PRINCIPLES OF
ISLAMIC FINANCING: A SURVEY

By

Monzer Kahf and Tariqullah Khan

Islamic Research and Training Institute
Islamic Development Bank
1409H

CONTENTS

INTRODUCTION

I FINANCING IN THE EARLY PERIOD OF ISLAM.

1.1 FINANCING DURING THE PROPHET'S ERA

1.2 THE NEED FOR FINANCING

1.3 ENCOURAGEMENT OF BENEVOLENT LENDING

1.4 POSTPONEMENT OF DEBT RE-PAYMENT

II RECENT DEVELOPMENTS IN ISLAMIC FINANCING PRINCIPLES

2.1 CONTRIBUTIONS PRECEDING ISLAMIC BANKS

a. Review of Theoretical Contributions
Difference Between Sale and Interest.
Objection to Fixed Return on Financial Capital.

b. Evolution of Financial Principles During the Period
Profit Sharing Principle (PSP)
Profit and Loss Sharing Principle (PLSP)
Other Principles

2.2 FINANCING PRINCIPLES IN ISLAMIC BANKING PERSPECTIVE

a. Critique of Profit Sharing Principle

b. Sale-Based Principle
Mark-Up Principle
Renting Principle

2.3 POLICY ORIENTED STUDIES

2.4 AN OWNERSHIP-CUM-MANAGEMENT APPROACH

III JUSTIFICATION FOR RETURN ON FINANCING

3.1 DIFFERENCE BETWEEN PROFIT, RENT AND INTEREST
3.2 BASIS OF ENTITLEMENT TO RETURN

CONCLUSIONS
BIBLIOGRAPHY

INTRODUCTION

Financing involves channelling of resources from wealth holders to the deficit producing or consuming units[1]. As such, financing enables the deficit units to have command on a quantity of resources larger than what they can command with their 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 purchases of goods and services. Whereas a deficit consumer 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 the other forms of finance.

The core of the premises used by Islamic scholars to deduce 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 the jurists is inter alia, based on the saying of Prophet Muhammad (pbuh), *al kharaj bi al daman* (which relates entitlement of the return of an asset to carrying the risks resulting from its possession). This puts the axioms of continued ownership and *al ghurm bi al ghunm* (entitlement to return is related to the liability of risk) in the heart of Islamic financing.

Although, the literature dealing with Islamic finance is rich in general, but the principles of finance have not been directly focused. 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 by reviewing the literature related to the rationalization, explanations and justification of the Islamic modes of

---

1 Φορ μορε δεταιλσ, πλεασε σεε, ϑαμεσ Λ. Πιερχε ,Μονεταρψ ανδ Φινανχιαλ Εχονομιχσ , ΝΨ: ϑοην Ωιλεψ & Σονσ, 1984; παρτιχυλαρλψ, χηαπτερ φουρ.

financing.

The determination of a concise concept of financing in Islam is not possible at the beginning of this paper. However, drawing on these 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 hold the responsibility of ownership of an asset to reap the increments accrued to the asset, i.e., a return on financing can only be claimed on the basis of ownership, ii) all such 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 on such resources which was otherwise not possible and iii) However, lending is an act of benevolence which doesn't entitle the creditor to any return because, he is no more an owner of the lent resources whose payment is guaranteed by the debtor.

The paper consists of three sections. Section one concentrates on the early works of Muslim scholars especially commentaries on the Holy Qur'an, Hadith and fiqh writings. In this section, 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 the section also deals with benevolent lending and the postponing of repayment of loans because these two issues provide a deep insight into the matter of return bearing finance.

Section two reviews contemporary writings on Islamic economics related to the subject. 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 return on financing in the Islamic economic thinking. In this section, attempt has been made to put together arguments given in Islamic economic literature on the distinction between profit and interest and the reasons for which 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 the paper doesn't aim to deal with the principle of lending in detail. This must not mean that such a benevolent act may not serve economic objectives as it is apparent that, whether loans are given by individuals or the state, they certainly increase the amount of material resources available to the borrowers.

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

I. FINANCING IN THE EARLY PERIOD OF ISLAM

This section deals with some of the 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 the principles underlying individual modes of finance and rationalize them. However, since each Islamic financing technique could be discussed separately, in this section four points of general nature viz., financing during the Prophet's era, the need for credit as seen in Islamic jurisprudence, encouragement of lending in Islam, and benevolent postponement of debt re-payment and its implications are discussed. The discussion is hoped to shed some light on the principles of financing as understood by early Islamic writers.

1.1 Financing During the Prophet's 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) saying that in financing the battle of 'Uhud, Quraish used funds accumulated by means of *riba*. Furthermore, 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 the 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 of the Jewish practice of *riba* (IV: 160); again quoting early writers, Homoud (op. cit., p. 131) argues that many Jews were working as money lenders in Madinah and 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 *riba*-based borrowing and perhaps *mudarabah* may rank second in terms of practical importance.

While discussing the legitimacy of *mudarabah*, the *fuqaha'* usually call the 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 society, (see for example *al Muhalla*, V. 8, p. 247 and Abu Zahrah (p. 55). It is worth noticing that *mudarabah* implies that the net profit of the 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 under the name of *muzara'ah* and *musaqah*. The first applies to open fields used for crops and the second to orchards of trees especially palm. Land in *muzara'ah*, land and trees together in *musaqah* are fixed assets put under 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 time. There are many sayings about the Prophet's (pbuh) buying on credit, taking loans and sometimes giving personal belongings as 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, p. 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 in sale is used to finance consumption. It is also practiced 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 *salam* basis and the Prophet (pbuh) mentioned that gold and silver can be exchanged on 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*, is 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 sale of things which are not in possession at the time of contract. Thus, *bai' al salam* is a form of financing which provides the producer with funds that can be used for working capital including payments to labor and raw materials. It was practiced in the agricultural sector of Madinah at the time of the Prophet (pbuh).

Riba-ridden lending is forbidden and generally eliminated from the Muslim society of the Prophet's 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 the peoples' 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 neither every one who owns money has trading skills nor every one 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 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 and his orphan nephews were under 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 the funds of orphans on *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, 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 turn-over (*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 certain 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 bellow). Commenting on these sayings Ibn Qudamah argues that the purpose of lending is to relieve and assist a person who is under pressure and 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 not ask for a loan unless out of necessity and financial despair. It should be noted that needs which call for borrowing may pertain to either consumption or production. Hence *bai'al salam* was looked at as 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*, inspite of its violation of the rule against selling what is not in 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 provision of relief to one's Muslim brother, fulfillment of his needs and extension of help and support.

"[2] Desired", in the *fiqh* terms means that *Shari'ah* stands in favor of doing it without making it obligatory, i.e., *Shari'ah* is not neutral about it.

The help and relief component of lending is very well recognized by the *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 certain privilege without getting any compensation. This means that *fiqh* scholars do not dispute that in lending, one makes certain 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 internal cost on the part of lender.

Moreover, as loans imply guaranteeing the principal of the loan by the borrower, risk avertors may prefer giving their funds on 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 ingredient in the relationship is substantial. It is reported that the Prophet's Companion al Zubair used to tell his depositors that it is better for them to consider what they give him for safe keeping 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 suggested that it may be made by the *zakah* fund (Qardawi, *fiqh al zakah*, p.634 and Kahf, 1977, p.p. 104-106), or by the banking system as it has been practiced by the nationalized banks in Pakistan after Islamization in the area of loans to students and other needy segments of the 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

[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 case of gross negligence on the depository's part.

Muslim communities.

1.4 Postponement of Debt Re-payment

The Qur'an tells about re-scheduling 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 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 of Thaqif tribe on 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, Thaqif asked for their principal to be paid back and Bani al Mughirah complained to the Prophet (pbuh) that they lacked liquidity. Then, the verse, ordering putting off the repayment of these debts, was revealed.

Al Qurtubi, however, continues that despite 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).

Postponement of debts, as prescribed by the verse above, is done without any financial compensation. This applies regardless of the causes of default be it involuntary or deliberate. However, according to 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 the early Islamic society financing was provided with the motives of help (lending) and expectation of profit. Although lending serves the financial purpose of the borrower, its supply 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 cost are born 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 - price becomes due as debt) and *salam* (immediate payment with deferred delivery: Object of sale becomes 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 concludes once for all and the price or merchandise, respectively in *mua'jjal* and *salam* sales are transformed into fixed debt. In case the debt is in terms of money as in *mua'jjal*, the return on financing is known at the time of delivery of the objects of the sale.

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

a) In case the purpose of the *salam* purchase is simply acquisition of merchandise (in the future), rather than its resale, the operation ends with the delivery on the due date. Thus in this case too, like in *mua'jjal*, the return on financing will also be known at the time of conclusion of the sale contract. The risk of failure to deliver goods or of any damage in this is insurable. Therefore, taking this and the price paid together, return on this financing is known and fixed at time of the conclusion of the sale contract and payment of price.

b) But, if the objective of the *salam* purchase is resale rather than simple acquisition, then the final outcome of the operation can only be known when the resale actually takes place. In this case the return cannot be known ex ante. Therefore, unless there is an order from an ultimate purchaser, a financial institution is hardly expected to involve in such a risky operation.

II. RECENT DEVELOPMENTS IN ISLAMIC FINANCING PRINCIPLES

Abolition of interest is the fundamental issue in the contemporary discussions on Islamic financing. In this regard, it should be pointed out at the outset that in the modern Islamic literature, *riba* and interest are treated synonymously. So, 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, therefore, dominated contemporary Islamic economic thinking. Moreover, during the last two decades the Muslim societies have also witnessed a unique experience in the emergence of public as well as private sector applications of the Islamic financing principles. In the following, major academic and policy oriented works related to the Islamic financing principles are briefly reviewed with a view to highlight some of the important developments in this area.

This section is divided into four sub-sections dealing respectively with contributions preceding the establishment of Islamic banks, the implication of the rise of Islamic banks for the principles of financing, 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 with the objective to highlight the underlying principles.

a. Review of Theoretical Contributions

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

The Difference Between Sale and Interest

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

Maududi looked into the difference between *bai'* and interest in context of 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. Whereas trade conforms to the natural uncertainty. Therefore, it 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) Qurishi says:

> One, who sells clothes worth Rs. 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 Rs. 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 re-emphasized in context of time value of money. al Abji (1986) and al Masri (1986) 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 fixed rent, or fixed price in deferred sale doesn't mean fixed return on capital because of uncertainty and risk incorporated in these transactions (Khan 1986) rejects the above proposition and suggests that time value of money can only be ex post.[4] Saadallah (1985) also identifies the acceptance of the value of time by the *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, not by itself. Under *riba*-based transactions, postponement of liability justifies a return to capital. Whereas in real transactions, 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 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, capital involved in trade may grow or decline through time. Whereas, 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 potential of trade in creating liabilities (i.e., its financing potential) did not attract the attention of these scholars. The financing aspect of the differences between sale and *riba* was not discussed either.

<u>Objection to Fixed Rate of Return on Financial Capital</u>

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 lend-

---

4 However, Khan discussed this point in the context of discounting and he pre-assumed that money is always invested in accordance with *Shari'ah* i.e. lending at a variable rate of interest is excluded.

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 strongly been challenged by Muslim scholars on ethical and efficiency grounds. 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 almost absolute consensus among Muslim scholars that the answer to these and similar questions is negative. However, it must be pointed out that the difference between <u>contractual return on lending</u> and <u>contractual return on sale based financing</u> was not spelled out in the literature under review. Thus, charging any guaranteed return on financing was considered illogical, irrational and unjust (see, particularly 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 viewed that the Islamic financing approach should primarily be based on 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, e.g., Maududi and Qurishi <u>op.cit.</u>, Ahmad 1947, Uzair 1954, Siddiqi 1983 a, b, Chapra 1985). The application of this kind of VRRP in Islamic financing can take the form of Profit Sharing Principle (PSP) or Profit and Loss Sharing Principle (PLSP). These and some other principles of financing emerging from the literature under review are discussed in the

---

5 *Riba*, may also be practiced in all quantifiable commodities which are characterized by similarity in exchange such as quality-standardized been, cotton, grain, etc.

6 Although new form 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 sharing form of contract instead of lending form.

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 contractual agreement whereas losses under normal circumstances would be written on capital. The first indication of the principle in the literature under review was given by Qurishi (op.cit) in his notion of partnership. But his concept is ambiguous as he suggests capital will be provided by one party and work by another and profit or losses will be shared by the two parties. More specifically, as far as provision of capital and division of work are concerned, Qurishi's partnership follows the *mudarabah* principle, while regarding liabilities, it is close 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). Emphesis added.

The above quotation introduces *mudarabah* in 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 simply 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 doesn't share the profit and claims back his principal without any return. While 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 detailed framework of financial intermediation based on it along with a formal model of financing were however, 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 whole of these funds to another party on the basis of another profit sharing contract. The question 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 has been raised by Siddiqi himself. He relies on contemporary works in support of the 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 mixing up personal money of the *mudarib* with the *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 made it clear that *mudarabah* can also have numerous capital owners (depositors) facing one entrepreneur i.e., the bank.

ii) In the classical *mudarabah* mixing of personal capital of the *mudarib* with *mudarabah* capital is an exception, while in contemporary thinking, this became the fundamental rule as the Islamic bank will use its own share capital together with the depositors' money.

iii) Using *mudarabah* money for making other *mudarabah* contracts is an exception in the classical form but in the contemporary time this also became a predominant rule of *mudarabah* and gave rise to an innovation: 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 evidenced empirically by the resource mobilization practices of Islamic banks as well as by the theoretical works on the subject.

Profit and Loss Sharing Principle (PLSP):

The PLSP is related to the *musharakah* principle. Profits are distributed according to the contractually agreed shares but liability of loss would be proportionate to capital contribution. The principle was first mentioned by Qurishi 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 other Muslim economists, Chapra assigns an important role to the *musharakah* principle because of two important reasons. First, he does not present any model of a typical financial intermediation system as Siddiqi or Uzair did. Second, his emphasis is on institutional arrangements which characterize the Islamic financing institutions more as investment institutions rather than typical financial intermediaries. Ahmad (ibid.) 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 seem to agree with the fundamental role of the VRRP of financing. The only exception may be that of al Sadr (1961), who prefers the principles of *ju'alah* and *ijarah* as bases of financial intermediation.

According to al Sadr, banking services could be rendered on the basis of the *ju'alah* principle - contract between the client and the bank for specific service against specific fees. Earlier Qurishi (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 service charge e.g., like the provision of health, education and other social services. The idea also got support from Muslihuddin (see, Siddiqi 1981 p 221) whose understanding of *mudarabah* made him apprehensive about its capability 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's credit can only be financed by *qard* i.e., benevolent loan (see, particularly Siddiqi 1983 pp 155-61). In an Islamic society consumers' 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. Therefore, their simultaneous existence becomes important. The cooperatives can keep their cash balances with the Islamic banks and can earn profits. The banks always maintain a certain part of current accounts in cash form. This can be used as a base for the generation of *qard*.

Irshad (1963) suggested that the Islamic bank shall promote sale on credit for consumption purposes. This will increase demand and the resultant increase in sale could be an incentive for earning profit. It should be noted that this point is dealt with latter in detail particularly by Homoud but with an entirely new perspective.

The natural implication of what has so far been suggested regarding the Islamic principles of financing is that the literature did not attach any significance to debt financing.

Rather in some circles the concept of an Islamic economy was considered as a synonym of a debt free economy (see e.g., 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's credit.

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

i) The VRRP (comprising of mudarabah and *musharakah*) was considered a synonym of Islamic finance. Therefore, it was presented as the only alternative to interest based finance (the two exceptions to this position are al Sadr and Muslehuddin). The potential of sale-based principle are 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 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) became tremendous as consumption was considered to be financed only by this principle.

2.2 Principles of Finance in Perspective of Islamic Banks

With the rise of Islamic banks pioneered by the Dubai Islamic Bank UAE, 1974 and Islamic Development Bank Jeddah, 1975 The practice of Islamic financing principles were initiated. To start their operations, these banks naturally faced tough innovative challenges. Data of early operations undertaken under the Islamic financing principles are available in case of 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, substantially high compared to other modes of operations. This operational mode became popular among the Islamic banks to the extent that in 1984 it covered 84 % of the operations of five Islamic banks on average (see, Ahmad 1986). The operational needs of the Islamic banks attracted the attention of several scholars and induced a number of policy related studies as 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, prominent among these are Homoud (1982) and Ismail (1989). According to Homoud the classical *mudarabah* principle faces the following limitations in its application to the modern needs of financing :

Firstly, the most important characteristic of classical *mudarabah* is its bilateral nature. This characteristic doesn't allow the classical *mudarabah* to satisfy the needs of financial intermediation. The bank has to deal with a large number of depositors and mix their funds together, thus sacrificing this bilateral characteristic. According to Homoud it requires a multilateral or collective *mudarabah* which did not exist in the classical writings. To evolve a collective *mudarabah*, he suggests to benefit from the concept of *al 'amil al mushtarak* (collective employee) e.g., 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*.

Unlike under the "two-tier-*mudarabah*", in the "collective *mudarabah*" the depositor is not liable to any loss where as the intermediary is entitled to profit only for assuming 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) objected 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 remaining surplus is treated as *mudarabah* profit. In a financial intermediation system of today, retiring the investment and distributing profits is an extraordinary exception as it is done on the basis of evaluation of present value of a pool of investment instead of liquidation of bilateral *mudarabah*.

Thirdly, Homoud invites attention to the cases where *mudarabah* is incapable to provide financing e.g., consumer's goods, (durable or non), goods supplied to government and industry, etc.

b. Sale-Based Principle

Although sale-based liability creating finance has been widely used by the Islamic banks, the general principle has only recently been focused in the literature. By studying the differences between the terms *riba*, *bai'* and *dayn* (debt) as they appear in the Holly 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 Holly Qur'an by Ibn al Arabi, al Qurtubi, and al Jassas respectively to determine the meaning of the two verses of the Holly 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 five forms of permissible deferred sales which create deferred obligations viz.:

i) *Salam* sale (price is paid at the time of contract but object of sale becomes due as debt {in kind}),
ii) *Mua'jjal* sale (object of sale is delivered at the contract time but price becomes due as debt),
iii) *Istisna'* sale (price paid at the time of contract and object of sale to be manufactured and delivered later),
iv) *Ijarah* (sale of use rights of assets where assets are delivered to the user, who in turn pays periodical rentals) and
v) *Murabahah li al 'amer bi al shira'* (sale with a known profit; 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 Holly 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

---

[7] However, we should also note that another cause of future obligations is direct borrowing) *qard*) which dominates the contemporary financial system. Borrowing existed among Arabs and Jews at the time of the Prophet (pbuh) as showed by the commentaries of Ibn al Arabi, al Jassas, al Razi and others.

which have been mentioned in the previous verse.

Mark-up Principle (MUP)

Since the publication of Homoud (1982) *murabahah* emerged as a principle distinct from the VRRP of finance. It also became the backbone of contemporary Islamic banking. In his presentation of the *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 (MUP) of finance results from incorporating deferred payment in *murabahah*. In the MUP, the financier benefits from the difference between the immediate and deferred prices of the goods. The MUP 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, financier's claim for return derives its *fiqhi* legitimacy from the fact that the financier owns the subject of sale, for at least some period of time. Such an ownership implies carrying risk and uncertainty. Thus a return is justified on the ground of ownership as well as on the ground of risk in accordance with the principle of *al kharaj bi al daman*.

The mark-up creates a fixed, pre-determined and secure indebtedness. This has made the MUP attractive for the Islamic banks as an alternative to the 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 the mark-up based financing. In fact the final return to the financier is lower than the mark-up price because of the element of risk carried by the financier while the merchandise are in his possession. By the same token the MUP saves the user of funds the risks which he would have otherwise born, 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 mark-up price (see, Khan 1989).

Renting Principle (**Ijarah**)

By separating ownership rights of an asset from its use rights the renting principle (*ijarah*) makes the use of an asset independent from its financing. 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 had 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. However, in the recent literature (e.g., Chapra 1985, Council of Islamic Ideology 1981) the principle has been discussed, but it has not been widely used by the Islamic financial institutions (Ahmad 1987) except IDB (see, particularly 12th Annual Report of IDB).

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

In a hire-purchase form of finance, the client (purchaser of an asset) knows the price of the asset, the bank's profits in the underlying sale transaction as well as the amount of rent to be paid. After paying the principal plus the profit and rents for the relevant period, the client takes over the ownership. In a recent opinion the Islamic Fiqh Academy of the OIC has suggested to refrain from the use of the hire-purchase principle unless appropriate care is made with regard to the provision of extension of the lease period, termination of lease contract, return of the asset to its owner, 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 that he completes all payments. It is understood that the bank's profits in the operation are incorporated in the agreed upon 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 superiority of the former is highlighted.[8] In an interesting study, al Masri (1986) has compared renting with the PSP and suggested that PSP (whether based on output or profit sharing) can also be applied to the durable assets more efficiently than the renting principle.

2.3 Policy Oriented Writings

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 is an exhaustive document jointly prepared by economists, bankers and *Shari'ah* scholars to eliminate interest from a contemporary economy. In preparing this report the Council had the advantage of benefitting from sources of *Shari'ah*, views of Islamic economists and 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 blue print for transforming the banking system in Pakistan yet its general validity is widely acknowledged. In the following lines the salient features of the report are reviewed.

[8] Such a discussion is frequently undertaken in the International Leasing Year Book, particularly see, the 1986 issue of the Year Book.

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 elimination of interest. These included bank safety, sectoral resource allocation, suitability of the proposed modes for different users, etc. The report classified the Islamic instruments of financing into PLS, sale and services based modes.

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

Various variants of the sale-based financing modes were visualized by the report such as *murabahah*, *bai'salam*, hire-purchase, leasing, etc. Lastly, the service-based financing includes: loans on the basis of 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 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 the Islamic banks in understanding the different modes of Islamic financing in contemporary banking perspective.

2.4. Ownership-Cum-Management Approach

Kahf (1991) attempts to present a general framework to interpret Islamic modes of financing. The premises of his attempt is the considerations regarding characteristics of ownership and ways of its integration 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 <u>entitlement of gain</u> is linked to the <u>responsibility for loss.</u>

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 provides the foundation for the concept of financing in Islam.

Accordingly, Kahf calls commercial financing all those techniques which retain managerial authorities to the owner: The owner himself takes all managerial decisions with regard to his assets. Managerial decisions could be spread over a period of time as in *sharikah*

[9] The word "management" used here implies decision making about a property "Mal". However, when an owner takes himself managerial responsibilities, he may do that in person or through an agent who acts on his/her behalf such as a paid employee. In this case the right to take decisions remains in the hands of the owner who may at any time revoke the power he/she bestows on his/her agent.

Alternatively, when management is assigned to somebody else on <u>Mudarabah</u> basis, the <u>Mudarib</u> takes, in his own capacity all the managerial decision given to him on the basis of sharing in any resulting profit.

where the financier becomes a partner and shares in the managerial responsibilities. The financier may also chose to enter in only one managerial decision related to a property he owns by selling it, i.e., by such an act an owner/manager deprives 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 could be termed as "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 share-cropper in *muzara'ah* and *musaqah* is concerned, he takes managerial decisions with regard to properties handed to him similar to those of the working partner in *mudarabah*.

The third category is that of renting where two types of managerial decisions are separated from each other: i) 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). ii) 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 creditor/lender because they are inter-personal obligations not properties, and their repayment is guaranteed by debtors/borrowers (hence creditor/lender has no *ghurm* to carry and thereby 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 manage. & 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 three 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, renting principle was also discussed and applied.

ii) An approach which provides a general explanation of Islamic financing may be found in the implication of the relationship between ownership and management. Whenever one owns a property, one is entitled to its return 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 returns. 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.

III. 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 mark-up 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 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 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 shares of respective factors of production. In a 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. The Islamic economic literature threw interest out as it is prohibited in 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 usufruct rights of fixed assets (rent). Therefore, the question can further be specified: What is profit and how is it different from *ujrah* (rent/wage) and interest?

In the Holly 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 the 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) viz., pastures growing on a 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 either transform an asset to a higher valued one as in the case of manufacturing steel into machines.[10]

In both Islamic economics and *fiqh* literature, physical capital (see, al Masri 1986) and labour may enter the production process either on *ujrah* or 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 labour i.e., an entrepreneur or a working partner/entrepreneur. Profit in the 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 known and fixed return *ujrah*

---

[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 Kasani, *al Badae'*, v.6, p.62 and IBn Qndamah, Al Mughni, v.5, p.p. 114-129.

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 of debt repayment by the reputed party. His share in the enterprise's profit is justified because of this 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 case of partnership, it is then called *sharikat al sanae')*.

Hence the concept of *daman* boils down to a guarantee of certain payment or of certain work, since the guarantee puts the guarantor under 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 labour 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, the 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 the case when one owns a personal obligation, no return is provided for.

(wage) to labour.

A working partner, without any share in capital, can also be the decision maker of the firm and profit becomes his residual after payment of fixed and known return *ujrah* (rent) to physical capital and may be to other working persons whose human inputs are obtained on the basis. By the same token labour or physical capital may select to enter the production process without any decision making responsibility, i.e. either of them can dispose off every bit of uncertainty and risk involved in the production process and restrict its 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. In isolation no flows come out of money through time. Therefore, from the point of view of Islamic economic writings, 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, how could they grow?

Since money has what the *fuqaha* call potentiality of growth only through the process of exchange, it is needed in the production process for making payments to physical capital, labour and intermediate inputs. As money does not posses a flow of services of its own,[12] it can only

---

[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 personal nature and it is inseparable from ownership. Therefore, this satisfaction cannot be rented out.

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 uncertainty and risk inherent in a market economy.[13]

3.2 Basis of Entitlement to Return

The above discussion is helpful to clarify the basic axioms for the justification of return in the Islamic economic thinking. In the following these axioms are summarized with a view to highlight their implications for wage/rent and profit.

i) The first and foremost axiom for 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, such as a machine or a plot of land, the asset could be rented otherwise given on 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 assets which could also be given away on *ujrah* (wage) or 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 assets. 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 like 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.

CONCLUDING REMARKS

---

[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 instance coins, as well as paper currency, may be used for decoration purposes. In such cases, many *fuqaha* argue that it may be given on rent basis.

In the light of some historical evidences from the early period of Islam and contemporary literature a comparative review of the Islamic financing principles has been presented in the paper. Important points have been summarised at the end of each section. In the following some general remarks are made in a way of concluding the paper.

Fixed nature of return on capital was considered as the unique characteristic of interest by most contemporary Muslim economists writing on the subject. As a corollary therefore, the Islamic principle of financing was considered to be based on variable rate of return i.e., profit sharing. Therefore, *mudarabah* has been treated by these scholars as a synonym of Islamic finance and the need for finance has been discussed in this context. This was perhaps the reason of neglecting the financing potential of the sale-based principle of finance and 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 the Islamic financial institutions highlighted the immense financing potential of the sale-based principle where financing results into 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 return on capital invested in pure finance (where ownership is separated from management). However, as sale on deferred basis serves the financial needs of the buyer and seller, it is no wonder that mark-up and renting principles became dominant practice of the contemporary Islamic financial institutions.

Recently, by putting emphasis on 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 where as *musharakah* like trading is investment in real transactions.

Debt (*dayn*), has two primary sources: A non-market source i.e., loan and a market source i.e., sale. The question of return on non-market debt doesn't arise because the cause of the debt is a humanitarian consideration and the question of return on debt created by sale doesn't arise because the return has already been incorporated in the price of the assets traded. Thus once the debt is created, irrespective of its origin the extension of its repayment period can only be non-economic in nature. A debt default doesn't 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 to tackle the numerous financial needs of the society.

BIBLIOGRAPHY

al Abji, Kauther Abdul Fatah (1985), "A Study of Investment Feasibility in the Light of Fiqh", Journal of Research in Islamic Economics, Vol. 2, No. 2, pp1-44.

Ahmad, S. Mahmud (1947), Economics of Islam, Lahore: Sh. M. Ashraf

Ahmad, Ziauddin (1985), Some Misgivings About Islamic Interest Free Banking, Islamabad: IIIE.

Ali, Abdallah Yusuf, Translation of the Meaning of the Holly Qur'an. All quotations from the Qur'an are taken from this translation, sometimes with minor modification to bring closer to the literal meaning of the Arabic text.

Al Amin, Hasan Abdullah, (1985) "Hukm al Ta'amul al Masrafi al Mu'asir bi al Fawa'id," unpublished paper IRTI.

____________________,(1989) al Mudarabah al Islamiyah wa Tatbiqatuha al Haditha, IRTI.

Azhar, Ahmed Rauf, (1987), "A Theory of Investment Decision Making in an Islamic Economy", a paper presented to the Seminar on Teaching Islamic Economics for University Teachers, Islamabad, IIU.

Chapra, M. Umar, (1985) Towards A Just Monetary System Liecester: The Islamic Foundation.

Council of Islamic Ideology Pakistan, (1981) A Report on the Elimination of Riba from the Economy, reproduced in Ahmad, Z., et.al eds., 1983

Islamic Fiqh Academy of the Organization of Islamic Conference (1989) Islamic Fiqh Academy Resolutions and Recommendations, Jeddah.

Habibi, Nadir, (1987) The Economic Consequences of the Interest free Banking Systems, Ph. D. Dissertation Michigan State University

Ibn Hazm, Ali ibn Ahmad (died 456H), no date Al Muhalla, V. 8, Dar al Fikr, Publishers, Cairo.

Homoud, Sami Hasan, (1982) Tatwir al A'mal al masrafiyyah lima yattafiq wa al Shari'ah al Islamiyyah, 2nd ed., Amman.

__________________, (1985) Islamic Banking, London: Arabian Information.

________________, (1987), "The Application of Murabaha Sales From Simple

Investment to the Formation of an Islamic Capital Market, with the Case of Baraka Bank of Bahrian as a Practical Model" Paper presented to the workshop on Investment Strategy in Islamic Banking: Applications, Issues and Problems, Royal Academy for Islamic Civilization Research, Amman.

al Masri, Rafic, (1986), "Participation of Capital Goods in the Produce or the Profit", Journal of Research in Islamic Economics, Vol. 3, No. 1 pp 3-57.

Irshad, S.A., (1963), Interest Free Banking, Karachi: Orient Press of Pakistan 100p.

Ismail, Abdul Halim, (1989), "Al Quran on Deferred Contracts of Exchange: Commentary on Three Verses of Injunctions", paper presented to a workshop on Thoughts relating to Islamic Economic System Based on Shari'ah, Islamic Affairs Division, Prime Ministry, Kuala Lumpur, March 21, 1989.

al Jarhi, Ma'bid Ali, (1983) "A Monetary and Financial Structure for an Interest Free Islamic economy: Institutions, Mechanism and Policy", in Ahmad, Ziauddin et. al., eds., Money and Banking in Islam, Islamabad: IPS & Jeddah: KAAU pp. 69-88

__________________, (1981) "The Relative Efficiency of Interest Free Monetary Economics: The Fiat Money Case", in Ahmad, K., eds., Studies in Islamic Economics, pp 85-118.

Kahf, Monzer (1977), "The Economies of Muslim Minorities" in Outlines of Islamic Economics, Association of Muslim Social Scientists, Indianapolis, Indiana, USA 1977, p.p. 93-117.

___________, (1981) "The Economic Views of Ibn Taymiyyah", al Ittihad, MSA of the US and Canada, Vol. 18, No. 3.

___________,(1978), The Islamic Economy, Indiana: Muslim Trust Publication.

___________, (1991) The Concept of Credit in Islamic Economics, (Arabic) IRTI.

___________ (1988) and Tariqullah Khan, "Alternative Strategies of International Financing", paper presented to the Seminar on Islamic Perspectives on International Economic Relations, Tübigen, W. Germany August-September.

Khan, M. Fahim, (1987) "Value of Time in Islamic Perspective", Mimeograph, IIIE, Islamabad.

______________, (1987b), "Economic Rationality of Islamic Banking", a paper presented to the Seminar on Islamic Banking, University of Loufbrough.

_________________(1989), "Comparative Economics of Islamic Financing Techniques" unpublished IRTI.

Khan, Mohsen S., (1987) "Principles of Islamic Monetary Theory and Policy",

Paper presented to a Seminar on Islamic Economics for University Teachers, Islamabad, 22nd August 3rd September.

Khan, Mohsin S. and Mirakhor, A., (1986) "The Financial System and Monetary Policy in an Islamic Economy", in Theoretical Studies in Islamic Banking and Finance" pp 163-164.

Khan, S. R., (1984) "An Economic Analysis of a PLS Model for the Financial Sector", Pakistan Journal of Applied Economics, Vol. IV, No. 2.

Khan, Waqar Masood, (1985) Towards an Interest Free Islamic economic System: A Theoretical Analysis of Prohibiting Debt Financing, Liecester: The Islamic Foundation.

al Kutub al Sittah, (1981) Istanbul print which contains: Al Bukhari, Muslim, Al Tirmidhi, Al Nasa'i, Abu Dawud, Ibn Majah, Musnad Ahmad and other famous Hadith books, Istanbul.

Al Marghinani, Burhan al Din ibn Abi Bakr (died 593H), (1970) Al Hidayah, printed with Fath al Qadir, V. 8, Mustafa al Babi al Halabi Publishers, Cairo 1970.

Maududi, S.A., (1950) Tafhimul Qur'an Urdu Commentary on the Holly Qur'an; English translation of Vol. 1 by Zafar Ishaq Ansari, Leicester; The Islamic Foundation 1987.

Mirakhor, Abbas and Zaidi, Iqbal, (1987) "Stabilization and Growth in an open Islamic Economy", paper presented to the Seminar on Islamic Economics for University Teachers", Islamabad 1987

Ibn Qudamah, Muwaffaq al Din (died 630H), Al Mughni, V. 4 and 5, Dar al Kitab al 'Arabi Publishers, beirut, 1392H.

Qurishi, Anwar Iqbal (1947), Islam and the Theory of Interest, Lahore: Sh. M. Ashraf

Al Qurtubi, Muhammad ibn Ahmad (died 671H), al Jami' li Ahkam al Qur'an, 3rd printing, Dar al Kutub al Misryyah Publishers, Cairo 1967, V 3.

Ibn Rushd (died 595H; book published 1986), Bidayat al Mujtahid wa Nihayat al Muqtasid, Vol. 2, Beirut: Dar al Tiba'ah.

Saadalla, Ridha, (1986) "Concept of time in Islamic Economics" unpublished paper, IRTI.

Al Sadr, Muhammad Baqir, al Bank al La Ribawi Fir al Islam, al Matba'ah al Asriyyah, Kuwait, no date.

Saleh, A. Nabil (1986), Unlawful Gain and Legitimate Profit in Islam, London: Cambridge University

Al Sarakhsi, Shams al Din (died 286H) Al Mabsut, v. 18, Dar al Ma'rifah, Beirut, without date.

Abu Saud, Mahmud, (1981) "Money Interest and Qirad", in Ahmad, Khurshid (ed.), Studies in Islamic Economics, pp 59-84.

Siddiqi, M. N, (1981) Muslim Economic Thinking: A Survey of Contemporary Economic Literature, Leicester: The Islamic Foundation

_______________, (1983a) Issues in Islamic Banking, Leicester: The Islamic Foundation.

_____________., (1983b) Banking Without Interest, Leicester: The Islamic Foundation.

____________, (1985), Partnership and Profit Sharing in Islamic Law, Leicester: The Islamic Foundation

____________, (1988), "Islamic Banking: Theory and Practice", in Mohammad Ariff ed., baking in South east Asia, Singapore: Institute of Southeast Asian Studies, p.p. 34-67.

Abu Zahrah, Muhammad, (1970) Buhuth fi al Riba, Dar al Buhuth al 'Ilmyyah Publishers, Kuwait.

Zarqa, M.A., (1983) "Stability in an Interest Free Islamic Economy: A note", Pakistan Journal of Applied Economics, 2 2 1983, pp 181-188.

5A:rh