along with the Quran, Sunnah and Qiyas (analogical deduction), by most of the jurists.

Illah: Reason, charteristic, or underlying cause behind a Shariah ruling such that if a particular reason/charteristic is found in other instances, the same ruling will apply.

Inan: financial partnership

Inah: A sale in which a purchase buys merchandise from a seller for a stipulated price on a deferred payment basis and then sells the same merchandise back to the original seller for a price lower than the original purchase price.

J

Jahl: Ignorance (of morality or divinity)

Jahala: Ignorance, lack of knowledge. In contrasts, it refers to lack of information with respect to the subject matter of the contract or the terms and conditions of the contract.

K

Kafalah (guarantee): Shariah principle governing guarantees. It applies to a debt transaction in the event of a debtor failing to pay.

Kharaj bi Al-Daman: A *Hadith* forming a legal maxim. It means entitlement to profit accompanies liability for loss.

Khilabah: A form of fraud, either in word or deed by a party to the trading contracts with the intention of inducing the other party into making a contract. This is prohibited according to the *Shariah*.

Khiyanah: Refers to deception by not disclosing the truth or breaching an agreement in a hidden way. This is prohibited according to the *Shariah*.

Khiyar: Lit. option, choice. The option extended to one or more of the parties in a sale contract to rescind the sale, upon the appearance of a defect, for example. The traditional jurists have recognized several types of *Khiyar*, including *Khiyar al-Ru 'yah, Khiyar al-Shart, Khiyar al-Majlis*.

Khiyar al-ayb: Option to rescind a sales contract if a defect is discovered in the object of sale.

Khiyar al-Majlis: Option to rescind a contract during the same meeting in which contract is agreed.

Khiyar al-Ru 'yah: Option to rescind a sales contract after physical inspection of the object of sale.

Khiyar al-Shart: The option to rescind a sales contract based on some conditions. One of the parties to a sale contract may stipulate certain conditions, which if not met, would grant a right to the stipulating party an option to rescind the contract.

***Khiyar al-Tadlees*:** Option to rescind a contract if a party finds that it has been cheated.

L

Loan (with service charge): Some Islamic banks give loans with service charges. The Council of the Islamic Fiqh Academy has resolved that it is permitted to charge a fee for loan-related services offered by an Islamic bank, provided that the fee relates to service-related expenses. The service charge can only be calculated accurately after all administrative expenditure has been incurred (at the end of the year). However it is permissible to levy an approximate charge on the client, and then reimburse/claim the difference when the actual expenses are known.

M

***Manfa 'ah*:** Lit. benefit. The yield which a utilizable property produces. The term is often used by *Fuqaha* to describe the usufruct associated with a given property, especially in leasing transactions. For example, in an automobile lease, the term *Manfa 'ah* might be used to describe the benefit which the lessee derives from the use of the car for the duration of the lease (as opposed to the actual ownership of the car).

***Maqasid*:** The general objectives of Islamic law.

***Maqasid al-Shari 'ah*:** Lit. the objectives of the *Shariah*. The term *Maqasid al-Shariah* refers to a juristic-philosophical concept developed by the later generations of the classical, who attempted to formulate the goals and purposes of the *Shariah* in a comprehensive manner to aid in the process of investigating new cases and organizing previous existing rulings.

Maaliki: Islamic school of law founded by Imam Malik Ibn Anas. Followers of this school are known as Maalikis.

***Mal*:** Wealth, money, property; any valuable thing which can be possessed.

Madhhab (Plural= *Madhahib*)**:** Lit. way of going. A *Fiqh* school or orientation characterized by differences in the methods by which certain source-texts are understood and therefore differences in the *Shariah* rulings which are deduced from them. There are four well-known *Madhahib* among Sunni Muslims whose names are associated with the classical jurists who are said to have founded them (Hanafie, Maliki, Shafie, and Hanbali).

Maysir: One of three fundamental prohibitions in Islamic finance (the other two being *Riba* and *Gharar*). The prohibition on *Maysir* is often used as grounds for criticism of

conventional financial practices such as speculation, conventional insurance and derivatives.

Muamalat: The lease of land or fruit trees for money, or for a share of the crop.

Mudarib: The entrepreneur or investment manager in a *Mudarabah* who puts the investor's funds in a project or portfolio in exchange for a share of the profits. A *Mudarabah* is similar to a diversified pool of assets held in a discretionary asset management portfolio.

Mufit: A highly qualified jurisconsult who issues *Fatawa* (sing. Fatwa, informal legal pronouncement), usually in response to questions posed to him.

Mujtahid: Legal expert, or a jurist who expends great effort in deriving a legal opinion or interpreting the source of law.

Musawamah: Sale at a price mutually agreed upon by the buyer and the seller.

Muqasah: Debt settlement by a contra transaction.

Musaqah: A contract in which the owner of agricultural land shares its produce with another person in return for his services in irrigating the garden.

Muzara'a: A contract in which one person works the land of another person in return for a share in the produce of the land.

N

Nisab: Exemption limit for the payment of *Zakat*, which differs for different types of wealth.

P

PLS: The term stands for Profit and Loss Sharing. The term is used to describe any one of several financial schemes based on the principle of interest-free lending and featuring the use of *Mudarabah* and *Musharakah* as financing instruments.

Q

Qur'an: The Holy Book of Muslims, consisting of the revelations made by God to the Prophet Muhammad (PBUH). The Quran lays down the fundamentals of the Islamic faith, including beliefs and all aspects of the Islamic way of life.

Qabdh: *Qabdh* means possession, which refers to a contract of exchange. Generally, qabdh depends on the perception of '*urf*' or the common practices of the local community in recognizing that the possession of a good has taken place.

Qard: loan

Qard Hasanh: A loan contract between two parties for social welfare or for short-term bridging finance. Repayment is for the same amount as the amount borrowed. The borrower can pay more than the amount borrowed so long as it is not stated by contract. Most Islamic banks provide interest-free loans to customers who are in need. The Islamic view of loans (*qard*) is that there is a moral duty to give them to borrowers free of charge, as a person seeks a loan only if he is in need of it. Some Islamic banks give interest-free loans only to the holders of investment accounts with them; some extend them to all bank clients; some restrict them to needy students and other economically weaker sections of society; and some provide interest-free loans to small producers, farmers and entrepreneurs who cannot get finance from other sources.

Qirad: It is a synonym for *Mudarabah*

Qimar: An agreement in which possession of a property is dependant upon the occurrence of an uncertain event. By implication it applies to those agreements in which there is a definite loss for one party and a gain for the other, without specifying which party will gain and which party will lose.

Qiyas: Deductive analogy through which a certain law on a certain issue is derived based on the Quran, the *Sunnah* and the *Ijmah.*

R

Rab al-Maal: the investor in a *Mudarabah* contract

Rahn (collateral): An arrangement whereby a valuable asset is placed as collateral for a debt. The collateral may be disposed of in the event of a default.

Riba: An increase, addition, unjust return, or advantage obtained by the lender as a condition of a loan. Any risk-free or "guaranteed" rate of return on a loan or investment is *Riba. Riba* in all its forms is prohibited in Islam. In conventional terms, *riba* and "interest" are used interchangeably, although the legal notion extends beyond mere interest.

Riba al-Nasiah: Increment on the principal of a loan payable by the borrower. It refers to the practice of lending money for any length of time on the understanding that the borrower would return to the lender at the end of this period the amount originally lent together with an increment in consideration of the lender having granted him time to pay.

The increment was known as *Riba al-Nasiah*. It was in vogue in Arabia in the days of the Prophet Muhammad (SAW).

Riba al-Buyu (usury of trade):Also known as *Riba al-Fadl*. A sale transaction in which a commodity is exchanged for an unequal amount of the same commodity and delivery is delayed. To avoid riba al buyu, the exchange of commodities from both sides must be equal and instant. *Riba al-Buyu* was prohibited by the prophet Mohammad to forestall *Riba* (interest) from creeping into the economy.

Riba al-Diyun (usury of debt): Also known as usury of delay (*Riba al-Nasiah*). The usury of debt was an established practice amongst Arabs during the pre-Islamic period. It can occur as an excess increment on top of the principal, which is incorporated as an obligatory condition of the giving of a loan. Alternatively, an excess amount is imposed on top of the principal if the borrower fails to repay on the due date. More time is permitted for repayment in return for an additional amount. If the borrower fails to pay again, a further excess amount is imposed, etc.

Rukn (Plural *Arkan*): Lit. pillar. In *Fiqh*, an integral part of an act, such as a transaction, without which the act can not be said to have been performed.

S

Sadaqah: voluntary charitable giving

Sahih: Lit. sound, healthy, correct. Said of a valid contract (opposite to *Batil*). A *Hadith* of a highest level of authentication.

Sarf (currency sale): Refers to buying and selling of currencies.

Shafi'e: Islamic school of law founded by Abu Abdullah Ahmad bin Idris or Imam Shafie. Followers of this school are known as Shafi'es.

Shariah: Refers to the corpus of Islamic law based on Divine guidance as given by the Quran and the Sunnah and embodies all aspects of the Islamic faith, including beliefs and practices.

A "*Shariah* compliant" product meets the requirements of Islamic law.

A "*Shariah* Board" is the committee of Islamic scholars available to an Islamic financial institution for guidance and supervision in the development of *Shariah* compliant products.

A **"*Shariah* advisor"** is an independent Islamic trained scholar that advises Islamic institutions on the compliance of the products and services with the Islamic law

Shart (Plural = *Shurut*): A necessary condition, something which needs to exists or be present in order for something (like a transaction) to be valid. Also a condition or stipulation in a contract.

Sighah: *Sighah* is a term used by the *Fuqahah* to refer to the formal exchange which takes place between the contractual parties indicating their willingness to enter into the contractual agreement and therefore constitutes the contract itself. The *Sighah* is a *Rukn* (integral part) of the Islamic contract and essentially consists of a proposal (ljab) on the part of one contractual party and an acceptance (*Qabul*) on the part of the other, either of which may be verbal, written, or even gestural, depending on the circumstances under which the contract is closed.

Sunnah: The Sunnah is the second most important source of the Islamic faith after the Quran and refers to the Prophet (PBUH) example as indicated by his practice of the faith. The only to know the Sunnah is through the collections of *Ahadith*, which consists of reports about the saying, deeds and endorsements of the Prophet (PBUH).

T

Tadlis al' aib: Refers to the activity of a seller intentionally hiding the defects of goods. This activity is prohibited according to the *Shariah* principles.

Takaful (Islamic insurance): Based on the principle of mutual assistance, *Takaful* provides mutual protection of assets and property and offers joint risk-sharing in the event of a loss by one of the participants. *Takaful* is similar to mutual insurance in that members are the insurers as well as the insured. Conventional insurance is prohibited in Islam because its dealings contain several *haram* elements, such as *gharar* and *riba*.

Tawarruq (Reverse *Murabahah*): In personal financing, a client with a genuine need buys an item on credit from the bank on a deferred payment basis and then immediately resells it for cash to a third party. In this way, the client can obtain cash without taking out an interest-based loan.

Ta'widh: Penalty agreed upon by the contracting parties as compensation that can rightfully be claimed by the creditor when the debtor fails or is late in meeting his obligation to pay back the debt.

Tawliyah: Resale at original cost without profit or loss to the seller.

U

Ujrah (fee): The financial charge for using services, or manfaat (wages, allowance, commission, etc).

Ulema (Plural of *Alim*): *Shariah* scholars or jurists.

Ummah: The Muslim community.

W

Wadiah (Safekeeping): The safekeeping of goods with a discount on the original stated cost. An Islamic bank acts as the keeper and trustee of depositors' funds. It guarantees to return the entire deposit, or any part of it, on the depositor's demand. The bank may give to the depositor a *hibah* in appreciation.

Wakalah (Agency): Absolute power of attorney: where a representative is appointed to undertake transactions on another person's behalf.

Waqf (Plural = *Awqaf*): An endowment or a charitable trust set up for Islamic purposes (usually for education, mosques, or for the poor). It involves tying up a property in perpetuity so that it cannot be sold, inherited, or donated to anyone.

Z

Zakat (Religious tax): An obligatory contribution which every wealthy Muslim is required to pay to the Islamic state, or to distribute amongst the poor. According to Islam, *Zakat* – the third pillar of Islam – purifies wealth and souls. *Zakat* is levied on cash, cattle, agricultural produce, minerals, capital invested in industry and business. There are two type of *Zakat*:

Zakat al-Fitr, which is payable by every Muslim able to pay at the end of *Ramadan*. This is also called *Zakat al-Nafs* (poll tax).

Zakat al-Maal is an annual levy on the wealth of a Muslim above a certain level. The rate paid differs according to the type of property owned.

Zulm: A comprehensive term used to refer to all kinds of injustices, inequity, oppression, and exploitation that deprive others of their legitimate rights.

ACRONYMS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
CAMEL	Capital Adequacy, Asset Quality Management Capability, Earnings, Liquidity
CID	Credit Information Bureau (of the State Bank of Pakistan)
CIE	Commission for Islamization of Economy (Pakistan)
CII	Council of Islamic Ideology (Pakistan)
CTFS	Commission for Transformation of Financial System (Pakistan)
DM	Diminishing *Musharakah*
FSC	Federal Shariat Court (of Pakistan)
HBFC	House Building Finance Corporation of Pakistan
IBB	Islamic Banking Branches
IBD	Islamic Banking Division
IFIs	Islamic Financial Institutions
IIIE	International Institute of Islamic Economics (Islamabad)
MMFA	Master Murabahah Facility Agreement
OIC	Organization of Islamic Countries
PLD	Pakistan Legal Decisions
PLS	Profit/Loss Sharing
RFC	Riba Free Certificate
SAB	Shariat Appellate Bench (of the Supreme Court of Pakistan)
SBP	State Bank of Pakistan
SSC	Shariah Supervisory Committee (of the Bank of Khyber)