

PRINCIPLES OF ISLAMIC FINANCING

(A SURVEY)

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In the name of Allah, Most Gracious, Most Merciful

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FOREWORD

The research objective of the Islamic Research and Training Institute (IRTI) is to undertake studies for enabling the economic, financial and banking *activities in the Muslim countries to conform to the Shari'ah*. To make contributions towards achieving this objective, IRTI not only relies on its in house research capabilities but also mobilizes external scholars.

All completed research works go through a rigorous evaluation process first internally by the Core Technical Committee then externally by the Academic Committee of IRTI. The Academic Committee finally decides on the status of a particular research with a proposed Classification scheme. The present study was classified by the Academic Committee as a research paper. A research paper is expected to have undertaken an in-depth study of the subject with a rigorous analysis and it is expected to be extremely relevant.

The paper presents a survey of the historical evolution of Islamic principles of financing and their elaboration by the Islamic scholars at various times. In this manner the paper provides an integrated view of the Islamic principles of financing as reflected from academic works in the field, policy oriented studies aimed at financial Islamization and practices of Islamic banks.

The study first presents an overview of the financing principles during the early period of Islam. In the Second Section, it deals with the academic discussion by modern Muslim economists of the principles of financing used in the early period of Islam. It also discusses the emphasis and focus of these scholarly works. Then, the impact of the emergence of Islamic *banks and evolution- of Islamization policies on the development of the* principles of financing are discussed. In the Third Section, the paper offers some considerations for the justification of return on financing.

It is expected that the paper may be found . useful by the teaching community in particular and research and-policy circles in general. It is also expected that the research will be helpful in increasing general awareness about the holistic view of Islamic principles of financing.



Prof. Dr. Abdel Hamid El-Ghazali
Director, IRTI

INTRODUCTION

Financing involves the channelling of resources from wealth holders to deficit producing or consuming units⁽¹⁾. As such, financing enables deficit units to command a larger quantity of resources than they can command by internal means. In conventional economics, financing for a producing deficit unit may take the form of interest-based borrowing, offering stocks and shares (equities) and obtaining credit in the form of deferred payment against the purchase of goods and services. A deficit consumer, on the other hand, may acquire financing in the form of deferred payment facilities offered by sellers and interest-based borrowing. However, in an interest-based economy, interest-based financing dominates all other forms of finance.

The basis of the efforts of Islamic scholars to identify alternatives to the interest-based system is the explicit prohibition and condemnation of interest by Allah in the Holy Qur'an. In addition, the elaboration of issues related to financial matters by jurists is, *inter alia*, based on the saying of Prophet Muhammad (pbuh), *al kharaj bi al daman* (which relates the entitlement to the return on an asset to bearing the risks resulting from its possession). This puts the axioms of continued ownership and *al ghurm bi al ghum* (the entitlement to a return is related to the liability of risk) at the heart of Islamic financing.

Although the literature dealing with Islamic finance is extensive, the principles of financing have not been clearly delineated. However, references to the principles of financing can be found in writings dealing with the interpretation of the above mentioned axioms and Islamic modes of financing.

The objective of this paper is to derive the principles of Islamic financing from a review of the literature related to the rationalization, explanation and justification of the Islamic modes of financing.

A statement of a concise concept of financing in Islam is not possible at the beginning of this paper. However, drawing on the afore-mentioned axioms, it may be useful to make the following introductory remarks about the nature of financing in Islamic economics:

- (i) *Shari'ah* entitles only those who bear the responsibility of the ownership of an asset to reap the profits or increase in value accrued to the asset, (i.e., a return on financing can only be claimed on the basis of ownership),
- (ii) All exchange relationships which postpone either the payment of price or the delivery of goods and services fulfill the fundamental function of financing (i.e., facilitating the command of such resources which was otherwise not possible), and
- (iii) Lending is an act of benevolence which does not entitle the creditor to any return because he is not an owner of the lent resource whose payment is guaranteed by the debtor.

This paper comprises three sections. Section One concentrates on the early works of Muslim scholars especially commentaries on the Holy Qur'an, Hadith and *fiqh* literature. The rationale of the modes of financing used during the time of the Prophet (pbuh) and the explanation given by the early *fuqaha'* for different kinds of transactions and relationships involving some form of financing are discussed. In addition, Section One also deals with benevolent lending and the postponing of the repayment of loans because these two issues provide a deep insight into the matter of return bearing finance.

Section Two reviews the relevant contemporary literature on Islamic economics. It covers the views of Muslim writers regarding the relative importance, role and classification of the various modes of financing as well as the issue of financial intermediation which, by itself, is a direct manifestation of certain principles of financing.

Section Three deals with the justification of a return on financing in Islamic economic thinking. In this section, an attempt has been made to put together arguments given in Islamic economic literature on the distinction between profit and interest and the reasons why the former is permitted while the latter is not.

Since lending is basically an act of benevolence rather than a market oriented activity, it must be noted that this paper does not aim to deal in detail with the principle of lending. This does not mean that such a benevolent act cannot serve economic objectives as it is apparent that whether given by individuals or the state, loans certainly increase the amount of material resources available to borrowers.

Major points are summarized at the end of each section and at the end of the paper some concluding remarks are presented.

1. FINANCING IN THE EARLY PERIOD OF ISLAM

This section deals with early Islamic literature which refers to the principles of financing. The discussion will focus on the interpretations of Islamic financing techniques by Muslim scholars. These interpretations indirectly discuss and rationalize the principles underlying individual modes of finance. However, since each Islamic financing technique could be dealt with separately, in this section the following four general points are discussed: financing during the Prophet's (pbuh) era, the need for credit as seen in Islamic jurisprudence, encouragement of lending in Islam and benevolent postponement of debt repayment and its implications. It is hoped that this discussion will shed some light on the principles of financing as understood by early Islamic writers.

1.1 FINANCING DURING THE PROPHET'S (PBUH) ERA

As trade was the main economic activity of the tribe of Quraish, a good deal of its caravans were financed by persons who did not accompany the caravans. Homoud (1982, p. 135) quotes Al Razi (circa 606H) as saying that in financing the battle of 'Uhud, the Quraish used funds accumulated by means of *riba*. Furthermore, in commenting on verses 275-280 of Surah II of the Qur'an, almost all writers make reference to the deep-rooted practice of *riba* in pre-Islamic Arabia, especially among members of the tribes of Quraish and Thaqif and by the Jewish communities. They usually mention Al Abbas, the uncle of the Prophet (pbuh), and several major families of Thaqif as prominent financiers in the Makkan economic life of that period. Moreover, with respect to the Qur'anic reference to the Jewish practice of *riba* (IV: 160), Homoud (ibid, p. 131) again quoting early writers, argues that many Jews were working as moneylenders in Madinah and that they used to lend at a rate of 12% per annum. Therefore, one may conclude that the most dominant mode of financing during the pre-Islamic era was *ribabased* borrowing and that *mudarabah* may perhaps have ranked second in terms of practical importance.

While discussing the legitimacy of *mudarabah*, the *fuqaha'* usually call attention to the *mudarabah* enterprise the Prophet (pbuh) had with Khadijah which started more than fifteen years before the beginning of the revelation. They also mention the common practice of *mudarabah* in the Makkan soci-

ety (see, for example al Muhalla, V. 8, p. 247 and Abu Zahrah, p. 55). It should be noted that *mudarabah* implies that the net profit of trade is shared between the owner (*rab al mal*) and the worker (*mudarib*) after it is actually realized at the end of the transaction.

Additionally, the agricultural society of Al Madinah used to practice *crop sharing* which was called *muzara'ah* and *musaqah* with the former applying to open fields used for crops and the latter to orchards of trees especially palm. *Land in muzara'ah* and *land and trees together in musaqah* are fixed assets put at the disposal of the working partner. These arrangements ensure the use of assets without actually paying for them which is tantamount to financing. Both *muzara'ah* and *musaqah* require sharing the gross output and allow for limited flexibility in the contractual distribution of operational expenses.

On the other hand, sale on credit also existed in the Prophet's (pbuh) time. There are many sayings about the Prophet's (pbuh) buying on credit, taking loans and sometimes giving personal property as a security or lien. For instance, Abdullah Ibn Abi Rabi'ah said:

'A'ishah reported that:

The Prophet (pbuh) bought some food on credit from a Jew and he the Prophet (pbuh) gave him (the Jew) his mail (armor iron cloth) as a security (in another version she said: *thirty sa' of barley* instead of saying some food). Al Bukhari, V 3, pp. 15 and 231 (our translation from Arabic)

and Abu Hurairah also reported:

That the Prophet (pbuh) borrowed (once) a male camel. Ahmad, V 2, p. 509 (our translation from Arabic).

In the above mentioned saying, credit is used to finance consumption. It is also used to finance production whereby the producer is paid cash for future delivery. The latter form of credit creates an in kind debt and is called *salam*.

As Arabs depended on seasonal trade and agriculture for their livelihood, the practice of *salam* sale with forward delivery must have been common in their life. Al Bukhari reports from Al Bara' Bin 'Azib:

(when) The Prophet (pbuh) came (to Al Madinah) we used to do *salam* sell forward against cash payment until the season. al Bukhari, V 4, p. 269. (our translation from Arabic).

The fuqaha'elaborate more on this point with respect to the discussion of *riba al fadl*. They argue that the Arabs used to sell gold for silver and other items on a *salam* basis and that the Prophet (pbuh) mentioned that gold and silver can be exchanged on a spot basis only. The same applies also to a few food items which are mentioned in the well known Hadith regarding *riba al fadl*.

Also, *bai' al salam*, was made lawful by the Prophet (pbuh) in order to make economic relations easy and responsive to the variety of financing needs people have, although it is said to be in violation of the general rule of prohibiting the sale of things which are not in one's possession at the time of contract. Thus, *bai' salam* is a form of financing which provides the producer with funds that can be used for working capital including payments to labor and the purchase of raw materials. It was practised in the agricultural sector of Madinah at the time of the Prophet (pbuh).

Riba-ridden lending is forbidden and was generally eliminated from the Muslim society of the Prophet's (pbuh) era. Other forms of financing (e.g., *mudarabah*, benevolent lending, sale on credit, *muzara'ah*, *musaqah* and *bai' al salam*) dominated the financing practices of that period.

1.2 THE NEED FOR FINANCING

According to prominent Muslim scholars, the need for financing arises because of the natural differences in resource endowments. This justification for the need for financing is found in the books of all schools of *fiqh*. For instance the *fuqaha'* argue that *mudarabah* is needed because not everyone who owns money has trading skills and not everyone who is skillful in trading possesses money (Ibn Qudamah, circa 630H: *Al Mughni*, Vol. 5, p. 135). Al Marghinani (circa 593H) puts it more explicitly by saying that:

People are either rich in money terms but feeble-minded in disposition, or well guided in disposition but empty-handed money wise. This makes legalization of this kind of transaction (*mudarabah*) very much needed in order to render proper the interests of both the inarticulate and the intelligent, and the poor and the wealthy. *Al Hidayah*, V. 8, p.446 (our translation from Arabic).

Therefore, according to the *fuqaha'*, differences in resource endowments along with the necessity of matching financial resources with business skills may be the most important reason behind the need for financing. However, *fiqh* scholars consider two other points in the process of their rationalization of *mudarabah*.

The first point is derived from the fact that exchange or trade is indispensable for all societies. Indeed, trade was the backbone of the Makkan economy at the time of the Prophet (pbuh). According to Ibn Hazm (circa 456H), all those Makkans who could not afford the mental and physical strain and hardship of trading had to rely on some kind of financing in order to *earn their livelihood* (*Al Muhalla*, Vol. 8, p. 247). *This means that Ibn Hazm looked at financing not only as a means of cooperation necessitated by the absence of compatibility in endowment distribution, but also as a source of income, i.e., an occupation of its own. The income earning motive underlying financing is further emphasized by several narrations from the Companions about extending orphans' funds as finance. Al Qasim Ibn Muhammad (who together with his orphan nephews were under the supervision of 'A'ishah) says:*

We had funds in the custody of 'A'ishah and she used to give them on *mudarabah* basis. *Al Mabsut*, V. 22, p. 18 (our translation from Arabic).

'Umar, *the second Khalifah*, also used to give funds of orphans on a *mudarabah* basis (ibid.).

The *second motive for financing* mentioned by *the fuqaha'* is the human desire to make one's wealth grow. Ibn Qudamah argues that unlike certain forms of wealth such as, plants, trees and livestock which have a natural process of growth or certain assets whose value increases due to an increase in demand or to changes in other market conditions, money can only grow by means of exchange and turnover (*Al Mughni*, V. 5, p. 135). On the basis of this desire of growth, Ibn Qudamah validates a sort of financing in which an owner supplies a real productive asset instead of cash. He argues that *although this kind of relationship is definitely not mudarabah, it is very similar to musaqah in which productive assets (capital goods) are furnished to the working party on the basis of gross output sharing* (ibid., p. 117). Within this context of growth, Al Sarakhsi points out that profit can only be generated from the combination of skills and material resources (*Al Mabsut*, V. 22, p. 19).

Apparently, these two motives of financing along with the motive of matching resources with business skills portray productive financing, i.e., the use of financing in the process of producing marketable goods and services. This process is always associated with the expectation of profit or return which will be distributed between the financier and the entrepreneur according to an agreed formula.

However, there are still other needs for financing especially those emerging out of unforeseen circumstances. In this regard Muslim writers usually quote two famous sayings of the Prophet (pbuh) promising an ample reward for benevolent loans (see below). Commenting on these sayings, Ibn Qudamah argues that the purpose of lending is to relieve and assist a person who is under pressure and is facing adversity (*Al Mughni*, V. 4, p. 353). In fact as the text of the Hadith shows, the Prophet (pbuh) himself indicates that a loan seeker would only ask for a loan as a result of necessity and financial despair. It should be noted that needs which require borrowing may pertain to either consumption or production. Hence *bai' al salam* was looked upon as a means of providing financial facilities to producers.

1.3 ENCOURAGEMENT OF BENEVOLENT LENDING

The Prophet (pbuh) has advocated lending and sale on credit. Ibn Masud narrates that the Prophet (pbuh) said:

Whoever gives two loans will have a reward (equivalent to the reward) of one of them (be it given as charity). Reported by Ibn Majah, V. 2, p. 812 (our translation from Arabic) and

Anas narrates that the Prophet (pbuh) said:

The night I was taken up to Heaven, I saw written on the Heaven's gate 'Charity is (multiplied) ten times and a loan is (multiplied) eighteen times.' I said 'O Jibril, why is a loan better than a charity? He said "because a beggar (may) ask while he has (wealth) and a borrower would not ask for a loan except out of need". Reported by Ibn Majah (ibid) (our translation from Arabic) and

Suhaib narrates that the Prophet (pbuh) said:

Three (things) have blessings: Sale on credit, *muqaradah* (i.e., *mudarabah*) and mixing wheat with barley for (food at) home not for sale. Reported by *Ibn Majah*, Chapter on *tijarah*, No. 63 (our translation from Arabic).

Lastly, the permissibility of *bai' al salam*, in spite of its violation of the rule against selling that which is not in the possession of the seller, points out an inclination to promote business credit among transactors.

Commenting on the encouragement of lending, Ibn Qudama (*Al Mughni*, Vol. 4, p.353) argues that giving loans is considered "desirable" in the *Shari'ah*⁽²⁾ because lending implies the provision of relief to one's Muslim brother, the fulfillment of his needs and the extension of help and support.

The help and relief component of lending is well recognized by *fiqh* scholars. They classify lending under contributory contracts for which the term '*uqud al tabarru'*' is used. This category of contracts is characterized by having one party grant the other a certain privilege without receiving any compensation. This means that *fiqh* scholars do not dispute that in lending one makes a sacrifice, i.e., a sacrifice of the opportunity of using one's own funds. This is, in a sense, an acceptance of the idea that liquidity counts and lending implies an internal cost on the part of the lender.

Moreover, as loans imply guaranteeing the principal of the loan by the borrower those who wish to avoid risk may prefer giving their funds on a loan basis over giving them on *mudarabah* and risk takers may prefer borrowing over *mudarabah* or *musharakah*. This consideration of risk and security also arises when one compares a loan with a deposit, i.e., *wadi'ah* in the *fiqhi* terms⁽³⁾. A *wadi'ah* does not include a guarantee by the depositories. Therefore, both the depositor and depository may prefer a loan over a *wadi'ah* if the security component in the relationship is substantial. It is reported that the Prophet's (pbuh) companion, Al Zubair, used to tell his depositors that it was better for them to consider what they gave him for safekeeping as loans instead of deposits in order for him to provide them with a guarantee of their funds (Al Bukhari, IV, p. 52).

Loans may be for consumption or production purposes. In either case, loans may be granted by individuals or by institutions. In discussing institutional lending, some contemporary Muslim writers have suggested that it may be made by the *zakah* fund (Qardawi, *fiqh al zakah*, p. 634 and Kahf, 1977, pp 104-106), or by the banking system as practiced by the nationalized banks in Pakistan after Islamization in the area of loans to students and other needy segments of society. The same is also suggested by Siddiqi (1983) and Chapra (1985, p 162). However, one may add that institutional lending may also be carried out by general or specialized cooperative organizations as in the case of credit cooperatives which exist in several Muslim communities.

1.4 POSTPONEMENT OF DEBT REPAYMENT

The Qur'an tells about rescheduling the payment of debts:

If the debtor is in a difficulty, grant him time till it is easy for him to repay... (II: 280).

As may be observed from the preceding and following verses, the context of this verse is mainly the issue of business lending and the elimination of *riba*. In his Commentary (V. 3, p. 371), Al Qurtubi contends that the above

verse was revealed in connection with the debts owed to the Thaqif tribe by the tribe of Bani Al Mughirah. These debts were interest-bearing and the preceding verses (II: 278- 279) prohibited any increase above the principal of debts. As a result, the Thaqif asked for their principal to be paid back and the Bani Al Mughirah complained to the Prophet (pbuh) that they lacked liquidity. Then, the verse ordering postponing off the repayment of these debts was revealed.

Al Qurtubi, however, contends that despite the specific circumstances of the revelation of this verse, its meaning is general and it applies to all debts regardless of their source or origin adding that :

The best thing said about the application of this verse is the statement of 'Ata', Al Dahhak and Al Rabi' Ibn Khaitham that: it is for any debtor who is in difficulty, he must be granted time (free of charge) whether the debt was originally based on *riba* or not (ibid p. 372, our translation from Arabic).

The postponement of debts, as prescribed by the verse above, is done without any financial compensation. This applies regardless of the causes of *default* - involuntary or deliberate. However, according to the majority of the *fuqaha'*, deliberate *default* is punishable in the Islamic penal code by imprisonment and/or fines payable to the state 'treasury'. But it should be noted that none of the classical writers permits any financial compensation to be paid to the creditor.

To sum up the important points of this section, it should be noted that in early Islamic society, financing was provided with the motives of help (lending) and the expectation of profit: Although lending serves the financial purpose of the borrower, it is not dependent upon market factors. Therefore, for all economic purposes, financing was based on the following principles:

- i) The principle of sharing the net outcome of an enterprise or business transaction by the financier and the user of funds as in *mudarabah*,
- ii) The principle of sharing the gross output while operating costs are borne by one party and are naturally considered' in the distribution of shares in the agreement, and
- iii) The principle of financing through sale, i.e. credit sale which used to take two forms viz., *mua'jjal* (immediate delivery with deferred payment with the price of the object of the sale being due as debt) and *salam* (immediate payment with deferred delivery with the object of the sale being due as debt):

The modes of financing covered by the first two principles imply a continuous relationship between the concerned parties. Therefore, the results of the enterprise or transaction can only be known ex post.

On the other hand, in the modes of financing covered by the third principle, the transaction is concluded once and for all and the price of the merchandise or the merchandise itself, respectively in *mua'jjal* and *salam* sales, is transformed into fixed debt.

If debt is in terms of money as in *mua'jjal*, the return on financing is known at the time of the delivery of the objects of the sale.

If the debt is in kind, as in the case of *salam*, depending on the purpose of the purchase, two different situations can arise with respect to the return on financing:

- a) If the purpose of the *salam* purchase is simply the acquisition of merchandise (in the future) rather than its resale, the operation ends with the delivery on the due date. As in the case of *mua'jjal*, the return on financing will also be known at the time of the conclusion of the sale contract. The risk of the failure to deliver the goods or of any damage is insurable. Therefore, taking this and the price paid together, the return on this financing is known and fixed at the time of the conclusion of the sale contract and the payment of the price of the goods.
- b) But if the objective of the *salam* purchase is resale rather than simple acquisition, then the final outcome of the operation and the return can only be known when the resale actually takes place. Therefore, unless there is an order from an ultimate purchaser, a financial institution can hardly be expected to involve itself in such a risky operation.

2. RECENT DEVELOPMENTS IN ISLAMIC FINANCING PRINCIPLES

The abolition of interest is the fundamental issue in contemporary discussions on Islamic financing. In modern Islamic literature, *riba* and interest are treated synonymously and, thus, in the following, the two terms are used interchangeably.

The views of contemporary Muslim scholars on the principles of financing are related to their studies of rationalizing the prohibition of interest and evolving efficient alternative institutions to the *riba*-based system. This subject has dominated contemporary Islamic economic thinking. Moreover, during the last two decades Muslim societies have also witnessed, for the first time, the emergence of public as well as private sector applications of Islamic financing principles. In the following, major academic and policy oriented works related to important developments in the area of Islamic financing principles are briefly reviewed.

This section is divided into four subsections dealing respectively with contributions preceding the establishment of Islamic banks, the implication for principles of financing of the rise of Islamic banks, policy oriented works and the ownership-management approach to financing.

2.1 CONTRIBUTIONS PRECEDING ISLAMIC BANKS

In this subsection the contributions made to the subject before the advent of modern Islamic financial institutions are reviewed.

A. Review of Theoretical Contributions

The views of Muslim scholars who effectively contributed to contemporary thinking in this area may be summarized by concentrating on two major issues: the difference between sale and interest-based transactions and the rejection of the idea of a fixed rate of return on financial capital..

The Difference Between Sale and Interest

In order to understand the principles of financing in Islam, the distinction between *riba* (interest) and *bai'* (sale) is of crucial importance as God explicitly permitted sale and prohibited interest. Maududi (1950) and Quraishi (1947) have discussed this issue.

Maududi looked into the difference between *bai'* and interest in the context of the equitable distribution and efficient management of risk. In interest-based transactions, risk is transferred to the borrower so that all interest-bearing assets become risk free. This is socially inequitable and economically inefficient. On the other hand, trade by conforming to natural uncertainty is not only equitable but also efficient. This is generally used as a criterion to differentiate *riba*-based transactions from sale/trade.

In differentiating trade from *riba*, referring to Al Qaffal (circa 417H), Quraishi says:

One, who sells clothes worth As. 10 for Rs. 20 does so believing that the clothes are equivalent to that sum. When mutual agreement has been arrived at, *the exchanges value become equal*, with the result that the parties to the transactions all benefit. But if a person were to acquire Rs. 20 for Rs. 10, the additional As. 10 does not represent any real benefit. It will not be then admissible for him to say that he obtained the additional sum in exchange for time, in as much as "time" is neither a commodity of exchange nor any such thing which could be pointed out as an exchangeable wealth (1946, p. 50).

From this comparison it is clear that in *riba*-based transactions the object of sale is time and its price is *riba*. This point has recently been reemphasized in the context of the time value of money. Al Abji (1986) and Al Masri (1986) hold the view that since a higher deferred price of an object of sale, compared to its spot price is legitimate, it implies a recognition of the time value of money in Islam. This value may be determined *ex ante*. However, arguing that a fixed rent, or a fixed price in a deferred sale does not mean a fixed return on capital because of the uncertainty and risk incorporated in these transactions, (Khan 1986) rejects the above proposition and suggests that the time value of money can only be determined *ex post*⁽⁴⁾. Saadallah (1985) also identifies the acceptance of the value of time by *Shari'ah* scholars but only in relation to real transactions.

Therefore, the value of time is related to its being, needed for the completion of a real transaction. Under *riba*-based transactions, the postponement of liability justifies a return to capital. However, in real transactions, the return to capital is linked to owning real goods which are subject to uncertainty by virtue of their nature. Time is one of several factors that effect profit and loss because it is required to complete real transactions.

In the context of the above discussion, two important points are worth mentioning:

- i) As far as the difference between sale/trade and *riba* transactions is concerned, the first category of transactions is subject to the natural conditions of uncertainty and risk in relation to time and the second is not. As a result, the capital involved in trade may grow or decline through time, while in *riba*-based transactions, capital automatically increases over time, and
- ii) The difference between debt created by loan (*qard*) and debt created by credit sale was not clearly discussed. As a result, the liability creating potential of trade (i. e., its financing potential) did not attract the attention of these earlier scholars. The financing aspect of the differences between sale and *riba* was also not discussed by them.

Objection to Fixed Return on Financial Capital

Technically, *riba* is a contractual increment received by a lender from a borrower over and above the principal (Maududi 1950). This implies that *riba* essentially applies to money lending⁽⁵⁾ as this is a predominant source of debt/liability creation. Therefore, the presence of an advance contract on the return on capital is considered the distinctive and unique characteristic of interest. The rationale of charging interest has been strongly challenged by Muslim scholars on grounds of ethics and efficiency. Maududi says :

... Which rational principle, which logic, which cannon of justice and which sound economic principle can justify that those who spend their :time, energy; capacity and resources, and whose efforts and skills make a business thrive, are not guaranteed a profit at any fixed rate, whereas those who merely lend out their funds are fully secured against all risk of loss and are guaranteed a profit at a fixed rate? (*ibid*, p. 214)

There is an almost complete consensus among Muslim scholars that the answer to these and similar questions is negative. However, it must be • pointed out that the difference between *contractual return on lending* and *contractual return on sale based financing* was not spelled out in the literature under review. Thus, charging any guaranteed return on financing was considered illogical, irrational and unjust (see: Uzair 1954, Siddiqi 1983b, Chapra 1985, and Khan 1987b).

B. Evolution of Financial Principles during the Period

As a result of the line of thinking briefly reviewed above, many Muslim scholars held the view that the Islamic financing approach should primarily be based upon a principle whereby the rate of return on financial capital

should vary in accordance with the variations in the return of the whole enterprise⁽⁶⁾. (see: Maududi and Quraishi *op.cit.*, Ahmad 1947, Uzair 1954, Siddiqi 1983 a, b, and Chapra 1985). The application of this kind of variable rate of return principle in Islamic financing can take the form of the Profit Sharing Principle (PSP) or the Profit and Loss Sharing Principle (PLSP). These and other principles of financing emerging from the literature under review are discussed in the following.

Profit Sharing Principle (PSP)

PSP is based on the *mudarabah* principle i.e., profits will be shared between the owner of capital and the entrepreneur on the basis of a contractual agreement whereas losses under normal circumstances would be written on capital. The first indication of this principle in the literature under review was given by Quraishi (*op.cit.*) in his notion of partnership. But his concept is ambiguous as he suggests that capital will be provided by one party and work by another and profit or loss will be shared by the two parties. More specifically, as far as the provision of capital and the division of work are concerned, Quraishi's partnership follows the *mudarabah* principle, while in regard to liabilities, it is closer to *musharakah*.

Uzair (1954) emphasized and focused the PSP by quoting the following from Quduri (circa 428H):

...*mudarabah* is a contract based on the combination of capital from one of the two parties and *it means participation in profit*. This is feasible with capital from one of the two parties and work from the other party. There is no *mudarabah* except with this condition. If, however, the whole of profit would go to the owner of capital, it (the *mudarabah*) becomes simple investment; and if it is agreed that the worker enjoys the whole of it (the profit), the contract is a *qard* (Uzair 1978, p. 117). Emphasis added.

The above quotation introduces *mudarabah* into contemporary economic literature for the first time and draws lines between the principles of direct investment, *qard* and *mudarabah*. In direct investment the capital owner takes all decisions or employs a manager. If direct investment takes the form of *musharakah*, decision making becomes collective. Capital owners claim all profits and bear all losses. In *qard*, the lender does not share the profit and claims back his principal without any return.

In *mudarabah*, the owner of funds shares the profits with the working partner but he alone bears all risks of loss. Uzair also presented a sketch of a financial intermediation system based on the PSP which he called the

"two-fold *mudarabah*". This principle implies that resource mobilization and allocation will be based on the PSP.

Elaborate theoretical foundations of the PSP and a detailed framework of financial intermediation based on it along with a formal model of financing were presented by Siddiqi [1985 (Urdu 1966), 1983 (Urdu 1969), 1983b]. Siddiqi's contribution in this regard is the formalization and extension of Uzair's work. However, Siddiqi's work also has two distinctive elements.

Firstly, the axiom of two-fold *mudarabah* becomes the fundamental principle of an economy-wise credit system as suggested by Siddiqi. It entitles an entrepreneur who has obtained financial resources on the basis of a profit sharing contract to lend part or all of these funds to another party on the basis of another profit sharing contract. Siddiqi himself has raised, the question of whether a *mudarabah* profit can be attributed solely to the specific function of generating a second *mudarabah*, i. e. whether a financial intermediation system based on the two-fold *mudarabah* is permissible. He relies on contemporary works in support of this idea:

It is not clear if the practice of *two-tier-mudarabah* reflected in these juristic discussions had evolved into pure financial intermediation, where one who obtained profit - sharing funds conducts the sole business of supplying these funds to other (working) parties on the basis of profit-sharing. What is important for us in this paper is, however, the fact that the permissibility of doing so was made the basis of a new model of banking by a large number of Muslim economists and jurists writing between 1945 and 1975 (reference to Siddiqi 1981, Siddiqi 1988, p. 35).

Secondly, Siddiqi formalized the principle of combining the personal money of the *mudarib* with *mudarabah* funds.

From the above brief review of the PSP of finance, we can derive three conclusions vis-a-vis the classical *mudarabah*:

- i) The classical *mudarabah* is based on a one to one relationship between the owner of capital and the entrepreneur, whereas most contemporary Muslim writers make it clear that *mudarabah* can also have numerous capital owners (depositors) and only one entrepreneur i. e., the bank.
- ii) In classical *mudarabah*, the mixing of the personal capital of the *mudarib* with *mudarabah* capital is an exception. However, in contemporary thinking, this has become the fundamental rule as the Islamic bank uses its own share capital together with the depositors' money.

- iii) Using *mudarabah* money for making other *mudarabah* contracts is an exception to the classical form but in modern times this has become a predominant rule of *mudarabah* and has given rise to an innovation, i. e. that the PSP can be used for the purpose of financial intermediation. The significance of this innovation for the Islamic system of finance is immense as is evidenced by the resource mobilization practices of Islamic banks as well as by theoretical works on the subject.

Profit and Loss Sharing Principle (PLSP)

The PLSP is related to the *musharakah* principle.' Profits are distributed according to contractually agreed shares, but the liability of loss is proportionate to the capital contribution. The principle was first mentioned by Quraishi but formally discussed by Ahmad (1947). According to Ahmad, Islamic financing may take one of two forms: shares may be floated by ordinary joint stock companies in accordance with the *musharakah* principle, or banking institutions may mobilize resources on the basis of the *mudarabah* principle.

Among Muslim economists, Chapra (1985) assigns an important role to the *musharakah* principle for two important reasons. First, he does not present any model of a typical financial intermediation system as do Siddiqi or Uzair. Second, his emphasis is on institutional arrangements which characterize the Islamic financing institutions more as investment institutions than as typical financial intermediaries. Ahmad (1947) and several other scholars are in line with this approach. The natural outcome of such arrangements is expected to provide a much more fertile ground for *musharakah*. On the other hand due to its nature, the two-tier- *mudarabah* was found suitable as a basis of the intermediation system.

Other Principles

Before the advent of Islamic banking practices, most of the scholarly writings on the subject seemed to agree with the fundamental role of the VRRP of financing. The only exception was that of Al Sadr (1961), who preferred the principles of *ju'alah* and *ijarah* as bases of financial intermediation.

According to Al Sadr, banking services can be rendered on the basis of, the *ju'alah* principle - contract between the client and the bank with-specific fees for specific services. Earlier Quraishi (1947) had also suggested a similar arrangement whereby a central finance house, in addition to administering *zakah*, may offer banking services on the basis of a service charge e.g., like the provision of health, education and other social services. The idea

was also supported by Muslihuddin (see: Siddiqi 1981, p. 221) whose understanding of *mudarabah* made him apprehensive about its use as a financing principle. Al Sadr also downplayed the role of the PSP in managing the bank's assets and gave preference to the principle of *ijarah*.

In the framework of the literature so far reviewed, consumer credit can only be financed by *qard*, i. e., a benevolent loan (see, particularly: Siddiqi 1983, pp. 155-61). In an Islamic society, consumer cooperatives are expected to enhance the provision of this service. In this regard, an important observation is the complementarity of the operations of the two institutions of Islamic banks and *qard* funds or cooperatives (see: Ahmad 1947). These institutions promote each other and, therefore, their simultaneous existence becomes important. The cooperatives can keep their cash balances with Islamic banks and earn profits. The banks always maintain a certain part of their current accounts in cash. This can be used as a base for the generation of *qard*.

Irshad (1963) suggests that the Islamic bank should promote sales on credit for consumption purposes. This will increase demand and the resultant increase in sales could be an incentive for earning profit. It should be noted that this point is dealt with in detail by Homoud (see, section 2.2) but with an entirely new perspective.

The natural implication of what has so far been suggested regarding the Islamic principles of financing is that this literature does not attach any significance to debt financing. Rather, in some circles, the concept of an Islamic economy was considered as a synonym for a debt free economy (see: Khan 1984, Khan 1985 and Nadiri 1984). Consequently, all debts in the economy would be caused by benevolent lending which is made on humanitarian and social grounds. This characterizes such debts as "non-economic", although the debt itself may play an important financial role, especially in consumer credit.

As a summary of the discussion of this subsection, it should be noted that:

- i) The VRRP (consisting of *mudarabah* and *musharakah*) was considered a synonym for Islamic finance. Therefore, it was presented as the only alternative to interest based finance (the two exceptions to this position are Al Sadr and Muslihuddin). The potential of the sale-based principle is not discussed in the literature so far reviewed. Therefore, the Islamic economy became known as debt free.

- ii) *Some exceptional rules of the classical mudarabah emerged as the fundamental basis of the new mudarabah. The difference between musharakah as an Islamic form of joint investment and mudarabah as a form of pure Islamic finance was, however, not highlighted.*
- iii) *The significance of loans (interest free) increased dramatically as consumption was considered to be financed only by this principle.*

2.2 PRINCIPLES OF FINANCING IN THE PERSPECTIVE OF ISLAMIC BANKS

With the rise of Islamic banks pioneered by the Dubai Islamic Bank, UAE, 1974 and the Islamic Development Bank, Jeddah, 1975, the practice of Islamic financing principles was initiated. In starting their operations, these banks naturally faced tough innovative challenges. Data of early operations undertaken under the Islamic financing principles are available in the case of the IDB. Sale-based financing (*i. e., murabahah*) is shown for the first time in IDB operations in the year 1397H (1976). The quantitative value of this operation was US \$ 50.52 million, which was substantially high when compared to other modes of operation. This operational mode became so popular among Islamic banks that in 1984 it covered, on average, 84% of the operations of five Islamic banks (see: Ahmad 1986). The operational needs of Islamic banks attracted the attention of several scholars and led to a number of policy related studies, which are briefly discussed in the following:

A. Critique of Profit Sharing Principle

Banking finance based on the classical mudarabah principle has been challenged by some scholars, most prominently Homoud (1982) and Ismail (1989). According to Homoud, the classical mudarabah principle has the following limitations when applied to the modern needs of financing:

Firstly, the most important characteristic of classical *mudarabah* is its bilateral nature. This characteristic does not allow the classical form of *mudarabah* to satisfy the needs of financial intermediation. The bank deals with a large number of depositors and has to combine their funds, thus sacrificing this bilateral characteristic. According to Homoud, it requires a multilateral or collective *mudarabah* which does not exist in classical writings. To evolve a collective *mudarabah*, he suggests benefiting from the concept of *al 'amil al mushtarak* (collective employee). An example of this is a barber whose services are utilized by many customers on the basis of *ujra* (wage). The barber works for an unspecified number of people upon the payment of

a wage for his service. The payment, however, takes place when the work is rendered. On the same principle a collective entrepreneur can be visualized in *mudarabah*. With the "collective *mudarabah* ", unlike the "two-tier-*mudarabah* " *the depositor is not liable to any loss and the intermediary is entitled to profit only for assuming the liability of loss:*

That a party would not be entitled to receive profit unless he has contributed money, work or liability. In the case under review (collective *mudarabah*), *neither money nor work is involved, there remains only liability as a cause for entitlement to profit* (Homoud 1985, p. 228).

This is in contrast to the "two-tier-mudarabah " where depositors bear the liability of loss. Therefore, many writers, e.g. Siddiqi (1983) and Al Amin (1989), object to Homoud's proposal, questioning the depositor's entitlement to profits if he is not liable to losses.

Secondly, *in the bilateral mudarabah, profits are distributed after accomplishing and completing the transaction. As the entire transaction concludes, the principal is recovered, then the remaining surplus is treated as mudarabah profit. In a modern financial intermediation system, retiring the investment and distributing profits is an extraordinary exception as it is done on the basis of the evaluation of the present value of a pool of investment instead of the liquidation of bilateral mudarabah.*

Thirdly, Homoud invites attention to cases where *mudarabah* is incapable of providing financing e. g., durable or nondurable consumer goods, goods supplied to government and industry, etc.

B. Sale-based Principle

Although sale-based liability creating finance has been widely used by Islamic banks, the general principle has only recently been dealt with in the literature. By studying the differences between the terms *riba*, *bai'* and *dayn* (debt) as they appear in the Holy Qur'an, Ismail (1989) attempts to show that sale-based liability-creating financing is the Islamic alternative to interest. He selects three prominent commentaries on the Holy Qur'an by Ibn Al Arabi, Al Qurtubi and al Jassas respectively to determine the meaning of the two verses of the Holy Qur'an which mention these terms. The Qur'an (II: 275) says:

... That is because they say: Trade (*bai'*) is only like interest (*riba*), but God has permitted trade and forbidden interest...

At the time of revelation, the Arabs had two very common transactions: *bai'* and *riba*. Based on the commentaries of the above mentioned scholars,

Ismail rightly concludes that as *bai'* can be spot or deferred, the term used in the verse must refer to deferred sale as it is used in contrast to another form of financing - *riba*. Ibn Al Arabi and Al Qurtubi specifically mentioned that *bai'* in this verse covers *all permissible deferred sales*.

Ismail concludes that the *fuqaha'* usually mention the following five forms of permissible deferred sales which create deferred obligations:

- i) Salam sale (the price is paid at the time of contract but the object of sale becomes due as debt in kind),
- ii) *Mua jjal* sale (the object of sale is delivered at the contract time but the price becomes due as debt),
- iii) *Istisna'* sale (the price is paid at the time of contract and the object of sale is manufactured and delivered later),
- iv) *Ijarah* (the sale of the use rights of assets where assets are delivered to the user, who in turn pays periodic rentals) and
- v) *Murabahah li al 'amer bi al shira'* (sale with a known profit which may or may not create debt).

In the present context, *riba* applies only to liabilities (debts) whether they result from lending or deferred trade. *Riba* is an increment taken over and above the principal of a debt (whether caused by lending or deferred trade) against granting time for repayment?⁽⁷⁾. In the above mentioned verse, the three commentaries support this assertion of Ismail.

As far as the exact meaning of *dayn* is concerned, the Holy Qur'an (11:282) says:

O Ye who believe! When ye deal with each other in transactions involving *dayn* (debt) in a fixed period of time put them in writing...

The three commentators agree that *dayn*, in this verse must be the result of deferred sales which have been mentioned in the previous verse.

;Mark-up Principle

Since the publication of Homoud (1982), *murabahah* has emerged as a principle distinct from the VRRP of finance. It has also become the backbone of contemporary Islamic banking. In his presentation of *murabahah*, Homoud quotes Ibn Qudamah who defines it as follows:

(murabahah is) Selling for the cost price plus a specified profit, provided that both the seller and the buyer know the cost price. The seller says, my capital, or the cost price, is a hundred, and I sell it to you for a

profit of ten.' This is permitted and there is no doubt about its legitimacy. No scholar is reported to have regarded it with legal 'dislike' (*karahah*) (Homoud, 1987, p. 7).

However, to incorporate a purchase order in this transaction, Homoud turns to Imam Shafi'i:

If a man shows, certain goods to another and says, 'buy this for me and I will give you so much profit', and the second man buys it; then the transaction is permitted. However, the one who has made the promise has the right of withdrawal. If he buys, it makes no difference whether he pays immediately or at a later date. So, the first sale is valid but there is no commitment as to the other; they are at liberty (*ibid.*).

This example of Imam Shafi'i has led Homoud to evolve the financing mode called *bai' al murabahah li al 'amir bi al shira* (sale with declared profit to the purchase order i.e., the mark-up).

The mark-up principle of finance results from incorporating deferred payment in *murabahah*. In the mark-up principle, the financier benefits from the difference between the immediate and deferred prices of the goods. The mark-up principle is justified on the basis of a generally accepted axiom that time may be valued provided it is incorporated in a sale transaction (Saadallah 1986). As such, the financier's claim for return derives its *fiqhi* legitimacy from the fact that the financier has owned the object of sale for at least some period of time. Such ownership implies carrying risk and uncertainty. Thus, a return is justified on the grounds of ownership as well as on the grounds of risk in accordance with the principle of *al kharaj bi al daman*.

The markup creates a fixed, predetermined and secure indebtedness. This has made the mark-up principle attractive for Islamic banks as an alternative to interest based transactions. It should, however; be noted that in contrast to interest based lending, the final return to the financier is not fixed in markup based financing. In fact the final return to the financier is lower than the markup price because of the element of risk carried by the financier while the merchandise is in his possession. By the same token, the mark-up principle saves the user of the funds the risks which he would have otherwise borne, had he owned the goods for the same period of time. Thus, the final cost of the finance for the finance user may be less than the markup price (see: Khan 1989).

Renting Principle (Ijarah)

By separating an asset's ownership rights from its use rights, the renting principle *Ijarah* makes the use of an asset independent from its financ-

ing. The owner of the asset bears all the risks associated with ownership and the user of the asset pays a fixed price (rent) for the benefits of the asset. One can, thus, use an asset without owning it. Therefore, *Ijarah* plays an important financial role.

Although in the early sixties Al Sadr suggested the relevance of the *Ijarah* principle in the management of the bank's assets, this principle remained insignificant until the emergence of Islamic banks. In recent literature (e. g., Chapra 1985, Council of Islamic Ideology 1981), the principle has been discussed. However, it has not been widely used by Islamic financial institutions (Ahmad 1987) except by the IDB (see, particularly: 12th Annual Report of IDB).

Two variants of the *Ijarah* principle have been used in Pakistan: hire-purchase and rent-sharing.

In a hire-purchase form of finance, the client (the purchaser of an asset) knows the price of the asset, the bank's profits in the underlying sale transaction and the amount of rent to be paid. After paying the principal plus the profit and rents for the relevant period, the client assumes the ownership. In a recent opinion, the Islamic Fiqh Academy of the OIC has suggested refraining from the use of the hire-purchase principle unless appropriate care is taken with regard to the provision of the extension of the lease period, the termination of the lease contract, the return of the asset to its owner, the purchase of the asset at the end of the lease contract, etc. (see: The Islamic Fiqh Academy, 1989, p. 88).

In a rent sharing contract, in addition to the principal, the client pays a known share of the market rent of the building until such time as he completes all payments. It is understood that the bank's profits in the operation are incorporated into the agreed rent.

In the conventional literature of economics and finance, a comparison of the renting principle (i. e., leasing and interest bearing finance) is frequently undertaken and the superiority of the former is highlighted⁽⁸⁾. In an interesting study, Al Masri (1986) has compared renting with the PSP and suggested that the PSP (whether based on output or profit sharing) can also be applied to durable assets more efficiently than the renting principle.

2.3 POLICY ORIENTED STUDIES

The most important document in this regard is the report of The Council of Islamic Ideology Pakistan (1981) on the elimination of *riba* from the economy. This report, jointly prepared by economists, bankers and *Shari'ah* scholars is an exhaustive document which deals with the elimina-

tion of interest from the contemporary economy. In preparing this report, the Council benefitted from the sources of *Shari'ah*, the views of Islamic economists and the experience of Islamic banks which had already been operating for some time when the report was prepared. Although in preparing the report the Council aims at providing a blueprint for transforming the banking system in Pakistan, its general validity is widely acknowledged. The salient features of the report are reviewed below.

The report provides a comprehensive package of interest-free financing. The authors of the report had several considerations in addition to the primary objective of the elimination of interest, including: bank safety, sectoral resource allocation, suitability of the proposed modes for different users, etc. The report classifies the Islamic instruments of financing into PLS, sale and service based modes.

Among the PLS-based modes, *musharakah* and *mudarabah* have a wide variety of uses as they can be the basis of such financing instruments as rent sharing, equity participation and *mudarabah* certificates.

According to the report, variants of sale-based financing modes include *murabahah*, *bai'salam*, hire-purchase, leasing, etc., while service-based financing includes loans on the basis of the actual administrative cost of service and benevolent loans. However, the report gave priority and preference to the PLS modes. Sale-based financing was suggested only in those cases where the PLS system does not work. On the other hand, service-based modes were considered exceptional and of a non-economic nature.

While implementing the recommendations of the Council, the State Bank reclassified the modes of financing as:

Investment-based financing which comprises *musharakah* and *mudarabah*. *Sale-based financing* comprises purchase of trade bills, mark-up and buy-back arrangements. *Rent-based financing* which includes hire - purchase, rent-sharing and leasing. Actual service cost based financing and *ju'alah* are classified *service-based financing*.

Finally, the *Shari'ah* Councils of private sector Islamic banks played an important role in developing new Islamic financing techniques by means of issuing their opinions (*fatawa*). In the past decade or so, these *fatawa* have guided Islamic banks in understanding the different modes of Islamic financing in contemporary banking.

2A. OWNERSHIP-CUM-MANAGEMENT APPROACH

Kahf (1991) attempts to present a general framework to interpret Islamic modes of financing. The premises of his attempt are the considerations regarding the characteristics of ownership and the ways it can be integrated with management.

In Islam, ownership has two inherently interrelated characteristics: i) ownership rights entitle the owner to all earnings, returns, increments, etc., which accrue to the owned assets regardless of the process of their accrual (i.e., *growth may either be due to natural reasons, transformation of assets or exchange*) and ii) simultaneously, ownership makes the owner the 'sole bearer of all responsibilities and risks regarding the property. These risks include quantitative and/or qualitative loss of property caused by natural factors, exchange or transformation. These two interrelated characteristics are expressed in the Prophet's saying "*al kharaj bi al daman*" and in the general *fiqh* axiom "*al ghurm bi al ghunm*", which means *entitlement of gain is linked to the responsibility for loss*.

The combination of management and ownership may take one of three forms: i) the owner may himself manage the properties he owns e.g., trading, ii) he may contractually give up management⁽⁹⁾ to somebody else (e.g., *mudharabah*) or iii) he may assign management of usufruct rights to somebody else (e.g., renting). These three forms of combining management and ownership along with the above mentioned characteristics of the right of ownership provide the foundation for the concept of financing in Islam.

Accordingly, Kahf calls *commercial financing* all those techniques in which the owner retains managerial authority. The owner himself takes all managerial decisions with regard to his assets. Managerial decisions can be spread over a period of time as in, *sharikah* where the financier becomes a partner and shares in managerial responsibilities. The financier may also choose to involve himself in only one managerial decision related to a property he owns by selling it. By such an act, an owner/manager removes himself from any further managerial decisions related to that property.

Therefore, sale-based financing is a form of commercial financing because it represents an owner managing his properties. *Sharikah*, *murabahah*, *salam*, and *mua'jjal* are all variants of commercial financing. In commercial financing, the right to own the return on financing is based on ownership, i.e., as long as one owns a property he also owns the benefits associated with it.

The second category of financing according to Kahf is effected by complete separation of ownership and management and can be termed "pure financing". This consists of *mudarabah* whereby ownership of the funds continues to be retained by the owner, but management is assigned to another party, "the working partner". *Muzara'ah* and *musaqah* are similar to *mudarabah* except for one difference: the owner of land and trees has already taken an entrepreneurial decision in investing his wealth in these properties. As far as the sharecropper in *muzara'ah* and *musaqah* is concerned, he takes managerial decisions with regard to properties handed to him similar to those taken by the working partner in *mudarabah*.

The third category is that of renting where two types of managerial decision are separated from each other. The first involves managerial decisions related to the asset itself (e.g., holding it, maintaining it in usable shape and selling its usufruct rights). This category of decision is retained by the owner (lessor). The second category consists of decisions related to the management (use) of the usufruct rights (e.g., how, when and under what conditions the fixed assets are used within the framework given in the contract). This second category of decision is taken by the lessee.

Lastly, it should be noted that debts and loans do not generate any return to the creditor/lender because they are interpersonal obligations not properties, and their repayment is guaranteed by debtors/borrowers (hence the creditor/lender has no *ghurm* to carry and, therefore, he is not entitled to a *ghunm*).

The characteristics of different categories of Islamic modes of financing along with benevolent lending and interest-based lending are summarized by Kahf in the form of a table. The table is reproduced for its usefulness. It should be noted that in this table, *musharakah* is distinguished from other commercial financing techniques.

Islamic Financing Modes in Comparison to Interest-based Loans

Characteristics	PF	S	SF	R	Q	I
Separation of management & ownership	y	n	n	yn+	y	y
Ownership	y	y	n	yn+	n	n
Restriction to productive projects	y	y	n	n	n	n
Work makes property grow	y	y	n	n	n	n
Purpose of profit making	y	y	y	y	n	y
Fixation of return	n	n	y	y	n	y
Declaration of profit to financier and user of funds	y	y	n"	n	n	y
Owner of property bears loss	y	y	y	y	n	n
Conditions of specific use	y	n	n	y	y	y

Notations: PF-Pure Financing; S-*sharikah*; SF-Sale-based Financing; R-Renting; Q- qard; I-Interest-based Lending; y=yes and n=no; + - two sets of ownership-cum- management.

Except in *murabahah*.

Source: Adapted from Kahf (1991)

To summarize the discussion of Section Two, it should be noted that :

- i) With the emergence of Islamic banks and Islamization efforts in some countries, the principles of Islamic finance have diversified. In addition to the VRRP, sale based finance was introduced and extensively used. Moreover, the renting principle was also discussed and applied.
- ii) An approach which provides a general explanation of Islamic financing may be found in the implications inherent in the relationship between ownership and management. Whenever one owns a property, one is entitled to a return on that property and liable to the risk of loss. Ownership is retained by the owner in the VRRP as well as in rent based financing. In *mudarabah*, ownership is separated from management. In *musharakah*, sale-based financing including *murabahah* and renting, the owners manage their properties and are entitled to their re-turns. It should, however, be noted that in *murabahah* and other sale-based financing ownership is not retained. It is rather transferred to a new owner. That is why after the contract, no return accrues to the former owner as he becomes a creditor of a definite and fixed liability.

3. JUSTIFICATION FOR RETURN ON FINANCING

It is clear from the preceding discussion that Islamic economics accepts the idea of fixed indebtedness in both leasing and markup principles of financing. In both cases, contractually fixed liability against the use of financing emerges out of the financing relationship. This is in addition to the variable return in PSP and PLSP. One may, therefore, ask why in some cases, fixed payment is justified while it is prohibited in the case of interest? This section attempts to answer this question. In the first sub-section, we will compare profit, rent, wage and interest and in the second, we will look into the premises for the entitlement to a return on financing from the Islamic point of view.

3.1 DIFFERENCE BETWEEN PROFIT, RENT, WAGE AND INTEREST

In conventional economics, profit, rent, wage and interest are considered to be factors of production. In one way or another, all are fixed in relation to time except profit. Profit is an uncertain amount whereas wage, rent and interest are fixed and known. Islamic economic literature dismisses interest as it is prohibited by the Holy Qur'an. Rent and wage are treated as one and the same as the term *ujrah* is used for the price of both human resources per unit of time (wage) as well as the usufruct rights of fixed assets (rent). Therefore, the question can be asked: what is profit and how is it different from *ujrah* (rent/wage) and interest?

In the Holy Qur'an, the term profit is used only once:

These are they who have purchased error in exchange for guidance.
Their trade has brought them no *profit* (II: 16)

In Islamic jurisprudence literature, profit is defined as the increase in the value of assets (fixed or mobile) actually realized in exchange (Al Amin 1985, p. 15).

Profit may be the result of a natural process of growth without any effort or cost on the part of the owner, e. g., pastures growing on privately owned land or the increase in water of a privately owned well. Profit may also result from mere changes in the conditions of supply and demand rather than an effort on the part of the asset owner, e.g., an increase in the number of people or a decline in the amount of production were cited by Ibn Taymiyah as factors which raise the exchange value of an asset (Kahf 1978). Profit may also arise out of human action applied to an asset which increases its exchange value. Such a human action may transform an asset to a higher

valued one as in the case of manufacturing steel into machines¹¹⁾.

In both Islamic economics and *fiqh* literature, physical capital (see: Al Masri 1986) and labor may enter the production process either on *ujrah* or on a profit basis depending on the different combinations of management and ownership. Managerial (or entrepreneurial) responsibilities may be carried out by the owner of capital or by labor (i. e., an entrepreneur or a working partner/entrepreneur). Profit in Islamic economic thinking is inherently associated with the responsibility of decision making. In a market economy this responsibility exposes the decision maker to an uncertain outcome. Hence, when the capital owner becomes also the decision maker of the firm, his earning is called profit i.e., the residual after paying a known and fixed return *ujrah* (wage) to labor.

A working partner, without any share in capital, can also be the decision maker of the firm and can share in profit once payment of a fixed and known return *ujrah* (rent) is made to physical capital and possibly to other workers who have made a human input. By the same token, labor or physical capital may select to enter the production process without any decision making responsibility, i.e. either of them can dispose of every bit of uncertainty and risk involved in the production process and restrict the return to *ujrah* (wage/rent) per unit of time sold to the entrepreneur.

Human and physical capital (e.g., working hours, plants, machines and equipment) can be rented out because they have lasting substance and a flow of definite services. In contrast, the nature of monetary capital is such that it can only grow through exchange and does not, in isolation, generate a flow of services over a period of time. Therefore, from the point of view of Islamic economics, interest is a fictitious and unjust convention. It is always described as oppressive because it is taken in exchange for nothing.

In the same manner, debts regardless of their origin share with money the incapability of growing independently. But while money is readily usable in exchange, debts need to be liquidated (i.e., they should be transformed into money, commodities or physical capital) before being invested - a utilization which permits growth⁽¹¹⁾. Debts are mere personal obligations; they cannot grow.

Since money has what the *Fuqaha'* call the potentiality of growth only through the process of exchange, it is needed in the production process for making payments to physical capital, labor and intermediate inputs. As money does not possess a flow of services of its own⁽¹²⁾, it can only enter the production process on the basis of sharing the outcome of exchange. In

other words, it can enter production only on the basis of sharing the uncertainty and risk inherent in a market economy⁽¹³⁾.

3.2 BASIS OF ENTITLEMENT TO RETURN

The above discussion helps to clarify the basic axioms for the justification of return in Islamic economic thinking. In the following, these axioms are summarized in order to highlight their implications for wage/rent and profit.

- i) The first and foremost axiom for the justification of return is the ownership of an asset. If the nature of the owned asset is such that it can produce a flow of services without being depleted (e.g., a machine or a plot of land), the asset can be rented or otherwise given on a profit sharing basis.
- ii) Like privately owned natural resources and other forms of capital produced by any combination of human and natural resources, human resources are a special form of asset which can also be given away on *ujrah* (wage) or on a profit basis.
- iii) Earning *ujrah* (wage/rent) is based on selling a flow of definite services of the assets owned. Human resources are in this sense a form of owned asset. This means that *ujrah* (wage/rent) earners are in fact owners of lasting resources who enter the market offering their services and become subject to the law of supply and demand. Accordingly, *ujrah* earners are subject to market risk and uncertainty as are profit earners. The essential difference between the two categories however, is the extent of risk taking which is inherently associated with the extent of the decision making authority.

CONCLUSION

In the light of historical evidence from the early period of Islam and contemporary literature, a comparative review of Islamic financing principles has been presented in this paper. Important points have been summarized at the end of each section. In the following, some general concluding re-marks are made.

The fixed nature of return on capital is considered the unique characteristic of interest by most contemporary Muslim economists. As a corollary, therefore, the Islamic principle of financing is considered to be based on the variable rate of return (i.e., profit sharing). Therefore, *mudarabah* has been treated by these scholars as a synonym for Islamic finance and the need for finance has been discussed in this context. This is perhaps the reason for neglecting the financing potential of the sale-based principle of finance and for the difference in this regard between interest and sale. As a result, Islamic economists tend to describe the Islamic economy as debt free.

However, the emergence of Islamic financial institutions has highlighted the immense financing potential of the sale-based principle where financing results in debt creation. This clarifies the point that there is a difference between the fixed nature of return on capital invested in real transactions (sale) and on capital invested in pure finance (interest). It is, therefore, clear that profit sharing is the only Islamic principle of earning a return on capital invested in pure finance (where ownership is separated from management). However, as sale on a deferred basis serves the financial needs of the buyer and seller, it is no wonder that mark-up and renting principles became the dominant practice of contemporary Islamic financial institutions.

Recently, by emphasizing the characteristics of ownership in Islam and its combination with different forms of property management, it has been concluded that *mudarabah* is a principle of pure finance whereas *musharakah*, like trading, is investment in real transactions.

Debt (*dayn*), has two primary sources: a nonmarket source (i.e., loan) and a market source (i.e., sale). The question of a return on nonmarket debt does not arise because the cause of the debt is a humanitarian consideration and the question of a return on debt created by sale does not arise because the return has already been incorporated into the price of the assets traded. Thus, once the debt is created, irrespective of its origin, the exten-

sion of its repayment period can only be non-economic in nature. A debt default does not improve the quality or quantity of the debt. Therefore, claiming a return for extending the repayment period is unnatural and illogical.

The diversified nature of the principles of Islamic financing makes it capable of meeting the numerous financial needs of the society.

NOTES

1. For more details, please see: James L. Pierce, Monetary and Financial Economics:: John Wiley & Sons, New York, 1984 (particularly, chapter four).
2. "Desired" in *fiqh* terms means that the *Shari'ah* stands in favor of doing it without making it obligatory, i.e., the *Shari'ah* is not neutral about it.
3. A *wadi'ah* means putting something with some body (depository) to hold it in a place as secure as the depository's own similar things. In *wadi'ah*, the depository does not guarantee the deposited things against any loss or hazard except in the case of gross negligence on the depository's part.
4. However, Khan discussed this point in the context of discounting and assumed that money is always invested in accordance with *Shari'ah*, i.e. lending at a variable rate of interest is eluded.
5. *Riba* may also be practiced in all quantifiable commodities which are exchanged in a similar way, such as, quality-standardized beans, cotton, grain, etc.
6. Although new forms of *riba*-based lending apply in contemporary economics, (e.g., variable rate of interest), variation in the rate of return is not the only characteristic of VRRP in Islam. Other characteristics of VRRP include non guaranteed principal and a money income and a sharing from of contract instead of a lending form.
7. However, we should also note that another cause of future obligations is direct borrowing (*qard*) which dominates the contemporary financial system. The commentaries of Ibn Al Arabi, Al Jassas, Al Razi and others show that borrowing existed among Arabs and Jews at the time of the Prophet (pbuh).
8. Such a discussion is frequently undertaken in the International Leasing Year Book, (particularly see: the 1986 issue of the Year Book).
9. The word "management" used here implies decision making about a property (" *Mal*). However, when an owner assumes managerial responsibilities, he may do that in person or through an agent e.g., a paid employee who acts on his/her behalf. In this case, the right to take decisions remains in the hands of the owner may at any time revoke the power he/she bestows on his/her agent.

Alternatively, when management is assigned to somebody else on *mudarabah* basis, the *mudarib*, takes, in his own capacity, all the managerial decisions given to him on the basis of sharing in any resulting profit.
10. *Fuqaha'* usually add *daman* as a source of profit, i.e., they attribute profit to either of three reasons: ownership of a property, work and *daman* (responsibility or guarantee). See, for instance; Al Sarakhsi, *Al Mahsut*, v.11, p.159, Al Badae', v.6, p.62 and Ibn Qudamah, *Al Mughni*, v.5, pp 114.129. In this regard two examples may be cited :

The first is *sharikat al wujuh* (liability partnership) in which two parties, having no funds of their own, make a trading partnership on the basis of the credit merits and reputation of either or both of them. The credit purchase is effected by assuming the responsibility.

The second example is of a person guaranteeing some work to be done by somebody else, like the manager of a repair shop assuming the responsibility of certain repairs to be done by his employees or partners (in the case of partnership, it is then called *sharikat al sanae'*).

Hence, the concept of *daman* boils down to a guarantee of a certain payment or of certain work, since the guarantee puts the guarantor under the liability to provide the pledged work/funds, when due. Hence, *daman* (guarantee/responsibility) as a justification for earning may not be more than a special case of labor or capital.

Earning a profit by virtue of responsibility/guarantee elucidates the importance of uncertainty and risk as a reason for profit. If the market risk is totally eliminated, the right to return goes along with it. Therefore, Islamic economic thinking is based on accepting the reality that in the market nothing is certain or risk free. This applies even to *ujrah* earners. The moment risk and uncertainty are totally eliminated such as in the case when one has a personal obligation, no return is provided for.

11. Because of this difference, debts cannot be used as a principal in *mudarabah*, while money can.
12. The satisfaction of owning money is of a personal nature, and it is inseparable from ownership. Therefore, this satisfaction cannot be rented out.
13. It may be worthwhile to mention that there may be cases where money may change character and become able to generate a flow of services on its own. For example, coins as well as paper currency, may be used for decoration purposes. In such cases, many *fuqaha'* argue that it may be given on a rent basis.

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