

INTRODUCTION TO
**ISLAMIC
FINANCE**

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Glossary of terms

<i>‘Aqd</i> (plural <i>‘Uqūd</i>)	An agreement between two willing parties to initiate, adjust or terminate a given transaction in a manner binding upon both parties.
<i>‘Asabah</i>	Agnatic heirs/ paternal relations, the second class in the hierarchy of heirs after the Qur’anic heirs.
<i>‘Illah</i>	Legal effective cause. Basis for applying analogy in determining the permissibility or otherwise of a transaction.
<i>‘Uqūd al-Islāmiyyah</i>	Contracts in Islamic Law.
<i>‘Urf</i>	Customary practice.
<i>‘Urūd al-Tijārah</i>	Goods, commodities or articles that are considered as valid subject matter in trade.
<i>Ahl al-Dīwān</i>	People of the <i>Diwan</i> , all persons under the state payroll.
<i>Ahliyyatul- Wujūb</i>	Receptive legal capacity, it refers to the eligibility of a person to acquire rights for or against himself.
<i>Ahliyyatul-Adā’</i>	Active legal capacity, it refers to the eligibility of a person to execute or discharge his rights and duties in the manner recognized by the law.
<i>al-‘Aqd ‘Aqibal-Ibtāl</i>	A voidable contract. It applies to a contract or agreement whereby one of the parties has the option of either continuing with the contract or rescinding it.
<i>al-‘Aqd al-Bātil</i>	A void contract. It applies to a contract which never had any legal existence or effect. It is also applicable to a sale which has a defect in its essential aspects, such as a sale by an insane person, a sale of particular goods which do not exist, or which are incapable of being delivered.
<i>al-‘Aqd al-Fāsīd</i>	An invalid contract. It applies to an agreement whereby the elements of the offer and the conditions of a valid contract are fulfilled, but there are some illegalities involved in the contract.

<i>al- 'Aqd ghair al-Nāfidh</i>	An unenforceable contract either permanently or temporarily.
<i>al-Asl</i>	The foundation of something.
<i>al-Awāridh al-Muktasabah</i>	Voluntary impediments to legal capacity. They originate from an act or the choice of the affected person.
<i>al-Awāridh al-Samāwiyyah</i>	Act of God. Involuntary impediments to legal capacity. They are factors that exist without the affected person's choice.
<i>al-Dararu Yuzāl</i>	A legal maxim that means; Injury shall be removed.
<i>al-Dharūriyyāt al-Khams</i>	The Five Imperatives (protection of life, religion, intellect, lineage and wealth).
<i>al-Ghunm bil Ghurm</i>	A legal maxim that means 'return goes with risk.'
<i>al-Kharāj bi al-Dhamān</i>	A legal maxim that means 'gain accompanies liability for loss.'
<i>al-Māl al-Mustafād</i>	Earned income, such as salaries, wages, professional fees, bonuses, windfalls, up-fronts, inheritance and gifts.
<i>al-Mu'āmalāt al-Islāmiyyah</i>	Transactions in Islamic Law.
<i>al-Mu'āmalāt al-Māliyyah</i>	Financial Transactions.
<i>al-Salam al-Muwāzi</i>	Parallel advance purchase.
<i>al-Ta'āwun</i>	Mutual assistance.
<i>Amānah</i>	The ethical value of trustworthiness and honesty in mutual dealings. It also refers to deposits in trust, where a person may hold property in trust for another.
<i>'Aqd al-Muā'wadah</i>	A contract of exchange in which compensation is given against the goods or services received.
<i>Arkān</i>	Pillars or elements, they are the essential components for the existence of something.

<i>Bāb as-Sadaqah</i>	The gate of voluntary charity, it is one of the eight gates of paradise exclusively reserved for the believers who were benevolent.
<i>Bātil</i>	Void. Something that has no legal existence or effect.
<i>Bay‘ al-‘Īnah</i>	Sale and buy-back - The sale of a commodity for a deferred price and its repurchase for a spot price lower than the deferred price.
<i>Bay‘ al-Dayn</i>	The sale of debt by the creditor to a third party. The debt can be either money or due and described commodities sold in accordance with the <i>Sharī‘ah</i> parameters.
<i>Bay‘ Mu‘ajjal</i>	A contract involving the sale of goods on a deferred payment basis.
<i>Bint Makhād</i>	The camel that has completed one year and has entered into its second year.
<i>Da‘awah</i>	The practice, activity or policy of conveying the message of Islam.
<i>Damān</i>	Contract of guarantee. It is also applicable to a guarantee provided on a debt transaction in the event of a debtor failing to fulfil his debt obligation. It also implies responsibility toward property, entailing bearing the risk of its loss.
<i>Dharar</i>	Harm.
<i>Dharūrah</i>	Necessity.
<i>Dhirār</i>	Reciprocating harm.
<i>Dīnār</i>	A unit of currency, usually a gold coin.
<i>Dirham</i>	A unit of currency, usually a silver coin.
<i>Diyah</i>	Blood money.
<i>Falāh</i>	Success as measured in this world and the hereafter.
<i>Fatwā</i>	A legal ruling on a point of Islamic law given by a qualified jurist in response to a question.

<i>Fiqh</i>	Knowledge of the legal rulings pertaining to conduct, which have been derived from specific evidence.
<i>Fulūs</i> (singular <i>fals</i>)	Money, it is also a monetary unit in certain countries of the Middle East and north Africa.
<i>Ghabn</i>	The reduction or decrease in the buying or selling price, or the difference between the manipulated price and the fair price.
<i>Ghabn fāhish</i>	Abnormally inflated price.
<i>Ghabn yasīr</i>	Slightly abnormally inflated price.
<i>Ghalabah al-Naqdiyyah</i>	Major currency standard.
<i>Ghalabah ath-thamaniyyah</i>	Measuring tool for prices.
<i>Gharāmah</i>	Fine/Financial penalty.
<i>Gharar</i>	Uncertainty.
<i>Gharar fāhish</i>	High or major uncertainty.
<i>Gharar yasīr</i>	Low or minor uncertainty.
<i>Gish</i>	Concealment of defect.
<i>Hadīth</i>	A report of a saying, action or approval of Prophet Muhammad (peace be upon him). It is often used interchangeably with <i>Sunnah</i> .
<i>Hājah</i>	Need.
<i>Halāl</i>	Lawful/permissible.
<i>Hāmish al-Jiddiyyah</i>	An amount paid by the purchase orderer to guarantee the fulfilment of his promise to purchase.
<i>Harām</i>	Unlawful/prohibited.
<i>Hawālah</i>	Contract of Transfer of Debt.
<i>Hibah</i>	The payment of money or transfer of an asset to another party without consideration.
<i>Hīlah</i>	Legal trickery, bypassing legal requirements.

<i>Hilf al-Fudūl</i>	A pact by resolute persons in Makkah, before the advent of Islam, who swore to defend oppressed people.
<i>Ibādah</i>	An act of devotion prescribed by the <i>Sharī'ah</i> .
<i>Ibrā'</i>	An act of a holder of a right resulting in relinquishment, in full or in part, of his/her rights and claims arising from an obligation established as the liability of another party.
<i>Ihtikār</i>	The prohibited practice of purchasing essential commodities, such as food, at the time of need, and storing them in anticipation of price increase.
<i>Ījāb</i>	Offer, in a contract.
<i>Ijārah</i>	A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental.
<i>Ijārah Mawṣūfah fī al-Dhimmah</i>	Forward lease. It is a contract where the lessor leases the usufruct of a specific future asset, which will be delivered by the lessor to the lessee for the latter to acquire the usufruct on a specific date in the future.
<i>Ijārah Muntahiyah bi al-Tamlīk</i>	A lease contract combined with a separate promise from the lessor giving the lessee a binding promise to own the asset at the end of the lease period either by purchase of the asset through a token consideration, or by the payment of an agreed-upon price or the payment of its market value.
<i>Ijārah-wa-Iqtinā'</i>	Similar to <i>Ijārah</i> , except that the customer is able to buy the item at the end of the contract.
<i>Ijmā'</i>	Consensus of all or majority of the leading qualified jurists on a certain <i>Sharī'ah</i> matter in a specific age.
<i>Ijtihād</i>	An exhaustive endeavour by a qualified jurist to derive or formulate a rule on the basis of evidence found in the Islamic sources.
<i>Iqālah</i>	To cancel, to annul or reverse a transaction, normally, in a sale contract where the buyer, for one reason or the other, regrets the transaction after leaving the contractual session. Thus, the agreement of the seller to receive back the commodity and

	return the price to the buyer is technically known as <i>Iqalah</i> .
<i>Istihsān</i>	Juristic equity, a doctrine of Islamic law that allows exception to strict legal reasoning, or guiding choice among possible legal outcomes, when considerations of human welfare so demand.
<i>Istisnā'</i>	A contract of acquisition of goods by specification or order where the price is paid progressively in accordance with the progress of a job.
<i>Istithmār</i>	Investment.
<i>Īydā'</i>	Contract of Bailment.
<i>Jahālah/Jahl</i>	Ignorance, unawareness, lack of knowledge; indefiniteness in a contract.
<i>Ju'ālah/Ji'ālah</i>	Stipulated price for performing a service.
<i>Jumhūr</i>	The majority of jurists in a given matter.
<i>Kafālah</i>	Adding the liability of the guarantor to that of the guaranteed in settling a debt so that it will be established on both of them.
<i>Kafīl</i>	Guarantor/ surety
<i>Kāfīl al-Yatīm</i>	The guardian of an orphan.
<i>Kalimatush-Shahādah</i>	The phrase: "There is no god but Allah, Muhammad is the Messenger of Allah.
<i>Khadamāt</i>	Services.
<i>Khiyār (plural Khiyārāt)</i>	Option or a power to annul or cancel a contract.
<i>Khiyār al-Majlis</i>	The power to annul a contract possessed by both contracting parties as long as they do not separate.
<i>Khiyār al-Shart</i>	A right, stipulated by one or both of the parties to a contract, to cancel the contract for any reason within a fixed period of time.
<i>Khums</i>	A fifth share that is assigned to Allah and His Messenger out of what the Muslims acquire as spoils of war.

<i>Lā dharara wa lā dhirāra</i>	No harm, no foul. Meaning that there should be neither harming nor reciprocating of harm.
<i>Li al-zaman nasīb/hissah min al-thaman</i>	A legal maxim which means ‘time has a share in pricing’.
<i>Ma’din</i>	Minerals.
<i>Maḥsada</i>	That which brings about harm.
<i>Manfa’ah</i> (plural <i>Manāfi’</i>)	Usufruct(s) associated with a given property, especially in leasing transactions.
<i>Maqāṣid al-Sharī’ah</i>	The fundamental objectives of the <i>Sharī’ah</i> , which aim to promote and protect the interests of all human beings and avert all harm that impairs their interests.
<i>Maslaha</i>	Public interest, good or benefit.
<i>Maysir</i>	An ancient Arabian game of chance played with arrows without heads and feathering, for stakes of slaughtered and quartered camels. It came to be identified with all types of hazard and gambling.
<i>Mu’āmalāt</i>	Transactions.
<i>Mu’ātah</i>	Contract by conduct. For instance, where a buyer picks a commodity and pays price or where the seller delivers the commodity and receives the price in return without any expression.
<i>Mubādalatul Arbāh</i>	Profit rate swap.
<i>Mudārabah</i>	A partnership contract between a capital provider and an entrepreneur whereby the capital provider contributes capital to an enterprise or activity that is to be managed by the entrepreneur. Profits are shared based on an agreed sharing ratio, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contractual terms.
<i>Mudārib</i>	The person or party who acts as entrepreneur in a <i>Mudārabah</i> contract.
<i>Mufāwadah</i>	Equal, unlimited ownership.

<i>Mughārasah</i>	An arrangement in which one party presents a treeless piece of land to another to plant trees on it on the condition that they share the trees and fruits in accordance with a defined percentage.
<i>Mukhātarah</i>	Risk-taking, which is defined as the situation that involves the probability of deviation from the path that leads to the expected or usual result.
<i>Murābaha</i>	A sale contract whereby the institution sells to a customer a specified asset, whereby the selling price is the sum of the cost price and an agreed profit margin.
<i>Murābaha li al-āmir bish-shirā</i>	<i>Murābaha</i> to Purchase Orderer arrangement. Under this arrangement, a financial institution, at the request of a client/customer, buys, owns and takes delivery of a specific commodity, and then sells it to the client/customer on <i>Murābaha</i> , deferring payment to a date agreed by the two parties.
<i>Murāwadah</i>	Contract by conduct. For instance, where a buyer picks a commodity and pays price or where the seller delivers the commodity and receives the price in return without any expression.
<i>Musāqāh</i>	Contract of Irrigation. It, legally, refers to giving a worker access to trees that he maintains and waters, with the fruits being shared between the owner of the trees and the worker.
<i>Musāwamah</i>	A kind of sale in which price of the commodity to be traded is bargained between the seller and the buyer without the disclosure of the asset cost price and profit margin to the buyer.
<i>Mushā'</i>	A share that is undivided and completely mixed up with the shares of the other partners, that is, it is to be found in each particle of the joint property.
<i>Mushārah</i>	Partnership.
<i>Mushārah (Sharikah al-'inān)</i>	A form of partnership in which each partner contributes capital and has a right to work for the business, not necessarily equally.

<i>Mushāarakah (Sharikah al-Abdān)</i>	Partnership between two or more parties whereby each partner contributes the work and management (devoid of capital). It is also called <i>Sharikah al-‘amal</i> or <i>al-sanā’i</i> .
<i>Mushāarakah (Sharikah al-‘Aqd)</i>	A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the <i>Mushāarakah</i> contract, while losses are shared in proportion to each partner’s share of capital.
<i>Mushāarakah (Sharikah al-Mulk)</i>	The participation of two or more partners in owning an asset either voluntarily or obligatorily. The profit loss-sharing ratio will be based on the equity of each partner.
<i>Mushāarakah (Sharikah al-Wujūh)</i>	Partnership between two or more parties whereby each partner contributes no capital but their creditworthiness in the society i.e. they obtain goods on credit, sell the goods and share the profit, if any.
<i>Mushāarakah Mutanāqisah</i>	Diminishing Partnership. A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner.
<i>Muslam fih</i>	The purchased commodity in Advance payment contract.
<i>Muslam ilaih</i>	The seller, in Advance payment contract.
<i>Mutlaq ath-thamaniyyah</i>	Absolute position of being a price measure. This refers to the fact that the ‘ <i>illah</i> of <i>ribā</i> that occurs in gold and silver, based on the strongest view amongst the jurists, is due to their values (<i>mutlaq ath-thamaniyyah</i>).
<i>Muwā’adah</i>	Bilateral undertaking under the <i>Sukuk</i> structure.
<i>Muzāra’ah</i>	Sharecropping is a partnership in which one party presents land to another for cultivation and maintenance in consideration for a common defined share in the crop.

<i>Nāfidh</i>	Enforceable (contract).
<i>Naqd</i>	Money, anything that gains general acceptance as a medium of exchange, whenever or wherever that occurs and in any way that it occurs.
<i>Nisāb</i>	Threshold for the payment of <i>Zakāh</i> , which differs for different types of wealth.
<i>Qabd</i>	Taking constructive or physical custody and possession of an asset.
<i>Qabūl</i>	Acceptance, in a contract.
<i>Qard</i>	The payment of money to someone who will benefit from it provided that its equivalent is repaid.
<i>Qard-hasan</i>	A loan contract between two parties for social welfare or for short-term bridging finance. Repayment is for the same amount as the amount borrowed.
<i>Qawā'id</i>	Juristic principles.
<i>Qimār</i>	An arrangement in which possession of a property is contingent upon the happening of an uncertain event. It applies to a situation in which there is a loss for one party and a gain for the other without specifying which party will lose and which will gain.
<i>Qiyās</i>	A derivation of the law on the analogy of an existing law if the basis (<i>'illah</i>) of the two is the same. It is one of the sources of Islamic law.
<i>Qur'ān</i>	The Holy book revealed to Holy Prophet (PBUH).
<i>Ra's al-māl</i>	The capital in a <i>Mudārabah</i> contract.
<i>Rabb al-māl</i>	The person who invests the capital in a <i>Mudārabah</i> contract.
<i>Rabbus-salam</i>	The buyer in Advance payment/ deferred delivery contract.
<i>Rahn</i>	An arrangement whereby a valuable asset is placed as collateral for a debt. The collateral may be disposed of in the event of default.

<i>Ribā</i>	Any increase over principal in a loan transaction as a condition of the loan or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense (<i>‘iwad</i>) in return to the other party.
<i>Ribā al-Fadl</i>	An excess in the exchange of <i>ribawī</i> goods within a single genus. It is also called <i>ribā al-buyū’</i> .
<i>Ribā al-Nasī’ah</i>	An excess required of a debtor to pay to the creditor in consideration for the creditor having granted him more time to pay. It is also called <i>ribā al-duyūn</i> .
<i>Ribā al-Qard</i>	The practice of lending money for any length of time on the understanding that the borrower would return to the lender at the end of the period the amount originally lent together with an increase on it.
<i>Ribawī</i>	Goods subject to <i>Fiqh</i> rules on <i>ribā</i> in sales, variously defined by the schools of Islamic Law: items sold by weight and by measure, foods, etc.
<i>Ribh</i>	Profit, gain or addition.
<i>Rikāz</i>	Buried Treasures.
<i>Sadaqah</i>	Voluntary charity.
<i>Sadaqah Jāriyah</i>	Continuous voluntary charity
<i>Safqah</i>	Hand shake or deal, it signifies the agreement of meeting of minds of the parties to a commercial bargain.
<i>Sahīh</i>	Valid or authentic.
<i>Sā’i</i>	A standard of measurement, and a unit for the people of Madina which equals four times the size of a <i>mudd</i> . (about 653 grams or approx. 6½ bags).
<i>Salam</i>	The sale of a specified commodity that is of a known type, quantity and attributes for a known price paid at the time of signing the contract for its delivery in the future in one or several batches.
<i>Sālih</i>	Valid, right or good.
<i>Sarf</i>	Exchange or small change of money.

<i>Sharī'ah</i>	The practical divine law deduced from its legitimate sources: the <i>Qur'ān</i> , <i>Sunnah</i> , consensus (<i>ijmā'</i>), analogy (<i>qiyās</i>) and other approved sources of the <i>Sharī'ah</i> .
<i>Shibh al-'amd</i>	Quasi-intentional (killing). Where the suspect intended the strike but not the result of death. This is usually determined by the circumstances of the case, or the weapon or implement used in the act, such as a cane, slap or blow.
<i>Sukūk</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is <i>Sharī'ah</i> -compliant.
<i>Ta'wīd</i>	What is paid in compensation for harm resulting from violation of a contract.
<i>Ta'āwun</i>	Mutual assistance.
<i>Tabarru'</i>	It is a donation/gift the purpose of which is not commercial but, rather, seeking the pleasure of Allah. It is also used to describe the amount of contribution that the <i>takāful</i> /retakāful participant commits to donate in order to fulfil the obligation of mutual help in bearing the risks and paying the claims of eligible claimants.
<i>Takāful</i>	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
<i>Tanāzul</i>	Abandonment by a holder of a right, or his representative, of a specific financial right established by the <i>Sharī'ah</i> as the liability of another party, or transferral of its ownership to that party fully or partially, with or without consideration.
<i>Taqṣīt</i>	Installment payment.

<i>Tawarruq</i>	Purchasing an asset with deferred price, either on the basis of <i>Musāwamah</i> or <i>Murābaha</i> , then selling it to a third party to obtain cash.
<i>Tawliyah</i>	Sale based on cost price.
<i>Thaman ‘Ājil</i>	Sale based on advanced price.
<i>Ujrah</i>	Commission or fee. The financial charge for using services.
<i>‘Urbūn</i>	Earnest money - an amount to be taken during signing of the contract, and considered part of the price if the contract is executed, and as compensation in the event, the contract is terminated.
<i>Wa‘d/Wa‘dān</i>	An undertaking by someone to perform an act in the future related to someone else.
<i>Wadhī‘ah</i>	Resale of goods with a discount on the original stated cost.
<i>Wadī‘ah</i>	A contract for the safekeeping of assets on a trust basis and their return upon the demand of their owners. The contract can be for a fee or without a fee. The assets are held on a trust basis by the safekeeper and are not guaranteed by the safekeeper, except in the case of misconduct, negligence or breach of the conditions.
<i>Wakālah</i>	An agency contract where the customer (principal) appoints an institution as agent (<i>wakīl</i>) to carry out the business on his behalf. The contract can be for a fee or without a fee.
<i>Wakālah bil Istithmār</i>	Investment Agency.
<i>Wakīl</i>	Agent.
<i>Waqf</i>	An endowment or a charitable trust set up for philanthropic purposes (usually for education, health, mosques, or for the poor). It involves tying up a property in perpetuity so that it cannot be sold, inherited, or donated to anyone.
<i>Waqf Ahlī</i>	Family endowment, it is the endowment that dedicates its fruits, services or dividends to the

	family members of the endower such as his wives, children, etc.
<i>Waqf Khayrī</i>	Charitable endowment, it is the endowment that dedicates its dividends, services or fruits to charitable institutions of perpetual nature.
<i>Waqf Mushtarak</i>	Joint endowment, it is the endowment that dedicates some part of its benefits to the family members and other dividends to a charitable institution.
<i>Wasīlah</i>	Medium.
<i>Wasiyyah</i>	Bequest or Will. It refers to a gratuitous contract that involves the transfer of ownership of real property or usufruct which takes effect after the death of the testator.
<i>Za'im</i>	Being responsible (surety).
<i>Zakāh</i>	An obligatory financial contribution disbursed to specified recipients that is prescribed by the <i>Sharī'ah</i> on those who possess wealth reaching a minimum amount that is maintained in their possession for one lunar year.

Glossary of acronyms

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ACE	Advisory Committee of Experts
AfDB	African Development Bank
AMC	Asset Management Corporation
ATMs	Automated Teller Machines
AuM	Assets Under Management
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BoD	Board of Directors
BOFIA	Banks and Other Financial Institutions Decree
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CBN	Central Bank of Nigeria
CCM	Conventional Capital Market
CFIs	Conventional Financial Institutions
CG	Corporate Governance
CIS	Commonwealth of Independent States
COMCEC	Standing Committee for Economic and Commercial Cooperation
CRR	Cash Reserve Requirement
CSC	Certificate of <i>Shari'ah</i> Compliance
CSR	Corporate Social Responsibility
DJIMI	Dow Jones Islamic Market Index
DMBs	Deposit Money Banks
DMO	Debt Management Office

ECAIS	External Credit Assessment Institutions
ESG	Environmental, Social and Governance
EU	European Union
FGN	Federal Government of Nigeria
FinTech	Financial Technology
Fis	Financial Institutions
FRACE	Financial Regulation Advisory Council of Experts
FTSE	Financial Times Stock Exchange <i>Shariah</i> Global Equity Index
FX	Foreign Exchange
GCC	Gulf Cooperation Council
GCIBF	General Council for Islamic Banks and Financial Institutions
GDP	Gross Domestic Product
HDI	Human Development Index
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IBFIM	Islamic Banking and Finance Institute Malaysia
ICD	Islamic Corporation for the Development of Private Sector
ICM	Islamic Capital Market
ICT	Information and Communication Technology
IFC	International Finance Corporation
IFDI	Islamic Financial Development Indicator
IFDR	Islamic Finance Development Report
IFIs	Islamic Financial Institutions
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IFSI	Islamic Financial Services Industry
IIFA	International Islamic Fiqh Academy

IIFM	International Islamic Financial Market
IIFs	Islamic Investment Funds
IMF	International Monetary Fund
IMFs	Islamic Mutual Funds
INCEIF	International Centre for Education in Islamic Finance
IOSC	International Organization of Securities Commissions
IoU	I-Owe-You
IsDB	Islamic Development Bank
ISRA	International <i>Shari'ah</i> Research Academy for Islamic Finance
ITFC	International Islamic Trade Finance Corporation
KLSI	Kuala Lumpur <i>Shariah</i> Index
KYC	Know Your Customer
LCs	Letters of Credit
LIBOR	London Inter-bank Offered Rate
MENA	Middle East and North Africa
MESA	Middle East and South Asia
MFBs	Microfinance Banks
MFRS	Malaysian Financial Reporting Standards
MIFC	Malaysia International Islamic Finance Center
MSCI	Morgan Stanley Capital International World Islamic Indices
MYR	Malaysian Ringgit
NAICOM	National Insurance Commission
NDIC	Nigeria Deposit Insurance Corporation
NGN	Nigerian Naira
NGO	Non-Governmental Organization
NIFIs	Non-interest Financial Institutions
OECD	Organisation for Economic Cooperation and Development

OIC	Organisation of Islamic Cooperation
OIFIs	Other Islamic Financial Institutions
PLS	Profit and Loss Sharing
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
REITs	Real Estate Investment Trusts
S&P-SI	Standard & Poor's <i>Shariah</i> Indices
SAB	<i>Sharī'ah</i> Advisory Board
SAC	<i>Sharī'ah</i> Advisory Council/Committee
SCIFs	<i>Sharī'ah</i> -compliant Investment Funds
SEA	South-East Asia
SEC	Securities and Exchange Commission
SMEs	Small and Medium Enterprises
UAE	United Arabs Emirates
UK	United Kingdom
UNDP	United Nations Development Programme
USA	United States of America
USD	United States Dollar
Y-o-Y	Year-on-year

Dedication

We dedicate this book to all those who have contributed, in any way, to the actualisation and development of Islamic finance in Nigeria. May Allah accept and bountifully reward the effort of everyone.

About the Authors

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Uthman has served in several academic and administrative capacities such as Head, Department of Islamic Law, Deputy Dean of Law, Director, Institute of Administration, Director, Centre for Islamic Legal Studies and Member, Ahmadu Bello University Governing Council. He has also served as external examiner for several universities in and out of Nigeria such as Bayero University, Kano, the University of Ilorin, the University of Maiduguri and the International Islamic University of Malaysia. He currently teaches Islamic Constitutional Law to undergraduate students and Islamic jurisprudence and Legal Theory to Ph. D students at his *Alma Mata*, Ahmadu Bello University, Zaria.

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Prior to joining the academic community, he worked in the banking industry for nearly three years. He has participated in many academic conferences and gatherings as a paper presenter in the areas of conventional and Islamic finance, banking and economics in Nigeria, Malaysia, Saudi Arabia and Bangladesh. He has also published a number of papers in academic journals and books in Nigeria and

abroad. He also served briefly as a member of the Advisory Committee of Experts for Halal Takaful Company in Lagos Nigeria. He is currently a reviewer and member of the editorial advisory board of numerous international journals in the area of Islamic banking, economics and finance.

Foreword

It is a pleasure for me to see that this book has been written and is being published widely by the International Institute of Islamic Thought (IIIT) Central Nigeria Office, Abuja. We have waited very long for a book of this nature. It is a practical guide for Muslims wishing to follow Islamic economics and finance paradigms as much as possible in a financial system that does not follow Islamic precepts in most of its basic principles and violates them in many of its practices. I congratulate the authors and pray to Allah to bless them on this accomplishment. They have contributed to breaking the stereotype of talking about Islamic finance without producing a blueprint for it. I appreciate the difficulties that the authors must have gone through to write the book when there are very few actual models of Islamic economics and finance to learn from and some of these models are syncretic combining the Islamic and non-Islamic in an inconvenient marriage.

I consider this book to be among the glad tidings of new economic thinking and new economic systems. It has made a very laudable effort to apply the Islamic system of commercial transactions, *mu'āmalāt*, to a basically capitalist system. The attempt has its strengths and its shortcomings. The shortcomings can be mitigated by more research on the Islamic economic system and by learning from practical experiences of Islamic banking, insurance and investment. The final solution, however, will be developing *de novo* and testing new Islamic economic systems whose implementation may start in a humble way in a geographical area or a defined economic sector. The systems are not utopia; they are a human effort that can be improved with more practical experience. What is needed is persuasion, education, training, conviction and, most importantly, learning from experience within the scope of the purposes of the Islamic Law, *maqāsid al-Sharī'ah*.

An Islamic economic system is based on the moral teachings of Islam and works best if economic practitioners believe in and apply Islamic ethics in all fields. The system cannot survive without an underlying bedrock of faith, *īmān*, and consciousness of Allah, *taqwā*. The system cannot perform well if it is based only on structures and regulations without a supporting Islamic system of social ethics. As an example, a trader in the system is not controlled by pursuit of profit or fear of legal sanctions for business malpractices; he will also be controlled and restricted by Islamic morals and ethics that he has learned by growing up in an Islamic community.

The most important ingredient of an Islamic economic system is a proper Islamic understanding of money and its economic functions. Money as a medium of

exchange was invented early in human history to replace the inefficient barter system. The Islamic concept of money is that of a medium of exchange. The development of economic tools such as usury, *ribā*, changed the function of money from being purely a medium of exchange to being an economic commodity that can be lent or borrowed to make more money not related to specific goods or services. *Pari passu*, the economic expansions in trade and investment have created the phenomenon of ‘virtual’ money in modern economies. Political authorities had realised quite early in human history that money was vital, so they controlled its production and regulated its value. It seems that they are losing this control with the expansion of a virtual economy not limited to government-issued currency. Alternative currencies such as bitcoin are also weakening government control but then who else is in control? It is very important that Muslim economic thinkers research money in more detail and come up with practical solutions.

Finally, it is important to acknowledge the effort of the IIIT Central Nigeria Office, Abuja, for assembling the wonderful resource persons that accomplished the task of writing this all-important book on Islamic Finance. This effort is in line with the Institute’s programme of Research, Seminars and Conferences during the last 43 years.

I look forward to a second edition of this book or a follow up book dealing with theoretical issues that challenge the Islamic economic system.

Professor Omar Hasan Kasule
Riyadh

Preface

In the name of Allah, the Most Gracious, the Most Merciful. All praise is due to Allah, the Most High, the Provider of all prosperity. May His blessings and peace be upon His Messenger, Muhammad, his family, companions and all those who emulate them until the end of times.

In recent decades, the globe has witnessed a paradigm shift from unethical and usurious financial transactions toward an ethical alternative to usurious transactions. At the turn of the twentieth century, Capitalism thrived and multinational businesses dominated by a profit-driven desperation for wealth generation through strategically located subsidiaries in a network of countries spread around the continents. Conventional banks and other financial institutions were and still remain highly usurious. In spite of the fact that Muslims are prohibited from usury and other economically exploitative transactions, they have, for ages, remained trapped within a vicious web of non-compromising debt and interest-based transactions. With the emergence of Interest-free/Islamic banking and finance institutions, Muslims and other ethically-minded persons around the globe have been offered an alternative to the *status quo*. More and more people are turning towards cleaner and more ethical business products.

Today, especially in international business, it would be absurd for one to impose his freedom of contract upon the values and ethics of others. With the ailing of Capitalism, the global financial crises, Brexit, the Corona Virus debacle, and the emergence of BRICS, many countries around the world are coming to grips with the fact that capitalistic economic and political domination of the past has certainly been dealt a crippling blow.

Since the 1960s, the Islamic Banking and Finance (IBF) industry has been expanding tremendously. According to the Islamic Corporation for the Development of Private Sector (ICD) of the Islamic Development Bank Group-LSEG Islamic Finance Development Report, 2023, the total Islamic finance assets have grown by 11% to USD 4.5 trillion in 2022. In Nigeria, the Minister of Finance, Wale Edun, recently, in December 2023, lamented the detrimental impact of high interest rates. He noted that the high interest rate “makes it impossible to access the funds needed for development, infrastructure and even social services.” In wide contrast, he drew attention to a recent USD 30 million grant from the United Arab Emirates dedicated to climate action and adaptation in Nigeria. He referred to Islamic finance as a “veritable tool for financing development.”

Islamic finance has developed out of two main approaches: that of the Arab countries such as Sudan and the Gulf States on one hand; and Malaysia and some European countries on the other. The Malaysian model is more flexible in the sense that many concessions in the form of *al-Hiyal al-Shar'iyah* (legal stratagems) have been recognised to a far greater extent than in the approach of the Arab countries who have a lesser need for drawing concessions as their legal and economic systems are more amenable to Islamic finance principles than in other jurisdictions such as Malaysia that are still labouring under the influence of colonial and conventional policies.

The idea behind this book is to provide a simplified bird's eye view of Islamic finance to readers and other stakeholders. The book comprises eight chapters.

In the first chapter, the reader is given an overview of Islamic Finance, its definition, concept and idea. The nature of currency and how money is not regarded as wealth until it is utilised in conjunction with other resources is discussed. The Islamic, economic, ethical and social objectives of Islamic finance are also discussed. The chapter furthermore discusses the core and auxiliary principles that govern Islamic finance. These are juxtaposed against conventional finance. Finally, an assessment is made of the Islamic finance global outlook up to the year 2022. The section identifies the largest players in the Islamic finance industry and assets and growth statistics for Islamic banking, *Sukūk*, Islamic equity and funds, *Takāful* and Other Islamic Financial Institutions (OIFIs).

The second chapter deals with Islamic Financial Contracts. It commences with a conceptual discourse on financial contracts (*al-Mu'āmalāt al-Māliyyah*) which include the legal framework for contracts, elements of contract and classification of contracts according to their nature, circumstances and legal consequences. The chapter concludes with a brief discussion on the ethics of Islamic contract.

The third chapter covers Islamic Banking. The chapter traces the evolution of Islamic banking right from around the year 1200 in places such as Baghdad, Damascus, Cordova and Fez. It discusses modern IBF that was initiated in the 1960s and the Nigerian legal and regulatory framework for NIFIs. This is followed by a description of some of the Islamic banking products and services along with their various structures. The dimensions of risk analysis in its various forms are also presented along with the challenges facing the IBF industry.

The fourth chapter treats *Takāful* (Islamic Insurance). It discusses the concept, definition and historical development of *Takāful*. Furthermore, it compares Islamic

Insurance with Conventional Insurance; gives an overview of the principles and models of *Takāful*. The *Takāful* services in the forms of Family and General *Takāful* are explained alongside risk management methods.

The fifth chapter covers Islamic Capital Market (ICM). It introduces the idea of Islamic Capital Market, its modes of operation and conditions. The chapter also discusses operational system factors for ICM. Furthermore, ICM is compared with Conventional Capital Market. The chapter then delves into ICM instruments such as *Sharī'ah* compliant stocks/equity securities; Islamic unit trust/mutual funds; Islamic Real Estate Investment Trusts (REITs); Islamic private equity; and *Sukuk*. Furthermore, the chapter gives an overview of regulatory and *Sharī'ah* issues in ICM and introduces discussion into issues in *Sukūk* defaults and their implications and concludes with some suggestion as to the way forward for the *Sukūk* market.

The sixth chapter discusses Islamic Investment Funds (IIF). It commences with a discussion on the concept and distinguishing features of IIF. The chapter then explains the types of investment funds by investment portfolio.

The seventh chapter focuses on Corporate Governance in Islamic finance. It starts with an introduction to *Sharī'ah* and corporate governance for financial institutions, key goals and basis of corporate and *Sharī'ah* governance in Islamic financial institutions (IFIs). The chapter then delves into the structure of *Sharī'ah* governance for NIFIs in Nigeria, the Guidelines on the governance of Advisory Committees of Experts for NIFIs and explains some key sections. Furthermore, *Sharī'ah* standards setting organisations are presented.

The eight chapter focuses on Islamic Social Finance. This system is usually a not-for-profit/charitable effort such as *Zakāh*, *Waqf*, *Sadaqah* and those for mutual cooperation such as loan (*qard*) and guarantee (*Kafālah*). Zakatable items and their thresholds (*nisāb*) for gold, silver and modern currencies, agricultural produce, grazing livestock and cattle, trade goods and assets including company shares and minerals are discussed in detail. The chapter also discusses beneficiaries of *Zakāh* and the circumstances in which a company may pay out *Zakāh* on behalf of shareholders. Similarly, the basis and types of *Waqf* have been discussed. The chapter concludes with a presentation of the importance and benefits of *Zakāh*, *Waqf*, *Sadaqah*, *Qard al-Hasan* and *Kafālah* as vehicles of Islamic Social Finance in society.

For the authors, it is elating to witness its completion. It is hoped that its readership ranging from students, academics, lawyers, judges and practitioners from diverse backgrounds will appreciate the brevity and simplicity of the book in its

presentation and language. After exhaustive effort and research, this work is hereby presented to the world for reading and assessment. We pray that Allah, the Most High, will accept it from us and make it a light for all those who contributed to it in anyway whatsoever.

Professor Ahmad Bello Dogarawa
(Lead Author)

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Finally, special gratitude to all those who have contributed in any way to the completion of this work. May Allah, the Most High, accept it from us.

1

AN OVERVIEW OF ISLAMIC FINANCE

1.1 Introduction

Today, Islamic finance has become an integral part of the global financial system that simply cannot be ignored. Its role in catering for the need of not only the Muslim community but also non-Muslims who wish to pursue their financial activities based on the principles and rules of Islamic law (*Sharī'ah*) cannot be over-emphasised. In this chapter, an attempt is made to define the term Islamic finance, explain its principles and highlight the main differences between Islamic finance and Conventional finance.

1.2 Concept of Islamic Finance

Individuals and organisations need finance in the course of pursuing economic activities as it helps in the production of additional wealth. If financing activity is carried out in the light of the principles and rules of Islamic Law (*Sharī'ah*), it is known as Islamic Finance.

According to the Islamic Development Bank (IsDB), Islamic finance can be defined as "financial activities conducted through a variety of financial contracts that comply with *Sharī'ah* (Islamic law) rules and principles."¹ The International Monetary Fund (IMF) defines Islamic finance as "the provision of financial services in accordance with the principles and rules of Islamic Law (*Sharī'ah*)."² The Bank of England defines it as "a way to manage money that keeps within the moral principles of Islam."³ On his part, Suleiman defines it as "a system based on advancing society, and ourselves, from the degradation resulting from desires, greed, and selfishness, to a society that moves away from the mindset of scarcity and competition towards a mindset of abundance and mutual benefit."⁴ Islamic

¹ Islamic Development Bank (n.d.). Islamic Finance Advisory and Technical Assistance: Expanding into New Frontiers. *Digest*, <https://www.isdb.org/sites/default/files/media/documents/2021-03/NEW%20Final%20English%20Digest.pdf>.

²The International Monetary Fund (2017). Islamic Finance and the Role of the IMF. <https://www.imf.org/external/themes/islamicfinance/>.

³Bank of England. What is Islamic finance? <https://www.bankofengland.co.uk/knowledgebank/what-is-islamic-finance>.

⁴ Suleiman, H. (2020). Defining 'Islamic Finance'. Available at SSRN: <https://ssrn.com/abstract=3721663>

finance is therefore a system of financing activity that complies with the *Shari'ah* and its practical application through the development of Islamic economics.

Central to Islamic finance is how money is conceptualised. Although money can take a variety of forms, it can be broadly classified into two types: money that has intrinsic value such as commodity money, and money that does not have intrinsic value such as representative or fiat money. Commodity money is a type of money that has intrinsic value because it is made from a valuable thing such as gold, silver, or other precious metals, which are used for purposes other than money. The intrinsic value of commodity money is the inherent value that comes from it “in itself,” or “for its own sake” due to its rarity, durability, and widespread acceptance as a store of wealth.

In contrast, representative money has no intrinsic value but represents something of value such as gold or silver, in which it can be exchanged. Fiat money including paper currency also lacks intrinsic value and is established as a legal tender by government regulation and accepted based on the creditworthiness of the issuing government.⁵ In figures 1-7, some images of gold and silver coins, and gold *dīnār* and silver *dirham* are presented.

Figure 1: Gold Coins



Source: <https://www.dreamstime.com/photos-images/gold-coins.html>



Source: <https://www.dreamstime.com/stock-photos-money-gold-coins-pile-stack-image3579703>

⁵ Sullivan, A. & Sheffrin, S. M. (2007). *Economics: Principles in Action*. Pearson Prentice Hall, Upper Saddle River, pp. 246-248.

Figure 2: Silver Coins



Source: https://www.123rf.com/photo_69918249_ancient-silver-islamic-coins-with-arabic-letters-selective-focus-vertical-closeup.html

Figure 3: Mix of Ancient Gold and Silver Islamic Coins



Source: https://www.123rf.com/photo_69918238_mix-of-ancient-golden-and-silver-islamic-coins-closeup-selective-focus.html

Figure 4: Umayyad Gold Dīnār and Silver Dirham



Source: <https://www.pinterest.com/pin/318629742363715019/>
<https://coinsweekly.com/the-most-expensive-islamic-coin/>
<https://www.sovr.co.uk/products/umayyad-silver-dirham-fil-ah79-bm01571>

Figure 5: Abbasid Gold Dīnār and Silver Dirham

Abbasid, Gold Dīnār, AH166.

Abbasid Coins (750-1258CE)



Abbasid, Harun Al-Rashid, gold Dīnār, AH189/805CE

Early Abbasid Silver Dirham 750-800CE



Source: <https://www.baldwin.co.uk/product/abbasid-harun-al-rashid-gold-dinar-ah189-805-ad/>

Figure 6: Ayyubid Gold Dīnār

Ayyubid, 'Uthman, 1193-1198 AD, Gold dīnār

Ayyubid, Abu Bakr I, 1196-1218 AD, Gold dīnār



Ayyubid, al-Kamil Muhammad I, 1218-1238 AD, Gold dīnār



Source: http://www.ancientresource.com/lots/islamic_arabic/islamic-persian-gold-coins.html

Figure 7: Copper Coins (*fulūs*)



Source: <https://en.wikipedia.org/wiki/Fals>

Under Islamic finance, fiat money is used both as a medium of exchange and store of value but it is not regarded as a commodity. It cannot therefore be sold at a price higher than its nominal value and also cannot be rented out. Accordingly, it is not permissible to lend money to, or receive money from, someone and expect interest (known as *ribā*). To make money from money without combining it with other resources for productive use through legitimate trade and investment is forbidden. This means the concept of time value of money as conceptualised and operationalised in conventional finance is not in conformity with the *Sharī'ah*. In conventional finance, time value of money and its application in borrowing and lending arrangements in the form of a predetermined increment on the loan principal are recognised.⁶ This means that, in Conventional finance, money held at hand without combining it with other resources to undertake a productive venture is considered as capital which, by itself, can produce money.

In contrast, Islam considers money that is being held at hand not yet capital but potential capital. It is when the money is combined with other resources to undertake productive activities that it becomes capital.⁷ On the basis of the above, in Islamic finance unlike its conventional counterpart, time value of money is only allowed in business and trading transactions. A genuine framework exists for converting money to assets from which time value of money may then apply and

⁶Ahmad, A. U. F. & Hassan, M. K. (2006). The Time Value of Money Concept in Islamic Finance. *The American Journal of Islamic Social Sciences*, Vol. 23, Number 1, p. 66.

⁷ Yusuf, O. T. (2019). The Time Value of Money Concept: Did Islamic Finance get it Wrong? <https://www.linkedin.com/pulse/time-value-money-concept-did-islamic-finance-get-wrong-toyeeb/>.

be claimed through profit or loss sharing (PLS) mechanisms as in partnerships and price differentials or sale-like transactions such as *Murābaha* (mark-up/cost-plus transaction), *Salam* (advanced payment and deferred delivery based transactions) and *Ijārah* (lease-based transactions).⁸ The recognition of time value of money in pricing of assets and their usufruct in Islamic finance is premised upon a number of statements made by many early Muslim scholars⁹ and a popular *fiqh* maxim that says, time has a share in pricing (*li al-zaman nasīb/hissah min al-thaman*).¹⁰

Islamic finance offers opportunity to people who wish to adhere to *Shari'ah* principles or simply want to be ethical in their financial dealings to trade securely, invest for growth and access ethical finance. It can play a vital role in the economic development of countries by facilitating the mobilisation of dormant savings that are being intentionally kept out of interest-based financial institutions in order to channel them to productive use using different *Shari'ah* compliant financing modes. It can also facilitate the development of capital markets in both Muslim and non-Muslim countries. Furthermore, Islamic finance has what it takes to contribute to the pursuit of the Sustainable Development Goals (SDGs) and to general development because inclusion, fairness, accountability and sustainability are all embedded in its principles.¹¹

Islamic finance has clear objectives. Lone¹² categorised the objectives of Islamic finance into four namely; Islamic, economic, ethical, and social objectives. According to him, Islamic finance is governed through well-defined principles which are geared towards spreading justice and welfare in the world for human

⁸ Ibid.

⁹ Such as Al-Kasānī's statement, "the price may be increased based on deferment;" Ibn Rushd's statement, "he has given time a share in the price;" Al-Nawawī's statement, "deferment earns a portion of the price"; and Ibn Taymiyyah's statement, "deferment takes a share of the price." See also Ahmad, A. U. F. & Hassan, M. K. (2006). The Time Value of Money Concept in Islamic Finance. *The American Journal of Islamic Social Sciences*, Vol. 23, Number p. 75.

¹⁰ Kaḥf, M. M. (2011). *Asāsiyyāt al-Tamwīl al-Islāmī. International Shari'ah Research Academy for Islamic Finance*, Kuala Lumpur, p. 73. For a good illustration, also see Abdul Khir, M. F. (2013). The Concept of the Time Value of Money: A *Shari'ah* Viewpoint. *International Journal of Islamic Banking & Finance*, Vol. 3, Issue 2, pp. 1-15.

¹¹ Ahmed, H., Mohieldin, M., Verbeek, J. & Aboulmagd, F. (2015). On the Sustainable Development Goals and the Role of Islamic Finance. World Bank Group Policy Research Working Paper 7266, <https://openknowledge.worldbank.org/bitstream/handle/10986/22000/On0the0sustain0e0of0Islamic0finance.pdf?sequence=1&isAllowed=y>.

¹² Lone, F. A. (2016). *Islamic Banks and Financial Institutions*, Palgrave Macmillan Studies in Banking and Financial Institutions book series, p. 75.

beings. The principles, which are said to govern Islamic finance, are the principle of equity, the principle of participation and the principle of ownership.¹³ These principles are based on the dos and don'ts contained in the *Qur'ān* and *Sunnah* to guide the smooth conduct of business activities. The Islamic objective of Islamic Financial Institutions (IFIs) is to adhere to the principles that guarantee the spread of justice and welfare. Any financial institution that deviates from this is not considered *Shari'ah* compliant in the real sense even if the "Islamic" prefix is attached to its name.

Islamic finance is also characterised by economic objectives. Like their conventional counterpart, IFIs are profit making organisations. They are not charitable institutions; they work towards the same goal of making profit as conventional banks, but they are required to adhere strictly to the principles of the *Shari'ah*. The economic objective of IFIs therefore is to pursue the goal of profit maximisation but within the boundary of Islamic principles. They also have to compete with conventional financial institutions in order to keep pace with them as far as quality products and services and rates of return are concerned and to continue to exist as going concerns. Some scholars have identified a number of activities that relate to economic objectives which IFIs are required to achieve. These objectives include boosting all forms of deposits, improving the quality of customer services, expanding the base of financial products and services, protecting capital, offering viable and competitive financial products, and providing humanitarian and social services.¹⁴

Islamic finance prescribes some social objectives that IFIs are required to achieve. In Islam, mankind is considered one family; all members of this family are equal before Al-Mighty Allah their Creator. In the sight of Allah, the rich are not superior to the poor, the high is not better than the low, and no discrimination is allowed due to race or colour or position. According to the teachings of Islam, the only criterion

¹³Hussain, M., Shahmoradi, A. & Turk, R. (2015). An Overview of Islamic Finance. IMF Working Paper WP/15/120. International Monetary Fund.
<https://www.imf.org/external/pubs/ft/wp/2015/wp15120.pdf>.

¹⁴Ibid, p. 76.

of a man's worth is the fear of Allah,¹⁵ character,¹⁶ and service to humanity.¹⁷ As organisations that do not exist in a vacuum, IFIs are required to be socially responsible and to concentrate on social objectives in view of their importance to the development of the Islamic finance industry. The social objectives of finance include helping in alleviating poverty (poverty reduction), promoting sustainable development projects, contributing to social welfare and contributing to removing society's inequalities and improving the general standard of living.¹⁸

In Islam, businesses are governed by divine principles covering values such as fairness, equality and morality. In Islamic finance, risk sharing is an essential element based on the principle of "(entitlement to) profit is accompanied by responsibility."¹⁹ What this means is that a person has the right to profit only when he takes up the burden of bearing risk. Again, interest payment or receipt is not allowed. In the same vein, speculation, gambling activities and activities associated with excessive risk levels are all prohibited. These are ethical objectives. The wisdom behind them is to realise fairness, social justice and moral values. In the light of the above, IFIs are required to conduct their businesses on the basis of fairness and integrity, equity, honesty, truthfulness and fair dealing.²⁰

From the Islamic point of view, transactions in business and trade should be characterised by fairness, equity, transparency and justice. The aim of Islamic finance in this regard is to make society a fair, equitable and better place to live for everyone. In this regard, Islamic financial institutions are required to operate within the purview of Islamic law. At the same time, IFIs are required to work towards profit maximisation by achieving a good percentage of return to investors; providing employment opportunities; minimising the cost of operations; enhancing product and service quality; offering viable and competitive financial products; and offering a complete service as an alternative finance system.

¹⁵ *Qur'ān*, 49:13.

¹⁶ This is based on a number of *Hadīth* that include the Prophet's (peace be upon him) saying, "the best of you is the one who has the best character." (Transmitted by Al-Bukhārī in *Al-Adab al-Mufrad*, Book 14, *Hadīth* 271.) The Prophet (peace be upon him) also said: "the best of you in Islam is the best of you in character when they possess understanding (of the religion)." (Transmitted by Al-Bukhārī in *Al-Adab al-Mufrad*, 14, *Hadīth* 285.)

¹⁷ This is based on the *Hadīth*, "the best of mankind is the one who is more beneficial to them." (Transmitted by At-Tabarānī, 5787.)

¹⁸ Lone, F. A. (2016). *Islamic Banks and Financial Institutions*, Palgrave Macmillan Studies in Banking and Financial Institutions book series, pp. 78-79.

¹⁹ The principle is derived from the *fiqh* legal maxim, "*Al-Ghunm bi al-ghurm*."

²⁰ Lone, F. A. (2016). *Islamic Banks and Financial Institutions*, Palgrave Macmillan Studies in Banking and Financial Institutions book series, pp. 79-82.

Ahmad²¹ identifies the following number of advantages of Islamic finance:

- (i) Efficient allocation of resources to profitable and more productive use of capital that will lead to promotion of economic growth, equitable distribution of wealth and employment generation;
- (ii) Information cost saving through partnering with the entrepreneur or firm;
- (iii) Debt burden reduction through encouraging conversion of debt into equity;
- (iv) Promoting ethical behaviour;
- (v) Reduction in run-on-deposits since Islamic financial institutions (IFIs) use profit and loss sharing (PLS) to mobilize resources;
- (vi) Less likelihood of flight of capital;
- (vii) Reduction in speculative transactions;
- (viii) Reduction of inflationary pressures; and
- (ix) Reduction in unproductive use of borrowings since, under PLS, lending is directly related to project appraisals and feasibility.

1.3 Principles of Islamic Finance

Islamic finance is based on some principles that distinguish it from its conventional counterpart. Four main principles and three auxiliary ones are identified and discussed in the following sub-sections:²²

1.3.1 Prohibition of Interest (*ribā*)

Ribā, also called interest or usury, is a term that literally means “excess” and “increase” or “addition.”²³ It is defined according to Islamic terminology as “any unjustifiable increase of capital whether in loans or sales” or “any positive, fixed, predetermined rate tied to the maturity and the amount of principal regardless of the performance of the investment.”²⁴

²¹ Ahmad, S. (2004). Islamic Banking and Finance in the Contemporary World, pp. 22-23, available at www.biharanjuman.org/Dissertation_XLRI-Islamic_Finance_Shakeel_Ahmad.doc.

²² Most of the information in this section was taken from Dogarawa, A. B. (2013). Principles of Islamic Banking. *Readings in Islamic Banking and Finance*, 60-75.

²³ This is based on Q22:5 and 2:276.

²⁴ Greuning, H. & Iqbal, Z. (2008), *Risk Analysis for Islamic Banks*, World Bank Publication, Washington D.C. p.7.

Under Islamic finance, it is forbidden to charge, pay or receive interest. The system does not recognise the time value of money where money gives birth to money by charging interest through lending activities. Rather, money must be used to create real economic value and it is only permissible to earn a return from investing it in *Shari'ah*-permissible commercial activities that will make the financier or investor take some commercial risk.

It should be noted that the *Qur'an* and the *Sunnah* have not altogether forbidden all types of excess; as it is present in trade as well, which is permissible. In the *Qur'an*, a clear distinction is made between the excess in capital resulting from sale and excess resulting from interest. The first type of excess that results from sale is called profit and is permissible. The second type of excess is called *ribā* or interest and is forbidden.²⁵ Accordingly, two main types of *ribā* namely, *ribā al-duyūn* (loan-based interest) and *ribā al-buyū'* (trading or exchange-based interest) are identified in Islamic literature.

Loan-based interest is further classified into two. The first category, which is referred to as *ribā al-qard* is described as a predetermined or pre-agreed increment in money lent whether in kind or cash over and above the principal amount. The most common example is taking a loan from a conventional bank. The bank gives a loan, and the borrower conditionally repays the money at a later date with a pre-determined or pre-agreed percentage increase over the original amount. Other examples of *ribā al-qard* in modern financial transactions are interest on savings accounts/fixed deposits, interest on government bonds and treasury bills, interest on other debt instruments such as debenture and credit cards. The second category is called *ribā al-nasī'ah*, which represents an increase in the amount to be paid due to delay in time of repayment of a debt obligation.

It is allowed for a borrower to pay to the lender an optional gift or increase during loan repayment provided it is not pre-agreed or stipulated by the lender but something coming out of the good will of the borrower to show gratitude. This is in line with what the Prophet's companion, Jabir bin Abdullah (may Allah be pleased with him), said: "I went to the Prophet while he was in the Mosque. After the Prophet told me to pray two *raka'āt*, he paid me the debt he owed me and gave me an extra amount."²⁶

²⁵ In *Qur'an*, 2:275, Allah the Most High says, "Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, 'Trade is [just] like interest.' But Allah has permitted trade and has forbidden interest."

²⁶ *Sahīh al-Bukhārī*, Vol. 3, Book 41, Hadīth 579.

The second type of *ribā* occurs in trading and exchange transactions. It is further classified into *ribā al-fadhl* (excess-based interest) and *ribā al-nasī'ah* (postponement/deferred-based interest).

On one hand, *ribā al-fadhl* arises from unequal exchange of certain homogeneous commodities commonly referred to as *amwāl ribawiyyah* (*ribā* related commodities) such as gold, silver, barley, dates, salt, wheat, etc. For example, exchanging 2kg of dates for 3kg of dates, on a particular day, at the same time, or exchanging ₦10,000 for ₦10,100. The excess of 1kg dates or ₦100 is *ribā al-fadhl*. The basis of prohibition of this type of *ribā* is contained in the following *Hadīth*: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell or exchange as you wish, provided that the exchange is hand-to-hand."²⁷ Also, 'Ubādah bin as-Sāmit (may Allah be pleased with him) stood up to deliver a speech and said: "O people, you have invented (various) kinds of transactions, I do not know what they are, but make sure it is gold for gold, of the same weight, or silver for silver, of the same weight. There is nothing wrong with selling silver for gold, hand to hand, giving more silver than gold, but no credit is allowed. When you sell wheat for wheat and barley for barley, it should be measure for measure, but there is nothing wrong with selling barley for wheat, hand to hand, giving more barley than wheat, but no credit is allowed. And when you sell dates for dates, it should be measure for measure". And he mentioned salt, "measure for measure; and whoever gives more or asks for more has engaged in *ribā*."²⁸

On the other hand, *ribā al-nasī'ah* takes place when two *ribawī* commodities are exchanged, one immediately and the other with a delay. The basis of prohibition of this type of *ribā* is contained in the two *Ahādīth* quoted above. Both of them mention that, for homogeneous commodities (commodities of the same kind and same basis) such as gold and gold, silver and silver, dates and dates, the exchange should be like for like, equal for equal, and hand-to-hand. However, if the commodities are heterogeneous (i.e. different in kind and basis) such as gold for silver or wheat, or barley for dates, then the parties may sell or exchange as they wish, provided that the sale or exchange is without delay or postponement.

For example: two parties agree to exchange 50kg of wheat for 50kg of wheat or \$10 for ₦15,000 such that the former is handed over immediately and the latter is to be delivered five days from the date of the transaction. This is not permissible because, in the first scenario, even though the exchange is like for like and equal

²⁷*Sahīh Muslim*, Book 10, Hadīth 3853.

²⁸*Sunan an-Nasā'ī*, Vol. 5, Book 44, Hadīth 4567.

for equal due to the homogeneity of the commodities, it is not hand-to-hand. In the second scenario, even though it is not required that the sale or exchange should be like for like and equal for equal since the commodities are heterogeneous, it is required to be hand-to-hand. This means that *ribā al-nasī'ah* happens because of the deferment at the time of the exchange.

Throughout its succeeding history of about four thousand years, interest has been variously condemned and declared prohibited by the religious institutions of Judaism,²⁹ Christianity³⁰ and Islam, on one hand, and Western philosophers such as Plato, Aristotle, Catos, Cicero, Seneca, Plutarch, ancient politicians and various modern socio-economic reformers on the other hand.³¹ The declaration of its prohibition was mainly on moral, ethical, religious and legal grounds.

The *Qur'ān* condemns interest (*ribā*) in unequivocal terms. It discusses the subject of *ribā* in a total of 12 verses. The word *ribā* occurs in eight places in the *Qur'ān*.³² In addition to the *Qur'ānic* verses, many statements of the Prophet (peace and blessings of Allah be upon him) condemn and clearly indicate the prohibition of *ribā*.³³

Looking at the *Qur'ānic* verses on *ribā* sequentially,³⁴ one would see that, in the first instance, charity is preferred to the gift given in the hope of getting an increase

²⁹ See for example, Deuteronomy 23:19-20; Exodus 22:25; Leviticus 25:36-37; Jeremiah 15:10; Ezekiel 18:8, 18:13, 22:12; Proverbs 28:8; Psalms 15:5; and Nehemiah 5:7. In addition to some Jewish *talmudic* provisions that confirm the prohibition of interest, the 1912 Jewish Encyclopaedia compared the money-lender to a murderer who the *Mishnah* disqualifies from giving evidence in a court of law.

³⁰ In Christianity, the provisions of the Old Testament *vis-à-vis* interest are sustained. In addition, a New Testament reference contained in the book of Luke 6:35 can be added to reemphasise the prohibition of interest. Early Christian Councils used to disallow interest and ask all Christians to refrain from indulging in interest-bearing transactions. For example, in 1179, the Third Lateran Council upheld that those who obviously deal in interest shall not be admitted to communion, and if they die in their sin of collecting interest, shall not receive Christian burial.

³¹ Visser, W. A. M. & McIntosh, A. (1998). A Short Review of the Historical Critique of Usury. *Accounting, Business and Financial History*, Vol. 8, No. 2, pp. 176-177.

³² The word occurs three times in 2:275; once each in 2:278, 2:279, 3:131, 4:161 and 30:39.

³³ The analysis of *Qur'ānic* verses on *ribā* was taken from Dogarawa, A. B. (2013). Principles of Islamic Banking. *Readings in Islamic Banking and Finance*, 60-75.

³⁴ Engku Ali, E. R. A. (n.d.). *Ribā* and its prohibition in Islam. Centre for Research and Training. <https://www.maybank2u.com.my/iwov-resources/islamic-my/document/my/en/islamic/scoe/knowledge-centre/research-paper/riba-and-its-prohibition.pdf>.

in return. According to the *Qur'ān*, the former multiplies in blessing and reward while the latter attracts no blessing. Allah (the Most High) says: “And that which you give in gift³⁵ (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allah; but that which you give in countenance, then those, they shall have manifold increase.”³⁶

Secondly, Allah (the Most High) condemns the Jewish practice of consuming *ribā* despite the clear prohibition on that. He says: “For the wrong doing of the Jews, We made unlawful for them certain good and pure foods which had been lawful for them – and their hindering many from Allah’s Way. And their taking of *ribā* (usury) though they were forbidden from taking it, and their devouring of men's substance wrongfully (bribery). And We have prepared for the disbelievers among them a painful torment.”³⁷

In the third instance, a strong warning has been given to believers to desist from interest or face the consequence of being thrown into the hellfire that has been prepared for the disbelievers. Allah (the Most High) says: “O you who believe, do not consume interest, doubled and multiplied, but fear Allah that you may be successful. And fear the Fire, which has been prepared for the disbelievers.”³⁸

Thereafter, the *Qur'ān* declares that those who consume *ribā* are like the insane person who resorts to all kinds of immoderate acts due to his state of mind. It further makes it clear that *ribā* is different from legitimate business transactions and that the former is destroyed while the latter receives increase from Allah. Allah (the Most High) says: “Those who consume interest cannot stand (on the Day of Resurrection) except as one stands who is being beaten by Satan into insanity. That is because they say, ‘Trade is (just) like interest.’ But Allah has permitted trade and has forbidden interest. So, whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns (to dealing in interest or usury) those are the companions of the Fire; they will abide eternally therein. Allah destroys interest and gives increase for charities. And Allah does not like every sinning disbeliever.”³⁹

³⁵ This is the interpretation of Ibn Abbas, Mujahid, Dahhāk, Qatādah, Ikrimah and others. See Ibn Kathir’s commentary for details.

³⁶ *Qur'ān*, 30:39.

³⁷ *Qur'ān*, 4:160-161.

³⁸ *Qur'ān*, 3:130-131.

³⁹ *Qur'ān*, 2:275-276.

Finally, the *Qur'ān* declares that those who take *ribā* are at war with the Almighty Allah and His Prophet (peace and blessing of Allah be upon him), and calls such people to repentance if they truly are believers. Allah (the Most High) says: “O you who believe, fear Allah and give up what remains of interest, if you should be believers. And if you do not, then be informed of a war from Allah and His Messenger. But if you repent, you may have your principal sums – (thus) you do no wrong (to others), nor are you wronged.”⁴⁰

In addition to these *Qur'ānic* verses, the Prophet (peace and blessings of Allah be upon him) made a number of statements concerning interest. The following are some of his statements on interest recorded in various books of *Hadīth* with authentic chains of narration:

1. “Avoid the seven destructive sins: associating partners with Allah, sorcery, killing a soul which Allah has forbidden— except through due course of the law, devouring interest, devouring the wealth of orphans, fleeing when the armies meet, and slandering chaste, believing, innocent women.”⁴¹
2. The Companion, Jābir (may Allah be pleased with him), said: “The Messenger of Allah (peace and blessings of Allah be upon him) cursed the one who takes interest, the one who pays interest, the witnesses to it and the recorder of it. Then he said, “They are all the same.”⁴²
3. “One coin of interest that is knowingly consumed by a person is worse in Allah’s sight than thirty-six acts of illegal sexual intercourse.”⁴³
4. “*Ribā* is of seventy-three types, the least of which equals one having sexual intercourse with his own mother.”⁴⁴
5. “If illicit sexual relations and interest openly appear in a town, they have opened themselves to the punishment of Allah.”⁴⁵

⁴⁰*Qur'ān*, 2:278-279.

⁴¹Sahīh al-Bukhārī, Vol. 4, Book 51, Hadīth 28.

⁴² Sahīh Muslim, Book 22, Hadīth 132.

⁴³ Musnad Ahmad, 36/288.

⁴⁴ Sunan Ibn Mājah, Vol. 3, Book 12, Hadīth 227.

⁴⁵Hakim, 2261.

6. “Interest - even if it is a large amount - in the end will result in a small amount.”⁴⁶

It is in the light of the above quoted *Qur’ānic* verses and statements of the Prophet (peace and blessings of Allah be upon him) that many scholars opine that the warning against involvement in interest is so stringent that it cannot be equated with warnings against other immoral acts such as fornication, adultery, homosexuality, consuming alcohol and murder. In fact, Jamaluddīn Zarabozo⁴⁷ even quotes Sayyid Qutb as saying, “No other issue has been condemned and denounced so strongly in the *Qur’ān* as has usury.” Umar Chapra argues that while the *Qur’ān* and *Hadīth* prohibit interest in unequivocal terms, no distinction was made between interest and usury, and even a small gift is not allowed as a condition for a loan.⁴⁸

Explaining the rationale for the prohibition of interest, Askari, Iqbal and Mirakhor wrote:

Prohibition of *ribā* is based on arguments of social justice, equality, and property rights. Islam encourages the earning of profits but forbids the charging of interest because profits, determined *ex post*, symbolize successful entrepreneurship and creation of additional wealth whereas interest, determined *ex ante*, is a cost that is accrued irrespective of the performance of the business and may not create wealth if there are losses. The argument is that social justice demands that borrowers and lenders equitably share rewards as well as losses and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity.⁴⁹

1.3.1.1 *Ribā* in Paper Money (Banknotes and Coins)

It is important at this juncture to explain the concept of paper or fiat money, which occurs in the modern time in form of banknotes and coins, and to examine the

⁴⁶ Sunan Ibn Mājah, Book 11, Hadīth 66.

⁴⁷ Interest and Its Role in Economy and Life, p. 7. Available at <http://www.islamreligion.com>.

⁴⁸ Chapra, U. (2007). The case against interest: is it compelling? *Thunderbird International Business Review*, Vol. 49, Issue 2, pp. 161-186.

⁴⁹ Askari, H., Iqbal, Z. & Mirakhor, A. (2009). New Issues in Islamic Finance and Economics: Progress and Challenges. Singapore: John Wiley & Sons, p. 9.

applicability of *ribā* in it. This is important because there are still some misconceptions being propagated by the opponents of modern Islamic finance.

According to Ibn Manī',⁵⁰ money (*naqd* in Arabic) is "anything that gains general acceptance as a medium of exchange, whenever or wherever that occurs and in any way that it occurs." The word "anything" implies "whether it is intrinsically valuable, e.g., gold and silver or whether its value is due to external factors imposed in order to avoid chaos, as is the case with paper money."⁵¹

The above definition of money is in line with Imam Mālik's statement in *Al-Mudawwanah*, "If the people were to agree amongst themselves on using skins (as money) such that these were made into coins and monetary units, I would dislike these to be sold for gold and silver with deferred payment."⁵² It is also in line with Imam al-Ghazālī's statement that money is "whatever is agreed or accepted to be considered as such, even if it were pieces of stone or wood."⁵³

Paper money itself has undergone four developmental phases, beginning from when it was treated as a letter of declaration in substitute of money or receipt of debt (bank money), to its treatment as gold value backed money, to the phase when it was seen as a means of payment (when *fulūs* was in use), to the fourth and its last developmental phase during which it has been accepted as a complete substitute for gold and silver and an independent type of money in form of bank notes and coins.⁵⁴

Money is therefore whatever is generally accepted as a medium of exchange, whether its value is intrinsic or extrinsic (or a mixture). One of the secrets of the validity of paper money is the fact that its value is not intrinsic but guaranteed by government. The confidence the public has in paper money as a trustworthy store of value and in its unrestricted buying power; and its enforcement as legal tender by governments have elevated its status to an independent type of money similar to gold, silver and other mineral money.

⁵⁰Ibn Manī', A. S. (1984). Paper money: its reality, history, value and legal ruling. Abridgement and notes by Usama Hasan, p. 5, <https://unity1.files.wordpress.com/2009/06/paper-money-islamic-legal-analysis.pdf>.

⁵¹Ibid.

⁵²*Al-Mudawwanah*, Vol. 3, pp. 395-396.

⁵³Al-Ghazālī, A. H. (1982). *Ihya Ulūm al-Dīn*, Dār al-Ma'arifah, Beirut, Vol. 4, pp. 91-92.

⁵⁴Yaacob, A. E. (2014). The Ruling of Paper Money Usage: Analysis Based on the Evolution of Currency Development. *Asian Social Science*, Vol. 10, No. 3, p. 87.

There are a lot of intellectual arguments regarding the applicability of *ribā* in paper money. The arguments stem from the differences of opinion regarding the '*illah*'⁵⁵ (cause and reason) of the occurrence of *ribā* in the exchange of gold and silver. In a *Hadīth*, the Prophet (peace be upon him) said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand."⁵⁶

The minority of the scholars including the followers of the Zāhirī school and Ibn 'Aqīl from the Hanbalī school argued that the *ribā* prohibition on gold and silver as well as the other *ribawī* items mentioned in the *Hadīth* have no known or discernible '*illah*' (reason or cause); it should therefore be accepted as it is and the ban should be limited to only the six items mentioned by the Prophet (peace be upon him). According to this opinion, the items should not be classified into certain categories according to '*illah*'.⁵⁷ Ibn Sīrīn and Sa'īd bin Jubayr are said to have held this opinion.⁵⁸

In contrast, the majority of scholars including the Hanafī, Mālikī, Shāfi'ī and Hanbalī jurists maintained that the six *ribawī* items have a special '*illah*'. They however differed in setting the '*illah*' with some of them setting the same '*illah*' for the six items because, to them, all the items have the same benefits. Other scholars divided the items into two categories of '*illah*', namely gold and silver having one '*illah*', while the four remaining items have one other '*illah*'.⁵⁹ Since the objective of this section is to examine whether the *ribā* prohibition extends to paper money or it is limited to only gold and silver, our discussion will focus on the '*illah*' of *ribā* in gold and silver. Accordingly, Al-Zuhaylī identified and outlined three main opinions in this regard as follows:⁶⁰

- a) The Hanafī school and the famous opinion of the Hanbalī school maintain that the '*illah*' of *ribā* for gold and silver is in the form of scales (*mauzūn*) or

⁵⁵ According to the majority of scholars, '*illah*' means (i) a fact, (ii) a circumstance, or (iii) a consideration that the Lawgiver has contemplated when issuing a ruling. It is mostly used in the books of *usūl* to explain the cause of a ruling, its sign or reason.

⁵⁶ Sahīh Muslim, Book 10, Hadīth 3853.

⁵⁷ See Engku, A., "Riba and its prohibition in Islam", pp. 16-17.

⁵⁸ Lateh, N., Osman, M. R. & Md Rejab, S. N. (2018). Implication of the Determination for the Gold Ribawī 'Illah (Cause) towards Fiat Money in Islam. *The Turkish Online Journal of Design, Art and Communication*, p. 1248.

⁵⁹ Ibid.

⁶⁰ Al-Zuhaili, W. (1984). *al-Fiqh al-Islami wa Adillatuhu*, Dār al-Fikr al-Mu'asir, Beirut, Vol. 5, pp. 706-730.

measures (*makīl*). Therefore, all weighable items like iron, copper or tin and measurable items like salt are analogised to gold and silver while non-weighable items are exempted. This opinion is also reported from Al-Hasan al-Basārī, Al-Nakha'ī, Hammād, Al-Auzā'ī, Al-Zuhrī, Al-Thaurī and Ishāq among the Tābi'ūn.⁶¹ They used the following statements of the Prophet (peace be upon him) as proof for their opinion: “Do not sell gold for gold and silver for silver except weight for weight, like for like, equal for equal.”⁶² They also cited the following *Hadīth*, “Gold for gold should be with equal weight, like for like, and silver for silver should be with equal weight, like for like. Whoever pays more or takes more has indulged in *ribā*.”⁶³

Based on this opinion, gold exchange with gold, iron with iron, copper with copper, tin with tin, meat with meat or cotton with cotton, for example, should be of equal weight and on the basis of hand-to-hand, otherwise *ribā* will occur in the transaction. Transactions of non-identical items such as gold and silver or silver and iron must be hand-to-hand, but does not require the same weight. Extending the discussion to paper money, this viewpoint implies that since a banknote denoting 1,000 units, for example, may weigh the same as one denoting 100 units, the ruling on *ribā* in gold and silver cannot be applied to banknotes.⁶⁴

However, the opinion has been criticised because today people use paper money which is weightless; yet, it performs the function of medium of exchange and generally enjoys public acceptance and confidence like gold and silver. In this regard, to say that *ribā* does not apply to paper money because of its non-weighability is not acceptable.

- b) The second opinion states that the '*illah* of *ribā* for gold and silver is their being the major currency standard and measuring tool for prices (*ghalabah ath-thamaniyyah* or *thamaniyyah/naqdiyyah ghālibah*). This means the cause of *ribā* prohibition in the exchange or sale of gold and silver is the fact that they have become the main price-setter. This is the opinion of the Shāfi'ī school and the famous opinion in the Mālikī school. It is also one of the reported opinions in the Hanbalī School. This opinion makes gold and silver as a measure of the value of an item, hence the '*illah* of *ribā* in both of them. According to them, gold and silver are the standard or currency prices and a kind of habitual price

⁶¹Engku, A. “Riba and its prohibition in Islam”, p. 17.

⁶² Sahīh Muslim, Book 10, Hadīth 3848.

⁶³ Sahīh Muslim, Book 10, Hadīth 3857.

⁶⁴ Sahrish, A. (2014). Concept of paper money in Islamic Law.https://www.academia.edu/7190458/concept_of_paper_money_in_islamic_law.

that serves as the basis of price for all goods such as land, food, clothing and so on. Therefore, only gold and silver are applied to *ribā*. Other items, which are not used as a measure of value such as iron, copper and tin are not exposed to *ribā*.⁶⁵

The notion of *ghalabah ath-thamaniyyah* of gold and silver, that is their main price-setter status hence the wisdom of *ribā* in them, has been criticised on the basis that paper money also enjoys general acceptability, widespread use, and public confidence as a medium of exchange, a store of wealth, and measure of value. It is today regarded as a price-setter.

- c) The third opinion is that the '*illah* of *ribā* for gold and silver is its position as a price measure (*mutlaq ath-thamaniyyah*). This opinion is one of the narrations from Imam Ahmad and the minority opinion in the Mālikī and Hanafī schools. The opinion is reported from Yahya ibn Sa'īd, Rabī'ah, Al-Layth, and one of the narrations from Az-Zuhri.⁶⁶ It is also the opinion chosen by Ibn Taymiyyah and Ibn al-Qayyim, both of the Hanbalī School. According to them, the '*illah* for the prohibition on *ribā* in gold and silver is that they have the property of being fixed or unchanged that can be used as a price or valuation tool for all goods.

According to this view, any other medium of exchange that possesses this property and can be used as a price or valuation tool for all goods, whether it is gold, silver, copper, or paper money (banknotes and coins) is associated with the law of *ribā* when a transaction is made. Ibn Taymiyyah strongly supported the view and considered it the most accurate opinion.⁶⁷ Ibn al-Qayyim also supported it and concluded that it is the authentic and accurate opinion."⁶⁸

In view of the foregoing, the '*illah* of *ribā* that occurs in gold and silver, based on the strongest view amongst the jurists, is due to their values (*mutlaq ath-*

⁶⁵ Lateh, N., Osman, M. R. & Md Rejab, S. N. (2018). Implication of the Determination for the Gold Ribawi 'Illah (Cause) towards Fiat Money in Islam. *The Turkish Online Journal of Design, Art and Communication*, p. 1248. Also see: Imtiaz, M. S. & Azhar, M. (2018). From Metal to Paper: Validating Paper Money from Islamic Perspective. *International Journal of Ethics and Systems*, Vol. 34 Issue 1, pp. 13-15.

⁶⁶ As narrated in *Musannaf Abdir Razzāq*, 7/267.

⁶⁷ Ibn Taymiyyah, A. A. (1995). *Majmū' al-Fatāwa li Ibn Taymiyyah*. Majma' al-Malik Fahad, Riyadh, vol. 29, p. 471.

⁶⁸ Ibn al-Qayyim al-Jawziyyah (1991). *I'ilām al-Muwaqqi'īn 'an Rabb al-'Ālamīn*. Dār al-Kutub al-'Ilmiyyah, Beirut, vol. 2, p. 105.

thamaniyyah). The *'illah* is not limited to only gold and silver even though originally it is so.

The following justify the application of *ribā* prohibition on paper money.

- a) Gold and silver are a medium (*wasīlah*) of exchange. On their own, they do not have any superiority over other forms of currency. As Imam Al-Ghazālī observed, “they are two metals with no benefits in themselves; no purpose of their own but they serve as medium of exchanging goods, hence people need them in order to exchange them for different things such as food, clothing and other goods.”⁶⁹ He added, “*Dirhams* and *dīnārs* are not created for any particular persons, they are useless by themselves; they are just like stones. They are created to circulate from hand to hand to govern and to facilitate transactions. They are symbols to know the value and grades of the goods.”⁷⁰ Ibn Taymiyyah also emphasised the above point by saying, “*dirhams* and *dīnārs* are not sought for themselves. Rather, they are means by which mutual transactions are carried out, and this is why they serve as money ...”⁷¹ In view of the role that paper money plays as a medium of exchange the same way gold and silver do, their rulings regarding *ribā* should be the same.
- b) Since by the consideration of both the higher goal of Islamic law (*maqāsid al-Sharī'ah*) and public welfare (*maslahah 'āmmah*), paper money is needed as a medium of exchange that substitutes gold and silver, the rules that apply to gold and silver with respect to *ribā* prohibition, *Zakāh* and investment should also apply to paper money.
- c) Although unlike gold and silver, paper money is not precious, it is now superior to precious metals and stones in being better for the exchange of goods and services and with respect to general acceptance, widespread use, and public confidence in it as a store of wealth, measure of value and medium of exchange.⁷² The paper money that exists today is of value because of the government guarantee on the value. More so, the community has accepted it as a storage device and as a means of payment even if its value is not the paper but the numbers or writings printed on it. This makes it a standard measure of price

⁶⁹ Ghazālī, A. H. (1982). *Ihya Ulūm al-Dīn*. Dār al-Ma'arif, Beirut, Vol. 4, p. 91.

⁷⁰ Ibid, p. 92.

⁷¹ Ibn Taymiyyah, A. A. (1995). *Majmū' al-Fatāwa li Ibn Taymiyyah*. Majma' al-Malik Fahad, Riyadh, Vol. 19, pp. 251-252.

⁷² Ibn Manī', A. S. (1984). *Paper money: its reality, history, value and legal ruling*. Abridgement and notes by Usama Hasan, p. 10 & 12.

(*thamaniyyah*) and to take the place of gold and silver in its use.⁷³ Accordingly, the *ribā* prohibition placed on gold and silver applies to it.

- d) Some contemporary scholars have argued that paper money is the same as *fulūs* (popularly known as copper money) even though *fulūs* does not necessarily have to be made of copper. They argue that since paper money is the same as *fulūs*, *Zakāh* is not due on it unless it is set aside for sale, in which case, it will take the ruling of trade goods. In addition, *ribā* does not apply on it. However, a critical analysis of paper money as being the same as *fulūs* view would show that, unlike *fulūs* that can be traded as a commodity, paper money is used for no other purpose than as a measure of value. In terms of value, *fulūs* is much less than gold and silver whereas paper money reaches the same value as gold and silver. In fact, some banknotes are today worth far more than any gold or silver coin. Furthermore, *fulūs* is generally used in pricing low-value items, and this is partly why some ‘ulama have allowed *ribā al-fadl* in the case of *fulūs*. Only gold, silver or paper money is used in high-value transactions. This, therefore, means that the argument of similarity of *fulūs* with paper money is weak. The rulings of *fulūs* in terms of non-zakatability and lack of occurrence of *ribā* cannot be extended to paper money.
- e) The claim by some contemporary scholars that gold *dīnār* and silver *dirham* are the only currency that are exposed to *ribā* because they are a form of Islamic currency that served as the only basis of prices and means of exchange used during the era of the Prophet (peace be upon him) until the era of the Ottoman Government in 1924 when paper money emerged is a weak claim. The exaggerated claim made by the World Murābitūn Movement⁷⁴ that the use of paper money is illegal and forbidden⁷⁵ because the Prophet (peace be upon him) used only gold and silver as measurement in respect of *nisāb* of *Zakāh* on cash, amount of cash *diyyah* (blood money), and limit of stolen property that will attract theft punishment. They argue further that some verses of the *Qur’ān* have indicated that gold and silver are the only measurements of money known to the Muslim community such as the verse that warns against hoarding of gold and silver.⁷⁶

⁷³ Yaacob, A. E. (2014). The Ruling of Paper Money Usage: Analysis Based on the Evolution of Currency Development. *Asian Social Science*, Vol. 10, No. 3, p. 91.

⁷⁴ Barakat, E. R. & Haneef, M. A. (2006). Must Money be limited to only Gold and Silver? A Survey of Fiqhi Opinions and some Implications (2006). *Journal of King Abdulaziz University: Islamic Economics*, Vol. 19, No. 1, pp. 26-27.

⁷⁵ Vadillo, U. I. (2002). *The Return of the Islamic Gold Dinar*. South Africa: Madinah Press.

⁷⁶ *Qur’ān*, 9:34; 3:75 & 91; 12:20; and 18:20.

The above arguments are not only erroneous but also misleading for the following reasons:

- i) It is on record that Caliph Umar bin al-Khattab (may Allah be pleased with him) had wanted to use camel skins as a medium of exchange, but the other companions did not approve of it because of the fear that it would provide an incentive for people to be indiscriminately slaughtering camels for the purpose of using its skins as a medium of exchange instead of eating and using it for other domestic purposes.⁷⁷ If gold and silver were known to be the Islamic currency, the Caliph would not have attempted to do that.
- ii) It is accepted that gold and silver have been more suitable than other items as money, and this is why the sacred texts mention the ruling of *ribā* regarding them, whether they are in minted or unminted form. However, paper money has the same ‘moneyness’ (*thamaniyyah*) as the gold and silver and it is a medium (*wasīlah*) of exchange like gold and silver. Since the *Sharī’ah* is based on objectives and meanings, not mere words and labels, the attributes of paper money and the functions it performs in the financial system clearly make it a substitute for, and independent from, gold and silver.
- f) The argument that paper money is an I-owe-you (IOU) from the issuer, that is, it is a receipt of debt, or that paper money is a commodity, and therefore carries the same characteristics and legal rulings as trade commodities is neither logical nor sound. Paper money is not a receipt of debt because it has a value predetermined by the government. Also, it is not a commodity because, if it loses its status as money, it reverts to being worthless paper. The IOU and commodity arguments represent two extremes that open the door to *ribā* and nullify most forms of *Zakāh*. A billion naira placed in a fixed deposit account at 12% interest rate per annum would neither fall under *ribā* nor be liable for *Zakāh*!
- g) Issuing a *fatwā* that paper money does not involve *ribā* corrupts the society and subjects it to many evils. Since all the injustices and evils associated with *ribā* in the exchange of gold and silver are clearly present in paper money, why should they have a different ruling? As some scholars have observed, issuing an Islamic ruling that paper money is not exposed to *ribā* leads generally to corruption and, had the four Imams been alive to witness the widespread use of paper money and general public confidence in it, they would have most likely ruled that *ribā* applies to it.

⁷⁷*Futūh al-Buldān* of al-Balādhurī, 1/453 available at <https://al-maktaba.org/book/12221/449#p7>.

- h) Paper money is valuable wealth, which people store for their needs, which is the actual meaning of wealth (*māl*): human nature inclines towards it, and it can be bestowed for occasions of need. The possessor of paper money takes ownership of it by giving *dīnārs* or *dirhams*. The paper money is regarded as wealth and treasured (like gold, silver and *fulūs*), stored, gifted, bequeathed in wills and given in charity.
- i) The view of the fact that both *ribā al-fadhl* and *ribā al-nasī'ah* apply to paper money as they do to gold and silver and other money forms, like copper coins is in line with the resolution of the Council of the Saudi Arabian Senior Scholars by majority, the resolutions of many *fatwā* committees and the opinion of most contemporary scholars.⁷⁸

In view of the foregoing, it is concluded that it is impermissible to exchange the same currency on unequal or deferred payment basis, or exchange one currency for other forms of currencies of different material on a deferred payment basis.⁷⁹ For example, it is not permissible to sell or exchange 100 Nigerian Naira (₦) for any amount less or more than ₦100 whether the exchange involves minted, old or tattered banknotes. The amount must be equal (irrespective of the denomination) and must be on the spot. If the exchange is between currencies of different countries, the amount can be unequal as per the dictates of market demand and supply; however, it must be on the spot, not on deferred payment basis. In this regard, while, for example, it is permissible to exchange or sell one US Dollar (\$) for ₦400, or more or less, it is impermissible to be for deferred payment. Accordingly, it is impermissible to sell or exchange ₦100 banknotes for ₦110 since they are of the same type but it is absolutely permissible to sell or exchange one Saudi Riyal for ₦120 whether it is in banknotes or coins, more or less, since they are of different types of currencies, if payment is on the spot.⁸⁰

In addition, *Zakāh* is required on paper money when it reaches the minimum limit of *nisāb* (the minimum amount on which *Zakāh* is due) either by itself (one currency only or a mixture of different currencies) or when combined with other values and commercial commodities such as trade goods possessed by persons who are legally accountable to pay *Zakāh* after the passing of one full lunar year from

⁷⁸ See for example, Fatwa #3291, part 13, pp. 443-444 available at <https://abdurrahmanorg.files.wordpress.com/2014/08/fatwa-alifta-transactions-4336.pdf>

⁷⁹ Also, see: General Iftaa Department, Jordan (2018). Paper Currency Takes the Rulings of Gold and Silver, Fatwa 3392, <https://aliftaa.jo/QuestionEn.aspx?QuestionId=3392>.

⁸⁰ Ayub, M. (2002). Islamic banking and finance: theory and practice, pp. 28-29.

the time the *nisāb* is acquired. It is also permissible to use it as capital in *Salam* sales (sale with advance payment) and partnerships.

1.3.2 Prohibition on Speculation and Gambling

Under Islamic finance, profit-making from speculative or gambling (*maysir/qimār*) activities are not permissible. Generally, *maysir* or *qimār* involves easy acquisition of wealth by chance or game of chance in which one gains at the cost of others. It is defined as “any activity that involves an arrangement between two or more parties, each of whom undertakes the risk of a loss where a loss for one means a gain for the other.”⁸¹

Sharī’ah-compliant transactions must be free from speculative and gambling activities. Gain accruing from them is unlawful in Islam, as it diverts the player’s attention from productive activities, and leads to amassing of wealth without effort. From the *Sharī’ah* viewpoint, gambling and speculation represent an immoral inducement by the person involved in expectation of making a profit at the expense of another party. They are a means of consuming one another’s wealth unjustly.⁸² Muslims are therefore prohibited from having any affiliation to gambling or speculative activities including participating, investing or financing any businesses related to, or associated with, the gambling industry. On the basis of this, modern financial transactions such as options, futures and forward foreign exchange are considered unacceptable for Muslims.⁸³

A common transaction that is inconsistent with *Sharī’ah* dictates is betting. The increasing popularity of sport gambling/betting throughout the world and the fact that many more youth are getting involved in it daily compels explaining its position in Islamic Finance.⁸⁴ Gambling/betting makes one to risk money or other valuable items on an uncertain event. It is dependent on chance wholly or partly. It also causes harm to the speculator in the long run after he loses his chance of winning. Therefore, the notion of taking someone else’s wealth as a consequence of winning a game based on chance is unacceptable in Islam.

⁸¹International Organization of Securities Commissions (2004). Islamic Capital Market Fact Finding Report, p. 8 <https://www.iosco.org/library/pubdocs/pdf/IOSCPD170.pdf>.

⁸²*Qur’ān*, 2:188.

⁸³Organization of Securities Commissions (2004). Islamic Capital Market Fact Finding Report, p. 8.

⁸⁴Sule, M. M. & Adam, A. Y. (2018). The Interface of Footballing and Gambling Saga among Muslim Youths in Nigeria: Contemporary Challenges and Islamic Solutions. *International Journal of Humanities, Art and Social Studies (IJHAS)*, Vol. 3, No. 4, p. 5.

Many conventional financial economists such as Arthur Crump, Solomon Huebner and Nicholas Kaldor have tried hard to make a case for speculative transactions using three arguments.⁸⁵ Firstly, that such transaction provides liquidity in the foreign exchange market to the end-users due to their large volume. Secondly, due to competition between speculative participants, bid-buy spread often becomes tight and thus reduces transaction cost in such markets. Thirdly, speculation tends to facilitate price efficiency owing to the fact that participants normally trade out opportunities to make profit.⁸⁶

However, the above arguments have been refuted⁸⁷ on the ground that, in most cases, the main beneficiary of market liquidity and low transaction costs is the speculator himself. It is argued that a speculator would often prefer to deal with and execute a large volume of transactions at short notice in order to avoid downward movement of price. It is also argued that since it does not matter as far as the functioning of the real economy is concerned whether or not a foreign exchange transaction is concluded at short notice provided that what the funds are used for is viable, the argument of liquidity and low transaction costs would not hold water.⁸⁸

The third argument in favour of speculation, which borders on expected improvement in price efficiency, has also been faulted. It is argued that a market that does not allocate resources towards projects that maximise wealth creation cannot be considered efficient even where current prices in the market account for information available. In addition, since speculation is the major cause of foreign exchange volatility as confirmed in both theoretical and empirical literature, it is debatable if it can facilitate price efficiency devoid of stability in the market. For instance, how could a market in which prices are so unstable to the extent that within a few months, prices could go upward and then downward by 20%-30% be considered efficient?⁸⁹

Notwithstanding the above arguments and counter arguments, the majority of *Fuqaha* (experts in Islamic jurisprudence) contend that since there is hardly any

⁸⁵ Miyazaki, H. (2007). Between Arbitrage and Speculation: An Economy of Belief and Doubt. *Economy and Society*, Vol. 36, No. 3, p. 411.

⁸⁶ Kaldor, N. (1939). Speculation and Economic Stability. *The Review of Economic Studies*, Vol. 7, No. 1, p. 8.

⁸⁷ In *The Ethics of Speculation*, Ryan (1902, pp. 335-347) has comprehensively refuted the arguments advanced by proponents of speculation from ethical point of view.

⁸⁸ Dogarawa, A. B. (2013). Principles of Islamic Banking. *Readings in Islamic Banking and Finance*, pp. 69-71.

⁸⁹ Ibid.

commercial activity that is devoid wholly of speculative elements, prohibition on realising a gain from speculation is not in absolute terms. The ruling, unlike the case of *ribā*, depends on the extent of speculation and whether the intention behind the transaction is to realise a gain from some productive effort or to cause price distortion through unproductive effort. For instance, making an equity investment in a company that engages in a *halāl* business activity in order to realise future dividends and capital gains on the investment will be allowed provided the intention is not to make quick profit by speculating the expected share price movement over a very short period of time but based on a careful assessment of the company's past results and future prospects.⁹⁰ This underscores the need to distinguish between destabilising speculations and non-destabilising speculations similar to what obtains in conventional finance.⁹¹ Non-destabilising speculation is the type of speculation which does not negatively affect the economy by its presence and is therefore acceptable within the *Sharī'ah* framework. It is however argued that the distinction between prohibited and legitimate speculation is sometimes blurred, not often clear in practice.

1.3.3 Avoidance of Uncertainty (*Gharar*)

A key requirement for any transaction under Islamic finance is avoidance of uncertainty (*gharar*) or hazard that may lead to destruction or loss. *Gharar* occurs when a party ventures into a transaction blindly without sufficient knowledge. In simple terms, it refers to a lack of knowledge about, or lack of control of, the outcome of any transaction, which will consequently result in an outcome that could be detrimental to one party. This lack of knowledge or control may stem from misrepresentation, mistake, fraud, duress, or terms beyond the knowledge and control of one of the parties to the contract.

In practice, *gharar* relates to issues such as pricing, delivery, quantity and quality of assets that are transaction based and would, therefore, affect the degree or quality of consent of the parties to a contract. Examples of uncertainty in business transactions are:⁹²

- i) Selling goods that the seller is not in a position to deliver;
- ii) Selling known goods against an unknown price;

⁹⁰ Ibid.

⁹¹ Ryan, J. A. (1902). The Ethics of Speculation. *International Journal of Ethics*, Vol. 12, No. 3, p. 338. Also see: Kohlhagen, S. W. (1979). The identification of destabilizing foreign exchange speculation. *Journal of International Economics*, Vol. 9, Issue 3, pp. 330-331.

⁹² Dogarawa, A. B. (2013). Principles of Islamic Banking. *Readings in Islamic Banking and Finance*, p. 71.

- iii) Selling unknown goods against a known price;
- iv) Making a contract conditional on an unknown event; and
- v) Buying goods without proper examination.

Under Islamic jurisprudence, *gharar* is of two types: *gharar yasir* (tolerable uncertainty) and *gharar fahish* (intolerable/high level of uncertainty). On one hand, transactions involving slight or trivial uncertainty are condoned. Also, where the contract is unilateral or charitable (*tabarru'*) such as gift or bequest, or where there is a public need (*maslahatul 'am*) for the transaction, uncertainty is usually tolerated. On the other hand, transactions involving a high level of uncertainty where, for example, a clear description of the assets being sold, the sale price and the time of delivery of the assets to the purchaser are not known, are not permissible in Islamic finance.⁹³ However, risk taking is allowed when all the terms and conditions are clear and known to all parties.

Conventional insurance is generally considered one of the examples of *gharar fahish* in the financial market. The insurance policyholder enters into an agreement to pay a certain sum of premium and in turn the insurance company guarantees to pay a certain sum of compensation in the event of a disaster. However, the amount of compensation that the company will pay to the policyholder is uncertain and it is also dependant on the occurrence of specific events in the future. Due to this high level and large element of uncertainty (*gharar fahish*), *Shari'ah* scholars are of the opinion that conventional insurance is not *Shari'ah* compliant, therefore not permissible.⁹⁴

In contrast, *Takaful*, the Islamic alternative to conventional insurance is considered *Shari'ah-compliant* and hence permissible. *Takaful* is a form of insurance based on principles of cooperation and mutual indemnification of losses of members. It encompasses the elements of shared responsibility, joint indemnity, common interest and social solidarity.⁹⁵

In the case of leasing (*Ijarah*), the transaction will not be permissible if the clarity of the leased assets or lease duration or the rent payable under the lease is not determined. Islamic banks are, therefore, not allowed to engage in contracts in

⁹³ Ibid.

⁹⁴ International Organization of Securities Commissions (2004). Islamic Capital Market Fact Finding Report, p. 8.

⁹⁵ The concept, basis and principles, scope, and types of Takaful would be discussed in section four of this book.

which there is uncertainty about the subject matter, price, or both such as hedging and derivatives. Uncertainty in contract is similar to asymmetric information. The import of making certainty about contract under Islamic banking is to minimize the possibility of misunderstanding and conflicts between contracting parties.

An example of *gharar* based transactions in contemporary times is the Pyramid Scheme which is gaining popularity especially among the youth. Pyramid Scheme is an arrangement in which earnings are made from the act of recruitment into a scheme and not from the sale of products involved in it. The scheme entails members paying a high upfront fee for the opportunity to participate in the scheme in order to be remunerated for each new individual enrolled directly or indirectly without bearing in mind the underlying trade (i.e. business of product sales).⁹⁶ In pyramid businesses, the commission is mostly calculated based on the membership fee paid by an individual's direct and indirect down lines.

Pyramid schemes are similar to Multi-level marketing (MLM) in many ways. MLM, also called 'network marketing', 'direct selling', 'referral marketing', 'word-of-mouth marketing', 'interactive distribution' or 'relationship marketing',⁹⁷ is a marketing strategy for the sale of products/services where the company's revenues are derived from retail sales and recruitments. MLM companies recruit distributors to sell their products and services to the people and also encourage others to join the company as distributors and earn a commission, by selling the products further and inviting others to work.

Some have argued that there is a difference between MLM and pyramid scheme.⁹⁸ According to them, MLM companies, on the one hand, are legal. Their activities involve using a legitimate network marketing strategy and their focus is on selling products. MLM consultants, contractors, or distributors make their money by selling the products to other multilevel marketing participants and signing up non-members to the MLM Company. In addition, they earn a percentage of the income generated by their downline, that is, the distributors that they brought into the programme which makes it a kind of brokerage. On the other hand, pyramid schemes are illegal activities with a focus on getting money through recruiting new

⁹⁶Jumat, Z. H., Fazrihan, D. & Murtadha, M. (2018), *Sharī'ah* Perspective on Multi-Level Marketing & Pyramid Schemes: A Guide for Singapore Muslim Community, p. 2.

⁹⁷ Kalkin Media (2022). Multi-Level Marketing. Available at: <https://kalkinmedia.com/definition/m/multi-level-marketing>

⁹⁸ See: Ward, S. (2022). Pyramid Scheme vs. MLM: What's the Difference? Available at: <https://www.thebalancemoney.com/is-it-multilevel-marketing-or-a-pyramid-scheme-2947159#:~:text=Key%20Takeaways,its%20products%20ahead%20of%20time>

people and by accomplishing certain levels of achievement. Unlike MLM, the focus of pyramid schemes is solely on recruitment, not on sales. There may not be any product to sell at all with a pyramid scheme, or it may be low-value items.⁹⁹

However, in reality, in both MLM and pyramid scheme, enrollees are asked to pay money upfront in order to enroll. Also, both have hierarchical structures, with those at the top earning money from those below them. Participants make money from enrollment fees and by selling products (particularly in MLM). The companies rely on marketing and advertising of their product which emphasises the size of the large commission the participants can earn, and offers the incentive of a large profit in return for a small sum, which is the price of the product. In this regard, the product which the company sells to the participants is simply a screen for the transaction; it is not what the participants are seeking.

In Islamic perspective, dealing with MLM companies or pyramid schemes that charge a fee for joining or stipulate that one must buy a certain product in order to be able to engage in marketing and take commission is not permissible because that involves gambling and ambiguity and, because in this case, the item or product is not what is sought; rather, the participants pay a joining fee or pay the price of the product in the hope of being able to attract customers and get a lot of commission, which may or may not happen, hence, amounting to gambling.¹⁰⁰

Both MLM strategies and pyramid schemes are a kind of *gharar* (ambiguous transaction) because the participants do not know whether they will be successful in finding the number of purchasers (participants) required or not. No matter how long the network marketing or scheme lasts, it must inevitably reach an end and, when a person joins it, he does not know whether he will attain to a higher level and thus make a profit, or remain in the lower levels and thus make a loss. In reality, most of the participants lose out, except for the few at the top. This makes both of them ambiguous. The Prophet (peace be upon him) forbade ambiguous (*gharar*) transactions.¹⁰¹

Both MLMs and pyramid schemes involve consuming people's wealth unlawfully because the participants get commission from the effort of their downlines (from

⁹⁹ Federal Trade Commission (n.d.) Multi-Level Marketing Businesses and Pyramid Schemes, Consumer advice, at <https://consumer.ftc.gov/articles/multi-level-marketing-businesses-pyramid-schemes>

¹⁰⁰ See: <https://islamqa.info/en/answers/179122/dealing-with-a-multilevel-marketing-company>

¹⁰¹ Sahih Muslim (Hadith 1513)

the second level downwards) without making any further contribution. For example, if Mr. Zaid is the first independent distributor who is enrolled directly by the MLM Company, he finds himself at the top of the multi-level/pyramid. Zaid then recruits five independent distributors who each turn around and recruit five more independent distributors, and so on. The first five distributors recruited by Mr. Zaid, the subsequent 25 recruited by the first five and the subsequent 125 recruited by the third level of distributors, and so on, represent his downlines. For recruiting the first five distributors, Zaid gets a commission from the efforts of each of the distributors in the downline of the first five he recruited without making any further contribution. This is not permissible. Allah (the Most High) says, “O you who believe! Eat not up your property among yourselves unjustly.”¹⁰²

The argument that MLM is a kind of brokerage is faulty because, in brokerage, the broker receives payment in return for selling the product, whereas in network marketing the participant pays a fee in order to market the product. This means, in reality, whereas brokerage means marketing a product, the real aim of network marketing is to market the transaction, not the product, so the participant markets to others who will market to others who will market to others and so on. The purpose in MLMs and pyramid schemes is not to sell the product to those who need it, rather the purpose is to build an incentive system.

It is important to mention that introducing a product in MLM or pyramid scheme does not change the ruling on it because it is obvious that the product is not what most of those who rush to enrol actually want as is proven from the utterances of many participants. Changing the definition and name of things that are *harām* when their essence remains the same is even more evil, as well as involving an attempt to deceive Allah and His Messenger.”¹⁰³

In summary, both MLM and pyramid schemes are based on gambling, high level of uncertainty and ambiguity, consuming people's wealth unlawfully and a kind of cheating, deception, manipulation, trickery and tempting people to earn a lot of money unjustly.¹⁰⁴ Both are not in tune with the essence of Islamic contracts as well as the traditional *fiqh* legal precept which posits that the central requirement in every contract is justice. The popular legal Maxims, *al-‘Ibrah fī al-‘uqūd li al-maqāsid wa al-ma’ānī lā li al-alfāz wa al-mabānī*, that is, in contracts, attention is given to intention and meaning and not words and form and *lā dharara wa lā*

¹⁰² *Qur’ān*, 4:29.

¹⁰³ Ibnul Qayyim al-Jawziyyah (n.d.), *Ighāthah al-Lahfān*, Maktabah al-Ma’ārif, 1/354.

¹⁰⁴ See: *Fatāwā al-Lajnah al-Dā’imah li al-Buhūth al-‘Ilmiyyah wa al-Ifitā*, Saudi Arabia, Number 22935.

dhirāra, that is, harm should neither be caused nor reciprocated, which are based on Prophetic sayings, also apply in this case. Therefore, the two MLM and pyramid schemes are not permissible. This is the position of the Permanent Committee on Research and Fatwā, Saudi Arabia, Islamic Fiqh Academy, Sudan, the Fatwā House of Cairo, Egypt and the Fatwā Committee of Jordan.¹⁰⁵

1.3.4 Sanctity of Contracts

Islamic finance activities are based on sanctity of contracts. A necessary code of conduct for Islamic financial institutions is that they deal in only *halāl* (legally permissible) activities and avoid *harām* (unlawful/impermissible) activities. According to Scholars, a general principle under Islamic jurisprudence is that all ways and means are permissible except where otherwise declared by clear, unambiguous texts. Transactions that involve the following are considered *harām* in Islam:

- i) Interest (*ribā*);
- ii) Cheating and fraud in terms of quality, measure or weight;
- iii) Games of chance such as lotteries and betting;
- iv) Creating artificial scarcity through hoarding and the like;
- v) Manipulation of prices;
- vi) Exploitation of the poor, needy or disadvantaged; and
- vii) Dealing in unlawful products such as alcohol, pork or illegitimate professions such as prostitution.

Accordingly, under Islamic finance, financial institutions are not allowed to lend to individuals or invest in companies involved in activities considered to have a negative impact on society (for example, gambling, pornography, cinema, etc.) or that are illegal under the *Sharī'ah* such as buying of shares in interest-based financial institutions including conventional insurance companies, and financing the construction of a plant to make alcoholic beverages or tobacco and pork business. It is in this context that *Sharī'ah* scholars hold the view that any activity relating to these products and services such as processing, producing, marketing, supplying, selling or financing are also impermissible.

¹⁰⁵ Al-Shahrānī, H. M. H. (2010). *Al-Taswīq Al-Tijārī wa Ahkāmuh fī al-Fiqh al-Islāmī*, 1st edition, Dār al-Tadmuriyyah, Riyādh, pp. 517-522.

1.3.5 Auxiliary Principles

In addition to the aforementioned principles, Islamic finance makes it necessary for financial institutions to comply with a sound corporate governance practice. It promotes socio-economic activities and advocates a free economic system guided by a socially acceptable code of ethics, which is a built-in concomitant to safeguard and discipline human behaviour in both economic and social activities lest it goes astray.

a) Corporate governance

Under Islamic finance, the emphasis of corporate governance is on accountability, trustworthiness and honesty, transparency and disclosure, and responsiveness. In addition, Islamic financial institutions have the responsibility to ensure compliance with the *Shari'ah* principles in their products, instruments, operations, practices, management, etc. in addition to the existence of a proper framework of corporate governance. Hence, *Shari'ah* governance is another component that is peculiar exclusively to Islamic financial institutions. The uniqueness of corporate governance for Islamic financial institutions stems from the fact that it is a faith-based approach that mandates conduct of the business in accordance with *Shari'ah* principles; and profit-motive based that recognises business and investment transactions and maximisation of shareholder's wealth. *Shari'ah* governance is thus the backbone of Islamic banking and finance as it gives legitimacy to its practices, and boosts the confidence of the shareholders and the public that all the practices and activities are in compliance with the *Shari'ah* at all times.

b) Promotion of socio-economic justice

Another key element of Islamic finance is the promotion of socio-economic justice. This is because the religion of Islam is dedicated to universal brotherhood, social and economic justice. Under Islamic finance, banks are expected to promote social welfare. This may be through *Zakāh*, which they will collect and manage on behalf of investors and shareholders who give consent to the bank to do so. Islamic financial institutions may resort to only the role of enjoining and reminding depositors and shareholders of the obligation of *Zakāh* on any wealth that reaches the minimum specified zakatable amount (*nisāb*) where IFIs are not required by State law to pay *Zakāh* on behalf of fund owners; or where fund owners do not give consent or the IFIs do not have a policy on *Zakāh* payment on their behalf.

Other means by which Islamic financial institutions could promote socio-economic justice are *Waqf* and *Qard-hasan* (benevolent loan) account. On one hand, *Waqf* stands for holding an asset and preventing its consumption for the purpose of repeatedly extracting its usufruct for the benefit of an objective representing

righteousness and/or philanthropy for as long as its principal is preserved. It provides the material infrastructure and creates a source of revenue for use in, among others, social welfare enhancing activities both at family, community and state levels. On the other hand, *Qard-hasan* refers to a type of interest-free benevolent loan that Islamic banks grant to people who are in need of it, to be able to cater for necessities such as food, shelter and medical bills.

c) Promotion of ethical values

Under Islamic finance, banks are required to stick to a code of moral and ethical values while conducting their banking business. Some of the ethical values expected of Islamic banks are:

- a) Ensuring the legitimacy of all business transactions, and not unjustly and wrongfully taking money from customers' accounts or charging them illegally.
- b) Making all transactions between the bank and depositors/investors based on mutual consent.
- c) Honouring obligations and fulfilling contracts.
- d) Full disclosure of product, price and associated conditions, as lack of it amounts to deceit.
- e) Fair treatment of employees in terms of fair and timely payment of wages, good working conditions, taking care of overall welfare, not putting so many burdens on them that they will not be able to bear, and respect for dignity.
- f) Not to exploit customers' ignorance about banking business or types of charges and the amount to be charged on specific services provided thus making them to pay higher than what should have been the price.

1.4 Islamic Finance versus Conventional Finance

There are a number of areas of difference between Islamic finance and Conventional finance. Other than the departing point of prohibition of interest and other related issues covered by the principles of Islamic finance, Islamic finance differs from its conventional counterpart in the areas of what constitute sources and uses of funds for Islamic financial institutions. In addition to deposits and investment accounts, Islamic banks, for example, could obtain funds from religious institutions of *Waqf* and other forms of charities. On the uses of funds, while conventional financial institutions derive the bulk of their assets from interest-bearing activities, Islamic financial institutions, on their own part, draw their assets from various types of non-interest-bearing financial instruments based on equity, sales and rental modes. In addition to these, Islamic finance has a mechanism that allows financial institutions to combine the institution of *Zakāh* and other forms of

voluntary charity to provide financial services to the poorest members of the society.¹⁰⁶

Ahmad provides a summary of the differences between Islamic finance and conventional finance:¹⁰⁷

Table 1: Differences between Islamic and Conventional Finance

Characteristics	Islamic Finance	Conventional Finance
Guiding principle	Guided by principles of the <i>Qur'ān</i> and <i>Sunnah</i> , and Islamic ethics.	Guided by profit motive alone, with no religious or ethical considerations.
Ethics of financing	Asset-backed and meant for productive use that helps reduce the overall debt burden.	Debt burden arising from excessive use of credit, which leads to bankruptcies and waste of financial resources.
Return on Capital	Depends on productivity; idle money cannot earn any return. It is <i>ex-post</i>	Even idle money in bank deposits earns returns. It is <i>ex-ante</i>
Basis of profit	Profit on exchange of goods and services is the basis for earning profit	Time value is the basis for charging interest on capital
Profit and Loss Sharing (PLS)	Equity-based contracts of <i>Mudārabah</i> and <i>Mushārah</i> are based on PLS, dependent on business performance. Greater share of risks forces them to manage risks more professionally, to ensure better returns than conventional accounts.	There is no relationship between performance and returns to the depositors or investors, who mostly enjoy a risk-free return. Conventional institutions mostly act as intermediaries between lenders and borrowers enjoying almost a risk-free spread.

¹⁰⁶ Ahmad, W. (2008). *Islamic Banking in the UK: Opportunities and Challenges*. Unpublished M.Sc. Accounting and Finance Thesis submitted to Kingston Business School, Kingston University, London. Available at: <http://ssrn.com/abstract=1349170>

¹⁰⁷ Ahmad, S. (2004). *Islamic Banking and Finance in the Contemporary World*, pp. 16-17, available at: http://biharanjuman.org/Dissertation_XLRI-Islamic_Finance_Shakeel_Ahmad.doc. Also see <https://www.ubldigital.com/Banking/UBL-Ameen/Knowledge-Center/Differences-between-Conventional-Bank-and-Islamic-Bank>

Deposit/Liability contractual relationship	Depositor-custodian relationship; Lender-borrower relationship (but free from interest); and Investor-entrepreneur relationship	Lender-borrower relationship
Financing/Assets contractual relationship	Purchaser-seller relationship; Lessee-lessor relationship; Principal-agent relationship; and Entrepreneur-investor relationship	Borrower-lender relationship
Compounding or Interest on interest	Islamic financial institutions have no provision to charge any extra money from the defaulters except penalty, which would not benefit the banks, its depositors, investors or shareholders but would be transferred to non-permissible income (NPI) account for charity purposes	It can charge additional money (compound rate of interest) in case of defaulters.
Concept of money	Money is just a medium of exchange; real asset is a product	Money is a product besides being a medium of exchange and store of value

1.5 Islamic Finance Global Outlook

Islamic finance industry is the platform that accommodates Islamic finance activities and is made up of four major components namely Islamic banking, *Sukūk* (Islamic bond), Islamic equity and funds and *Takāful* (Islamic insurance).¹⁰⁸ Thus, the current Islamic finance industry arrangement can simply be viewed as the platform for the deployment of these Islamic modes of financing that abides by *Shari'ah* (Islamic law), under which a key tenet is the prohibition of interest or *ribā*.

The emergence of Islamic finance as a current formal area of study and also as a segment of the contemporary global finance architecture dates back to less than 70 years. Contemporary practice of Islamic finance gave birth to its more enhanced

¹⁰⁸ Dogarawa, A. B. (2018). Overview of the Scope and Dimensions of Islamic Finance in Nigeria. Being paper presented at 19th Annual Judges Conference organised by Centre for Islamic Legal Studies, Ahmadu Bello University Zaria in collaboration with National Judicial Institute Abuja at ABU Hotels, Zaria, p. 8.

consequent learning in formal school settings around the globe now. Here we note that the Islamic financial universe revolves around investment and financing activities that are ethically based and reflect *Sharī'ah* principles. From a neglected and minute size in the global finance sphere, the industry has transited in leap and bound to witness a phenomenal growth.

Despite a strong performance in 2019, it was forecasted that Islamic finance industry growth would slow-down in 2020-2021 due to lockdown measures occasioned by the global Covid-19 pandemic and ensuing recessions in Islamic finance core countries. However, the global Islamic Finance Services Industry (IFSI) maintained its growth momentum despite the pandemic and grew from USD 2.44 trillion in 2019 to USD 2.70 trillion in 2020 marking a growth of 10.7% year-on-year (y-o-y) in assets.¹⁰⁹ According to the Islamic Finance Development Report 2022, the total global Islamic finance assets in 2021 had reached USD 4.0 trillion with a growth rate of 17% and total of 1,679 institutions.¹¹⁰

Regionally, the Gulf Cooperation Council countries (GCC) (retained its position as the largest domicile for Islamic finance assets in 2020. The region accounted for 48.9% of the global Islamic finance market share, increasing from 45.9% in 2019. The Middle East and South Asia (MESA) region constituted the second-largest share, accounting for 24.9% of global IFSI assets, remaining consistent with the previous year. The South-East Asia (SEA) region's share shrank slightly to 20.3% in 2020 from 23.8% in 2019, while that of the Africa region remained small, with a share of 1.7%. The “Others” region, comprising Turkey, the UK and countries from the Commonwealth of Independent States (CIS) region, accounted for 4.3% of total global IFSI assets.¹¹¹

According to reports by the Islamic Development Bank, TheCityUK, Thomson Reuters and SP Global Rating, the market for Islamic financial assets has grown at an average rate of about 16 percent per annum since 2006 except in 2015, 2016 and 2017 in which growth was pegged at 5%, 8% and 2% respectively. The industry that started with a handful of institutions and negligible amounts in the late 1970's grew to total assets of about US\$1.7 trillion by 2013. The global Islamic finance market measured by *Sharī'ah* compliant assets was estimated at around \$2trn at the end of 2015. By the end of 2017, there were more than 1,300 institutions registered

¹⁰⁹Islamic Financial Services Board - IFSB (2021). *Islamic Financial Services Industry Stability Report 2021*, Islamic Financial Services Board, Kuala Lumpur, p. 6.

¹¹⁰ Islamic Corporation for the Development of Private Sector (ICD) - Refinitiv Islamic Finance Development Report 2022, p. 24.

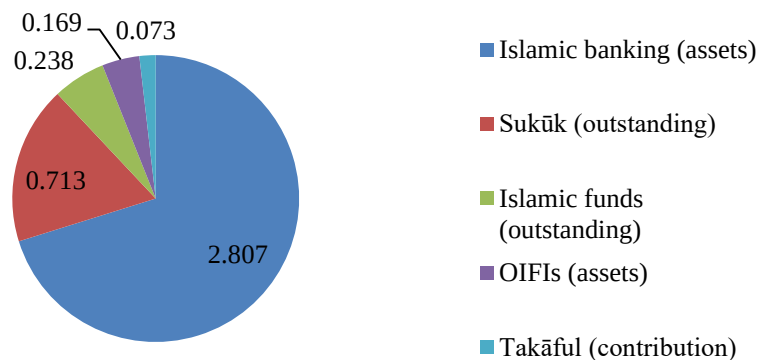
¹¹¹Ibid.

globally as *Shari'ah* compliant organisations in financial services. At the end of the same year, it was estimated that the assets of Islamic finance industry globally were about \$2.1 trillion of which \$1.7 trillion were in banking assets.¹¹²

In terms of assets composition of the Islamic finance sector, Islamic banking assets is approximated at 72-78.9%; *Sukūk* 15-17%; Islamic equity and funds 3-4%; *Takāful* 1-2%; Microfinance 1%; and Others 4%. With regard to equity and funds, the market compared to *Sukūk* has remained a niche in spite of its excellent performance over the past years. In 2018, a report by SP Global Rating revealed that the *Takāful* sector had continued to face legal and regulatory challenges around the world largely due to somewhat concentrated and undifferentiated business models and high transactional and operational costs that made them susceptible to adverse event risks related to solvency, governance, and accountancy. The contribution of Africa with regard to Islamic finance assets remained meagre as by end of 2017, it was estimated at less than 2% of global consolidated assets and 1% of the global *Sukūk* issuance. Till date, only a handful of Islamic banks operate in the African continent mostly in form of window and, so far, only a few countries in Africa have issued *Sukūk* over the last one and a half decades.¹¹³

Figures 8-11 diagrammatically illustrate the global Islamic finance outlook.

Figure 8: Segmental Composition of the Global Islamic Finance as of 2021 (trillion USD)



Data source: Islamic Finance Development Indicator Report 2022

¹¹² Dogarawa, A. B. (2018). Overview of the Scope and Dimensions of Islamic Finance in Nigeria, p. 11.

¹¹³ Ibid.

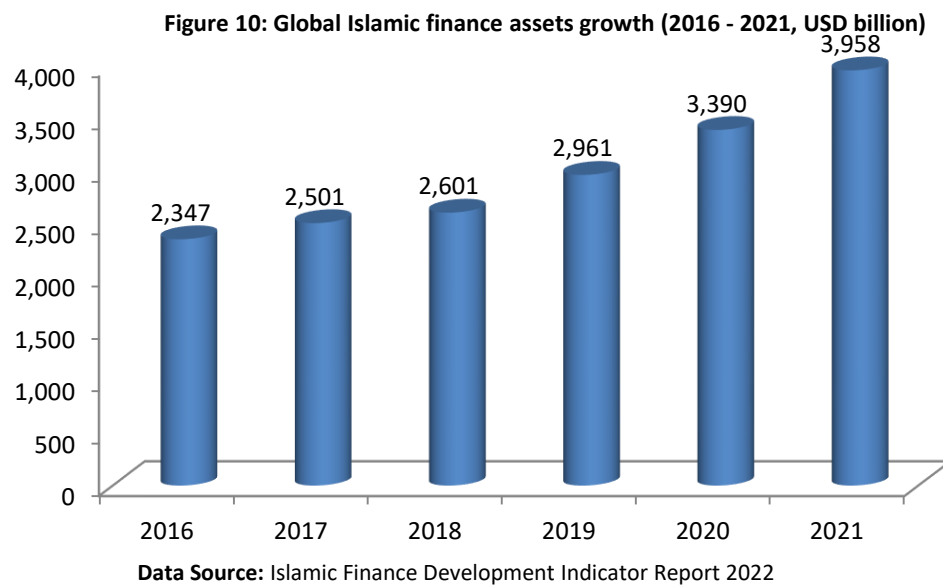
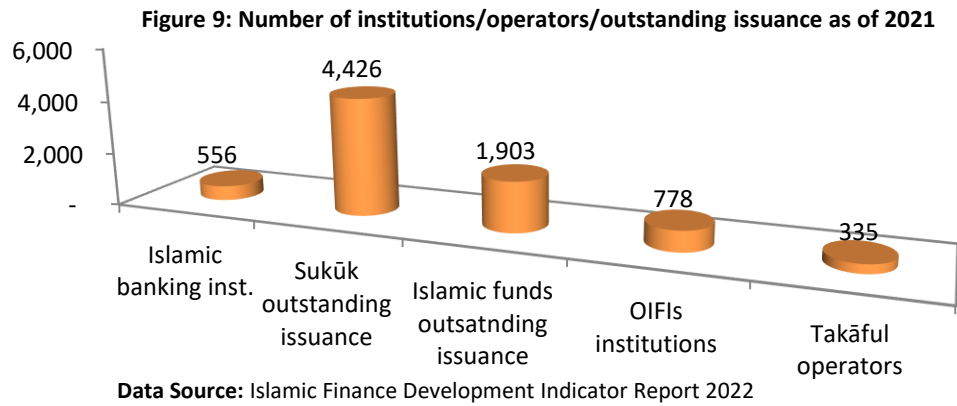
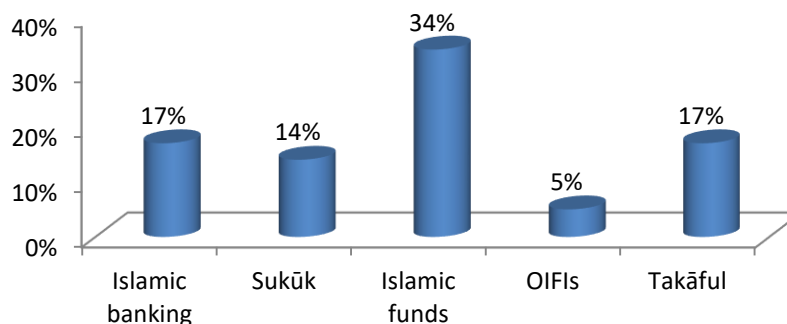


Figure 11: Islamic finance Sectoral growth rate as of 2021



Data Source: Islamic Finance Development Indicator Report 2022

1.5.1 Islamic Banking Outlook

The Islamic banking sector, which dominates the industry with approximately 75% of all Islamic financial assets under management, is predominant in the GCC, Southeast Asia and Middle East and North Africa (MENA) excluding GCC countries. In non-Muslim majority countries, Europe and the Americas are leading with a marginal presence of Islamic banking institutions. Out of the 75% owned by Islamic banks and conventional banks with Islamic windows, about 60% belong to full-fledged Islamic banks.¹¹⁴ Islamic microfinance is included in the banking sector. By the end of 2016, it was estimated that over 300 Islamic Microfinance Institutions operated in 32 countries with \$1 billion market size and more than 2 million active financing clients.

Over the past five decades, Islamic banking has emerged as one of the fastest growing industries. Its spread has covered all corners of the globe and has received wide acceptance by both Muslims and non-Muslims alike. In the present circumstances, being one of the most important players in the financial service industry, Islamic banking is now seen as a business entity that strives to, not only fulfill the religious obligations of the Muslim community, but also, as a business that is needed by the ethically minded, and which facilitates winning over other customers whilst retaining the old ones. Thus it is projected that Islamic banking will show stable total assets or low-single-digit growth. This follows 6.6% growth in 2019 thanks to good performance in the Gulf Cooperation Council (GCC),

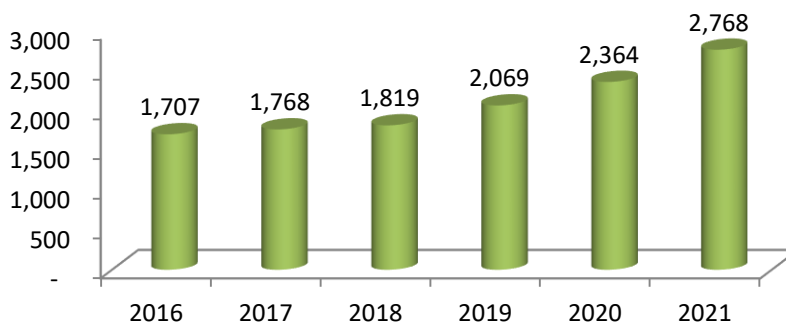
¹¹⁴ Sidlo, K. W. (2017). Islamic finance 2017: State of art and outlook for the future. K4D Helpdesk Report. Brighton, UK: Institute of Development Studies, p. 2.

Malaysia and, to a lesser extent, Turkey and Indonesia, but a declining contribution from Iran amid the deep recession reported by the IMF.

The global Islamic banking industry in 2020 experienced a growth of assets by 4.3% thus showing a slowdown compared to the momentum of 12.4% gained in the preceding year 2019, with total assets as at 3Q20 amounting to USD 1.84 trillion against 3Q19: USD 1.77 trillion. This negative development was not unexpected due to the outbreak of the global Covid 19 pandemic which had wide ranging implications on the global economy.¹¹⁵ It was further indicated in the report that jurisdictions where Islamic banking institutions had attained the status of domestic systemic importance rose from 13 to 15 as at 3rd Quarter of 2020. Put together, the 15 systemically important Islamic banking jurisdictions comprise a 92.4% share of the global Islamic banking assets as at 3Q20 [3Q19: 91.4%]. Aside from Iran and Sudan, where Islamic banking constituted 100% of the domestic market, Saudi Arabia and Brunei continued to be the only two jurisdictions that had a domestic Islamic banking share of over 50%. Saudi Arabia's Islamic banking share stood at 68.0%, while Brunei's share stood at 61.9%, as at 3Q20.¹¹⁶ As of 2021, global Islamic banking assets were put at USD 2.8 trillion and the growth of the sector's assets was 17% while Islamic banking institutions had reached 566.¹¹⁷

The global Islamic banking assets between 2016 and 2021 are presented in Figure 12.

Figure 12: Global Islamic banking assets 2016-2021 (USD billion)



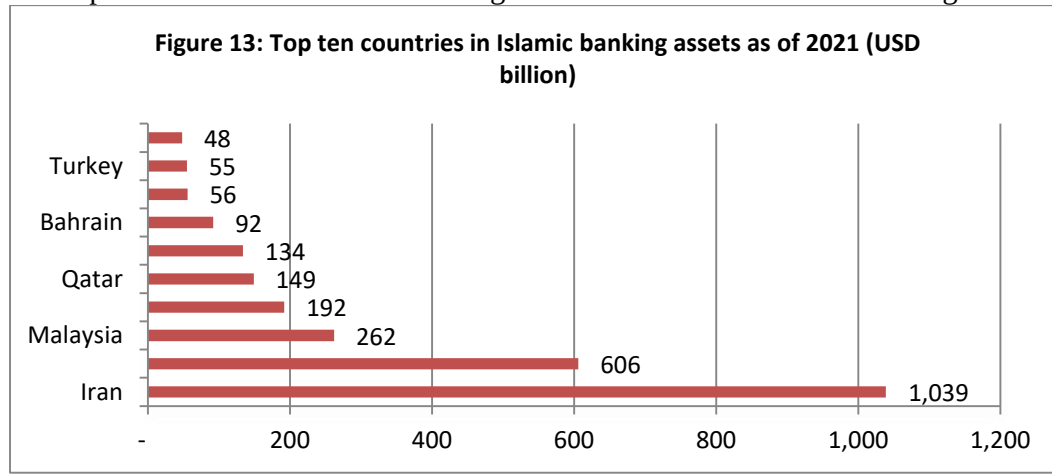
Data Source: ICD – Refinitiv Islamic Finance Development Report 2022

¹¹⁵Islamic Financial Services Board - IFSB (2021). *Islamic Financial Services Industry Stability Report 2021*, p. 27

¹¹⁶Ibid, p. 29.

¹¹⁷ Islamic Corporation for the Development of Private Sector (ICD) - Refinitiv Islamic Finance Development Report 2022, p. 30.

The top ten countries in Islamic banking assets as of 2021 is illustrated in Figure 13.



Data Source: TheCityUK (2022), Islamic finance: global trends and the UK market

Figure 13 indicates that Iran ranks first among the top ten countries in Islamic banking assets as of 2021 while Indonesia ranks tenth on the list.

1.5.2 *Sukūk* Outlook

Sukūk, plural of the Arabic term *Sakk*, are *Sharī'ah*-compliant bonds developed as alternative to conventional, interest-based bonds. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) defined *Sukūk* as “certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or the assets of particular projects or special investment activity.” For a defined period, the risk and return associated with such assets belong to *Sukūk*-holders, which makes their return permissible for them. Unlike the bond, which stands for a loan repayable to the holder on specified dates in any case, and mostly with interest, *Sukūk* represents the direct *pro rata* ownership of the holder in the assets of the pool from whose income he earns return.¹¹⁸

The origin of *Sukūk* is traced to the first Islamic century during which papers representing financial obligations/liabilities originating from trade and other commercial activities were issued in conformity with Q2:282. Under the Umayyads (661-750CE), government used commodity coupons known as *Sukūk al-Badā'i* (certificates for goods or groceries) as means of payment to soldiers and public

¹¹⁸ For further reading, see: Abubakar, M. and Abdullahi, N. (2019) Sukuk: Types and Valuation In: Hassan, M. K., Mamunur, R. and Sirajo, A. *Islamic Corporate Finance* 1st Edition, Taylor and Francis Routledge, pp. 136-146

servants, who would later redeem these certificates in line with their day-to-day consumption of such goods or groceries.¹¹⁹ The Organisation of Islamic Cooperation (OIC) Fiqh Academy laid the basis for development of *Sukūk* as a modern financial instrument through a statement in 1988, while AAOIFI continues to play an important role in harmonising *Sharī'ah* standards relating to it.

Sukūk is a suitable financial instrument for government to attract global investors. It provides diversification of investor base and instruments and may be utilised to achieve long-term funding for infrastructure projects. Financial institutions could use *Sukūk* as a long-term funding instrument to support balance sheet growth and maturity mismatch. Islamic banks may also issue *Sukūk* to fund their balance sheet in order to support their growth and become more competitive. Corporate organisations could also use *Sukūk* for long-term funding to support their growth, to access various new markets and new investors as well as a means of diversification.

The Malaysia International Islamic Financial Centre and IKAM Research Center for Islamic Economics have both reported that Malaysia issued the first local *Sukūk* in 1990 worth MYR 125 million and international US Dollar *Sukūk* in 2001 worth \$150 million; followed by several sovereign *Sukūk* issued by Qatar, Pakistan and Dubai. In Africa, *Sukūk* issuance, mostly sovereign, has continued to grow both in size and in number of countries that have keyed into it. African countries that have issued *Sukūk* include: Sudan, Gambia, Senegal, South Africa, Cote d'Ivoire, Togo, Nigeria, and Mauritius. Advanced work is ongoing in Egypt, Kenya, Uganda, Tunisia, Morocco and Tanzania to facilitate *Sukūk* issuance. As of September 2017, global *Sukūk* issuance had hit \$918.88 billion of which \$706.18 billion represented domestic issuance while \$212.7 billion represented international issuance.¹²⁰

Due to support from a myriad of policy actions, the *Sukūk* sector ended 2020 with a total outstanding asset size of USD 689.5 billion [2019: USD 543.4 billion], thus recording a growth of 26.9% on a year-on-year basis. Thus, the volume of *Sukūk*

¹¹⁹ Chance, C. (2009). *Sukuk Guidebook*. Dubai International Financial Centre, p. 9. Available at:

https://www.isfin.net/sites/isfin.com/files/dubai_international_financial_centre_sukuk_guidebook.pdf Also, see: Ulus, S. (2013). Fixed Income Investment (Sukuk) in Islamic Finance. *Afro Eurasian Studies*, Vol. 2, Issues 1&2, Spring & Fall, p. 299; and Eris, I. (2021). Historical Origins of Sukūk as a Popular Instrument in Modern Islamic Finance. *İslam Hukuku Araştırmaları Dergisi*, Vol. 38, pp. 108-109.

¹²⁰ Dogarawa, A. B. (2018). Overview of the Scope and Dimensions of Islamic Finance in Nigeria, p. 9.

outstanding, on its own, accounted for 25.6% of the global Islamic Financial Services Industry (IFSI) as at the end of 2020 [2019: 22.3%], with a compound annual growth rate (CAGR) of 26% over the last 16 years (similar to that recorded in 2019).¹²¹ *Sukūk* has maintained its position as a major growth driver in the IFSI. In addition, issuers and investors based in various established regions as well as new entrants have maintained the *Sukūk* progression trajectory.¹²²

Regionally, the GCC accounted for about 41% of the total volume of issuances in 2020, representing an overall increase in issuances from the region. The South-East Asia region (specifically, Malaysia, Indonesia and Brunei) accounted for about 42% of issuances. Overall, Malaysia remains the largest *Sukūk* issuer, followed by Saudi Arabia and Indonesia. There are several expected new entrants to the market in the coming years, including Egypt, Uzbekistan, Algeria and Mauritius. There were several events during 2020 which can be noted as landmark events such as private sector led issuance from various jurisdictions and increase in activity from countries such as Nigeria, Pakistan, Bangladesh, etc. Moreover, the continued interest from well-established sovereign, quasi sovereign and financial institutions issuers such as Governments of Malaysia, Bahrain, Indonesia, Turkey, Pakistan, Oman, Saudi Arabia, United Arab Emirates, Kuwait and the Islamic Development Bank which has kept the *Sukūk* market active.¹²³

The total global issuance (long-term and short-term) amounted to USD 174.641 billion in 2020 which was the highest value of yearly *Sukūk* issuances. Thus, the global *Sukūk* issuance showed an increase of around 19.84% p.a. or USD 145.702 billion in 2019 to USD 174.641 billion in 2020. As of 2021, *Sukūk* value outstanding was USD 713 billion while the number of *Sukūk* outstanding was 4,426 with a growth rate of 14%.¹²⁴ The steady issuance volume during 2020 and 2021 was mainly due to sovereign *Sukūk* issuances from Asia, GCC, Africa and certain other jurisdictions while Malaysia continued to dominate the *Sukūk* market though the share of countries such as Indonesia, UAE, Saudi Arabia and Turkey increased with good volume.

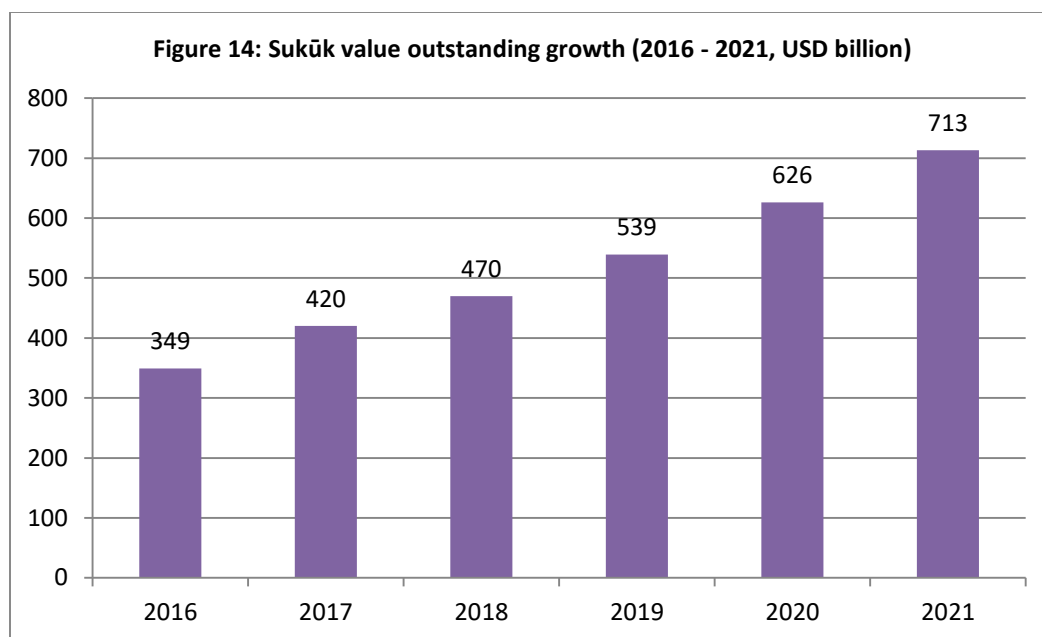
To give a clearer picture, the trend of *Sukūk* value outstanding growth between 2016 and 2021 is presented in figure 14.

¹²¹Islamic Financial Services Board - IFSB (2021). *Islamic Financial Services Industry Stability Report 2021*, p. 31.

¹²² International Islamic Financial Market - IIFM (2021). *Sukuk Annual report*.

¹²³ International Islamic Financial Market IIFM (2021). *Sukuk Annual Report*.

¹²⁴ Islamic Corporation for the Development of Private Sector (ICD) - Refinitiv Islamic Finance Development Report 2022, p. 44.



Data Source: ICD – Refinitiv Islamic Finance Development Report 2022

In Nigeria, *Sukūk* is being used by the Federal Government to support infrastructural development, promote financial inclusion and deepen the domestic securities market. So far, five sovereign *Sukūk* series have been successfully issued by the FGN totalling ₦742 billion: 2017 (₦100 billion), 2018 (₦100 billion), 2020 (₦162.557 billion), 2021 (₦250 billion) and 2022 (₦100 billion). The sixth series of FGN sovereign *Sukūk* worth ₦150 billion was offered for subscription in October 2023. In addition to the sovereign *Sukūk*, some State Governments have issued or are in the process of issuing sub-national *Sukūk*. The Osun State seven-year ₦11.4 billion *Sukūk* was the first sub-national *Sukūk* issued in Nigeria in 2013. State Governments that have either issued or are in the process of issuing sub-national *Sukūk* include Lagos, Niger, Gombe and Katsina. Apart from sovereign and sub-national *Sukūk* issuances in Nigeria, there were many corporate *Sukūk* issuances in the country. The Family Homes Limited was the first to issue a seven-year ₦10 billion corporate *Sukūk* in 2021 while the 2023 TAJBank's ₦11.4 billion *Mudārabah Sukūk* was the first corporate *Sukūk* to be listed on the trading floor of Nigerian Exchange Limited (NGX).

1.5.3 Islamic Equity and Funds Outlook

Islamic funds also called *Shari'ah* compliant funds are fund vehicles that comprise a joint pool where both Muslim and non-Muslim investors can contribute their surplus money for the purpose of investment to earn *halāl* profits in strict

conformity with the principles of the *Sharī'ah*. For Muslim investors, Islamic funds are considered as funds with a “religious” connotation, whereby, for non-Muslim investors, this type of fund falls under the category of ethical or socially responsible funds.

In terms of resources pooling, capital preservation and return optimisation objectives, Islamic funds are similar to conventional funds. In contrast to conventional funds, however, Islamic funds must be invested in line with the dictates of the *Sharī'ah*. Islamic funds include Islamic index funds, *Sharī'ah* private equity funds, *Sukūk* funds, *Sharī'ah* compliant hedge funds, Islamic equity funds, *Murābaha* funds, Islamic commodity funds and *Ijārah* funds.

The global Islamic fund is on the rise. As at March 2017, the Malaysia International Islamic Financial Centre put the total global Islamic fund assets at \$70.8 billion and the number of Islamic funds stood at 1,225. It was then projected that the funds would grow by 5.05% per annum to reach \$77 billion by 2019.¹²⁵ The value of the assets rose to \$146 billion, \$178 billion and \$238 billion in 2019, 2020 and 2021 respectively. The number of Islamic funds outstanding in 2021 stood at 1,903.¹²⁶

The total assets under management (AuM) of Islamic funds grew by 31.9% in 2020 despite the global Covid-19 pandemic. While total AuM grew significantly, the total number of funds increased at a slower rate, which was a positive indication of growth in the average size of funds. Islamic funds continued to remain concentrated by domicile in three core markets – Saudi Arabia, Malaysia and Iran – constituting around 81% of total AuM.¹²⁷

Global equity markets rebounded strongly from pandemic lows, with notable differentiation across countries depending on the spread of the virus, the scope of policy support and sectoral composition. Overall, 2020 was an exceptional year for the equity markets, with a bull market at the beginning of the year, followed by a steep crash from the initial market shock of the pandemic and a short-lived bear market, before once again entering a bull market. The technology sector, to which Islamic equities tend to have a relatively high exposure, outperformed the other

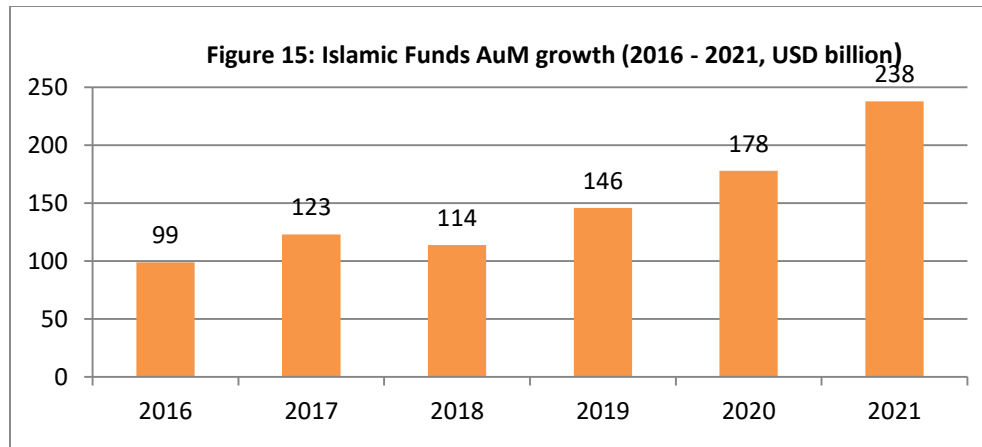
¹²⁵ Dogarawa, A. B. (2018). Overview of the Scope and Dimensions of Islamic Finance in Nigeria, p. 10.

¹²⁶ Islamic Corporation for the Development of Private Sector (ICD) - Refinitiv Islamic Finance Development Report 2022, p. 50.

¹²⁷ Islamic Financial Services Board IFSB (2021) Stability Report.

sectors, as companies in this sector benefited the most from the “new normal” of remote work and increased time spent at home as a result of lockdowns.¹²⁸

Figure 15 presents Islamic funds AuM growth between 2016 and 2021.



Data Source: ICD – Refinitiv Islamic Finance Development Report 2022

1.5.4 *Takāful* Outlook

Takāful refers to a *Shari’ah*-compliant insurance system that is based on the principle of mutual sharing of risks. Through the system, participants/members mutually contribute a sum of money to support each other and provide aid at the time of need and guarantee that losses arising from damage or theft are distributed equally across each member. In *Takāful*, the amount of contribution is decided according to the personal circumstances of members and the type of coverage they require.¹²⁹

The objective of *Takāful* is “to cooperate, live harmoniously amongst the community and protect each other against uncertain mishaps.” Regular monetary contributions of policyholders of *Takāful* are supervised and managed by a *Takāful* management firm. The surplus amount contributed, after losses (if any) are offset, is then employed for making investments which are helpful for earning a higher profit for the policyholders. *Takāful* insurance companies serve as an alternative to commercial insurance companies as the latter violate the restrictions on interest,

¹²⁸Islamic Financial Services Board IFSB (2021) Stability Report.

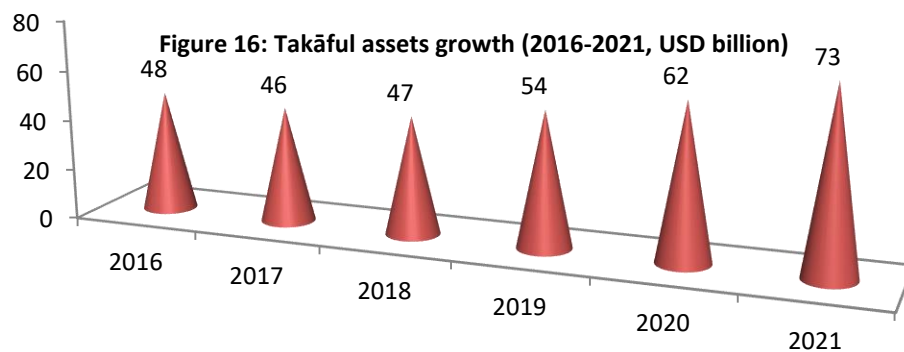
¹²⁹ Dogarawa, A. B. (2018). Overview of the Scope and Dimensions of Islamic Finance in Nigeria, p. 10.

uncertainty and gambling principles which are outrightly prohibited in the *Shari'ah*.

In 2018, a report by IMARC Group estimated the global *Takāful* market at \$46 billion in 2017. The market was projected to exceed \$40 billion by 2023 based on estimated average growth of 13% per annum during 2017-2023. *Takāful* contributions were estimated at USD 54 billion in 2019.¹³⁰ As of 2021, *Takāful* assets were US\$ 73 billion with 17% growth while the number of *Takāful* operators rose to 335.¹³¹ The Gulf Cooperation Council (GCC) currently dominates the global *Takāful* market, holding the majority of the share and is followed by Southeast Asia and Africa.

As in conventional insurance, the *Takāful* segment records a ratio of between life and non-life business that varies greatly between countries. This outlook is largely a reflection of the way individuals in those countries choose to save for their future needs which is influenced by history, and by social and cultural factors, rather than by the economic situation. Saudi Arabia and Iran are the largest *Takāful* markets by a considerable margin, and both are entirely Islamic.

Figure 16 illustrates the global *Takāful* assets growth between 2016 and 2021.

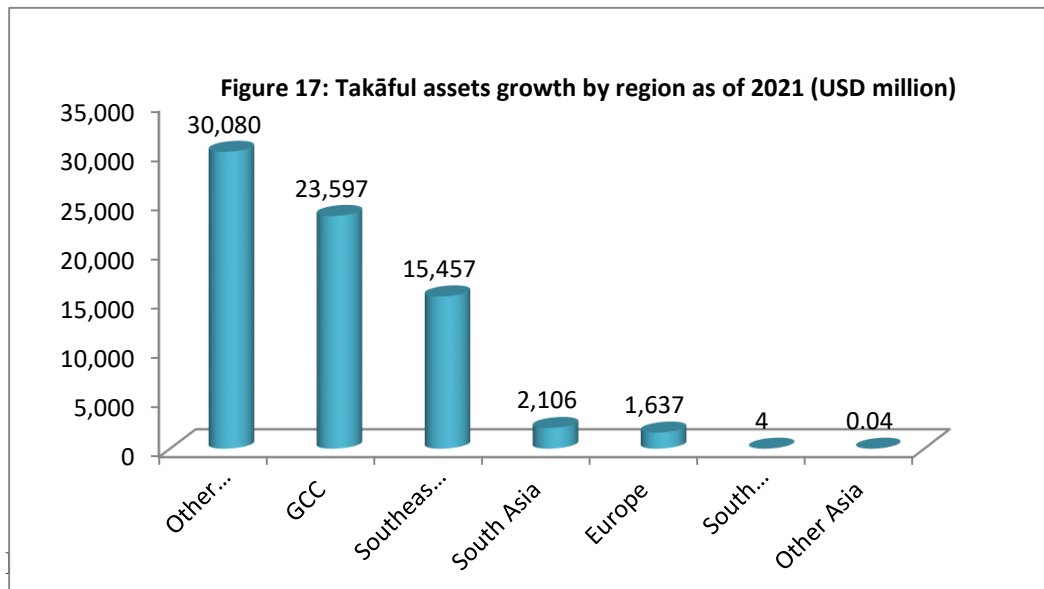


Data Source: ICD – Refinitiv Islamic Finance Development Report 2022

¹³⁰ Islamic Financial Services Board IFSB (2021) Stability report.

¹³¹ Islamic Corporation for the Development of Private Sector (ICD) - Refinitiv Islamic Finance Development Report 2022, p. 36.

The global *Takāful* assets growth by region as of 2021 is presented in Figure 17.



1.5.5 Other Islamic Financial Institutions Outlook

Other Islamic Financial Institutions (OIFIs) consist of all Islamic financial institutions that do not fall under the umbrella of Islamic banks and *Takāful* operators. This category of Islamic institutions includes investment firms, financial technology companies, financing firms, mortgage, leasing and factoring companies, and microfinance institutions.

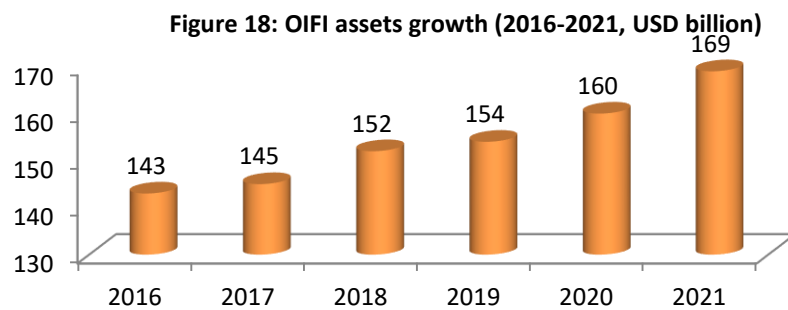
OIFIs make up 5% of the Islamic finance industry. In 2019, it witnessed a 6% y-o-y growth in total assets to reach US\$ 154 billion. The amount increased slightly to US\$ 160 billion in 2020. In 2021, OIFI assets were estimated at US\$ 169 billion with a 5% yearly growth rate. The total number of OIFIs (including FinTechs) was 778.¹³²

Investment firms dominated the OIFIs sector. They made up 45% of total global OIFIs and 40% of its assets in 2019. This is followed by financing companies, which accounted for 19% and 37% of OIFIs number and assets respectively. Malaysia, Iran and Saudi Arabia were considered the top three OIFIs markets. Their combined contribution accounted for a 72% of the total global OIFI assets in 2019.

¹³² Ibid, p. 40.

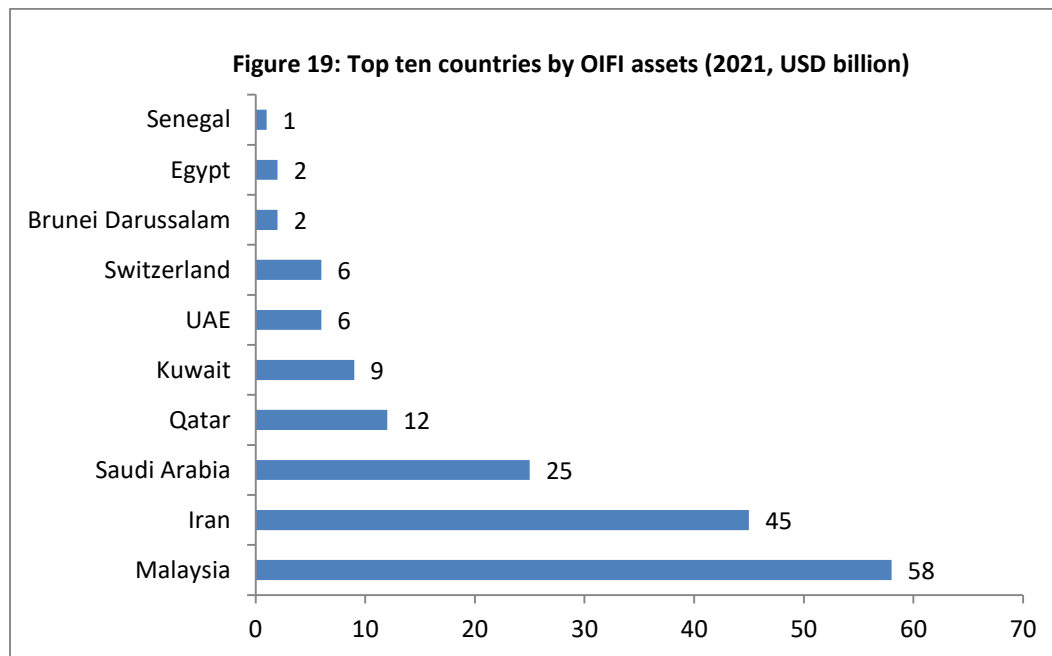
Investment firms, which accounted for the largest share of OIFIs and OIFI assets globally, are highly concentrated in Bahrain.¹³³

Figure 18 illustrates the global OIFI assets growth from 2016 to 2021.



Data Source: ICD – Refinitiv Islamic Finance Development Report 2022

Figure 19 presents the top ten countries by OIFI assets as of 2021.



Data Source: ICD – Refinitiv Islamic Finance Development Report 2022

¹³³ Alpen Capital (2021). Islamic Finance and Wealth Management Report, p.44. available at <https://argaamplus.s3.amazonaws.com/86f171a0-dcdc-4a26-b7f1-35345c16f250.pdf>

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ISLAMIC LAW OF FINANCIAL CONTRACTS

2.1 Introduction

Financial contracts in Islamic law (*al-Mu'āmalāt al-Māliyyah*), occupy the third category in pecking order after the laws governing creed (*al-Tauhīd*) and worship (*al-ʿibādāt*). It is a very essential aspect of Islamic law because it governs the legitimate transfer of ownership between members of the Muslim *Ummah* and also between Muslims and others. Islam promotes the concept of private ownership and, as such, prohibits the devouring of the property of one another in vanity as clearly spelt out in the *Qur'ān*, the first primary source of the *Sharī'ah*.¹³⁴

Therefore, any transfer of ownership concerning any contract (whether profit based or gratuitous) is regarded lawful and legitimate, in Islam, if it conforms with the required legal framework and satisfies the lawful methods for property acquisition in Islamic law. Thus, the laws governing financial contracts regulate the conduct of businesses in a systematic and well -arranged manner with a view to protecting the rights of persons in both private and public ownerships which is one of the essential necessities (*al-dharūriyyāt al-khams*) that Islam is out to promote.

Thus, this segment aims at examining the legal framework for the conduct of financial contracts and exploring some selected classical and emerging contracts that are, in one way or the other, related to contemporary Islamic financial dealings.

2.2 Conceptual Discourse on Financial Contracts in Islamic Law

The term financial contracts (*Al-Mu'āmalāt al-Māliyyah*) () connotes any action or transaction which involves the transfer or disposition of money, whether in return for consideration or gratuitous.¹³⁵ This term, even though novel, is well known to Islamic jurisprudence. Jurists have referred to it as '*Uqūd al-Islāmiyyah* (Contracts in Islamic law) or *al-Mu'āmalāt al-Islāmiyyah* (Transactions in Islamic law). In either of the two, the term is used to refer to *al-Bay'* (sale), *al-Ijārah* (lease), *al-Sharikah* (partnership), *al-Kafālah* (suretyship), *al-Rahn* (pledge/mortgage), and *al-Sulh* (settlement), etc. Its scope equally covers gratuitous contracts such as; *al-Qard* (loan), *al-Īdā'* (bailment), *al-Waqf* (endowment) and *al-Wasiyyah* (bequest).

¹³⁴*Qur'ān*, 2:188; 4:29.

¹³⁵Al-Zuhailī, W. (2005). *Maḥmūd al-Mu'āmalāt al-Māliyyah wa al-Aslu fīha*, in al-Jazeera Program "*al-Sharī'ah wa al-Hayāh*", Makkah, on 15/02/2005, by 16:53. See also; www.aljazeera.net/programs/religionandlife/2005/2/15/usulamuamalatalmaliyyah, p.1.

The above concept, however, was developed from the indispensable need of people to transact with and support each other.

The term *al-'Aqd*, which is synonymous to *al-Mu'āmalah* is the singular form of '*Uqūd*, and, literally means 'to tie' (between two ends), 'to fasten' and 'to link' together.¹³⁶ In the technical sense, the word has general and specific interpretations. In the former, it means anything that is intended by a person to do/perform; either on grounds of his own exclusive will, such as an endowment; or based on the consent of at least two parties such as a sale contract. While in the latter, the word *aqd* means the connection of the statement (offer) of one party to the utterance (acceptance) of the other party which gives legal effect to the transaction.¹³⁷

It is construed from the above definition that the term '*aqd* is more or less cognate to the technical term contract in western jurisprudence. In spite of this, the word '*aqd* does not necessarily require agreement which is a necessary element in a conventional contract because the term is as well utilized to describe a unilateral juridical act which is binding and operative without the consent of the other party.

The main objective of the aforementioned contracts is to initiate profitable investments for the benefit of the entire populace. This is because freezing of wealth creates a serious violation of public interest; therefore, circulation of money in the markets brings about general benefits not only to the parties in contracts, but to the economic development of each society.

2.3 Legal Framework of Financial Contracts in Islamic Law

Generally, financial contracts are conventionally the legitimate ways for wealth acquisition in Islamic law.¹³⁸ They are otherwise known as *al-mu'āmalāt* or *al-'uqūd al-māliyyah* as stated earlier. Almighty Allah says in the Glorious *Qur'ān*: "Oh you who believe fulfill your obligations"¹³⁹ '*Al-'uqūd*' as provided in the above verse is the plural of *al-'Aqd* which is rendered into English as "obligation." This text is regarded as the legal basis of contracts in Islamic law.

Other authorities that contemplate the legal basis of financial contracts in Islamic law are: "... So fulfil your engagements with them to the end of their term, for Allah

¹³⁶ Ibn al-Manzūr, M. M. (2002) *Lisānal-Arab*, Dār al-Ma'arif, Cairo, Vol. 3, p. 297.

¹³⁷ Ibn Abidīn, M. A. (2000). *Hāshiyat Radd al-Mukhtār alā al-Durr al-Mukhtār*, Daar al-Fikr, Beirut, Vol. 3, p.3.

¹³⁸ Al-Zuhailī, W. (2006). *Al-Fiqh al-Islāmī wa Adillatuh*, Dār al-Fikr, Damascus, Vol. 4, p. 2913.

¹³⁹ *Qur'ān* 5:1.

loves the righteous.”¹⁴⁰ So also the prophetic tradition that provides: “Muslims are bound by their conditions except a condition that makes the lawful unlawful or the unlawful lawful.”¹⁴¹ However, each distinct financial contract under Islamic law has an exclusive legal authority that backs it. The above general authorities, however, are applicable to virtually all contracts under Islamic law.

2.4 Elements of Contracts

Financial contracts (*al-Mu'āmalāt al-Māliyyah*) are initiated, established and regulated by some general principles that are applicable to virtually all categories of contracts. The technical phrase/term for these principles is “elements or pillars (*al-arkān*) of contract.” Thus, the most important pillars are; the formula (*sīghah*), parties to the contract (*al-‘āqidān*), and the subject matter (*al-ma’qūd alaihi*).¹⁴²

a) The Formula (*sīghah*) is obtained through the offer and acceptance (*al-ījāb wa al-qabūl*) emanating from either a bilateral contract, sale or lease contract which requires agreement or meeting of the minds of the parties concerned (*consensus ad idem*),¹⁴³ or from a unilateral contract that requires only the offer from one party, such as in the case of *Wasiyyah* (bequest) in favour of a charitable institution, or waiving a loan on a debtor.¹⁴⁴

The *sīghah* in question may be made verbally, in writing, by gestures, or any informative act that manifests the agreement of the parties involved. For instance, a person may intimate his intention to the contract by conduct, which is technically known in *fiqh* as ‘*Mu’ātah*’, ‘*Ta’āti*’ or ‘*Murāwadah*’. Thus, if a seller displays commodities for sale and labels or attaches to them their prices and a simple statement such as “first come first served” it is a valid offer to sell. Likewise, is the conduct of a buyer who picks the commodity and pays its price (offer to buy). And, in return to this, when the seller delivers the commodity to the buyer, even without any expression, the contract is valid and enforceable.

The Glorious *Qur’ān* says: “Oh you who believe, eat not up your property among

¹⁴⁰ *Qur’ān* 9:4.

¹⁴¹ Al-Baihaqī, A. (1994). *Sunan al-Kubrā*, Maktabah Dār al-Bāz, Makkah, Vol. 7, p. 248.

¹⁴² Kuwaiti Encyclopaedia of Jurisprudence (1427). Ministry of Endowment and Islamic Affairs, Kuwait, Dār al-Safwah, Egypt, Vol. 30, p. 200.

¹⁴³ The Latin term “*Consensus ad idem*” which means meeting of minds, also referred to as mutual agreement, mutual assent. In particular it refers to the situation where there is a common understanding in the formation of the contract. This condition or element is often considered as a necessary requirement to the formation of a contract.

¹⁴⁴ Al-Zuhailī, W. (2005). *Mafhūm al-Mu’āmalāt al-Māliyyah wa al-Aslu fīha*, in al-Jazeera Program “*al-Sharī’ah wa al-Hayāh*”, Makkah, on 15/02/2005, by 16:53. See also; www.aljazeera.net/programs/religionandlife/2005/2/15/usulamuamalatalmaliyyah, p.3.

yourselves in vanities except it be a trade amongst you, by mutual consent...”¹⁴⁵ Additionally, the Prophet (peace be upon him) says; “Verily, transactions are based on agreements”.¹⁴⁶

In a situation where a counter offer is made, it is regarded as a statement by the offeree that has the legal effect of rejecting the offer and proposing a new offer to the offeror. Therefore, when an acceptance is communicated containing some modifications to the original offer, this will amount to a counter offer rather than acceptance of the original offer. Thus, Islamic law requires that acceptance shall correspond to all elements of a standing offer.

b) Concerning the parties to the contract (*al-‘Āqidān*), the *Sharī‘ah* requires them to be persons of full legal capacity and prudent judgment to enter into or execute the contract. In other words, both parties shall be sane, adult, free persons and of free will. Contracts executed by insane persons, lunatics, minors (not the *mumayyiz*), intoxicated (according to some jurists) etc. are invalid. The Prophet (peace be upon him) said: “The pen is lifted upon three: an insane person until he regains sanity, the one asleep until he wakes up and a minor until he attains puberty.”¹⁴⁷

Therefore, the contracting parties (*al-‘āqidān*) are those who exercise the *sīghah* (*al-ījāb wal qabūl*) and, in order to conclude a valid contract, the contracting parties must possess legal capacity (*al-ahliyyah*).

Al-ahliyyah (legal capacity) has been defined by Muslim jurists as the eligibility of a person to establish a right and discharge an obligation upon him. Thus, *ahliyyah* is classified into two, namely:

- 1) *Ahliyyatul wujūb* (receptive legal capacity) which technically means; the eligibility of a person to acquire rights for and upon himself. This particular form of *ahliyyah* is further divided into two: complete; and incomplete receptive legal capacity.
- 2) *Ahliyyatul adā* (active legal capacity), which simply refers to the eligibility of a person to execute or discharge his rights and duties in the manner recognized by the law. Similarly, this type is also divided into two: complete and

¹⁴⁵ *Qur’ān*, 4:29.

¹⁴⁶ Ibn Mājah (Hadīth 1792). See also: Ibn Hajar, A. A. (1379). *Fath al-Bārī Sharh Sahīh al-Bukhārī*, Dār al-Ma’rifah, Vol. 4, p. 289.

¹⁴⁷ Al-Naisābūrī, M. A. (1990). *Al-Mustadrak alā al-Sahīhain*, Dār al-Kutub al-‘Ilmiyyah, Beirut, Vol. 1, p. 389.

incomplete active legal capacity. However, *al-ahliyyah* in question may be subjected to some factors that impede someone's legal capacity. These factors can be mainly categorized into two:

- a) Involuntary impediments otherwise known as *al-awāridh al-samāwiyyah*; these are the factors beyond one's control. In other words, these factors exist without the affected person's choice. For example; insanity, unconsciousness, sleep, and death-illness. Thus, due to the deficient legal capacity of the persons affected by the above factors, they cannot enter into a valid contract.
- b) Voluntary impediments also known as *al-awāridh al-muktasabah*; these are factors within one's control. They exist due to the person's own act and his choice. For instance; the state of being intoxicated, prodigal or insolvent. Since these factors exist due to peoples' own making their 'aqd is valid although in some situations it may be suspended.

C) Subject matter (*al-Ma'qūd 'Alaihi*); The subject matter, i.e., the object, property or usufruct that the contractual effect falls on, should constitute legal property. Thus, it should be available and in existence at the time of the contract. This is because the Prophet (peace be upon him) has said: "Do not sell what is not available."¹⁴⁸ Therefore, contracts involving unavailable things, or articles incapable of delivery at the contractual session such as the sale of unripe fruits, foetus in the womb, birds in the air, fish in the river, monkeys in the forest, etc, are all invalid.

An example of a modern business transaction that falls under selling what one does not possess is drop shipping business. Drop shipping is a popular method of selling goods online where the seller does not own the goods but advertises and sells them on their website or App. Once a customer pays for the goods, the seller buys the product from the manufacturer/producer and asks them to ship it directly to the customer. This method is *harām* (impermissible) in Islam as it violates the *hadith* of the Prophet peace be upon him, which says that one should not sell things that are not in their possession.

The alternative method of making drop shopping permissible is for the seller to use the *Salam* mode of transaction which allows spot payment to be made to him while he delivers the goods to the buyer at a later date provided certain conditions are met. In a *Salam* transaction, while it is not required that the seller must own the

¹⁴⁸ Al-Sajastānī, A. S. (2009). *Sunan Abi Dawūd*, Dār al-Risālah al-Ālamiyyah, Beirut, Vol. 5, p. 362.

goods at the time of the contract, he is required to give all details of the product, including measurements, weight, colour, expiration date (if applicable), and date and place of delivery.

A second method of making drop shopping permissible is to become an agent to either the buyer or producer/manufacture where one acts as a middleman in return for a fee. A condition that must be fulfilled when acting as an agent for the customers/buyers is to take money from them and buy items with it, and not to buy items with one's own money then ask them to pay back.

A third method of making drop shipping *halāl* is by buying the products from the supplier in bulk and storing them at his warehouse. Then, when a customer makes a purchase, the supplier will ship the product directly to them. Alternatively, since possession is not limited to having the physical goods in one's hand but also includes having documents and keys to the goods, the seller could have a contract with a courier company to act as a proxy agent, picking up the products from the manufacturer and delivering them to the customer.

The rationale behind this is to block the means leading to conflicts and chaos which may arise as a result of the inability to deliver the property at a later period. However, exceptions to this general rule are; *bay' al-Salam*, (sale by advance payment for future delivery), *bay' al-Istisnā'* (contract of manufacture), *Ijārah* (contract of hire or lease), and *Musāqāt* (contract of irrigation). These kinds of contracts, even though contrary to the above fundamental rule, are permissible based on the prevalent practices involving these contracts during the glorious period. Similarly, they are allowed because of necessity and custom.¹⁴⁹

The subject matter in contracts should also be known to both parties in such a way that its attributes and specifications are clearly spelt out. Thus, the sale of unknown property is void. The authority for this is the prophetic tradition which states that: "The Prophet (peace be upon him) forbade the sale of uncertain commodities."¹⁵⁰ Additionally, the subject matter should be of commercial value and as well valuable in the eyes of the *Sharī'ah*. In other words, it should be property recognized for transaction by the *Sharī'ah*. Thus, the sale of wine, pork, carrion, and blood is unlawful. Similarly, a transaction involving nudity or pornography is equally

¹⁴⁹ Al-Zuhailī, W. (2005). *Maḥmūd al-Mu'āmalāt al-Māliyyah wa al-Aslu fīha*, in al-Jazeera Program "al-Sharī'ah wa al-Hayāh", Makkah, on 15/02/2005, by 16:53. See also; www.aljazeera.net/programs/religionandlife/2005/2/15/usulamuamalatalmaliyyah, p.4.

¹⁵⁰ Al-Baihaqī, A, (1994), *Sunan al-Baihaqiy al-Kubrā*, Maktabah Dār al-Bāz, Makkah Vol. 5, p. 266.

prohibited. The origin of this assertion is the Qur'ānic provision thus: "Forbidden for you are carrion, blood, pork..."¹⁵¹ So also: "...He allows them as lawful what is good (and pure) and prohibits them from what is bad (and impure)."¹⁵² No doubt, the aforementioned items and their like are bad and impure; they also harm human beings in their norms, values, dignity and health. Thus, Islam forbids any transaction involving such things to safeguard and protect the Islamic society from social and moral vices emanating therefrom.¹⁵³

Lastly, the subject matter should be legally possessed by the person disposing of it. Therefore, if a person sells a property belonging to another without his express permission or agreement, the said contract is voidable. According to the majority of jurists, such a contract may be validated by the ratification of the original owner of the property. Thus, if he endorses and ratifies the transaction, the irregularities are abolished, and the contract becomes valid. However, Imam al-Shāfi'ī held the view that the contract is void *ab initio* and, therefore, cannot be validated unless by a new contract.¹⁵⁴

2.5 Classification of Financial Contracts

Financial contracts under Islamic law derive their governing rules from the divine law i.e the *Qur'ān*, *Sunnah* and other subsidiary sources. Thus, even though our classical and contemporary societies are full of various types of financial contracts/dealings which are aimed at the acquisition of wealth and subsequent public or private ownership, a strict application of the above rules dictates that not all contracts are valid and enforceable under the *Sharī'ah*. Additionally, the classification in question has three dimensions, namely: the nature, circumstances and legal consequences of the financial contracts.¹⁵⁵ The following is a brief explanation on these dimensions.

2.5.1 Classification of Contracts according to their Nature

Contracts are classified into numerous types taking into cognizance the nature and kind of the transaction. This is based on the intents of the parties to the contract and their eventual objectives and goals towards the financial transaction. Thus, in that

¹⁵¹ *Qur'ān*, 5:3.

¹⁵² *Qur'ān*, 7:157.

¹⁵³ Al-Zuhailī, W. (2005). *Maḥnūm al-Mu'āmalāt al-Māliyyah wa al-Aslu fīha*, in al-Jazeera Program "*al-Sharī'ah wa al-Hayāh*", Makkah, on 15/02/2005, by 16:53. See also; www.aljazeera.net/programs/religionandlife/2005/2/15/usulamuamalatalmaliyyah. p. 4.

¹⁵⁴ Ibid.

¹⁵⁵ Al-Dubayān, D. M. *et. al.* (1432). *Al-Mu'āmalāt Al-Māliyyah Asālatan wa Mu'āsirah*, Maktabah al-Malik Fahad, Riyād, Vol. 1, p. 45.

regard, a contract may involve the five main contracts in Islamic finance, i.e. silent partnership or profit-sharing contract (*Mudārabah*), partnership (*Mushārah*), cost-plus financing contract (*Murābaha*), lease (*Ijārah*) and advance payment (*Salam*) or other popular contracts such as; sale (*bay'*), loan (*Qard*), manufacture (*Istisnā'*), etc. The following is a conceptual discourse on the classification of contracts according to their nature.

a) Sale (*al-Bay'*) Contract

Sale (*bay'*) contract is an exchange of one item for another. The Arabic term, *bay'* refers to the combined activities of buying and selling. The Arabic term *bay'* is derived from the term *bā'* (forearm) because one extends one's arm to give or take. Another explanation for this is the likely possibility of extending one's arm to the other to shake hands at the completion of a sale; hence the other Arabic term for sale agreement *safqah* (literally, a handshake).¹⁵⁶

In the technical meaning, sale is defined as: “The exchange of one commodity for another, one of which is called the object and the other the price;” or “The transfer of ownership of property to another.”¹⁵⁷ Al-Nawawī defined sale as: “The exchange of owned commodity for another commodity with the transfer of ownership.”¹⁵⁸

Regarding the legality of the sale contract, the Glorious *Qur'ān* provides: “But Allah has permitted trade...”¹⁵⁹ Another verse says: “But let there be among you traffic and trade by mutual good will.”¹⁶⁰ Similarly, Prophet Muhammad (peace be upon him) was asked: “Which are the best forms of income generation?” He replied: “A man’s labour and every legitimate trade.”¹⁶¹ In another *Hadīth* the Prophet (peace be upon him) said: “A sale must be by mutual consent.”¹⁶² Finally, Muslims have reached a consensus on the permissibility of sale contracts.¹⁶³

A valid sale contract has the following essentials:

¹⁵⁶ Al-Zuhailī, W. (2003). *Financial Transactions in Islamic Jurisprudence*, Translated by El-Gamal, M. A. et. al., Dār al-Fikr, Damascus, Syria, Vol. 1, p. 5.

¹⁵⁷ Al-Jazīrī, A. M. (1999). *Kitāb al-Fiqh alā al-Madhāhib al-Arba'ah*, Dār ihyā al-Turāth al-Islāmī, 7th edition, Vol. 2, p. 147.

¹⁵⁸ Al-Zuhailī, W. (2003). *Financial Transactions in Islamic Jurisprudence*, Translated by El-Gamal, M. A. et. al., Dār al-Fikr, Damascus, Syria, Vol. 1, p. 5.

¹⁵⁹ *Qur'ān*, 2:275.

¹⁶⁰ *Qur'ān*, 4:29

¹⁶¹ Al-San'ānī, M. (2004). *Sabūl al-Salām Sharh Bulūgh al-Marām min Jam'i Adillah al-Ahkām*, Dār al-Hadīth, Cairo, Vol. 3, p.6.

¹⁶² Ibid, p. 5.

¹⁶³ Salim, A. K. (2003). *Sahīh Fiqh al-Sunnah wa Adillatuh wa Taudhīh Madhāhib al-A'imma*, Al-Maktabah Al-Tauqīfiyyah, Cairo, Vol. 4, p.253.

- i) An agreement;
- ii) Involvement of two or more parties who are legally capable to contract;
- iii) Free consent of the parties to the contract;
- iv) Subject matter of the contract should be the object, price and consideration recognized by the *Sharī'ah*;
- v) The object ascertained;
- vi) The price fixed or if the consideration is other than the price, then it should be ascertained; and
- vii) Immediate transfer of the ownership.

b) Advance Payment (*Salam*) Contract

Salam or *Salaf* rendered into English language as: advance payment/forward contract is, literally, the sale of a deferred item in exchange for an immediate (forward) price. In other words, it is the sale of a liability whose characteristics are described in exchange for a price or capital-sum (*ra's al-māl*) paid in advance.¹⁶⁴ Technically, the Shāfi'is and Hanbalis define the forward contract thus: "a contract over described merchandise sold as a deferred liability on one person, in exchange for a price that is received during the contract session."¹⁶⁵ The Mālikis define it thus: "A sale in which the capital sum (price) is paid in advance and the object of sale is deferred to a specified term."¹⁶⁶ However, the latter definition appears more simple and encompassing to the concept of *Salam*.

The legal basis for *al-Salam* is construed from the interpretation of 'Abdullah bin Abbās (may Allah be pleased with them) on the *Āyatal-Dain*, the learned companion said: "I bear witness that the guaranteed lending for a known term was made lawful by Allah in His Book, and is thus, permitted."¹⁶⁷ He then recited the verse.¹⁶⁸

Conversely, in the *Sunnah* of the Prophet (peace be upon him), the companion of the Prophet 'Abdullah bin Abbas narrated that; the Prophet (peace be upon him) came to Medina and found the people there conducting the *Salam* contract

¹⁶⁴ Al-Jazīrī, A. M. (1999). *Kitāb al-Fiqh alā al-Madhāhib al-Arba'ah*, Dār ihyā al-Turāth al-Islāmī, 7th edition Vol. 2, p. 304.

¹⁶⁵ Al-Zuhailī, W. (2003), *Financial Transactions in Islamic Jurisprudence*, Translated by El-Gamal, M. A. et. al., Dār al-Fikr, Damascus, Syria, Vol. 1, p. 5; Vol. 1, p. 238.

¹⁶⁶ Ibid.

¹⁶⁷ Ibid, p.282.

¹⁶⁸ *Qur'ān*, 2: 282.

involving fruits (on the basis of indefinite time), a year, two or three years and then he said: “Whoever pays in advance for anything must do so for a specific measurement and a specific weight at a specified time.”¹⁶⁹ While, in respect of *Ijmā*; Ibn al-Mundhir has reported that their predecessors from whom they received knowledge agreed on the legality of the *Salam* contract.¹⁷⁰ Thus the conduct of such contract is a bright exception to the general rule which prohibits the sale of non-existent property.¹⁷¹

c) Lease (*Ijārah*) Contract

Contract of hiring or lease (*‘aqd al-Ijārah*) is an agreement between two parties on a particular subject matter to temporarily transfer the title of that particular subject matter. For instance, one party offers a particular property to another who accepts it for a fixed period. However, the Mālikis define leasing thus: “It is a transfer of ownership of permitted usufruct for a known period in exchange for compensation.”¹⁷² This is also the definition adopted by the Hanbalis.¹⁷³

The majority of jurists base their permitting of the lease contract on the provisions of the Glorious *Qur’ān*, *Sunnah*, and the consensus of the Muslim *Ummah*. In the *Qur’ān*; the proofs are derived from: “And if they suckle your offspring, give them their recompense.”¹⁷⁴ So also the saying of Allah: “Said one of them: O father, hire him on wages, for truly the best to employ is the strong and trustworthy man, He said: I intend to wed one of my daughters to you, on condition that you work for me for eight years, and if you complete ten full years, that will be a grace from you.”¹⁷⁵ Using the latter verse as proof is valid based on the principle. “The laws of those who came before us are applicable to us as long as they are not abrogated.”¹⁷⁶

In the *Sunnah* of the Prophet (peace be upon him) the legality is derived from: “Pay

¹⁶⁹ Al-Zarqānī, M. A. (1411). *Sharh al-Zarqānī ‘alā al-Muwatta li al-Imām Mālik*, Dār al-Kutub al-‘Ilmiyyah, Beirut, Vol. 3, p. 372.

¹⁷⁰ Al-Maqdisī, I. A. (2005). *Al-Uddah Sharh al-Umdah*, Dar al-Kutub al-‘Ilmiyyah, 2nd edition, Vol. 1, p.224; Ibn al-Mummy, Z. A. (2003). *Al-Mumti’ Sharh al-Muqni’*, Maktabah al-Sa’dī, Makkah, Vol. 2, p. 522.

¹⁷¹ Al-Sarakhsī, A. S. (2000). *Al-Mabsūt li al-Sarakhsy*, Dār al-Fikr, Beirut, Vol. 12, p.217.

¹⁷² Al-Zuhailī, W. (2003). *Financial Transactions in Islamic Jurisprudence*, Translated by El-Gamal, M. A. et. al., Dār al-Fikr, Damascus, Syria, Vol. 5, p. 3804.

¹⁷³ Ibid.

¹⁷⁴ *Qur’ān*, 65:6.

¹⁷⁵ *Qur’ān*, 28:26-27.

¹⁷⁶ Al-Dhafri, A. M. (1999). *Al-Wādhīh fī Usūl al-Fiqh*, Mu’assasah al-Risālah, Beirut, Vol. 2, p. 136.

the hired worker his wages before his sweat dries off.”¹⁷⁷ Another *hadith* cited in this regard is: “Whoever hires a worker should inform him of his wages.”¹⁷⁸ Sa’id bin Musayyib reported on the authority of Sa’ad (may Allah be pleased with him), “We used to rent lands in exchange for water and seeds, but the Prophet (peace be upon him) forbade the practice and ordered us to rent it with gold and silver.”¹⁷⁹ In the *Ijmā*; it is also known that the Muslim *Ummah* during the time of the companions of the Prophet (peace be upon him) reached a consensus on the permissibility of leasing prior to the time of al-Assam, Bin ‘Ulayyah, and others. In this regard, the usable usufruct of goods is of clear benefit to the people, thus qualifying the lease of such usufruct valid.¹⁸⁰

In a nutshell, the validity of the contract of leasing/hiring depends on the fulfillment of the following conditions:

- i) There must be at least two parties possessing full legal capacity.
- ii) There must be free consent of the parties.
- iii) The price or remuneration of the hiring must be determined.
- iv) The object of the hiring must be ascertained.
- v) The subject matter should be legal.
- vi) The period of hiring should be ascertained.

d) Partnership (*Mushārah*) Contract

The term Partnership Contract (*‘aqd al-Sharikah* also known as *Mushārah*) linguistically signifies mixing of two properties in a manner that makes it impossible to define the separate parts.¹⁸¹ According to the Māliki School of law, *sharikah* is a right for all partners to deal with any part of the partnership’s joint property.¹⁸² Muhammad Akram Khan also defined *sharikah* as: “a contract between two or more persons who launch a business of financial enterprise to make

¹⁷⁷ Ibn Battāl, A. K. (2003). *Sharh Sahīh al-Bukhārī li ibn Battāl*, Maktabah al-Rushd, Riyād, Vol. 6, p. 402.

¹⁷⁸ Al-Albānī, M. N. (2002). *Mukhtasar Sahīh al-Bukhārī*, Maktabah al-Ma’ārif, Riyād, Vol. 2, p. 84.

¹⁷⁹ Al-Sajastānī, A. S. (2009). *Sunan Abi Dawūd*, Dār al-Risālah al-‘Ālamiyyah, Beirut, Vol. 5, p. 272.

¹⁸⁰ Al-Sarakhsī, A. S. (2000). *Al-Mabsūt li al-Sarakhsī*, Dār al-Fikr, Beirut, Vol. 15, p. 74.

¹⁸¹ Al-Zuhailī, W. (2003). *Financial Transactions in Islamic Jurisprudence*, Translated by El-Gamal, M. A. et. al., Dār al-Fikr, Damascus, Syria, Vol. 1, p. 465.

¹⁸² Ibid.

profit.”¹⁸³

It is construed from the above definitions that the idea of partnership is to share profit over the business and to share loss. Thus, a partnership needs to be defined as a contract between two or more persons in carrying out a particular business with a view of not only sharing the profit, but also the loss and liability between partners based on the terms of the contract.

This type of contract is legitimate by virtue of the following authorities: In the *Qur’ān*; the legality of the contract of partnership is derived from: “If they are more than that, then they shall share in a third.”¹⁸⁴ Also, the verse: “Truly many are the partners (in business) who wrong each other: not so do those who believe and work deeds of righteousness...”¹⁸⁵

In the *Hadīth*; the legality of *sharikah* is found in the *Hadīth al-Qudsī*, “I am the third of every two partners as long as neither one betrays the other. However, if one betrays the other, I leave their partnership.”¹⁸⁶ Thus, the rationale behind the permissibility of partnerships is premised on the fact that the contract allows individuals to join their assets in such a way that permits them to generate more wealth than they could each yield if they were to conduct the business individually.

The literature has identified five (5) types of partnership contracts.¹⁸⁷

Unlimited or Reciprocity Partnership (*Sharikah al-mufāwadhah*); this form of partnership is built upon the concept of *mufāwadhah*, whereby each of the partners delegates to the other the right to deal in his property.¹⁸⁸ This type of partnership requires full equality of the parties in terms of their shares in the overall capital, their legal rights of controlling the affairs of the partnership, and they must be of the same religion.

¹⁸³Laldin, M. A. (2011). *Introduction to Sharī’ah and Islamic Jurisprudence*, CERT Publishers, Malaysia, 3rd edition, p. 33.

¹⁸⁴*Qur’ān*, 4:12.

¹⁸⁵*Qur’ān*, 38:24.

¹⁸⁶ Al-Naisābūrī, M. A. (1990). *Al-Mustadrak alā al-Sahīhain*, Dār al-Kutub al-‘Ilmiyyah, Beirut, Vol. 2, p. 60.

¹⁸⁷ Ibn Qudāmah, M. (1996). *Al-Mughnī*, 1st edition, Dār al-Hadīth, Cairo, Vol. 6, p. 400.

¹⁸⁸ Al-Zuhailī, W. (2006). *Al-Fiqh al-Islāmī wa Adillatuh*, Dār al-Fikr, Damascus, 9th edition, Vol. 5, p. 3881.

Limited Partnership (*Sharikah al-‘inān*); Ibnul Mundhir states that this is a form of partnership where partners contribute the capital, as well as share the profits and losses.¹⁸⁹ It is a form of partnership in which each partner contributes a portion of the capital and participates in management and work but not necessarily equally. In this type of partnership, equality is not conditional either in contributed funds or efforts. In the same vein, the share in profit is not necessarily proportionate to their contributions but usually subject to their agreement. This means, in *sharikat al-‘inān*, the partners may have equal equity but unequal rights to profit, unequal equity with equal rights to profit or unequal equity and unequal rights to profit.¹⁹⁰ This form of partnership is approved by the consensus of ‘*Ulama*’. However, some differences exist among the jurists over its conditions as well as the etymology of the term ‘*inān*’.¹⁹¹

Reputation or Creditworthiness Partnership (*Sharikah al-wujūh*); this is the type of partnership where two or more creditworthy individuals join in a credit purchase, and follow it with a cash-and-carry sale,¹⁹² thus sharing the profits according to the conditions they stipulated in the formation of the contract. In *sharika al-wujūh*, the partners build on their reputation and prestige in addition to their commercial expertise.

Physical Labour Partnership (*Sharikat al-‘amal or al-abdān or al-sanā’i*); this is a type of partnership where two or more individuals agree to embark on a joint labour project (e.g., building a house and sharing the wages according to their stipulated conditions in the contract). It is done by commingling their physical and/or mental labour but without contributing capital investment. The partners may be of similar or different professions (e.g., a carpenter and a black smith).

Capital and Skills Partnership (*Mudārabah*); this form of partnership is known as the partnership of capital and skills. It means that one provides capital to another person for him to trade with using his relevant skills and experience and the resulting profit is divided amongst them according to what they stipulated. The capital provider/owner (*rabb al-māl*) is the silent partner while the skills provider (*mudārib*) is the active partner. The loss in this type of partnership is not subject to the agreement of the partners but rather to only the capital. Even if the capital owner and the entrepreneur were to agree that the profit and loss is divided among them, the profit would be between them while the loss would be only on the capital.

¹⁸⁹Ibid, p. 3880.

¹⁹⁰ See: <https://islamicmarkets.com/dictionary/s/shirkah-al-inan>

¹⁹¹Ibid, p. 3887.

¹⁹²Ibid, p. 3885.

Accordingly, there are three elements in *mudārabah*: (i) one provides the capital (silent partner) and the other works (active partner) on it; (ii) in case of profit, they both share in the profit according to the agreed upon ratio; and (iii) in case of loss, only the capital owner will incur the loss (because the active partner has also lost the benefit of his labour and work). However, if it is established that the active partner was negligent or had violated the terms of agreement, which consequently led to the loss, he will be required to bear the loss. This form of partnership is approved by the consensus of 'Ulamā.¹⁹³

e) Loan (Qard) Contract

The Arabic term for loan “*Qard*”, literally means “cutting-off a portion”, signifying that the person extending the loan is giving the borrower part of his property. It is also called “*Salaf*”, meaning “advance” to signify that the amount of the loan is offered, at some point, with the expectation of repayment at a later time.¹⁹⁴

Technically, loan contract is defined by the majority (excluding the Hanafī School of law) as: “The exchange of property for a legal responsibility on the receiver commensurate/equal to the amount he collected from the creditor to be exclusively used by him and liable to be settled at the agreed time.”¹⁹⁵ On the other hand, the Hanafī School of law construes loan as “The payment of fungible property from one to another in return for a future settlement of an equivalent quantity.”¹⁹⁶

Loan is a recommended act for those who can afford to give it out to those in need at the appropriate time, this is because of the Quranic provision where Allah the Most High says: “Who is he that will lend Allah a goodly loan: then (Allah) will increase it manifold to his credit (in repaying), and he will have (besides it) a good reward (i.e., paradise).¹⁹⁷

In the *Sunnah*; Ibn Mas’ud (may Allah be pleased with him) narrated that the Prophet (peace be upon him) said: “Every two loans offered by a Muslim to another count as one charitable payment.”¹⁹⁸ Similarly, Anas (may Allah be pleased with

¹⁹³ Ibn Hazm, A. A. S. (1998). *Marātib al-Ijmā' fī al-'Ibādāt wa al-Mu'āmalāt wa al-I'tiqādāt*, 1st edition, Dār Ibn Hazm, Beirut, p. 162.

¹⁹⁴ Al-Zuhailī, W. Financial Transactions, op cit, Vol. 1, p. 370. See also Al-Dasūqī, M. A. (n.d) *Hāshiyah al-Dasūqī 'alā al-Sharh al-Kabīr*, Dār al-Fikr, Beirut, Vol. 3, p. 222.

¹⁹⁵ Al-Zuhailī, W. (2006). *Al-Fiqh al-Islāmī wa Adillatuh*, Dār al-Fikr, Damascus, Vol. 5, p. 3786.

¹⁹⁶ Ibid.

¹⁹⁷ *Qur'ān*, 57: 11.

¹⁹⁸ Ibn Mājah, M. Y. (2009). *Sunan ibn Mājah*, edited by al-Arnā'ūt, S., Dār al-Risālah al-‘Ālamiyyah, Vol. 3, p. 500.

him) narrated that the Messenger of Allah said: “On the day I ascended to heaven, I saw writing on the door of paradise that reads: “Every charity is rewarded ten-fold, and every loan is rewarded eighteen-times.” I said: “O Jibril, why is a loan rewarded more than charity? He said: Because a person may ask for charity when he does not need it, but the borrower only borrows in cases of dire need.¹⁹⁹ Another *hadith* states: “Whoever relieves the hardship of a Muslim in this life, Allah will relieve one of his hardships on the Day of Judgment; and whoever eases a financial difficulty for a Muslim, Allah will relieve his difficulties in this life and the hereafter; and Allah always assists the believer as long as he is assisting his brother.”²⁰⁰ Muslims have also agreed on the legality of loan in the *Shari’ah*.²⁰¹

Loans are generally similar to sale, since they involve the exchange of property. It is also a form of prepayment (*Salaf*), since one of the two payments is made prior to the other. Some jurists have argued that loans are a subcategory of a sale. However, al-Qarāfi listed three differences between loans and sales where three legal violations are tolerated or relaxed in loans but not in sale:

- i) Loans may be conducted with goods eligible for *ribā*, for instance; goods measured by weight or volumes, according to the Hanafis and most of the Hanbalis, or foodstuffs and currencies according to the Mālikis and Shāfi’is. This relaxation violates the rules of *ribā*.
- ii) For goods not eligible for *ribā*, loans may be conducted where a known property is given out in exchange for the unknown, which is a violation of the rule of *Muzābanah*.²⁰²
- iii) For fungible goods, loans may involve selling what is not in the seller’s possession, which is not permitted in sale.

2.5.2 Classification of Contracts according to their Circumstances

Financial contracts under Islamic law may be categorized into different classifications taking into cognizance the circumstances upon which a contract is

¹⁹⁹ Al-Baihaqī, A. (2003). *Shu’ab al-Īmān, Maktabah al-Rushd*, Riyād, in Collaboration with Dār al-Salafiyyah, Mumbai, India, Vol. 5, p. 188.

²⁰⁰ Al-Zarqānī, M. A. (n.d) *Sharh al-Zarqānī ‘alā al-Muwatta’ al-Imām Mālik*, Dār al-Kutub al-‘Ilmiyyah, Beirut, Vol. 3, p. 489; Al-Nawawī, M. Y. (1392). *Al-Minhāj Sharh Sahīh Muslim*, Dār Ihya’ al-Turāth al-Arabī, Beirut, Vol. 17, p. 21.

²⁰¹ Ibn Qudāmah, A. (1405). *Al-Mughnī libni Qudāmah*, Dār al-Fikr, Beirut, Vol. 4, p. 313.

²⁰² *Muzābanah* is a contract of exchange where goods whose weight, size or quantity are not known, are sold in bulk for a definite weight, measure or quantity of some other goods. For example; sale of green dates for a definite measure of ripe dates. The basis of prohibition is the lack of knowledge about number, weight or measure of one of the goods.

performed. Thus, a valid contract may be formed in various circumstances. Some may exist unilaterally, some bilaterally²⁰³ and others may even be a mixture of both. Therefore, a contract may be classified according to its circumstances into the following four categories:

a) **Unilateral Contract (*al-‘Aqd al-Infirādy*)**: a unilateral contract is defined, as a transaction by one party only, or by which one party binds himself.²⁰⁴

b) **Bilateral Contract (*al-‘Aqd al-Thunā’ī*)**: a bilateral contract is the one which binds two parties through their offer and acceptance and, as such, they become mutually obligated to perform and deliver in accordance with the terms of their agreement. Thus, the bilateral contract is defined as “A form of contract where two parties take upon themselves an undertaking to do something. Thus, it comprises of an offer and acceptance.”²⁰⁵

The scholars have traditionally divided the bilateral contract into six classifications namely; contracts of exchange (*mu’āwadāt*), contracts of security (*tawthīq*), contracts of partnership (*shirkah*), contracts of deposit (*wadī’ah*), contracts relating to the use of usufruct of an asset (*ijārah*) and contracts relating to the performance of work or rendering a specific service.²⁰⁶

c) **Quasi Contract (*Shibhul ‘aqd*)**: A quasi-contract is an agreement that takes place between parties who have no prior contractual commitments or intention of getting into a contract. It is used to rectify situations where one side acquires something at the detriment of the other side or party benefits financially in a situation while financially draining the other party. For example, the concept of quasi-contract can be used to recover the money paid by mistake. If the innocent party mistakenly interprets the facts, pays to another party a sum of money which he does not really owe, the law being just, will require the wrongful receiver of the money to return it. However, because his obligation to return the money is manifestly not based upon consent, the arrangement is considered not to have satisfied the conditions of a genuine contract.²⁰⁷ A quasi-contract is not considered

²⁰³See website available at; Islamic-world.net/economics/contract_01.htm. 9/2/2022, 2:00 pm.

²⁰⁴Al-Zuhailī, W. (2006). *Al-Fiqh al-Islāmī wa Adillatuh*, Dār al-Fikr, Damascus, Vol. 4, p. 440.

²⁰⁵Ibid.

²⁰⁶Al-Zuhailī, W. (2006). *Al-Fiqh al-Islāmī wa Adillatuh*, Dār al-Fikr, Damascus, Vol. 5, p. 3786.

²⁰⁷ See: <https://blog.ipleaders.in/all-about-quasi-contracts-and-types/>. Retrieved on 10/10/2023

a true contract under Islamic law. However, its obligation is enforceable by the *Shari'ah* principles, since it is a matter of restoring the rights of others.²⁰⁸

d) Joint Contract (*al-'Aqd al-Mushtarak*): a contract need not necessarily be entered into by just one individual or person. In some situations, it can even be entered into by a group of people. For instance, in a case where property is jointly owned by a group of persons and they wish to sell it to a purchaser, these owners may sell that property with the condition that they are in complete agreement to do so.²⁰⁹

Likewise, if an owner of land wishes to sell his land to a group of people who have common interests over that land, the owner of such land may do so. In both examples such contracts are known as joint contracts and they are binding on all the parties of the joint property involved in those contracts, making these joint contracts enforceable in a court of law.

2.5.3 Classification of Contracts according to their Legal Consequences

Under Islamic Law, contracts can also be categorized based on their legal consequences. These classifications are solely for the sake of preservation of public interests based on the doctrine of public interest (*al-maslahah al-mursalah*), which are justified either expressly or impliedly by the divine sanctions in the Glorious *Qur'an* and the *Sunnah* of the noble Prophet (peace be upon him).

The varieties of contracts according to their legal consequences are as follows:

a) Valid Contract (*al-'Aqd al-Sahih or al-Salih*): a valid contract is an agreement that fulfills the required conditions of the *Shari'ah*, thus, it is enforceable while creating an obligation and legal liability on the contracting parties.²¹⁰ Thus, a valid contract is different from void, voidable and invalid contracts which appear to be its nullifiers.

²⁰⁸ Alam, N., Gupta, L. & Shanmugam, B. (2017). *Islamic Finance: A Practical Perspective*. Palgrave, Macmillan, pp. 61-62. Also, see: Niazi, L. A. K. (1991). *Islamic Law of Contract*, Research Cell, Dyal Sing Trust Library, pp. 319-324. Also, see: Nyazee, I. A. K. (2016). *Outlines of Islamic Jurisprudence*, 6th edition, Advanced Legal Studies Institute, Islamabad, p. 281.

²⁰⁹ Ibid.

²¹⁰ Al-Zuhaili, W. *al-Fiqh al-Islami*, op cit, Vol. 4, p. 595.

A valid contract under Islamic Law requires the following elements:

- i. Parties to the contract must possess legal capacity;
- ii. The format (*sīghah*) must conform with the *Sharī'ah*;
- iii. The subject matter must be valuable and recognized by Islamic provisions;
- iv. The consideration (*iwadh*) must be also valuable;
- v. The consent of the parties must be obtained freely;
- vi. No aspect of the contract should be contrary to the public interest (*maslaha āmmah*).
- vii. No aspect of the contract shall involve fraud, misinterpretation, undue influence or illegality.

b) Enforceable Contract (*al-'Aqd al-Nāfidh*): it is difficult to distinguish between a valid contract and an enforceable contract because the difference between the two is very slight. The distinction can be highlighted by the fact that a valid contract may not necessarily be enforceable in law whereas an enforceable contract is, of course, always valid.²¹¹

Supposing all partners enter into a contract of partnership with a view to making profit; the contract of partnership at this point is valid and enforceable. However, if one partner passes away, his death could be a good ground for the dissolution of the partnership. The contract is still valid but, owing to the subsequent death of one of its partners, it is unenforceable unless the remaining partners agree to continue their partnership with the representative of the deceased partner.

c) Invalid Contract (*al-'Aqd al-Fāsid*): an invalid contract is an agreement between the parties whereby the foundation (*asl*) of the contract is valid, but the attributes of the contract are unlawful. In other words, an invalid contract is an agreement whereby the elements of the offer and the conditions of a valid contract are also fulfilled.²¹² However, there are some illegalities involved in the contract. For example, if the object of the contract is unknown, or if there is a defect in the price of the goods sold, that contract becomes an invalid contract.

d) Void Contract (*al-'Aqd al-Bātil*): a void contract is an agreement which is merely null and void (i.e. of no effect). A void contract is, further, defined as the

²¹¹Ibid.

²¹²Ibid.

“one which never had any legal existence or effect, and such contract cannot in any manner have life breathed into it. In other words, a void contract is a sale which has a defect in its essential aspects, such as a sale by an insane person, a sale of particular goods which do not exist, or which are incapable of being delivered, i.e., not ascertainable, are void contracts.”²¹³

Below are circumstances upon which a contract is said to be void (*bātil*):

- i. A contract made by either or both parties who are legally incapable;
- ii. A contract made by either or both parties upon mistake;
- iii. A contract made without a valid consideration;
- iv. A contract which involves immorality;
- v. A contract which its object is unlawful;
- vi. A contract which its object is not ascertained.

e) Unenforceable Contract (*al-‘Aqd ghair al-Nāfidh*):²¹⁴ an unenforceable contract is different from a void contract, and it appears in three legal consequences based on three circumstances, namely:

- i) **The Permanently Unenforceable Contract** - this is a form of contract which cannot be enforced at all, at any time and in any situation. Such contracts include a contract with a foundation or substance, which is illegal; a contract which contains an unlawful subject matter or that which has no commercial value at all.
- ii) **The Temporarily Unenforceable Contract** - a contract may sometimes be unenforceable only for a particular period of time. A simple example in this regard is: a contract whereby both parties verbally agree to conclude it by signing a formal written agreement. We may conclude here that, in this situation, such a contract cannot be enforced unless a formal written agreement is prepared and signed by both parties. In other words, such a contract is unenforceable temporarily, only, subject to the signing of a formal written agreement in future which would then render the contract enforceable.
- iii) **The Permanently or Temporarily Unenforceable Contract** - after the conclusion of contract, that contract will not necessarily be enforced in law.

²¹³Ibid.

²¹⁴Ibid, p. 676.

This is because; there are situations whereby certain contracts appear in two legal consequences, a contract which is unenforceable permanently or temporarily. An example of a contract which has two legal consequences is a voidable contract whereby the aggrieved party has the full option of terminating the contract. Hence such a voidable contract has two different legal consequences; it can either be permanently unenforceable if the aggrieved party chooses to terminate the contract, or temporarily unenforceable if he chooses to ratify it.

- iv) **Voidable Contract**²¹⁵ (*al-‘Aqd ‘aqibal ibtāl*) - a voidable contract is different from a void contract in both its nature and legal consequences. It has been defined as a contract or agreement whereby one of the parties has the free option of either continuing with the contract or rescinding it. It must be remembered that from the moment the contract is entered into, until the time when the party makes his choice, the voidable contract shall have the legal effect, which it is intended to have. Such a voidable contract can, however, be disputed only by certain persons under certain conditions and the right of rescission may be relinquished by the party entitled to exercise it. If a third party acquires rights under a voidable contract of other transaction without notice and for value, they cannot afterwards be put in a worse position by it being set aside. Herein, a voidable contract differs from a void contract for, in the latter case, no third party can acquire such rights under the contract unless the party in whose favour it is void affirms it.

Under Islamic law, there are some circumstances whereby a contract is deemed to be voidable. These circumstances are mainly categorised into two:

Special circumstances, which would render the contract voidable. These circumstances are:

- i. Contract by an infant;
- ii. Contract under undue influence;
- iii. Contract under duress;
- iv. Contract under fraud;
- v. Contract under misinterpretation.

²¹⁵Ibid, p. 590.

The various options -these are options in Islamic Law under various circumstances whereby the party to a contract has the right to either accept or reject the contract. These options are known as *al-khiyārāt*.²¹⁶

2.6 Ethics in Islamic Financial Contracts

Ethics has recently become an interesting topic in finance due to serious unethical practices prevailing in the economic landscape. In an Islamic financial system, ethics differ from that of a conventional financial system because ethical theories, ideals, and practices in the former are designed by reverence to Almighty Allah (the Most High) while ethics in the latter are founded on transitory customs of societies. Some of these ethical ideals in Islamic finance include maintenance of honesty in all aspects of business dealings, maintenance of justice in all business activities, kindness or goodness to all parties involved in the business, honouring financial obligations, maintenance of patience and tolerance in business dealings, maintenance of public interest, avoidance of greed and extravagance, preservation of integrity and sincerity, vicegerency of humanity on earth and accountability to Allah before others. There are also customs and norms concerning brotherhood, mutual cooperation and solidarity which come in the form of encouraging good behaviour amongst people.²¹⁷

Ethics in *Shari'ah*-compliant business and finance comprises the following basic norms:

2.6.1 Avoidance of *al-Ghabn* (abnormal high price) and *al-Gish* (concealment of defect)

Ghabn is the reduction or decrease in the buying price or selling price, or the difference between the manipulated price and the fair price according to the calculation of experts in the business at which a transaction is carried out. *al-Ghabn* connotes the sale of a commodity with an abnormally high price where the right of the buyer to revoke the contract arises, or it is the sale with an abnormally less price where the seller owns the right of revocation.²¹⁸

²¹⁶Al-Shaukānī, M. A. (1987). *al-Darārī al-Mudhiyyah, Sharh al-Durar al-Bahiyyah*, Dār al-Kutub al-'Ilmiyyah, 1st edition, Vol. 2, p. 264. See also; Al-Tayyār, A. M. *et al* (2012). *Al-Fiqh al-Muyassar*, Madar al-Watan li al-Nashr, Riyād, Vol. 10, p. 38.

²¹⁷Hamman, A. M. (2018). A Review of Islamic Ethics in Business, paper presented at the 7th Conference on Islamic Economics as a Strategy for Achieving Inclusive growth. Organized by the Islamic Thought Association Conference (IETA), Department of Economics, Business School, ABU, Zaria, 12th November, 2018, pp. 4-8.

²¹⁸Al-Tasūlī, A. A. (1998) *Al-Bahjah fi Sharh al-Tuhfah*, Dār al-Kutub al-'Ilmiyyah, Beirut, 1st edition, Vol. 2, p. 174.

Generally, two types of *ghabn* namely *fāhish* (excessive) and *yasīr* (little) are identified in the books of Islamic jurisprudence. *Ghabn fāhish* means too much loss suffered by a party to a contract due to concealment or getting less than what is given in exchange. The loss, be it exorbitant/excessive or not, is to be determined in view of the market price of the subject matter. While *ghabn yasīr* is when the difference between the prices at which goods were sold and their real market price is so small that the parties do not usually bother about it in their transactions. For example, a dress worth ₦10, 000.00 is sold for ₦11,000.00, will not be considered as a *ghabn fāhish* but if it is sold for ₦15,000.00 or more, that may be considered as *ghabn fāhish*. The formula for the excess of *ghabn fāhish* is being equal to or more than one third of the total value of the property.²¹⁹ The Prophet (peace be upon him) has prohibited *ghabn fāhish* that is, selling something at an upper price while pretending to the client that he/she is being given the item at the market rate. In this case, the buyer has the choice to cancel the purchase and collect back his/her money.

According to Ibn Juzay, *al-Ghabn* is of three types;

- i) *Ghabn* that does not give rise, whatsoever, to the right of revocation, that it is where the buyer willingly increases the price for his own need and benefit;
- ii) *Ghabn* that gives rise to revocation whether of high, big or small price; that is where the buyer discloses his ignorance to the seller concerning the market price of the commodity and, thus, submits to the discretion of the seller;
- iii) *Ghabn* that jurists differ as to its legal position, and that is any type apart from the two above. Thus, on the opinion that it gives rise to the right of revocation, either the buyer or the purchaser can claim such right whenever the increase or decrease equals one-third of the normal price of the commodity or more. However, in another view, there is no limit to determine the *ghabn* in question, thus the determining factor is the prevailing custom. Therefore, whatever is regarded as *ghabn* by the custom, the aggrieved person shall have an option to uphold the transaction or recind it.²²⁰

²¹⁹Ibn al-‘Arabī, A. M. *Ahkām al Qur’ān*, Vol. 1, (Egypt: Idāra Tabat Munīriah), 241- 243 in Ahmad, S. Amjad, M. & Aslam E. (2019). Types of Interest in Islamic Law Analysis and Application, *Pakistan Journal of Islamic Research*, Vol. 18, No. 2, p. 7.

²²⁰Ibn Juzay, M. A. (n.d) *Al-Qawānīn al-Fiqhiyyah fī Talkhīs Madhab al-Mālikiyyah wa al-Tanbīh ‘alā Madhab al-Shāfi’iyyah wa al-Hanafīyyah wa al-Hanbaliyyah*, Wizārat al-Awqāf, Kuwait, Vol. 1, p. 177.

It is, however, pertinent to note that the right to claim choice or revocation of a contract where *ghabn* is ascertained can only be exercised upon the fulfillment of the following conditions:

- i) The claim to such right should not exceed one complete year from the time upon which the contract was entered into and executed;
- ii) The claimant (either the buyer or the seller) must have been ignorant of the market price of the commodity in question and;
- iii) The increase or decrease must equal one-third of the normal price of the commodity or more. However, in another view, there is no limit to determine the *ghabn* in question, thus the determining factor is the prevailing custom of the transaction itself or the place of the contract.²²¹

Al-Gish is an act of deceiving, or a dishonest trick or a person who uses deception.²²² It can be termed as falsification or fraud practised by a party to a sale. Islam strongly condemns any act of treachery in commercial dealings, deceit and racketeering. Prophet Muhammad (May the peace and blessings of Allah be upon him), while reprimanding dishonest traders and businesses, said: “Whosoever deceives us is not one of us.”²²³ This is a strong warning against cheating and deception.²²⁴ Consequently, fraudulent business practices and selfish interest can only prosper in morally bankrupt business settings.

In Nigeria, for instance, *al-ghish* is practised by some people selling food items. Hawkers and market sellers of potatoes and tomatoes and other vegetables and legumes do practise *al-ghish* by placing the biggest and fresh potatoes or tomatoes on the top of the container while placing rotten or spoilt ones below. When a customer sees the top, he may think that all the items in the basket are fresh if he does not check, until he reaches home, he realises that the ones below are spoilt. This is deception and is termed *al-ghish*.

Therefore, it is mandatory for Muslims to acquire sufficient knowledge and thorough understanding of the rules and regulations of business transactions in Islam as an essential prerequisite for adopting trade or business as an occupation.

²²¹ Al-Mālikī, M. A. (2000). *Sharh Mayyāratul Fāsī*, Dār al-Kutub al-‘Ilmiyyah, Beirut, Vol. 2, p. 63.

²²² Translation and meaning in Almānī English Arabic Dictionary.

²²³ Sahīh Muslim 102, Book 1, Hadīth 190.

²²⁴ Gambo, M. (2019). Islam, Ethics and the Prohibition of Al-Gush (Deception) In Business: The Ethical Marketing Perspective, 10th Global Islamic Marketing Conference proceedings: Advances in Islamic Businesses, Lumos Deluxe Resort Hotel Alanya, p. 11.

The Glorious *Qur'ān* has stressed the importance of fairness in business: "And, O my people, give full measure and weight justly, and defraud not men of their things, and act not corruptly in the land making mischief. What remains with Allah is better for you, if you are believers."²²⁵

2.6.2 Mutual cooperation, solidarity, and brotherhood

The norms concerning mutual cooperation, solidarity, and brotherhood are in the nature of advice and instances that extol and encourage good behaviour. The Islamic worldview, therefore, places proper checks and balances on economic actions of believers and puts special emphasis on social justice. In Islam, even the routine act of earning an honest living constitutes an active form of worship (*Ibādah*). Islam strongly emphasizes the necessity of ensuring the validity of all business transactions with a view to avoiding all types of fraud and selfish interest.²²⁶

Ethical considerations expected of people in *Sharī'ah*-compliant business and finance include²²⁷

a) Upholding honesty in all aspects of commercial dealings

Honesty in commercial dealings is emphasised in Islam more than any other faith. All parties in a business have to be honest with one another for their dealings to be clean and free from prohibited elements. Safeguarding honesty in commercial transactions means that the business should be transparent. The Code of Ethics of the Accounting and Auditing Organisation for Islamic Financial Institutions sourced from *Sharī'ah* rules and principles, lays emphasis on upholding integrity, sincerity, piety and righteousness.

Both the *Qur'ān* and *Hadīth* have emphatically covered the subject matter of honesty in business and truthfulness in trade. Therefore, Muslim business partners must be sincere in all their dealings with other parties, seeking Allah's satisfaction and not human pleasure. They should obey Allah and His requirements in undertaking any business dealings. They should be aware of relevant *Sharī'ah* rules and principles especially regarding financial transactions through formal training. They should not allow anyone to subject them to pressure or be influenced to do the wrong things like cheating a passive partner. They should fear Allah both in

²²⁵*Qur'ān*, 11: 85-86.

²²⁶ Dogarawa, A. B. (2013). *Principles of Islamic Banking*, International Institute of Islamic Banking and Finance, Bayero University, Kano, pp. 60-75.

²²⁷ Abdul Rahman, A. R. (2009). *An Introduction to Islamic Accounting: Theory and Practice*, CERT publications, International Islamic University Malaysia (IIUM), p. 42-53.

secret and in public, obey His commandments and avoid His prohibitions by enjoining good and forbidding all evil deeds.

b) Preserving justice and fairness in all business activities

Islam requires contracting parties to be just and fair in all financial dealings. It does not endorse the view that all is fair in business and that every kind of cleverness and deceit is justifiable in financial and business transactions. It regards business or commerce as an economic activity to be carried on in a spirit of humanity and justice. There is therefore no room for cut-throat competition, deceit, foul-play or deliberate short-change in Islam. In the context of financial contracts, contracting parties are required to look upon each other as brothers or fellow human beings who are trying to benefit, serve and help each other. On no account should a party to a transaction short-change or overcharge the other party. Similarly, Islam does not allow any clenched-based bargain in any transaction that does not give a buyer a fair chance to examine, assess or make an informed decision as doing that will amount to denying him a right that is his due. In the same vein, forcible transactions or transactions in which a seller takes undue advantage of the helplessness or misery of the buyer are strongly prohibited.²²⁸

The bottom line is justice and fairness in business activities because Islam abhors any financial dealing that involves injustice and lack of fairplay such as blackmail, fraud, bribery, or by monopolising the necessities of life thus unjustly consuming people's wealth.²²⁹ Allah (the Most High) says: "And do not consume one another's wealth unjustly or send it [in bribery] to the rulers in order that [they might aid] you [to] consume a portion of the wealth of the people in sin, while you know [it is unlawful]." ²³⁰He also says, "...deal not unjustly, and ye shall not be dealt with unjustly." ²³¹The Prophet (peace be upon him) said: "Whoever cheats my nation is not one of us." ²³²

c) Kindness or goodness to all parties to a contract

Kindness/goodness in business dealings is another important ethical value in Islamic financial contract. In order to show kindness and goodness to all parties in

²²⁸See Translation of Sahīh Muslim, Book 10: https://www.iium.edu.my/deed/hadith/muslim/010_smt.html.

²²⁹ See Wafy, A. A. W. (n.d). Human Rights in Islam. <https://www.islambasics.com/chapter/establishing-justice-in-financial-dealings-and-in-the-distribution-of-wealth>.

²³⁰ *Qur'ān*, 2:188.

²³¹ *Qur'ān*, 2:279.

²³² Sunan al-Tirmidhī, Vol. 3, Book 12, Hadīth 1315.

a contract, no partner or client should be subjected to any hardship. Businessmen or business organisations should also strive to make things easy for their clients or customers. For example, hoarding foods which people depend on to survive is oppression (*zulm*) and, therefore, prohibited. Allah frowns at those who oppress people. The Prophet (peace be upon him) said: “May Allah have mercy on a person who is lenient in his buying, lenient in his selling and lenient in demanding back his money.”²³³ Furthermore, the attitude of a seller towards a buyer should be characterized by generosity and empathy. Business partners should, therefore, help maintain the assets of the business, its rights and the rights of others in a suitable manner.

d) Honouring financial obligations in businesses

Each person will be held accountable for his/her deeds in this world and, eventually, in the hereafter. Allah (the Most High) says in the holy *Qur’ān*: “O you who believe! Fulfill (all) contracts.”²³⁴ Therefore, business partners should always fear Allah as the highest authority before their bosses or the public and honour their financial obligations. Accordingly, business partners in the market and any business setup or organization should always strive to fulfill obligations as contracted from the beginning. They should present and communicate relevant nonfinancial and financial information reliably, honestly and with adequate transparency to their customers or clients in both informal and formal organizations like banks and other companies.

Contractual parties and accountants in a business should be fair and unbiased. They should be free from conflict of interest and any activity that can impair their independence in fact, and as well as in appearance. They should refuse gifts, favours or hospitality that would threaten objectivity of their professional judgment.

e) Maintenance of patience and tolerance in commercial dealings

In any trade dealing, one should be patient in handling complicated transactions and endure challenges which come along when dealing with people. One should strive to endure and be lenient, demonstrating humility, love and brotherhood in order to enhance collaboration and trust when dealing with other contractual parties or customers. It is encouraged that one should also show leniency to debtors. Abu Hurairah (may Allah be pleased with him) reported that the Messenger of Allah (peace be upon him) said: “There was a person who used to loan money to the people and he used to say to his servant: ‘when an insolvent person comes to you,

²³³ Sahīh al-Bukhārī, 2076, Book 34, Hadīth 29.

²³⁴ *Qur’ān*, 5:1.

show him leniency so that Allah may forbear our faults.’ So when he met Allah (i.e., when he died), Allah forgave him.”²³⁵

f) Safeguarding public interest

Business partners should not carry out business dealings for the purpose of enriching themselves only. They should be concerned about the immediate community that is of public interest by way of solving problems, resolving conflicts and helping humanity through Corporate Social Responsibility (CSR). Business partners should make effort to spend part of their profit to meet social obligations or responsibilities. Furthermore, there should be respect for confidential information of a business and only presenting it where appropriate. Consequently, insider, confidential or privileged information should not be used for unethical purposes or for selfish interest. Some commercial activities do threaten the lives of the people living in the business area such as environmental ruin which can cause damage to life and property, hence they must be avoided or compensated. Business activities in chemical industries, for example, do cause air and water pollution while manufacturing of illicit drugs for public consumption can disrupt people’s intellect and should, therefore, be avoided at all costs in the public interest. The Islamic *fiqh*, in its totality, is based on the best interests of the public. That which contains benefit is desired and that which is harmful is prohibited.

Another activity found in business which causes hardship to the poor is hoarding basic necessities like maize, millet and other grains. Hoarding is an act of collecting or buying things and goods as much as possible in order to resell them out when many people are in need of those commodities at a higher price than the normal market value. The aim is to gain maximum benefit out of it at a future period. Ma’mar ibn ‘Abdullah reported: The Messenger of Allah, peace and blessings be upon him, said, “Whoever hoards food is a sinner.”²³⁶

Even though hoarding is strongly forbidden in Islam, it is not actually prohibited in totality. There are conditions, however, where hoarding is permissible in Islam and does not constitute a sin. For instance, when majority of the people are not in need of a particular commodity, then it is permissible to hoard it. Stocking up that commodity and saving it until people have need for it is allowed. This means that the goods are being sold with the aim of alleviating the suffering of people and not merely to seek benefit. Hoarding wealth for one’s family’s future use is also acceptable. Furthermore, hoarding wealth or commodities to be used on their own without intent to resell at a higher price is also permitted.

²³⁵ Sahīh al-Bukhārī, Book 56, Hadīth 687.

²³⁶ Ṣaḥīḥ Muslim (1605).

Other contemporary businesses that affect people negatively are also prohibited if they cause danger to people's lives. For example, selling arms and weapons to thieves, bandits, and terrorists, and financing the sale of weapons during *Fitnah* (crises) because of the conditions prevailing in that period. Similarly, selling motor bikes to kidnappers is also dangerous since they use it to abduct people and disappear into the forests easily.

g) Prevention of extravagance and greed

Resources in a business ought to be invested at a reasonable rate of return in addition to safeguarding business assets and the rights of other parties in the business. Business partners should avoid greed and extravagance, interest (*ribā*) must be abhorred, hoarding should be avoided and weights should be given full measure. In addition, businesses should refrain from manipulating transactions, exploiting the masses and deal in lawful products only.

h) Accountability to Allah before others

Man is encouraged in Islam to utilise his wealth and all the resources that Allah (the Most High) has created and entrusted him with to the best of his ability and to the fullest extent possible. The non-utilization of these beneficial resources is akin to being ungrateful. Wealth in Islam is considered a vital means by which man can pave the way for the realization of his ultimate objective, that is, the hereafter. Therefore, Islam denotes wealth as something good, a thing of enjoyment and satisfaction, and a means of support for the society. It is required in Islam that wealth be earned through good, beneficial and productive work, which also defines the methods of lawfully earning wealth as permitted in the *Shari'ah* hence, not only are legitimate means of earning wealth specified in Islam, but the forms of economic activity that may lead to unlawfully acquiring wealth are prohibited and are also spelt out. Consequently, lawfully earned wealth should be invested within the community to improve its well-being economically. Moreover, investing one's fortune is not only measured by the monetary gain associated with it, but as well as the benefits that accrue to the society through that wealth, a fact that is needed to be borne in mind at all times by the possessors of wealth.

Although Islam treats wealth that is legally acquired, and disposed of, as blessed and subject to *Shari'ah* protection, it places the owner of wealth as a trustee who holds his wealth on behalf of Allah (the Most High) and the society. This is evident in the fact that he came with nothing (wealth) in this world and is going back with nothing out of his wealth. The disposal of wealth in Islam is also subject to the rules and regulations of the *Shari'ah*.

First and foremost, the chief among the *Sharī'ah* guidelines is the recognition of the rights of others in one's wealth, bringing about the principle of invariant entitlement or claim to ownership of such wealth. These consist of taxes whose quantities and amounts are specified in the *Qur'ān* and others whose shares are left to be decided by the owner of the wealth. These charges fall due when one's wealth exceeds a certain minimum amount called *nisāb*. Thus, after these duties are met according to *Sharī'ah* prescriptions, what remains belongs to the owner, but it must be used in line with the principles of the *Sharī'ah*, which prohibits waste, lavishness and extravagance. Wealth in Islam cannot be used to harm others. It is not allowed for wealth to be used to bribe people in order to acquire political power or to corrupt the polity or the society. On the Day of Judgment everyone will be asked about how he earned and how he spent his wealth. The Prophet Muhammad (peace be upon him) said: "A Man's feet will not move on the Day of Judgment until he is asked about his life, how he lived it; his knowledge, what did he do with it; his wealth, how he earned it and how he spent it; and about his body, how he used it."²³⁷

In addition, all prohibited earnings in one's wealth or business wealth invested by people or organisations like banks should be separated from the business assets and its manner of disbursement should be stated clearly so that stakeholders can be assured that they are not consuming illegal money. This is because everyone will be held accountable for how he engaged in business dealings, how he acquired his wealth and how he used and disbursed same. Consequently, transparent reporting should be upheld in all Islamic business dealings.

In conclusion, ethics in business protects people from committing immoral activities. Business partners need to understand that they are accountable to Allah for their deeds not only in personal matters but also in commercial dealings, and that by fulfilling business dealings through justice, truthfulness and fairness, their actions are considered as a form of worship (*ibādah*), that is, as a virtuous deed (*'amal sālih*). Any harmful activity which may occur knowingly among contractual parties or between them and the customer or between a buyer and a seller is forbidden. Allah (SWT) says in the Glorious *Qur'ān*: "O you who believe! Betray not Allah and His Messenger, nor betray knowingly your trusts."²³⁸ Consequently, it becomes compulsory for Muslims who engage in commercial activities to abide by these ethical principles to guide their behaviour and activities in business dealings.

²³⁷ Al-Tirmidhi, (Hadīth 2341).

²³⁸ Qur'ān, 8:27

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3

ISLAMIC BANKING

3.1 Introduction

Islamic banking offers a variety of products and services to suit the needs of users. The main characteristic of Islamic banking is its forbidding of interest (*ribā*) on money capital and all other forms of non-*Sharī'ah* compliant products and activities. Islamic banking system is an incomparable and ethically unique arrangement which does not only support and promote stability in the financial system but also insists on justice and fairness in financial dealings to all members of the society.

This chapter provides an explanation on Islamic banking as the most important component of Islamic finance. The chapter begins with a highlight of the importance of Islamic financial intermediation and how it is different from its conventional counterpart. The chapter also explains the evolution and development of Islamic banking and the various risks associated with Islamic banking activities.

3.2 Islamic Financial Intermediation

Financial intermediation may be defined as a productive activity in which a financial institution (known as financial intermediary) incurs liabilities on its own account for the purpose of acquiring financial assets by engaging in financial transactions on the market. Its process channels funds from economic agents with surplus funds to economic agents that would like to utilise those funds.²³⁹ It exists to solve or reduce market imperfections such as differences in the preferences of surplus and deficit units of the economy in terms of size, maturity, liquidity, risk; presence of transaction costs; shocks in consumers' consumption; and asymmetric information (both adverse selection and moral hazard).²⁴⁰

Both Islamic and conventional banks are financial intermediaries but with different modes of operation. On the one hand, Islamic banks operate with the aim of making profits in accordance with the principles of *Sharī'ah*, while recognising the

²³⁹ Organisation for Economic Co-operation and Development, *OECD Glossary of Statistical Terms*, <https://stats.oecd.org/glossary/detail.asp?ID=972#:~:text=Financial%20intermediation>

²⁴⁰ Khaldi, K. & Hamdoun, A. (2011). Islamic Financial Intermediation: Equity, Efficiency and Risk. *International Research Journal of Finance and Economics*, Issue 65, p. 146.

uncertain nature of the outcome of the operations financed.²⁴¹ This reflects the principle of risk sharing in Islamic finance as opposed to risk transfer as in the case of conventional finance. On the other hand, conventional banks operate on the basis of interest for both lending and borrowing money.

The emergence of contemporary Islamic financial intermediation can be traced back to when Islamic Scholars and economists developed thoughts on the ills of the interest-based banking system and the need to have Islamic banking as an alternative financial system that would make up for the shortcomings of the conventional financial system. In its operations, amidst several economic hardships inflicted by conventional financial system, Islamic finance is distinguished primarily by its moral and religious dimensions in the definition of economic problems. Thus, Islamic banks have a different understanding of financial intermediation based on non-interest banking intermediation model. It is therefore an interest-free finance which also requires the backing of all transactions to an asset while being based on sharing of profits and losses, sale or lease.²⁴²

3.2.1 Islamic Financial Intermediation versus Conventional Financial Intermediation

Intermediation is essential in the financing of any economy since it consolidates the efficiency of the savings/investment process by eliminating incompatibilities between savers and investors in terms of maturity, funds and risk. In addition, this function allows economies of scale regarding transaction costs to be realized in the delivery of funds and reduces the risks associated with asymmetric information. Financial intermediation as a concept is not prohibited by the *Shari'ah* when it respects the Islamic precepts. The need for Islamic banks to act as financial intermediaries has been recognised by Islamic economists, bankers and scholars. However, there are points of convergence and divergence between Islamic banks and conventional banks in terms of financial intermediation, which need to be highlighted. This is important because, although Islamic banking, like its conventional counterpart, offers comparable financial intermediation functions, it conducts its business operations in a completely different manner.

A key difference between Islamic banking and conventional banking lies in the objectives of the foundation of each, which have influence on its overall financial intermediation function. Current financial intermediation theory builds on the idea that the *raison d'être* of financial intermediaries is to reduce transaction costs and

²⁴¹Drissi S. & Angade, K. (2019). Islamic Financial Intermediation: The Emergence of a New Model, *EJIF – European Journal of Islamic Finance*, No 12, p. 1.

²⁴²Ibid.

informational asymmetries which arise from debtor-creditor relationship. This idea of financial intermediation contrasts with the view of financial intermediation in Islamic perspective as a value-creating economic agent. It also conflicts in some ways with the objectives and inclusive functions of Islamic financial intermediaries.²⁴³

The foundation of financial intermediation of Islamic banks is based on two theories: theory of agency and theory of trust.²⁴⁴ Contractual relationships in Islamic banking are based on financial contracts and on *Sharī'ah* rules and principles. The additional element of *Sharī'ah* law has specific implications for agency-related problems, encapsulated as principal-agent conflict of interest in the areas of goals, behaviour and information asymmetry.²⁴⁵ It also adds another dimension to the financial intermediation role of Islamic banks.²⁴⁶

Firstly, a look at a typical balance sheet of Islamic banks will show that the principal-agent relationship appears in several components. Under balances and deposits with other banks, the assets are mainly grouped into asset based (*Murābaha*, *Salam*, *Ijārah*, *Istisnā'*), profit and loss sharing based (*Mudārabah* and *Mushārah*), and fee based (*Wakālah*). These three groups cover almost all the types of Islamic finance contracts and thus cover all the relevant types of relationships under agency theory. Secondly, on the liabilities side, demand deposits represent a principal-agent relationship, where funds are accepted from investors for either general (unrestricted) or specific (restricted) investment purposes as trust (*Amānah*). Liabilities on account of *Mudārabah* and *Mushārah* sharing are recorded as Special Investment Accounts.²⁴⁷

The two relationships thus represent principal-agent relationships in Islamic banks, with shareholders investing and providing the authority to the management to act on their behalf, and a relationship between Investment Account Holders (IAH) as principal and Islamic banks (not directly the management in this case) as an agent.

²⁴³ Karmila, H. (2018). Islamic Banks in the Theory of Financial Intermediation: A Review That Leads Towards Different Objectives. *Proceedings of National Conference on the Sciences and the Social Sciences*, Universiti Sains Islam Malaysia, pp. 438-439.

²⁴⁴ Drissi, S. & Angade, K. (2019). Islamic Financial Intermediation: The Emergence of a New Model. *European Journal of Islamic Finance*, Number 12, p. 4-5.

²⁴⁵ Shamsuddin, Z. & Ismail, A. (2013). Agency Theory in Explaining Islamic Financial Contracts. *Middle-East Journal of Scientific Research*, Vol. 15, No. 4, p. 533.

²⁴⁶ Aljifri, K. & Khandelwal, S. K. (2013). Financial Contracts in Conventional and Islamic Financial Institutions: An Agency Theory Perspective. *Review of Business and Finance Studies*, Vol. 4, No. 2, p. 79.

²⁴⁷ Ibid, p. 82.

This kind of relationship is often cited as one of the main variations in agency theory for Islamic financial intermediation. For example, in the case of an unrestricted *Mudārabah*, the IAH provides authority to the bank to invest funds on his or her behalf in any *Sharī'ah* approved activity without any restrictions, whereas in case of a restricted *Mudārabah*, the authority is restricted, with the need for more disclosure. The aggregate behaviour of the agents, in both types of principal-agent relationship, is subject to Islamic law, and as such dependent on religious approval.²⁴⁸

It is believed that the Islamic moral code and ethical values that relate to accountability and governance based on *Sharī'ah* principles are capable of facilitating a good and rewarding agency relationship in Islamic financial intermediation. In view of the foregoing, it can be concluded that if Islamic banking institutions implement to the letter the *Sharī'ah* approved contracts and operate according to the rules and principles of *Sharī'ah*, the principal-agent problem could be greatly minimised.

From the angle of trust, managers of Islamic financial intermediaries are treated as trustees and not just as managers. This brings in the concept of trust and trusteeship in Islamic financial intermediation, the objective of which is to protect the interest and rights of all stakeholders rather than the shareholders alone. In view of this, under Islamic financial intermediation, all relationships are required to be in line with *Sharī'ah* rules and principles. The principles and rules add ethical dimension to the relationship and bring in the concept of trusteeship and greater role towards society and mankind. Furthermore, in addition to the existing governance structure as in their conventional counterpart, there is also a *Sharī'ah* Supervisory Board for Islamic banking institutions, which oversees all areas of operations with a view to providing additional check and control, and ensuring strict compliance with the *Sharī'ah*.²⁴⁹

On their part, the financial intermediation of conventional banks chiefly manifests itself in the collection/borrowing of savings at a cost to them before redistributing part of them in the form of credits at a cost to the borrower. In other words, it is the link between depositors and borrowers to facilitate lending-borrowing relationships.

From this perspective, conventional financial intermediation is based on two main characteristics: transaction costs related to information retrieval and transaction

²⁴⁸ Ibid, p. 83.

²⁴⁹ Ibid, 85.

verification. In fact, for transaction costs, they are generally costs related to information asymmetry since the lender ignores the financial situation of the borrower in a direct and transparent manner. This is where the role played by banks is manifested in providing information about the borrower by assigning the conventional banks the role of information provider between the lender and the borrower which represents a resolution to the problem of asymmetry information that the least informed party suffers.

The second characteristic concerns the function of transforming financial liabilities into financial assets. In other words, conventional banks seek to transform deposits collected in the short or medium term into short-and-medium-term loans. Thus, the main role of conventional banks can be reduced to transformation by prohibiting the use of any other activities such as commercial transactions or industrial activity with the exception of ancillary activities to cover debts.

3.3 Evolution of Islamic Banking

Some historical accounts have shown that practices of certain forms of Islamic Banking and Finance (IBF) activities go back to 1200 years ago in Baghdad, Damascus, Fez and Cordoba. However, the history of modern Islamic banking can be divided into two parts: when it still remained an idea in the 1950s through to late 1960s and when it became a reality through private initiative in some countries and in others, by law from the mid-1970s. The first experiment, which lasted until 1967, started with a saving-investment bank in the town of Mit Ghamr, Egypt in 1963. Earlier, Pilgrims Funds was established in Malaysia in 1962 based on PLS. Though small in size and not into real commercial banking, the Mit Ghamr Bank maintained savings, investments and *Zakāh* accounts. The savings accounts attracted no interest, but withdrawals could be made on demand. Funds kept in investment accounts were invested on the basis of PLS. Small interest-free loans for productive purposes were allowed for only short-term but with a lot of caution.²⁵⁰

The 1970s witnessed involvement by institutions and some governments in the joint efforts to establish a full-fledged IBF system. Sequel to the international conferences held in Karachi in 1970, Egypt in 1972, Mecca in 1976 and London in 1977, the theory of IBF that had been substantially covered in the literature was applied in practical terms. The first interest-free financial institution with 'bank' in its name, Nasser Social Bank, was established in Egypt in 1971. Its main objectives were mainly social, such as providing interest-free loans to the poor and needy,

²⁵⁰ Dogarawa, A. B. (2012). Global Financial Crisis and the Search for New Financial Architecture: Can Islamic Finance Provide Alternative? *Journal of Islamic Economics, Banking and Finance*, vol. 8, No. 4, p. 39.

scholarships to students, and micro-credits to small projects on a profit-sharing basis. In 1975, a group of Muslim businessmen took the initiative of establishing the Dubai Islamic Bank in Dubai in the United Arab Emirates (UAE) making it the first Islamic Bank established on private initiative. Another important development in the history of Islamic banking took place in the same year with the establishment of the Islamic Development Bank (IsDB) as an international financial institution with the objective of providing funding for projects in Muslim countries.²⁵¹

The 1980s witnessed the expansion of IBF to many Muslim countries. In 1983 through 1984, Iran, Pakistan and Sudan openly announced their intention to implement full-fledged Islamic financial system in their countries. In 1988, the idea that was initially criticised by the opponents of IBF materialised in view of the convincing responses provided by Muslim economists to all the apprehensions of the critics.²⁵²

Within 50 years from a modest start in 1963 in Mit Ghamr, Islamic finance in general and Islamic banking in particular have penetrated into many Muslim dominated countries and widely accepted in the USA, Europe and most part of Asia. The wide acceptability that the industry enjoyed and the support it attracted from even international monetary organisations such as the World Bank and IMF were considered enough proof of its viability and relevance to the international financial system especially in view of the industry's appeal to many leading international banks that have opened Islamic banking windows or subsidiaries in different parts of the world.²⁵³ At the moment, there are more than 1500 Islamic financial institutions which are currently operating in more than 80 countries worldwide.²⁵⁴

3.4 Development of Islamic Banking in Nigeria

Efforts to provide Islamic banking services in Nigeria date back to the early 1960s. A certain bank in Lagos by name Muslim Bank West Africa Limited was reported to have attempted to provide Islamic financial services to interested customers in 1961. Three cases involving the Islamic Bank of West Africa, Lagos were reported in the Supreme Court of Nigeria between 1933 to 1975: *United Nigeria Insurance Co Limited v. Muslim Bank (West Africa) Limited* [1967 – 1975] 2 N.B.L.R. 391 (*Liability of bank to drawer*), *United Nigeria Insurance Co Limited v. Muslim Bank*

²⁵¹ Iqbal, M. & Molyneux, P. (2005). *Thirty Years of Islamic Banking: History, Performance and Prospects*. Palgrave Macmillan, New York, p. 27.

²⁵² Ibid.

²⁵³ Ibid, p. 40.

²⁵⁴ Malaysian Financial Sector (2022). *Islamic Banking and Takaful*, Bank Negara Malaysia, p. 1.

*(West Africa) Limited [1967 – 1975] 2 N.B.L.R. 391 (Duty of Bank) and Nigeria Breweries Limited v. Muslim Bank (West Africa) Limited [1933 – 1966] 1 N.B.L.R. 282.*²⁵⁵ The foregoing legal cases involving the Muslim bank have shown that Islamic banking efforts in Nigeria started in the 1960s.

The propagation of Islamic banking in Nigeria started gaining ground in the 1980s. Some University based Islamic centers and Islamic groups launched sensitisation campaigns through conferences and seminars in most parts of the North and South West of the country with a view to creating awareness among Nigerians, particularly Muslims, on the evils of interest/usury based banking and the need for adopting Islamic banking on the one hand, and on other hand, making the Government see reason why Muslims should be given the opportunity to conduct their financial activities in line with the provisions of the *Shari'ah*.²⁵⁶

The Banks and Other Financial Institutions Decree which was enacted in 1991 was the first piece of legislation that served as a gateway to Islamic banking in Nigeria. Two provisions in the Decree, Section 39(1) and Section 23(1) provided the first singular effort by the Government of Nigeria to recognise Islamic banking and provide the foundation for the establishment of Profit and Loss Sharing (PLS) banks in the country. Based on the provisions of the two sections, two banks were said to have been licensed in 1992 to carryout banking business using PLS modes but none was able to commence operation. In 1996, the defunct Habib Bank Nigeria Plc opened a non-interest banking window but could not also record significant success due to absence of framework for non-interest banking in the country. In 2004, the Central Bank of Nigeria (CBN) granted Jaiz Bank approval in principle to operate as a full-fledged Islamic bank. However, due to an upward review of minimum capital requirement from ₦2 billion to ₦25 billion for deposit money banks in July of the same year, Jaiz could not commence operation immediately.²⁵⁷

Following the Central Bank of Nigeria's (CBN) reclassification of banks into international, national and regional in 2010, a framework for the regulation and supervision of Non-Interest Financial Institutions (NIFIs) was released in 2011. According to the Framework, a NIFI is defined as: (i) full-fledged Islamic bank or full-fledged Islamic banking subsidiary of a conventional bank; (ii) full-fledged Islamic merchant or full-fledged Islamic banking subsidiary of a conventional merchant bank; (iii) full-fledged Islamic microfinance bank; (iv) Islamic branch or

²⁵⁵ Nigerian Banking Law Reports (1933-1989).

²⁵⁶ Dogarawa, A. B. (2018). Overview of the Scope and Dimensions of Islamic Finance in Nigeria, p. 12.

²⁵⁷ Ibid, pp. 12-13.

window of a conventional bank; (v) Islamic subsidiary, branch or window of a non-bank financial institution; (vi) a development bank regulated by the CBN offering Islamic financial services; (vii) a primary mortgage institution licensed by the CBN to offer Islamic financial services, either full-fledged or as a subsidiary; and (viii) a finance company licensed by the CBN to provide financial services, either full-fledged or as a subsidiary. According to the guidelines, interest-based banks, whether commercial or merchant, and other financial institutions operating in Nigeria may offer or sell *Shari'ah*-compliant products and services through subsidiaries, windows or branches only.²⁵⁸

Jaiz bank succeeded in obtaining a license to operate as a non-interest regional bank in November 2011 after satisfying the new capital requirement of the apex bank. The bank commenced operation in January 2012. Jaiz was upgraded to a national bank in 2016 following the license it obtained from CBN to offer Islamic banking services across the country. In 2019, a new bank, TAJ Bank was licensed to operate as a full-fledged non-interest regional bank and in July 2022, the bank secured CBN's approval for nationwide banking operations. A third non-interest bank, Lotus Bank was also licensed in 2021 to operate as a full-fledged regional bank.

In addition to the three full-fledged non-interest banks, Stanbic IBTC, Sterling and SunTrust banks were licensed to operate non-interest banking windows in the country. However, in 2018 Stanbic IBTC applied for withdrawal of its NIFI license and opted out of the list of banks that offer non-interest financial services in the country. In contrast, in December 2021, Sterling Bank Plc received the CBN's Approval-in-Principle for a stand-alone license for its non-interest banking business. Accordingly, a subsidiary of the bank, Alternative Bank Limited has been licensed to operate as a NIFI in Nigeria.

Furthermore, the NIFI framework has provided for, and accorded recognition to, full-fledged non-interest microfinance banks. However, in view of the peculiarity of microfinance and the inability of the NIFIs guidelines to cater for its specific needs, the CBN released another Guidelines on the regulation and supervision of Non-interest (Islamic) Micro Finance Banks (NIMFBs) in 2016. Tijarah Microfinance Bank Limited, and i-Care Microfinance Bank Limited were licensed as state and unit based non-interest microfinance banks respectively.²⁵⁹ However, the operating license of Tijarah microfinance bank limited was revoked by the CBN in May 2023 along with 131 other microfinance banks in the country thus leaving

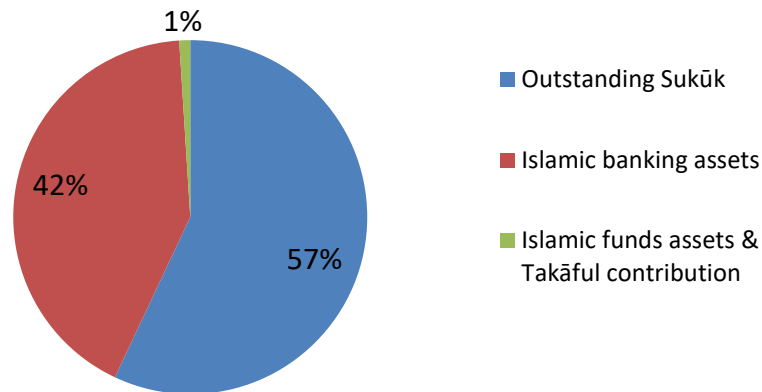
²⁵⁸ Dogarawa, A. B. (2018). Overview of the Scope and Dimensions of Islamic Finance in Nigeria, p. 13.

²⁵⁹ Ibid, p. 14.

i-Care Microfinance Bank Limited as the only non-interest microfinance bank in the country. According to the apex bank, the operating licenses of the affected microfinance banks were revoked because they had remained inactive, insolvent, failed to render returns, closed shop, or ceased to carry-on the type of banking business for which they were licensed for a continuous period of six months. This, according to the CBN, contravened the Banks and Other Financial Institutions Act (BOFIA) 2020, Act No. 5 and the Revised Regulatory and Supervisory Guidelines for Microfinance Banks in Nigeria.²⁶⁰

Figure 20 presents the composition of Islamic finance assets in Nigeria as of 2022.

Figure 20: Composition of Islamic Finance Assets in Nigeria as of 2022



²⁶⁰ Federal Republic of Nigeria (2023). Revocation of Operating License - Microfinance Banks Licenses Revoked. *Official Gazette*, No. 94, Vol. 110, B461. <https://www.cbn.gov.ng/Out/2023/CCD/Revocation%20of%20Operating%20Lice%20ONE.pdf>

Figure 21 presents the number of NIFIs in Nigeria as of August 2023.

Figure 21: Number of NIFIs in Nigeria

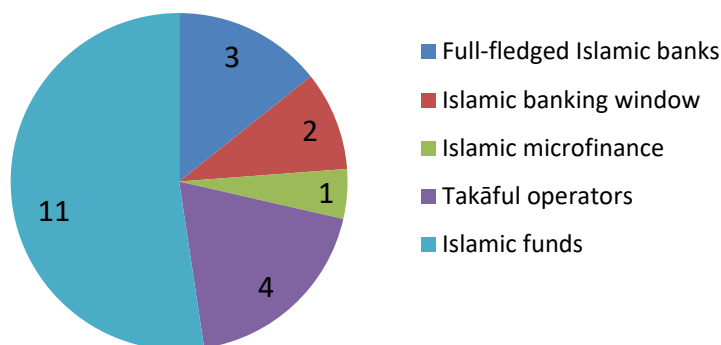
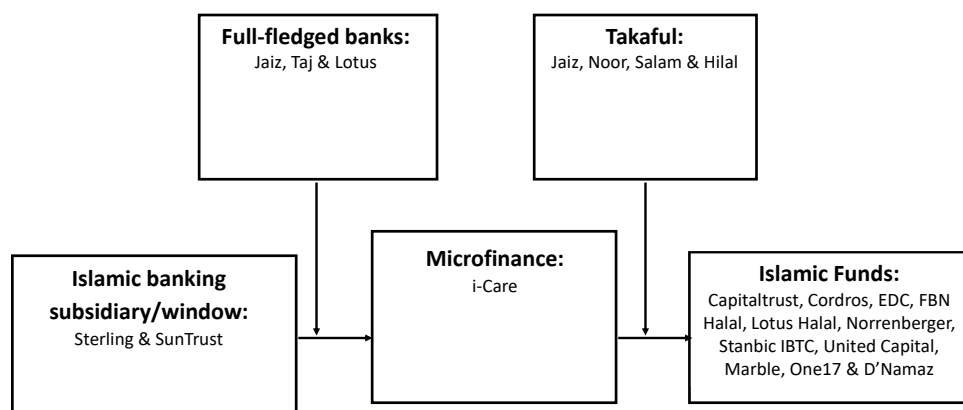


Figure 22 presents the list of NIFIs in Nigeria as of August 2023.

Figure 22: List of NIFIs in Nigeria as of August 2023



Nigeria's Islamic financial architecture has witnessed several developments in recent years. In 2012, the CBN set up a centralised advisory committee of well-versed Islamic scholars and Islamic finance experts, Financial Regulation Advisory Committee of Experts (FRACE) in line with the requirement of Section 9.1 of the NIFIs Guidelines. The Committee has a mandate to advise the apex bank on matters relating to Islamic commercial jurisprudence for the effective regulation and supervision of NIFIs in Nigeria with a view to ensuring that non-interest banking products and services as well as the general operations of NIFIs in the country

conform to the principles of the *Shari'ah*. This has, to a great extent, brought about standardisation of Islamic banking products and services, and has strengthened Islamic banking practices in the country.

The non-interest financial industry is expected to expand further to cater for the safety needs of the growing depositors of NIFIs. The global financial crisis of 2007-2009 that affected conventional financial institutions and resulted in the appreciation of Islamic finance as a promising alternative has increased the desire of depositors of NIFIs to have their deposits protected through deposit insurance system.

Deposit insurance is a system established to protect depositors against the loss of their insured deposits in the event that a bank is unable to meet its obligations to the depositors. It is an arrangement to protect bank depositors, in full or in part, against the loss of their insured deposits placed with banking institutions in the event of failure. It is predicated upon the fact that bank deposits represent a large portion of the national income; as such, any substantial losses in deposits would impact the status of the nation as a whole.²⁶¹

Deposits, according to the practice in non-interest banking today, are the funds deposited by clients in (a) current accounts; (b) savings accounts (which are managed according to the *Mudārabah*); and (c) short, medium and long-term investment accounts, which are also based on the *Mudārabah* contract. Deposit owners in NIFIs need insurance for their deposits like their counterpart in conventional banks in order to make their patronage of NIFIs more fulfilling. They however need a deposit insurance system that is consistent with the principles of the *Shari'ah* because conventional deposit insurance system will not be able to deal with the unique features of their deposits, especially profit-sharing investment account (PSIA) deposits.²⁶²

The *Shari'ah* basis of non-interest deposit insurance is the consideration of public interest (*maslaha*). The implementation of deposit insurance for NIFIs will help in

²⁶¹ International Association of Deposit Insurers (2019). Core Principles for Effective Islamic Deposit Insurance Systems (CPIDIS), p. 10. https://www.iadi.org/en/assets/File/Papers/Consultation/CPIDIS_version_for_public_consultation_clean_062019.pdf

²⁶² Dogarawa, A. B. (2020). Non-Interest Banking and Deposit Insurance in Nigeria. Being a Paper Presented at the 2020 Nigeria Deposit Insurance Corporation (NDIC) Annual Sensitisation Seminar for Federal High Court Judges at Federal High Court Complex, Abuja, pp. 7-8.

protecting the public from losing money that they place in a bank when the bank fails else depositors will be exposed to social ills and poverty and will be discouraged from patronising NIFIs. Deposit insurance will also help instil confidence among the general public as regards the safety of their bank deposits and reduces the likelihood of panic among depositors in the event of a rumoured or real bank failure. In addition, it will help maintain the competitiveness of Islamic deposits vis-à-vis conventional deposits.²⁶³

In view of the above reality, four years after the successful take off of the non - interest banking in Nigeria, the Nigeria Deposit Insurance Corporation (NDIC) developed a framework for insuring the deposit liabilities of NIFIs in 2015 and released it to the public in 2016. The framework, which was based on the principle of public interest, as indicated above, is meant to protect depositors against loss in the event of failure of any NIFI; engender public confidence and enhance resilience of NIFIs; encourage competitiveness of NIFIs; help to contain the cost of resolving failed NIFIs and provide an orderly Failure Resolution Mechanism (FRM); and promote and contribute to the stability of Nigeria's financial system.

The non-interest deposits covered by the NDIC's non-interest deposit insurance scheme, as provided in Section 5.2 of the Framework, are safe keeping deposits (*Wadī'ah*), interest free deposits for investment, profit sharing/loss bearing deposits (*Mudārabah*), profit and loss sharing deposits (*Mushārah*) and any other deposit type that is non-interest based and approved by the CBN. Section 4.2 provides that the Maximum Deposit Insurance Coverage (MDIC) for NIFIs in Nigeria is the same as the conventional banks. The Corporation provides ₦500,000 and ₦200,000 per depositor per account in non-interest Deposit Money Banks (DMBs) and Microfinance Banks (MFBs) respectively. Section 9.0 of the guidelines requires the setting-up of NDIC Advisory Council of Experts to advise the Management of the Corporation on matters relating to Non-Interest Deposit Insurance for the effective supervision of NIFIs and in matters relating to the Investment of the Non-Interest Deposit Insurance Fund (NIDIF).²⁶⁴

In addition to the above, the Securities and Exchange Commission (SEC) has issued the Non-Interest Capital Market Products Master Plan in 2015 (the NICM Plan) in order to boost the rapid development of Islamic capital markets products by establishing a strong regulatory framework, strengthen the institutional capacity of

²⁶³ Ibid, p. 8.

²⁶⁴ Nigeria Deposit Insurance Corporation – NDIC (2015). Framework for Non-Interest Deposit Insurance Scheme (NIDIS) in Nigeria. <https://ndic.gov.ng/deposit-insurance/draft-framework-for-non-interest-deposit-insurance-scheme/>

the regulator, continuous public awareness campaigns among others. The NICM has provided for non-interest banks and other NIFIs in the country to participate in capital market activities. This, undoubtedly, is a boost to Islamic finance in Nigeria.²⁶⁵

In the year 2020, the amended Banks and Other Financial Institutions Act (BOFIA) recognised non-interest banks as 'specialised' banks and includes them in many sections and subsections.²⁶⁶ For example, in Section 4 (1), the Act recognises non-interest-bearing securities and non-interest banking compliant products or investments. Section 22 (1)(a) exempts non-interest banks from the requirement for every bank to display at its offices and on its website its lending and deposit interest rates. In Section 61 (3), the Act mentions the power of the CBN Governor to appoint experts on non-interest banking or to constitute a panel of such experts to advise the Bank on matters of non-interest banking. This means that the subsection clearly recognises the role of FRACE. Subsection (4) of the same Section 61 goes further to mention the issue of remuneration of the persons appointed to advise the apex bank on matters of non-interest banking. Section 62 (2) recognises CBN as the lender of last resort to non-interest banks. Under “interpretation”, Section 131 of the Act includes non-interest bank and non-interest banking instruments. The Section interprets non-interest bank as “a bank which transacts banking business, engages in trading, investment and commercial activities as well as the provision of financial products and services in accordance with the principles and rules of Islamic finance.”²⁶⁷

3.5 Islamic Banking Products and Services

Non-interest banks operate based on profit or loss sharing, sale or lease contracts. The system has its own financial products and services which differ from the conventional banking. The products are *Shari’ah* compliant and are applicable for the smooth running of the system on the basis of ethics, fairness and social justice. The system over the years has managed to offer a wide array of products encompassing almost the entire range of Islamic modes of financing that are able to cater for the needs of the majority of the sectors of the economy.

²⁶⁵ Securities and Exchange Commission - SEC (2015). Non-Interest Capital Market Products Master Plan (the NICM Plan). <https://sec.gov.ng/nigerian-capital-market-masterplan/>

²⁶⁶ Banks and Other Financial Institutions Act (2020), Act No. 5. Federal Republic of Nigeria Official Gazette, No. 183, Vol. 107. Available at <https://www.cbn.gov.ng/out/2021/ccd/bofia%202020.pdf>

²⁶⁷ Banks and Other Financial Institutions Act, (2020) Act No. 5, p. A732.

The assets and liabilities sides of the balance sheet of a non-interest bank contain typically the range of products and services offered:

Asset side: The segments covered include agriculture, consumer, commodity, financing, SME sector, treasury and financial institutions, and corporate/commercial, through various *Sharī'ah* compliant modes such as *Murābaha*, *Mudārabah*, *Mushārah*, *Ijārah*, *Salam*, *Istisnā'* and *Wakālah*.

Liability Side: On the Liability side, non-interest banks offer various *Sharī'ah* compliant deposit/investment options that customers could avail themselves. These include: current account, *Mudārabah* savings account, investment/*Mudārabah* term deposits of various maturities, and certificates of investment.

On the one hand, current accounts, also known as call or demand deposits are loans to the Islamic bank in the *Sharī'ah* perspective. The bank is answerable for their safety and is therefore bound to returning them on call. The guarantee for current accounts is attributable only to the bank shareholders because they have the exclusive benefit of the profits from their investment. On the other hand, both savings and investment accounts are considered as *Mudārabah* capital. They are subject to the rulings applicable to *Mudārabah* contracts, including the non-guarantee of the capital of the *Mudārabah*.²⁶⁸

Other investment banking products and services offered are; *Sukūk* arrangement, financial advisory, private placement, syndication, trusteeship, underwriting, structured finance, listing on capital markets, project financing, and Mergers & Acquisition.

A description of some of the Islamic banking products and services are as follows:

1. ***Mudārabah* (profit sharing):** *Mudārabah* is a profit-sharing and loss-bearing contract where one party supplies funding as capital owner (*rabbul māl*) and the other provides effort and management expertise as manager (*mudārib*) with a view to generating a profit. The ratio in which the total profits of the enterprise are distributed between the capital-owner and the manager of the enterprise is determined and mutually agreed at the time of entering into the contract, before the beginning of the project. In the event of loss, the capital owner bears all the loss and the principal is reduced by the amount of the loss. It is the risk of loss that entitles the capital-owner to a share in the profits. The manager bears no

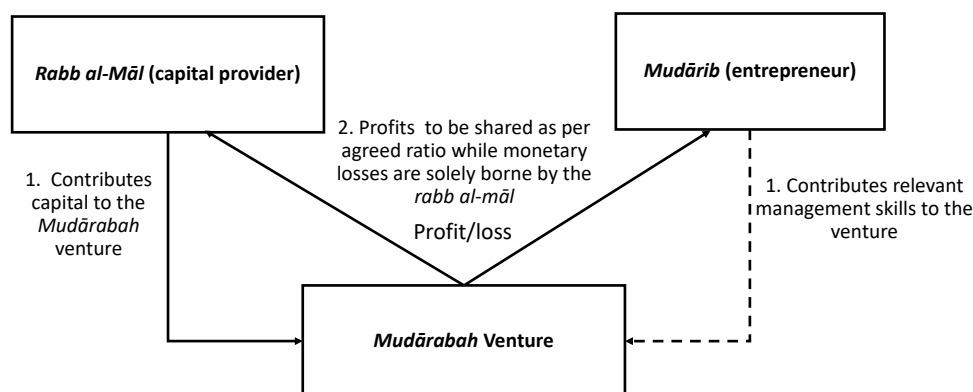
²⁶⁸ International Islamic Fiqh Academy - IIFA (2021). Resolution No. 86 (3/9), p. 163.

financial loss (unless it results from negligence on his/her part), having lost his time and his work efforts.

The liability of the capital provider (*rabbul māl*) in a *Mudārabah* is limited to the extent of his contribution to the capital. In Islamic banking, the bank may either act as the *rabbul māl* or the *mudārib*. In collecting deposits from its clients to be invested in productive businesses, Islamic banks act as *mudārib* and the clients as *rabbul māl*. However, in financing business projects or entrepreneurs, Islamic banks act as the *rabbul māl* and the entrepreneurs stand as the *mudārib*s. In this case, the bank is not joining in the running of the business financed. However, it could be involved in ample monitoring and supervision to safeguard the funds by ensuring that it is being used in line with the *Mudārabah* contract.²⁶⁹

A simple *Mudārabah* arrangement is presented in Figure 23:

Figure 23: *Mudārabah* structure



2. *Mushārah* (joint venture): *Mushārah* is a profit-and-loss sharing partnership. It is a contract of joint partnership where two or more partners provide capital to finance a project or own real estate or movable assets, either on a permanent or diminishing basis. Partners in *Mushārah* have a right to take part in management; they seem to bear the greatest risk among all Islamic financing modes with the potential for earning the highest reward. However, whereas profits are distributed according to pre-agreed ratios, losses are shared in proportion to capital contribution.

²⁶⁹ Abdul Rahman, A. R. (2009). *An Introduction to Islamic Accounting: Theory and Practice*, CERT publications, International Islamic University Malaysia (IIUM).

There are four general conditions for *Mushārah*. The first condition is capital of agency (*al-Wakālah*) whereby the transaction contracted for in the *Mushārah* must be capable of accepting the principle of agency (*al-Wakālah*). Consequently, the business partners must also be capable of being agents for their associates in the business. This is for the reason that the entire contract of *Mushārah* functions mainly on the principle of agency, through which, each partner is regarded as the agent of his business colleagues in transacting with the business property, and his relation with third parties.

The second condition is fixing the ratio of profit-sharing whereby the ratio for profit distribution must be agreed upon in advance. This is because; the profit distribution is part of the contract's subject matter. Ignorance relating to the subject matter may possibly render the contract invalid. Therefore, all partners must know the profit-sharing ratio.²⁷⁰

The third condition is that the profit-sharing should not be a fixed amount, but be calculated based on ratio. A fixed amount must not be specified in pre-fixing the profit-sharing. This is because the anticipated profit from the joint venture is still not known. Hence, setting a certain amount to be given to any of the business partners is not well-suited with the features of *Mushārah* contract. Instead, a ratio for profit distribution should be formulated in order to enable profit-sharing easily after the profit has actually been secured.

The fourth condition relates to the termination of the *Mushārah* contract. Here, there are reasons for bringing the contract to an end which includes cancellation of the contract of *Mushārah* by any of the partners. This is for reason that the contract of *Mushārah* is not a binding contract; therefore, any partner may at his will, terminate the contract. Another important reason for termination is the death of any of the partners and permanent insanity of any of the partners. This is because it renders the business partner incapable of entering into any contract at all.²⁷¹

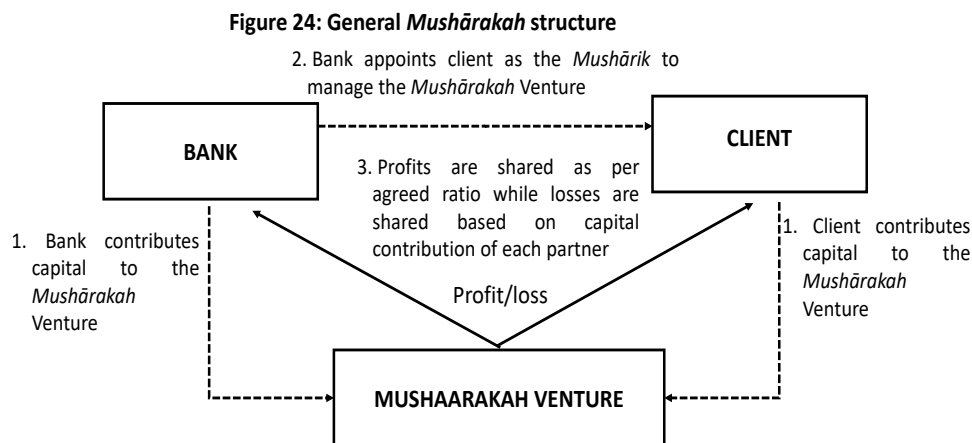
Mushārah is an ideal alternative for interest-based financing with far reaching effects on both production and distribution. In a typical *Mushārah* contract, both bank and the client have their shares in the venture, and both parties have a right to its management. A bank can also exercise the voting right which corresponds to their share of the firm and a representative of the bank can sit on the board.

²⁷⁰ Abdul Rahman A. R. (2009). *An Introduction to Islamic Accounting: Theory and Practice*, CERT publications, International Islamic University Malaysia (IIUM).

²⁷¹ Ibid.

Apart from financing long-term investment projects, *Mushārah* is also commonly used for funding entrepreneurs the working capital to purchase raw materials or goods as well as transactional banking service in the form of Letter of Credit (L/C). It can also be used for financing imports and exports. In this regard, an exporter or importer can arrange for a single transaction on the basis of *Mushārah* and share the profit with the financier according to a pre-agreed ratio.²⁷²

Figure 24 depicts the structure of a general *Mushārah*:



Mushārah Mutanāqisah (diminishing *Mushārah*) is another form of *Mushārah* that is commonly used in home financing. Diminishing *Mushārah* is "a new form of relationship involving a partnership between two parties in an income-producing project, and in which one party undertakes to, gradually, purchase the share of the other, whether out of the purchaser's share in the project income or from any other source." It is based on a contract concluded between two parties in which each of them subscribes to a specific share of the capital of the partnership, whether in cash or another type of cash-evaluated assets after they determine the share of profit distribution, providing that each party bears his share of the loss (if incurred) commensurate to his share in the capital.²⁷³

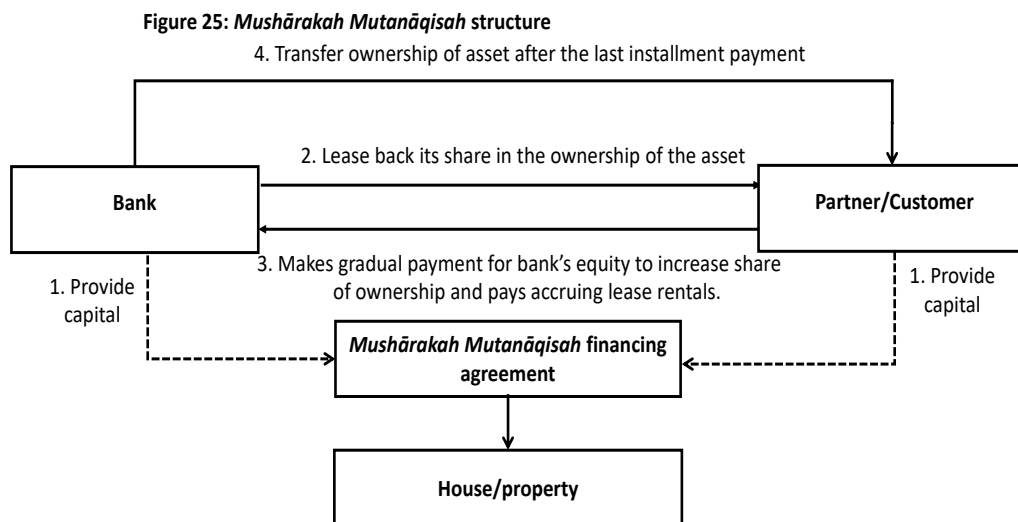
²⁷² Moriguchi, T., Khattak, M. A., Farhan, M., Mohamad, F., Worasutr, A., Hakim, A. L., Musthafa, F. & Muneeza, A. (2016). Contemporary Practices of Musharakah in Financial Transactions. *International Journal of Management and Applied Research*, Vol. 3, No. 2, p. 66.

²⁷³ International Islamic Fiqh Academy, Resolution No. 136 (2/15), pp. 288.

The dynamics of a typical home financing diminishing *Mushārah* involving an Islamic bank and a customer are as follows:

- (a) the bank and the customer form a partnership to jointly acquire a property on diminishing *Mushārah* basis;
- (b) the bank then leases its share to the customer and receives compensation in the form of rent, which is based on a mutually agreed fair market value; and
- (c) gradually, the customer buys the bank's share in the property.

The above dynamics are presented in Figure 25.



It is clear from the above that in a diminishing *Mushārah*, three contracts: partnership, leasing, and sale are involved in concluding the arrangement. In view of this, a number of Sharī'ah issues have been raised against it: use of multiple contracts in the same agreement, which is prohibited in the *Sharī'ah*; presence of a binding promise (wa'd), which forces the customer to take over the remaining equity shares owned by the bank thus coercing him to buy; and customer's gradual purchase of equity on the basis of values given in the initial contract.²⁷⁴ To address these concerns, the following conditions have been stipulated to make the contract *Sharī'ah*-compliant:²⁷⁵

²⁷⁴ Moriguchi, T. *et. al.* (2016). Contemporary Practices of *Mushārah* in Financial Transactions, p. 67.

²⁷⁵ International Islamic Fiqh Academy, Resolution No. 136 (2/15), pp. 288-289.

- (a) The contract should be concluded through separate relevant transaction documents. That is, the contracts and commitments relating to the *Mushārah* transaction should be kept independent from each other.
 - (b) The contract should be characterised by the presence of a binding undertaking from only one party (unilateral promise) to buy out the share of the other party, provided the latter has the option (to sell or not). The promise should not be for purchasing the shares of the other party at par value, else it will amount to providing a guarantee of the principal. The buyout should be effected by concluding a series of sale contracts when buying each share even if it is through the exchange of offer and acceptance notifications.
 - (c) Costs of insurance, maintenance, and the other expenses are to be charged to the *Mushārah* account, as per respective shares of the partners. Throughout the period of the diminishing *Mushārah*, the two parties' commitment towards the cost of essential maintenance will remain as per their respective capital shares.
 - (d) The purchase price of the shares should be determined at market value, or a price mutually agreed upon, on the same day of concluding the sale transaction.
- 3. *Murābaha* (cost plus finance):** *Murābaha* is derived from *ribh*, which means gain, profit or addition.²⁷⁶ It is defined as a particular kind of sale where the seller expressly mentions the (total) cost of the sold commodity he has incurred, and sells it to another person by adding some profit or mark-up thereon.²⁷⁷ A distinguishing feature of *Murābaha* from other kinds of sale is the disclosure of cost price. If a person sells a commodity for a lump sum price without any reference to the cost, the sale is called *Musāwamah* (bargaining).²⁷⁸

The purpose of *Murābaha* sale is to protect innocent consumers who lack expertise in trade from the tricks and exploitation of cunning traders. This perhaps is the reason for calling it 'a contract of trustworthiness' (*bay' al-amānah*) because the buyer must know the cost price (original price plus additional expenses, if any) and the amount of profit.

As a rule, the cost-price in *Murābaha* needs to be known by the purchaser at the time of the agreement (*majlis al-'aqd*). The mark up (profit) over the cost price too must be clearly stated and known by both parties. The profit/mark-up can be

²⁷⁶ Ayub, M. (2002). *Islamic Banking and Finance: Theory and Practice*, p. 217.

²⁷⁷ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 71.

²⁷⁸ Ibid, p. 66.

determined by mutual consent, either in lump-sum or through an agreed ratio of profit to be charged over the cost. The *Murābaha* sale price can be paid on spot or deferred basis. The deferred payment can be made on instalmental payment (*taqsīt*) basis, or any other method agreed by the parties.

The legality of *Murābaha* is deduced from the *Qur'ān*, the *Sunnah* of the Prophet (peace be upon him), the consent of the majority of Muslim jurists (*Ijmā'*) and *Qiyās* (analogy). The *Qur'ān* generally allows the sales contract.²⁷⁹ Although there is no direct juristic authority from the *Sunnah* of the Prophet (peace be upon him) on the legitimacy of *Murābaha* sale, its permissibility from the *Sunnah* is derived from the general permissibility of sale and encouragement to engage in it. In a *Hadīth*, the Prophet (peace be upon him) said, “The best earning is what a man earns with his own hands and from a permissible trade.”²⁸⁰ The legitimacy of *Murābaha* is also based on the consent of the majority of Muslim jurists. Analogically, since the Prophet (peace be upon him) has approved sale based on cost price (i.e. *tawliyah* sale), the sale on mark-up will be equally permissible.²⁸¹

Murābaha can be used by banks in normal trading and as a mode of financing. In the former, the financier purchases the commodity and keeps it in its own possession, or purchases the commodity through a third person appointed as agent, before selling it to the customer.²⁸² The latter represents the modern *Murābaha* which is conducted mainly by Islamic banks and other Islamic financial institutions on a deferred payment basis as a mode of financing based on *Murābaha li al-āmīr bish-shirā* (*Murābaha* to Purchase Orderer) arrangement. Under this arrangement, a financial institution, at the request of a client/customer, buys, owns and takes delivery of a specific commodity, and then sells it to the client/customer on *Murābaha*, deferring payment to a date agreed by the two parties. Generally, *Murābaha* to the purchase orderer is permissible on goods that are already in the physical possession of the seller, provided the seller carries the risk of loss before delivery or the consequences of returning the purchased goods due to concealed defects or any other reasons justifying the return of the goods after their reception, provided the conditions of the sale are met and with the absence of any impediments.²⁸³

²⁷⁹ *Qur'ān*, 2:275.

²⁸⁰ Transmitted by Tabarānī, *Hadīth* Number 13939.

²⁸¹ Bank Negara Malaysia (2009). Shariah Parameter Reference 1: Murabahah. *The Principles and Practices of Shariah in Islamic Finance*, p. 6. Available at <https://law.resource.org/pub/my/ibr/ms.bnm.shariah.01.2009.pdf>

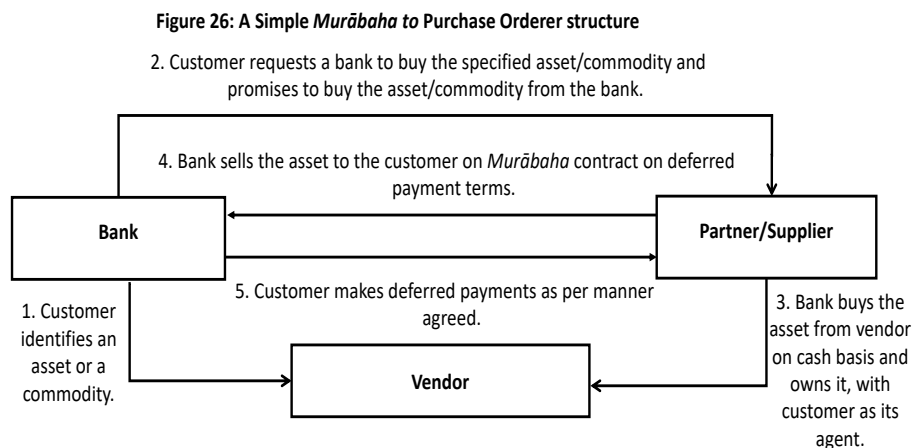
²⁸² *Ibid*, p. 73.

²⁸³ International Islamic Fiqh Academy, Resolution Nos. 40–41 (2/5 and 3/5), p. 75.

A typical *Murābaha* which is *Sharī'ah*-compliant should ensure that the Islamic bank actually owns the property before selling it to the customer. That is, the first sale and purchase transaction between the bank and the vendor/supplier of the commodity being a separate transaction altogether from the second sale and purchase transaction between the bank and the customer. In practice, the bank appoints the customer as its agent (*Wakīl*) to take delivery of the goods on its behalf from the supplier in line with the agency (*wakālah*) and then gives him another *Wakālah* to take delivery of the goods for himself after the second sale. Thus, in a *Murābaha* to Purchase Orderer (MPO) financing, the parties involved have different capacities at different stages as highlighted by Usmani.²⁸⁴

- (a) At the first stage, the institution and the client promise to sell and purchase a commodity in future. This is not an actual sale. It is just a promise to effect a sale in future on *Murābaha* basis. Thus, at this stage, the relation between the institution and the client is that of a promisor and a promisee.
- (b) At the second stage, the relation between the parties is that of a principal and an agent.
- (c) At the third stage, the relation between the institution and the supplier is that of a buyer and seller.
- (d) At the fourth and fifth stages, the relation of buyer and seller comes into operation between the institution and the client, and since the sale is effected on deferred payment basis, the relation of a debtor and creditor also emerges between them simultaneously.

In Figure 26, the structure of a *Murābaha* is given as follows:



²⁸⁴ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 75.

MPO is also known by several names, which include: combined *Murābaha*; *Murābaha* with promise to purchase, sale with promise; *Murābaha* for the giver of the purchase order; Bank *Murābaha*; and promise for *Murābaha*.²⁸⁵ The permissibility of MPO has been attributed to the Hanafi²⁸⁶ and Shāfi'i schools of Islamic law. It is also the preferred scholarly view to Ibn Al-Qayyim.²⁸⁷

Imam al-Shāfi'i explained the concept of MPO through an illustration. He said, "If a man showed another man a commodity and said buy for me this good and I will add a profit over its cost and the man bought it, the purchase is permissible. And he who said: I will add profit over the cost of the commodity, has a right to buy it or to leave it. Similarly, if he said: Buy me an item – and he describes it to him – or he says: Buy me any product you want, and I shall give you a profit on it, it is all the same. The first transaction is permissible, and they have the option of cancelling the second transaction, but if they renew it, it is permissible."²⁸⁸

The legality of MPO has also been confirmed by International *Sharī'ah* compliance bodies such as the International Islamic Fiqh Academy²⁸⁹ and AAOIFI.²⁹⁰ It is also the resolution of Saudi Arabia's Standing Committee for Research and Fatwā.²⁹¹ In addition, the majority of contemporary scholars and Islamic finance experts including Hassan Hamūd, Al-Qaradāwī, 'Alī Ahmad Al-Sālūs, Al-Siddīq Al-Darīr, Abdus-Sattār Abu Ghuddah, Mufti Taqī Usmani and Monzer Kahf have confirmed the legality and supported the permissibility of MPO.²⁹²

On the contrary, the view in the Mālikī school of law is that the practice of MPO or combined *Murābaha* falls under *'inah* (sale and buy-back agreement) and *al-*

²⁸⁵ Hamūd, S. H. A. (1982). *Tatwīr al-A'māl al-Masrafiyah bimā Yattaḥiq wa al-Sharī'ah al-Islāmiyyah*. 2nd edition, Matba'ah al-Sharq wa Maktabuha, Oman, p. 432.

²⁸⁶ This is based on a statement made by Al-Sarakhsī in *Al-Mabsūt*, Vol. 30, p. 237. Available at <https://shamela.ws/book/5423/6205>

²⁸⁷ Ibn al-Qayyim, A. (1437AH). *I'lām al-Muwaqqi'īn an al-Rabb al-'Ālamīn*. Dār 'Ālam al-Fawā'id, Makkah, 1st edition, Vol. 4, pp. 446-447.

²⁸⁸ Al-Shāfi'i, M. I. (1961). *Al-Umm*. Maktabah Kulliyāt al-Azhariyyah, 1st edition, Vol. 3, p. 39.

²⁸⁹ International Islamic Fiqh Academy, Resolution Nos. 40–41 (2/5 and 3/5)

²⁹⁰ AAOIFI Sharī'ah Standards, No. 8 (2/1)-(2/3), pp. 200-203. <https://aaoifi.com/ss-8-murabahah/?lang=en>

²⁹¹ *Fatāwā al-Lajnah ad-Dā'imah li al-Buhūth al-'Ilmiyyah wa al-Iftā*, Vol. 13, p. 153.

²⁹² Ibtihal, F. L. (2023). Consumer Protection in Islamic Contracts: The Case of the Murabahah Contract in Morocco. *Beijing Law Review*, Vol. 14, No. 3, p. 1277. Also, see: Al-Anzī, M. M. (2019). Bai al-Murābaha li al-Āmir bi al-Shirā, pp. 1-2, <https://www.alukah.net/sharia/0/122592/بيع-المرابحةللأمر-بالشراء/>

tahāyul alā al-ribā (getting round *ribā*) and is therefore not permissible.²⁹³ Some of the contemporary scholars who share the view of non-permissibility of MPO are Muhammad bn Sālih Al-'Uthaimīn, Bakr bn Abdillāh Abū Zaid, Rafīq al-Masrī, Muḥammad Sulaymān al-Ashqar and Ḥassan 'Abdullāh Al-Amīn.²⁹⁴

It should be noted that sequence is necessary for a *Murābaha* to Purchase Orderer contract to be valid. The sale contract between the bank and the customer must be executed only after the bank has taken ownership of the *Murābaha* asset either directly from the vendor or through the customer as its agent. If a client takes possession of the asset on behalf of the bank and consumes it before the *Murābaha* sale contract between him and the bank is executed, the bank must cancel the contract, recover the principal amount and give any agreed profit/excess to charity.

If the customer decides to back out on entering into a *Murābaha* with the bank after the goods are purchased from the supplier without a valid reason, the bank may sell the goods in the market and make up for its actual loss. It is permissible for the bank to keep any excess if the goods are sold for a higher price than its cost to the bank. If the amount realised from the sale is lower than the cost of the goods to the bank, the client is expected to make up for the difference provided it is established at the time of the contract's execution. This is permissible because, in a purchase-orderer *Murābaha*, a customer visits the location of a vendor, inspects the commodity and agrees on the price with the vendor before approaching the bank with the commodity's specification for financing on *Murābaha* basis.

The above position is in line with the resolution of the Islamic Fiqh Academy, which was taken in view of the fact that there is nothing in the Glorious *Qur'ān* or *Sunnah* which prohibits the making of such unilateral promises enforceable. According to the Academy, a promise (made unilaterally by the purchase orderer or the seller), is morally binding on the promisor, unless there is a valid excuse. It is however legally binding if made conditional upon the fulfillment of an obligation, and the promisee has already incurred expenses on the basis of such a promise. The binding nature of the promise means that it should be either fulfilled or a compensation be paid for damages caused due to the unjustifiable non fulfilling of

²⁹³ Ibn Juzai, M. A. (n.d.). *Al-Qawānīn Al-Fiqhiyyah*, p. 171. Available at <https://ia601308.us.archive.org/31/items/FP4331/4331.pdf>

²⁹⁴ Ibtihal, F. L. (2023). Consumer Protection in Islamic Contracts: The Case of the Murabahah Contract in Morocco. *Beijing Law Review*, Vol. 14, No. 3, p. 1277. Also, see: Al-Anzī, M. M. (2019). *Bay' al-Murābaha li al-Āmir bi al-Shirā*, pp. 1-2, <https://www.alukah.net/sharia/0/122592/بيع-المرا بحة للامر-بالشراء/>

the promise.²⁹⁵ However, the Academy has made the promises in commercial dealings binding on the promisor with the following conditions:²⁹⁶

- (a) It should be a one-sided promise.
- (b) The promisor must have caused the promisee to incur some liabilities.
- (c) If the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance.
- (d) If the promisor backs out of his promise, the court may force him either to purchase the commodity or pay actual damages to the seller.

The Academy further resolved as follows:

Mutual promise (involving two parties) is permissible in the case of *Murābaḥa* sale provided that option is given to one or both parties. Without such an option, it is not permissible, since in *Murābaḥa* sale, mutual and binding promise is like an ordinary sale contract, in which the prerequisite is that the seller should be in full possession of the goods to be sold, in order to be in conformity with the ḥadīth of the Prophet forbidding the sale of anything that is not in one's possession.²⁹⁷

The Islamic bank has a duty to bear the risk in the trade, that is, by being responsible for the property prior to its sale and actual delivery to the client. This is what will justify the bank's profit from the transaction. The popular *fiqh* Maxim of *al-ghunm bil ghurm*, which implies that one is entitled to a gain if one agrees to bear the responsibility for the loss, applies here. For example, where goods bought by a bank under a *Murābaha* agreement with a client are damaged or become defective before delivery to the client, it is the right of the buyer to reject the goods due to such damage or defect, and the bank is liable to make good the loss. The liability of the bank as regards goods to be sold under a *Murābaha* contract ends only after the goods are delivered to the client directly by the bank or by the client to himself on behalf of the bank where the client is appointed as the bank's *wakīl*. In case of imported goods, the bank's liability ends only after the goods arrive at the port and the client receives the shipping documents.

²⁹⁵ Resolution Nos. 40–41 (2/5 and 3/5), pp. 75-76.

²⁹⁶ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 87.

²⁹⁷ Resolution Nos. 40–41 (2/5 and 3/5), p. 76.

Furthermore, a down payment from the client to the bank is permissible in a purchase orderer *Murābaha* contract. After the successful execution of the *Murābaha* contract between the bank and the client, the down payment becomes part of the payment made by the client. In case of default by the client in purchasing the goods after the bank has paid for it and taken possession, the bank is entitled to deduct the value of actual damage incurred as a result of the default from the down payment.²⁹⁸

Below are additional important *Shari'ah* issues relating to *Murābaha* contract:

- (a) It is permissible for the financier to ask the client to furnish a security to his satisfaction. The security may be in the form of a mortgage or a hypothecation or some kind of lien or charge. The sold commodity itself can be given to the financier as security/mortgage after the purchaser has taken its delivery, either physically or constructively.²⁹⁹ Similarly, deposits, whether in current or investment account, can be used as mortgage through an arrangement precluding the account holder from having access to it for the duration of the mortgage. If the deposit is in a current account domiciled with the financier, the amount must be transferred to an investment account in order to prevent the financier from benefiting from any increase in the mortgage value. The profits arising from the *Mudārabah* should be credited to the account holder.³⁰⁰
- (b) The financier can also ask the purchaser/client to provide a guarantee from a third party. In case of default in the payment of price at the due date, the financier may have recourse to the guarantor, who will be liable to pay the amount guaranteed by him. It is not permissible to charge a fee for the issuance of the letter of guarantee whether it is with or without a coverage. However, charging the actual cost incurred for issuing the letter of both kinds are permissible by *Shari'ah*, taking into account, with regard to a guarantee with coverage, the possible effort that might be required to provide the coverage.³⁰¹ In the event the client defaults in payment without valid excuse, and the guarantee clause is invoked against the guarantor thus making him to pay the guaranteed amount, the guarantor can ask the client to pay a compensation for the harm he caused him.
- (c) If the client defaults or delays in payment of the *Murābaha* price at the due date, the price cannot be increased, and the financier is not allowed to impose any

²⁹⁸ Ethica Institute of Islamic Finance (2019). Handbook of Islamic Finance, p. 565.

²⁹⁹ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 88.

³⁰⁰ International Islamic Fiqh Academy (2021). Resolution No. 86 (3/9), p. 163.

³⁰¹ Ibid, Resolution No. 12 (12/2), p. 14; Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 90.

- kind of compensation or additional charges on him for the delay, whether by virtue of a predetermined condition or otherwise because goods sold under *Murābaha* constitute a debt on the purchaser. The same ruling applies to defaults in the delivery of goods transacted under *Salam* contract.³⁰²
- (d) It is permissible for the financier to make the customer undertake that, in case he defaults in payment at the due date, without a valid excuse, he will pay a specified amount to a charitable fund maintained by the bank as penalty (*gharāmah*). The purpose of this penalty is to deter dishonest clients from deliberately defaulting in payment without a valid excuse. The financier is not allowed to benefit from the penalty; rather, the amount should be given out to charity.³⁰³ If, after the penalty is charged, it is proven that the default was not deliberate but due to reasons beyond the control of the defaulter, the financier is required to return to the client the amount of penalty charged.
 - (e) *Murābaha* transaction cannot be rolled over for a further period. It is therefore not permissible for a financier to, on the request of the client, extend the maturity date of *Murābaha* by rolling it over and extending the period of payment on an additional mark-up. Rollover of *Murābaha* practically implies that another separate *Murābaha* is booked on the same commodity, which is totally against the well-settled *Sharī'ah* principles regarding sale.³⁰⁴ If the client is unable to settle his debt at the agreed time due to a valid excuse, the financier should give him some respite by extending the period of payment at no cost to the client. This is in line with Allah's statement, "If the debtor is in a difficulty, grant him time till it is easy for him to repay (his debt)."³⁰⁵
 - (f) It is not permissible for the contracting parties in a *Murābaha* transaction to stipulate, in the agreement, a rebate/discount for earlier payment by the purchaser. However, if it is not made to be a condition for earlier payment, and the financier voluntarily gives the client a rebate upon earlier payment, whether at the request of the client or not (pay less but ahead of time), it is permissible, as long as the relationship between the creditor and the debtor is bilateral. If a third party is involved, the discount is not permissible, subject to the *Sharī'ah* ruling regarding the discount of trading instruments. It is also permissible to discount the debt if it falls due following the death, bankruptcy, or procrastination of the debtor in order to accelerate settlement.³⁰⁶

³⁰² Ibid, Resolution No. 109 (3/12) pp. 218-219.

³⁰³ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, pp. 96-97.

³⁰⁴ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 98.

³⁰⁵ *Qur'ān*, 2:280.

³⁰⁶ International Islamic Fiqh Academy, Resolution No. 64 (2/7) p.118; Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 100.

4. ***Ijārah* (leasing):** *Ijārah* literally means “to give something on rent”³⁰⁷ or “providing services and goods temporarily for a wage.”³⁰⁸ From a *Shari’ah* point of view, it involves providing products or services on a lease or rental basis whereby a person or party is given the right to use the object (the *usufruct*) for a pre-defined period, in exchange for an agreed consideration, while the owner retains the ownership of the assets for the full lease period.³⁰⁹

Two different situations are used in the *Fiqh* of *Ijārah* on usufructs:³¹⁰

- a) Transferring the usufruct of a particular asset or property - a car, home, plant, or machinery to another person in exchange for a rent claimed from him. In this case, *Ijārah* relates to the usufructs of the rented property or asset not to the services of human beings. The term, in this case, is analogous to the English term ‘leasing’. The lessor is called *mu’jir*, the lessee is called *musta’jir* and the rent payable to the lessor is called *ujrah*. Unlike in sales where the corpus or principal of the property is transferred to the purchaser, in *Ijārah*, it remains in the ownership of the transferor while its usufructs, that is, the right to use it, is transferred to the lessee.³¹¹

All the liabilities emerging from the ownership of the leased property are borne by the lessor while the lessee bears the liabilities referable to the use of the property. Similarly, the lessor is responsible for the risk associated with the leased asset throughout the lease period in the sense that any harm or loss caused by the factors beyond the control of the lessee shall be borne by the lessor.³¹²

Another rule in this kind of *Ijārah* is that the period of lease must be determined in clear terms. Where the purpose of the lease is not specified in the lease agreement, the lessee can use the property for whatever purpose it is used in the normal course. The lessee is liable to compensate the lessor for any harm caused to the leased asset by any misuse or negligence on the part of the lessee.³¹³

³⁰⁷ Usmani, M. T. (1998). *An Introduction to Islamic Finance*. Arham Shamsi, p. 109.

³⁰⁸ Jamaldeen, F. (20212). *Islamic Finance for Dummies*. John Wiley & Sons, Inc, New Jersey, p. 157.

³⁰⁹ Ibn Qudāmah, *al-Mughnī*, 6/12.

³¹⁰ Abu Ghuddah, A. S. (2008). *Tamwīl al-Manāfi’ bi Urūbba*, p. 8. <https://www.e-cfr.org/blog/2014/01/31/التمويل-المنافع-بأوروبا/>

³¹¹ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 109.

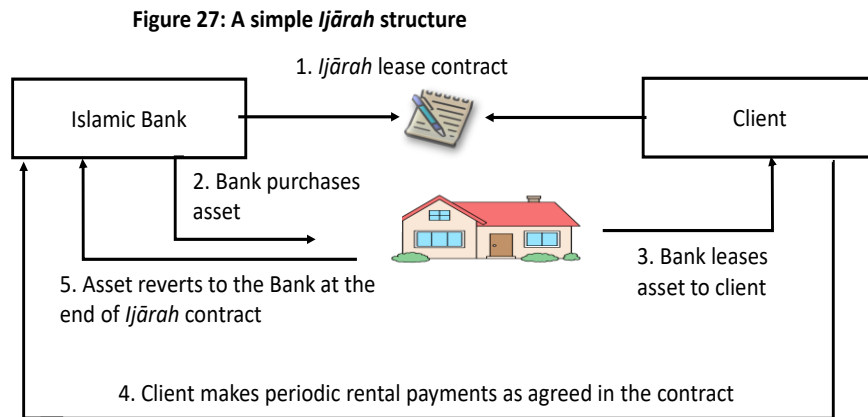
³¹² International Islamic Fiqh Academy, Resolution No. 110 (4/12) p. 221.-222.

³¹³ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, pp. 111-112.

The rent or any part thereof may be payable in advance before the delivery of the asset to the lessee,³¹⁴ but the amount so collected by the lessor shall remain with him as ‘on account’ payment and shall be adjusted towards the rent after its being due. The lease period shall commence from the date on which the leased asset is delivered to the lessee, regardless of whether the lessee has started using it or not.³¹⁵

Lease is originally a transaction meant to transfer the usufruct of a particular asset or property from one person to another for an agreed period against an agreed consideration. However, Islamic banks and many other IFIs have adopted leasing as a form of investment and as a mode of financing. This kind of lease is generally known as the ‘financial lease’ as distinguished from the ‘operating lease’.

Figure 27 graphically depicts the structure of a simple *Ijārah* based on financial lease arrangement.



An important feature of modern ‘financial leases’ is that after the expiry of the lease period, the corpus of the leased asset is normally transferred to the lessee. As having already recovered his cost along with an additional profit thereon, the lessor has no further interest in the leased asset whereas the lessee wants to retain it at the expiration of the leased agreement. In this regard, the leased asset is usually transferred to the lessee at the end of the lease, either free of any charge or at a nominal token price. It should be noted that if a clause is included in the lease contract to the effect of selling or gifting the leased asset to the lessee at the end of the lease period, the contract will be void because the two transactions become tied up to each other. The ruling of being void will also apply where this condition is

³¹⁴ This applies mostly to *ijārah mawsūfah fī al-dhimmah* (forward lease).

³¹⁵ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 113.

not mentioned in the contract expressly; however, it is understood between the parties that the title of the asset will be passed on to the lessee at the end of the lease term.³¹⁶

In practice, as alternative, the lessor signs a separate unilateral promise to, after the expiration of the lease contract; sell the leased asset to the lessee at a specified mutually acceptable price if the lessee wants to purchase it, subject to his payment of the amounts of rent according to the lease agreement. The promise is binding on the lessor only. While the lessor is bound to fulfil it, the lessee may exercise his option to purchase at the end of the period or decline. Similarly, the lessor may unilaterally undertake to gift the leased asset to the lessee at the end of the lease period subject to full payment of the amounts of rentals. It is also permissible, in a lease contract, to allow the lessee to make use of the leased property for a specific amount of rent and a specific period with an option to own the property at any time if he so wishes provided the sale, in this case, is to be made according to a new contract in due time and at the then-prevailing market price. This arrangement is called *Ijārah Muntahia bit Tamlik* (literally "lease that ends with ownership"), which a large number of contemporary scholars have allowed and is widely acted upon by Islamic banks and other financial institutions.³¹⁷

Ijārah Muntahia bit-Tamlik also called *Ijārah wa Iqtinā'* (literally "lease-and-own") has similar rules to the ordinary *Ijārah* except that it is associated with a promise by the lessor to transfer ownership at the end of the *Ijārah* period through a separate sale agreement or gift. The method of transferring the title in the leased asset to the lessee must be evidenced in a document separate and independent from the *Ijārah* contract document, using one of the following methods: (a) by means of a promise to sell for a token or other consideration, or by accelerating the payment of the remaining amount of rental, or by paying the market value of the leased property; (b) a promise to give it as a gift (for no consideration); or (c) a promise to give it as a gift, contingent upon the payment of the remaining instalments.³¹⁸

Another method of *Ijārah Muntahia bit Tamlik* as suggested by Kahf³¹⁹ is through gradual sale of the rented property. In this form, the lessor and lessee agree to make

³¹⁶ International Islamic Fiqh Academy, Resolution No. 110 (4/12) pp. 220-222.

³¹⁷ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, pp. 121-123. Also, see: International Islamic Fiqh Academy, Resolution No. 110 (4/12), p. 222; Resolution 13 (1/3), pp. 18-19; and Resolution No. 44 (6/5), p. 79.

³¹⁸ AAOIFI Shari'ah Standard No. (9), 8/1, pp. 249-250.

³¹⁹ Kahf, M. (2000), *Ijārah Muntahia bit Tamlik wa Sukūk al-A'ayān al-Mu'ajjarah*. Presented at the Twelfth Session of International Islamic Fiqh Academy held at Jeddah on 21-27

successive and consecutive leasing contracts for the share owned by the lessor from the rented property at each contract period. The lessee pays an amount of money equivalent to the portion at each rental period and pays another amount of money to buy shares or parts of the same rented property. In this case, the contract includes: agreement on the lease contract and on the gradual sale of the rented property. The usufruct of the property is involved as well as the property itself by dividing the property into portions. An amount is paid for the purchase of a portion in addition to the payment of each rental installment. The installment payments will remain the same (or fairly close to the same) through the contract. However, the portion of the payment going towards ownership of the property will increase to 100% over time as the portion going to pay rent decreases to 0%. This means the decrease in rent reflects the decrease in the bank's equity of the property as the client's ownership increases.

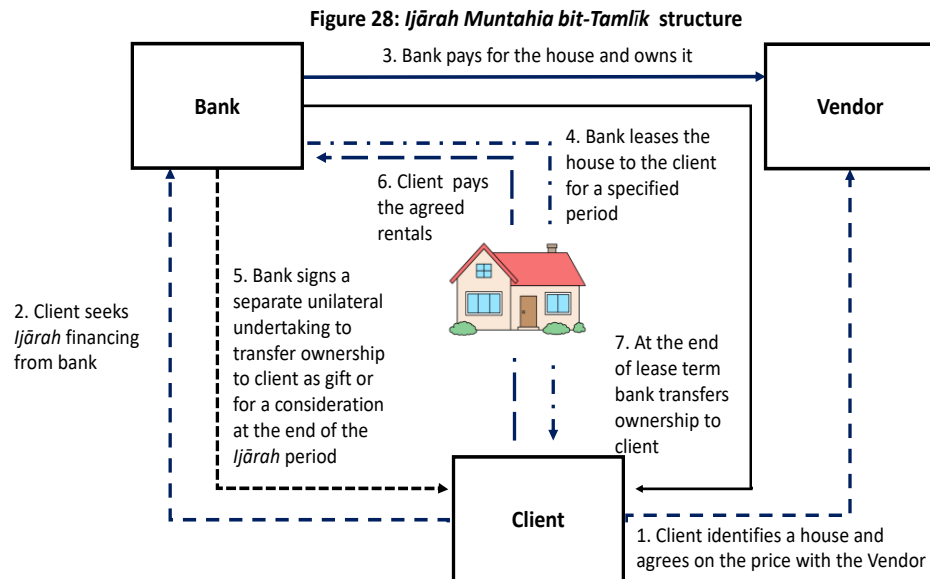
Kahf³²⁰ went ahead to suggest another form of *Ijārah Muntahia bit-Tamlīk* called *Ijārah Mubtadi'ah bit-Tamlīk* (literally "lease starting with ownership"). This form is proposed as an alternative to the lease ending with ownership arrangement. It is commonly referred to as property ownership with the exception of its benefits. In this kind of arrangement, the property is sold to the beneficiary of the financing with the exception of its benefits for the lease period at a price to be paid at the time of the contract. The benefit/usufruct is then leased to the buyer through a contract for a specific period of time at the end of which the property is then transferred to the client. The first payment is for the price of the property, and the subsequent periodic payments are for its rent for the period of exclusion of benefits.³²¹

September, 2000, p. 19. Available at https://ia801800.us.archive.org/29/items/economy_0001/economy0813-.pdf

³²⁰ Ibid, pp. 20-21.

³²¹ Ibid, p. 21.

Figure 28 depicts an *Ijārah Muntahia bit-Tamlīk* structure.



b) Hiring the services of a person - a doctor, a lawyer, a teacher, a medical doctor, a tailor, a driver, a labourer or any other person who can render some valuable services on wages given to him as a consideration for his hired services. The service may be provided directly to the hirer or to whom the service is sold. The employer or hirer of the service is called *musta'jir* while the provider of the service is called *ajr*. This type of *Ijārah* is used as a mode of financing services required by clients under financing benefits and services.

The subject of 'financing benefits and services' is considered one of the most significant developments and products innovations in Islamic finance generally and in the operations of Islamic banks in particular. Islamic financial institutions now obtain a wide range of services and benefits of services from their owners and offer them to customers who are in need of them on deferred or installment lease basis. These wide ranges of services and benefits are commonly known as *Ijārah* service products.

Ijārah service is a type of lease-based contract that involves leasing of specified usufruct or services from their owners and leasing them out to those who need

them.³²² In *Ijārah* service, an Islamic bank leases the usufruct or benefits of services offered by providers such as educational programmes in schools and universities, medical treatment in hospitals and trips of travel and tourism agencies in return for a specified cash amount.³²³ The bank then leases this right to its customers by virtue of leasing contracts at a known increase or defined mark-up/profit margin.

Many scholars and *Shari'ah* committees of Islamic financial institutions treat *Ijārah* service under the subject matter of lease of benefits and services.³²⁴ They posit that it is permissible to finance services by means of a lease contract. According to them, just as it is permissible to finance goods by selling through *Murābaha* to the purchase orderer, it is also possible to finance the benefits of services by means of a lease contract; but instead of the subject of the contract being the commodity, the subject becomes the benefit or benefits of service, and instead of the customer wanting the commodity being a purchase orderer, he becomes a lease orderer.³²⁵

In one of its resolutions, the Kuwait Finance House said: “It is permissible for whoever rents a service from a person to rent it to someone else for the same amount as the service was rented or more or less; because the renter of a person's service is entitled to its benefits; so it is permissible for him to transfer it to someone else.”³²⁶ This position is in line with the decisions and resolutions of *Shari'ah* and supervisory committee of many Islamic financial institutions including European Council for Fatwa and Research, Al-Barakah 28th Annual Symposium on Islamic Economics, and *Shari'ah* Supervisory Board of Dubai Islamic Bank.³²⁷

The *Shari'ah* Supervisory Council of Bahrain Islamic Bank was asked if it is permissible (for an Islamic bank) to buy travel tickets for its customers in order to make profit from the service it renders. The Board responded as follows:

³²² As-Sa'adi, A. A. (2018). *Ijārah al-Mawsūfah fī az-Dhimmah wa Tatbīqātuhā al-Mu'āsirah*, p. 322.

<https://www.bankalbilad.com/img/Shariah%20Board/Sharia%20Publications%20الموصوفة%20بالخدمة.pdf>

³²³ For details, see the recommendations of AlBarakah Annual Symposium for Islamic economics, 30/2/9. Also, see AAOIFI Standard 34/2.

³²⁴ Resolution 8/3/2006 of Fatwa and Shari'ah Supervisory Board of Abu Dhabi Islamic Bank. This is the view of scholars like Abdus Sattār Abu Ghuddah and Muhyiddīn Al-Qarra Dāghī.

³²⁵ Ad-Dumaijī, A. S. (2019). *Tamwīl al-Khadamāt: Dirāsah Fiqhiyyah Tatbīqiyyah*, Dārul Maimān, Riyād, p.77.

³²⁶ Communiqué of Kuwait Finance House third Fiqh Symposium, 27-29 April 1993.

³²⁷ For example, see: Resolution 34/15 of AlBilad Bank Shari'ah Committee and Resolution 8/3/2006 of Fatwa and Shari'ah Supervisory Board of Abu Dhabi Islamic Bank.

There is no objection to that, because it comes under the heading of buying and selling utilities (i.e. leasing services and works), and that is on condition that the bank owns the specified benefits of the services first and then sells it afterwards. It is also permissible to lease benefits of unspecified services on forward lease basis, then own them and deliver them at the specified time.³²⁸

Furthermore, the Libya Fatawa House was asked if it is permissible for a bank to purchase and own Hajj or Umrah services from a travel agency and sell it to intending pilgrims on the basis of gradual payment. It opined as follows:

Hajj and Umrah trips in the form they are currently organised - whose costs are predetermined in terms of transportation, accommodation, fees, and the like, and (the services and costs) agreed upon between the two parties - are no more than a type of service that is contracted, such as contracting benefits or benefits and objects together, and this is legally permissible. These services take the rule of a commodity, in the possibility of contracting it for a price to be paid instantly or in installments, with an advance or without a down payment, with an increase in the price with instalments or without an increase. It is permissible for the financing institution to purchase and own this usufruct in reality, and then sell it to intending pilgrims on instalment payment basis the way assets/properties are sold.”³²⁹

³²⁸ Fatāwa of Bahrain Islamic Bank Shari’ah Supervisory Council (1979-2011), p. 87. <https://www.bisb.com/sites/default/files/04-2019/20152-02-25bisb.pdf>

³²⁹ For the complete *fatwa*, see <https://ifta.ly/1760/بيع-المنافع-بالمراوحة-الإسلامية>

According to Izzuddīn Khawjah:³³⁰

Murābaha is permissible in benefits (or benefits of service) whereby a bank first buys the usufruct and owns it, such as buying travel tickets to enjoy a ride and travelling by plane, ship, or others. After that, the bank, in its capacity as the lessee of the benefit, has the right to re-lease it, i.e. selling the usufruct again during the period of its ownership, whether at the same rent, or less or more, and the only condition for that is that the benefit is specified in any recognised manner.

In view of the above, the following are identified as suitable services that Islamic banks can offer under *Ijārah* service:³³¹

- (i) Medical treatment financing - this covers cost of medical tests/examinations, surgeries, drugs, hospital accommodation and post-surgery follow-up services. The product is also suitable for financing medical check-up where breakdown of the total cost of the different specific medical investigations to be carried out is spelt out and made available.
- (ii) Education financing - this covers cost of all education-related services such as tuition/registration fees, hostel accommodation, manuals, domesticated books and laboratory reagents, and any other education-related expenses. The product is also ideal for financing capacity building trainings, workshops, mandatory continuing professional development (MCPD) programmes, seminars and conferences.
- (iii) Travels and tourism financing - this covers flight tickets, car rentals, transportation costs, tourists' accommodation, package tours, etc. The product is ideal for financing Hajj and Umrah travels and other *halāl* social tourism activities. It can also be used as a separate product to compliment medical or education trip.

An Islamic bank may provide financing to customers for any of the three *Ijārah* service products listed above based on the rules and conditions relevant and

³³⁰ Khawjah, I. (1998). *Ad-Dalīl ash-Shar'ī lil Murābaha*. Al Barakah Investment and Development Company, Jeddah, p. 101.

³³¹ For details, see: Dogarawa, A. B. (2021). Notes on *Ijārah* Service Products. A paper prepared and presented at 41st Jaiz Bank Advisory Committee of Experts' (ACE) meeting held from 25th to 26th October, 2021.

applicable to each of them provided it acquires and owns the service or its usufruct before selling it to customers. For each of the products, a clear description of the specific service(s) for which financing is required, the total cost of the package or item-by-item cost of the components of the package, and other relevant details need to be provided before signing the contract.

Some scholars added to the list of *Ijārah* service products: marriage reception and communication expenses financing. On the one hand, marriage financing may cover, among other things, the cost of venue of reception and decoration, guests' hotel accommodation and reception meals. However, those who genuinely require financing in the area of marriage boxes and their contents or physical house items required, can be financed through household *Murābaha* arrangement. On the other hand, communication related expenses may include the wholesale of airtime and maintenance cost.

Under the lease arrangement in *Ijārah* service, two forms are discussed. The first form is where the service exists and the bank owns it for a specified period at the time of the contract; or the service seeker approaches the bank for financing and presents the details of available services and costs he obtained from the service providing organisation. In this case, it is treated as a sub-lease contract.³³² The following steps are usually involved:

- A bank leases a specific service or benefits of a service from a provider or different providers.
- The bank clearly and unambiguously offers explanation to client(s) seeking financing for such service(s) about the location of the service and the company/person that will provide it; and leases the service or its benefits to seeker(s).
- The bank obtains profit from the difference between the client's lease payment and the amount it pays to the service provider since the client will pay in instalments.

A general concern to Islamic banks regarding this form is the risk associated with leasing services or benefits of services from their owners/providers before they are sought for by clients in view of the fact that a bank may tie its resources for a long time with no patronage by people. Mitigating this type of risk requires that banks do not lease services or benefit of services except on demand just like in the case

³³² For additional information, see AAOIFI's addendum on the basis of sub-lease in service *Ijārah* under Standard 34 and Section 5/1/5 of the same Standard.

of purchase orderer *Murābaha*.³³³ In this case, the dynamics of the *Ijārah* service transaction will be as follows:

- Bank acts as a financier in an *Ijārah* transaction with the customer.
- Bank provides funds to obtain the service requested by the customer and then sells/leases the service to the customer.
- Customer pays the bank on periodic instalments.

For instance, a student secures admission into an educational institution to read a particular course. Since he does not have the funds to pay tuition and other fees, he applies for *Ijārah* service financing to an Islamic bank. The bank verifies and confirms from the institution through an invoice that specifies the course of study, period, cost and its components, etc. Once it is approved, the bank makes payment directly to the institution and appoints the student as agent to acquire the educational service for and on behalf of the bank. The bank then sells or leases out the service to the student on the basis of installment payment of the sale price/lease rentals.

The second form is where the service to be provided is for a future time. In this regard, the arrangement is treated as a forward lease contract (*Ijārah mawsūfah fi al-dhimmah*).³³⁴ Two options are available in forward lease *Ijārah* service.

The first option has the following steps:

- A service seeker approaches a bank for financing of specific benefits of service on the basis of forward lease.
- The bank signs a forward lease contract with the service seeker before it possesses the service.
- The bank signs another contract with the service providing company.

³³³ Abu Ghuddah, A. S. (2008). *Tamwīl al-Manāfi' bi Urūbba*, p. 27.

³³⁴ AAOIFI Standard 34/5/1/3.

The above process is built on the principles of parallel advance purchase (*al-salam al-muwāzi*)³³⁵ and is considered permissible.³³⁶ In the context of *Ijārah* service, a bank will pledge to avail its client a clearly described service or its benefits with the same specifications it leases from the provider of the service using separate, unrelated contracts.

The second option, which is common in education *Ijārah* service, has the following steps:

- Bank signs a forward lease contract with an educational institution for specific number of admissions on the condition that the institution will deliver the service to the bank or its client(s) in the future.
- Bank later leases the service to clients who need financing for education on the basis of *Ijārah* service using a separate contract.

A *Sharī'ah* issue of concern in forward lease *Ijārah* service is whether a bank can sub-lease a service or its benefits before it owns or possesses it? Majority of scholars are of the view that since this kind of *Ijārah* service is usually based on forward lease contract, a lessee can sub-lease the service before it is delivered to him on the basis of a promise to deliver in a specified future date.³³⁷ They therefore agree that *Ijārah* service is permissible and valid in any of the two forms discussed above. However, depending on the form it takes, all the conditions and rules of *Ijārah* applicable to the first form, and the conditions and rules of *Ijārah* and parallel *Salam* applicable to the second form must be observed.

5. *Salam* (Deferred Delivery): One of the basic conditions for the validity of a sale in the *Sharī'ah* is that the subject matter of the sale (i.e. the commodity intended to be sold) must be in the physical or constructive possession of the seller. This means (i) a commodity which does not exist at the time of sale cannot be sold; (ii) if the commodity is existing, but the seller does not own it, he cannot sell it to anybody; and (iii) even if the seller owns a commodity, but he has not taken its delivery himself or through an agent, he cannot sell it.

³³⁵ Parallel advance purchase represents a future sale contract in which the seller pledges to hand over a commodity, with the same specifications of the commodity bought in the first advance purchase, so that he would be able to fulfill his commitment, but there is no link between the two contracts.

³³⁶ This view is in line with the resolutions of Al-Barakah 2nd annual symposium on Islamic economics, fatwa of Shari'ah Supervisory Board of Dubai Islamic Bank, Kuwait Finance House and AAOIFI's Standard number 9.

³³⁷ Abu Ghuddah, A. S. (2008). *Tamwīl al-Manāfi' bi Urūbba*, p. 27.

However, there are two exceptions to this general *Sharī'ah* principle. One is *Salam* and the other is *Istisnā'*. Both are sales of a special nature due to human need (*hājjah*) for them.³³⁸

Salam is simply a contract in which advance payment is made for goods to be delivered at a future date. It is a form of sale where the seller undertakes to supply some specific goods to the buyer at a future date that is specified in exchange for an advanced price fully paid at spot. In a *Salam* transaction, the price is cash, but the supply of the purchased goods is deferred. The buyer is called *rabbus-salam*, the seller is *muslam ilaih*, the cash price is *ra'sul-māl* and the purchased commodity is termed as *muslam fih*.³³⁹

The *Sharī'ah* basis of *Salam* is contained in the *Hadīth* of the Prophet (peace be upon him). A tradition narrated by Ibn Abbas reports that, when the Prophet (peace be upon him) emigrated from Makkah to Madina, he met a practice where farmers' farm produce (dates) was being bought and paid for in advance for the farmers to defer delivery until up to more than a year or two. The Prophet (peace be upon him) declared: "whoever pays in advance the price of a thing on a deferred delivery basis should do so on the basis of a specified measure at specified weight for a specified period."³⁴⁰

It can be inferred from the *Hadīth* that as a mode of financing, *Salam* is used to finance the agricultural sector. Its purpose is to meet the needs of small-scale farmers who need money to grow their crops and to feed their family up to the time of harvest. Similarly, traders who export goods to other places and import some other goods to their homeland, and need money to undertake this type of business are allowed to sell the goods in advance in order to undertake the business with the cash price they received. In view of this, *Salam* is beneficial to the seller, because he receives the price in advance to fulfil his needs.

Salam is also beneficial to the buyer because, normally, the price in *Salam* is lower than the price in spot sales. In this way, he benefits from the reduction in the market price of the commodity on the day of delivery. In the case of modern financing, the difference between the two prices may be a valid profit for the buyer (whether an individual or an institution such as bank).

³³⁸ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 128.

³³⁹ Ibid.

³⁴⁰ Sahīh Bukhāri, Book 35, Hadīth 2240 and Muslim (1604).

Salam was allowed by the Prophet (peace be upon him) subject to the following conditions, which are deduced from the above *Hadīth*:³⁴¹

- (i) the buyer pays the price in full to the seller at the time of effecting the sale although some scholars have allowed a concession of two to three days for payment to be made, albeit on condition, the period of deferment being neither equal to nor above the date fixed in the *Salam* contract;³⁴²
- (ii) *Salam* applies only to those commodities whose quality and quantity can be specified exactly;
- (iii) *Salam* cannot be effected on a particular commodity or on a product of a particular field or farm because there is a possibility that the crop of that particular field or the fruit of that tree is destroyed before delivery;
- (iv) the quality and quantity of the commodity (intended to be purchased through *Salam*) must be fully specified and unequivocally agreed upon leaving no ambiguity which may lead to a dispute;
- (v) the exact date and place of delivery must be specified in the contract, either by tying it to a well-known deadline or to an event whose happening is an absolute certainty even if the date of its occurrence may be subject to a slight difference not likely to cause discord such as the harvesting season;³⁴³ and
- (vi) *Salam* cannot be effected in respect of things which must be delivered at spot.

The following is an illustration of a general *Salam* contract:

Zaid is a farmer. He could produce 500 bags of paddy on his land in 4 months. However, he does not have enough money to start the project. He approaches JTL Bank for financing. The bank bought 400 bags of paddy from Zaid using a *Salam* contract at a price of ₦15,000/bag. The market price of paddy was ₦20,000/bag. Therefore, JTL Bank paid the total selling price ₦6,000,000 to Zaid on spot who in turn used the money to execute the project at the cost of ₦3,500,000. After 4 months, Zaid delivered 400 bags of paddy to JTL Bank. On his part, Zaid would gain a gross profit of ₦2,500,000 (*Salam* price - project cost). JTL Bank on its part could make profit by selling the paddy in the market at ₦20,000/bag to enjoy a gross profit of ₦2,000,000 [(₦20,000-~~₦15,000~~) x 400 bags].

³⁴¹ For details, see: Usmani, M. T. (1998). *An Introduction to Islamic Finance*, pp. 121-131.

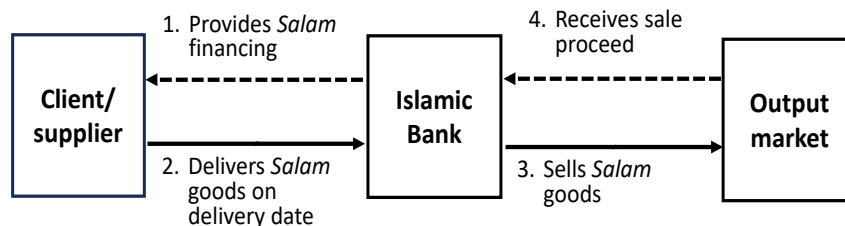
³⁴² International Islamic Fiqh Academy, Resolution No. 85 (2/9) p. 160.

³⁴³ Ibid.

Both parties in *Salam* face the risk of price movement. On one hand, if the price of paddy goes up to say ₦25,000/bag, Zaid would have to forego the opportunity of making higher profit because he has sold the paddy at the *Salam* price in which case JTL Bank may enjoy a higher profit of up to ₦4,000,000 while Zaid ends with ₦2,500,000. On the other hand, if the paddy price goes down to say ₦14,000/bag, then Zaid will be in a comfortable position because he has already sold to the bank at ₦15,000/bag. JTL Bank will now face the risk of loss because it could not recover its cost.

Figure 29 depicts a general *Salam* structure.

Figure 29: General *Salam* structure



Salam contract may take place in any permissible tradable goods/commodities with definable features, imputable as a debt, be they raw materials, agricultural products or manufactured goods.³⁴⁴ However, a general concern for Islamic banks and other financial institutions in *Salam* financing is that they will receive certain commodities from their clients, and will not receive money. Since from the standpoint of the *Shari'ah*, they cannot sell those commodities before they are actually delivered to them, it will be cumbersome for them to receive different commodities from different clients, to keep them in a warehouse/cell and to gradually sell them in the market. This is because, as financial intermediaries, banks do not operate like normal traders who own and operate shops in the market.

In practice, the above concern is addressed by the use of another separate *Salam* contract with a third party. This is called parallel *Salam*. The procedure is that after purchasing a commodity by way of *Salam*, the Islamic bank sells it through a parallel contract of *Salam* for the same date of delivery. The period of *Salam* in the second (parallel) transaction being shorter, the price is usually a little higher than the price of the first transaction. By this, the difference between the two prices

³⁴⁴ Ibid.

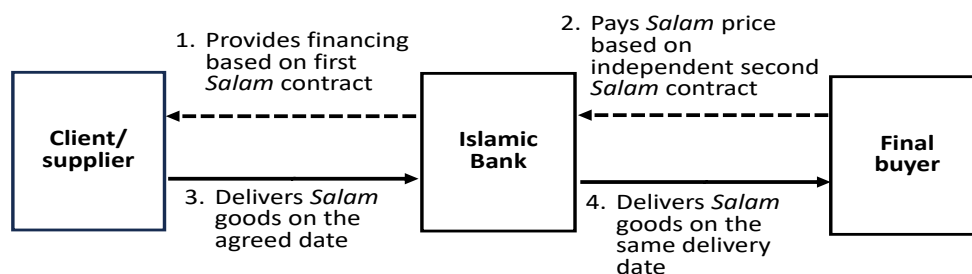
constitutes the bank's profit.³⁴⁵ However, it should be noted that the International Islamic Fiqh Academy has resolved that “a commodity purchased through a *Salam* (forward buying) contract cannot be sold before it is received.”³⁴⁶

In parallel *Salam*, it is necessary that the bank enters into two different separate and independent contracts; in one of which the bank is the buyer and in other one, the bank is the seller. The two contracts cannot be tied up in a manner that the rights and obligations of the first *Salam* contract are dependent on the rights and obligations of the parallel *Salam* contract. In addition, the parallel *Salam* can only be with a third party. The seller in the first contract cannot be made purchaser in the parallel contract of *Salam*, because doing that will make it a buy-back contract, which is not permissible in the *Sharī‘ah*.

To illustrate a parallel *Salam* contract, assume the wholesale price of paddy is ₦19,000/bag. Zaid sold 400 bags of paddy to JTL Bank at ₦15,000/bag on *Salam* basis. The bank paid Zaid ₦6,000,000 on Day 1. The bank then sold the 400 bags of paddy to a wholesaler at ₦17,500/bag on *Salam* basis and received the sale price of ₦7,000,000 from the wholesaler on Day 1 also. The transaction between Zaid and JTL Bank is the first *Salam* while the transaction between JTL Bank and the wholesaler is the second *Salam*. After 4 months, Zaid delivered the paddy to the bank and the bank consequently sent the paddy to the wholesaler. The wholesaler makes profit by selling the paddy to the retailer at the price of ₦19,000/bag. Assume the cost of the project was as illustrated in general *Salam*, Zaid would gain a gross profit of ₦2,500,000 (*Salam* price – project cost); JTL Bank would gain ₦1,000,000 profit; and the wholesaler would gain ₦600,000 profit.

The structure a typical parallel *Salam* is presented in Figure 30.

Figure 30: Parallel *Salam* structure

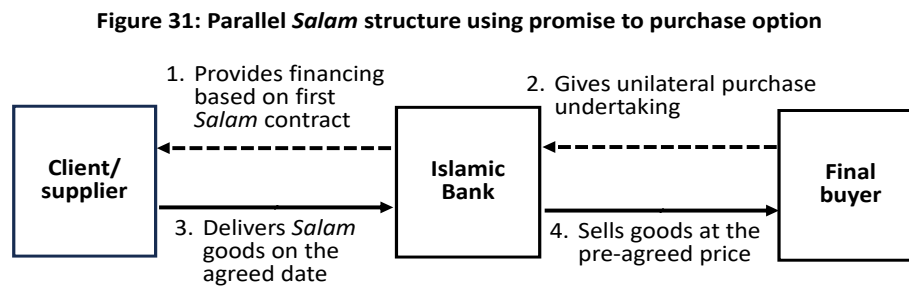


³⁴⁵ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, pp. 131-134.

³⁴⁶ International Islamic Fiqh Academy, Resolution No. 74 (5/8) p.140. Also, see: Resolution No. 63 (1/7).

If a parallel contract of *Salam* is not possible, the bank can obtain a unilateral promise to purchase from a third party. In that case, the buyer will not have to pay in advance because a promise does not constitute actual *Salam* sale. In practice, the pre-agreed price to the third party will be higher than the price paid by the bank. As soon as the commodity is received by the bank, it will be sold to the third party at the pre-agreed price, according to the terms of the promise. The difference between the two prices is the bank's profit.³⁴⁷ This second way of using parallel *Salam* financing addresses the concern raised by Resolutions No. 74 (5/8) and No. 63 (1/7) of the International Islamic Fiqh Academy that a commodity purchased through a *Salam* contract cannot be sold before it is received.

Figure 31 depicts a parallel *Salam* structure using promise to purchase option.



Ordinary or general *Salam* and parallel *Salam* contracts have some similarities. Both contracts involve advance payments and deferred delivery. The buyers, which is the bank for general *Salam* contract, and the client for parallel *Salam* contract, will pay full price in spot for future delivery. Also, the quantity, quality, and specifications of the assets or commodities involved are the same in both contracts. In addition, the delivery date and place specified in the contracts are the same.

Despite these similarities, there are some differences between general *Salam* and parallel *Salam*. Some of the differences are summarised in Table 2.

³⁴⁷ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, pp. 131-134.

Table 2: Difference between general *Salam* and parallel *Salam*

	General/ordinary <i>Salam</i>	Parallel <i>Salam</i>
Contractual relationship	In a general/ordinary <i>Salam</i> , the contractual relationship is between the supplier and the bank.	In an arrangement of parallel <i>Salam</i> , the bank enters into two different, separate, independent contracts. In one of them, the bank is the buyer and in the second one the bank is the seller.
Role of bank	For general <i>Salam</i> , the bank is the buyer paying in advance on spot to the supplier.	For parallel <i>Salam</i> , the bank acts as the buyer from the supplier in the first contract making payment in advance on spot, and acts as the seller to the client in the second contract receiving payment in advance on the spot.
Period of time	General <i>Salam</i> contract has a longer period of time compared with parallel <i>Salam</i> because the delivery date in both contracts is the same and the general <i>Salam</i> contract is signed first before the parallel <i>Salam</i> contract.	It has a relatively shorter period since the contract is signed after the first <i>Salam</i> contract while the delivery date in both contracts is the same.
Price	In general <i>Salam</i> , the bank pays a lower advance price at an earlier time compared to the amount the client paid in the parallel <i>Salam</i> contract.	The period of time in the second <i>Salam</i> contract is shorter compared to the first <i>Salam</i> contract and the price is higher

- 6. *Istisnā'*:** *Istisnā'* is the second kind of sale in which the exception to the general rule that a commodity cannot be transacted before it comes into existence applies. It means to order a manufacturer to manufacture a specific commodity for the purchaser. Whereas in the case of *Salam*, only generic goods are involved and require full payment up front, *Istisnā'* involves the construction or manufacturing of unique goods (which require certain specifications). The transaction comes into existence when the manufacturer undertakes to manufacture the specified goods for him with material from the manufacturer. However, if the material is provided by the customer, and the manufacturer is

required to use his labour and skill only, the transaction is not *Istisnā'*; rather it will be a transaction of *Ijārah* services.³⁴⁸

Istisnā' is similar to *Salam* in the sense that it can be transacted before the commodity comes into existence. However, there are several points of difference between *Istisnā'* and *Salam*. Table 3 summarises four areas of difference between the two kinds of contracts.

Table 3: Differences between *Istisnā'* and *Salam*

	<i>Istisnā'</i>	<i>Salam</i>
Subject	The subject of <i>Istisnā'</i> is always a thing which needs manufacturing.	The subject of <i>Salam</i> can be anything, regardless of whether it needs manufacturing or not.
Time of price payment	The time of payment may be fixed in whatever manner the parties wish and may also be in instalments	It is necessary in the contract of <i>Salam</i> that the price is paid in full in advance.
Cancellation option	Contract can be cancelled before the manufacturer starts the work.	Once effected, the contract of <i>Salam</i> cannot be cancelled unilaterally
Time of delivery	It is not necessary to fix the time of delivery although the International Islamic Fiqh Academy considers specification of deadline necessary.	The time of delivery is an essential part of the sale in <i>Salam</i> .

It is important to state that the International Islamic Fiqh Academy considers specification of deadline necessary in *Istisnā'*.³⁴⁹ However, if a maximum time for delivery is fixed, and the manufacturer delays the delivery after the appointed time, the purchaser is not bound to accept the goods and to pay the price.³⁵⁰ Accordingly,

³⁴⁸ International Islamic Fiqh Academy, Resolution No. 129 (3/14), p. 264.

³⁴⁹ International Islamic Fiqh Academy, Resolution No. 65 (3/7) p. 120.

³⁵⁰ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 136.

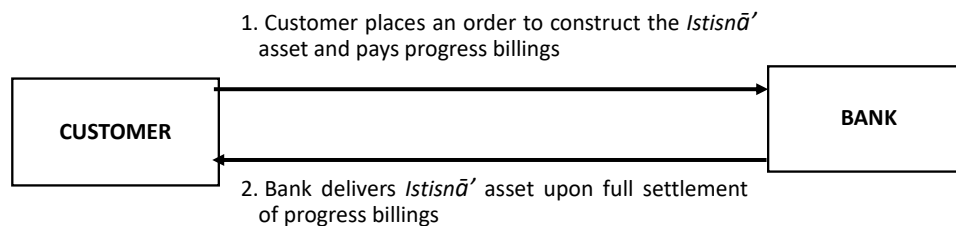
it is permissible to include a penalty clause if both contracting parties agree, unless where the delay is due to force majeure.³⁵¹

When the required commodity has been manufactured by the seller in conformity with the specifications agreed upon between the parties at the time of the contract, the purchaser is bound to accept the goods and he cannot exercise the option of seeing in order to decide whether to go ahead with the transaction or back out of it. This is because, in the context of modern trade and industry, it is damaging, that after the manufacturer has used all his resources to prepare the required goods, the purchaser cancels the sale without assigning any reason, even when the goods are in full conformity with the required specifications.³⁵²

As a mode of financing, *Istisnā'* is suitable for providing the facility of financing in the house finance sector. If a client has a piece of land on which he seeks financing for the construction of a house, an Islamic bank may undertake to construct the house at that open land, on the basis of *Istisnā'* contract. If the client has no land and he wants to purchase the land also, the bank may undertake to provide him a constructed house on a specified piece of land.

The structure of a single *Istisnā'* transaction is provided in Figure 32.

Figure 32: Single *Istisnā'* structure



Since it is not necessary that a financier in a contract of *Istisnā'* for construction undertakes the construction himself, a bank can enter into a parallel contract of *Istisnā'* with a third party, or hire the services of a contractor (other than the client) to carry out the construction work. In both cases, the bank can calculate its cost and fix the price of *Istisnā'* with the client in a manner which may give a reasonable profit over cost. In this case, the client's instalmental payment may start right from the day when the *Istisnā'* contract is signed by the parties, and may continue during

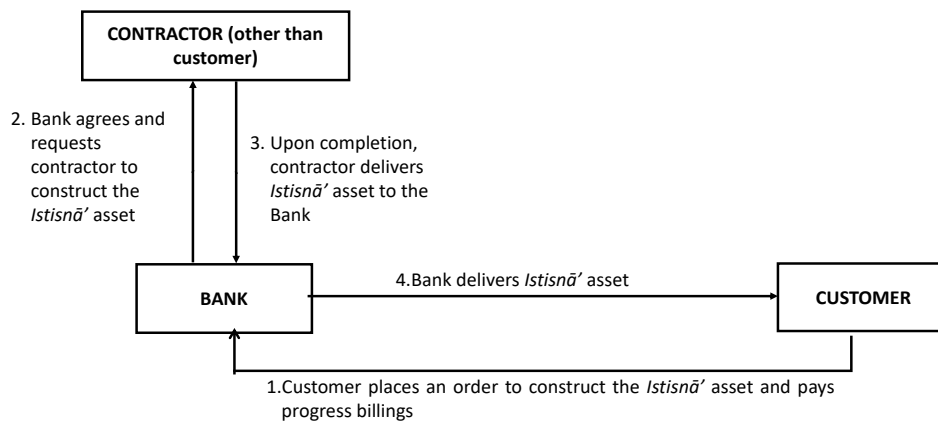
³⁵¹ International Islamic Fiqh Academy, Resolution No. 65 (3/7), p. 120.

³⁵² Ethica Institute of Islamic Finance (2019). *Handbook of Islamic Finance*, p. 187.

the construction of the house and after it is handed over to the client. The bank, in this case, will be responsible for the construction of the house in full conformity with the specifications stated in the agreement. In the case of any discrepancy, the financier will undertake such alteration at his own cost as may be necessary for bringing it in harmony with the terms of the contract.

The diagrammatical structure of a parallel *Istisnā'* is presented in Figure 33.

Figure 33: Parallel *Istisnā'* structure



Istisnā' can also be used for project financing on similar lines. For example, a client who wants to install an air-conditioning plant in his factory, and the plant needs to be manufactured, can approach an Islamic bank for financing through *Istinā'*. The bank may undertake to prepare the plant through the contract of *Istinā'* according to the aforementioned procedure. Similarly, the contract of *Istinā'* can be used for building a bridge or a highway.³⁵³

3.6 Risk Analysis in Islamic Banking

Risk is defined as the probability of negative outcome or potential losses that could bring an adverse impact to a firm. This negative outcome could be as a result of an expected event happening, either from factors within the bank such as staff negligence, mismanagement or external forces outside the bank (such as regulatory changes, economic downturn or changes in tax or interest rate structure) that have significant impact on the bank's performance. According to conventional theory, banks' risk behaviour provides additional justification for financial intermediation.

³⁵³ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, pp. 138-139.

The equivalent of the word risk in Arabic language is *Mukhātarah*, which is defined as the situation that involves the probability of deviation from the path that leads to the unexpected or usual result. It is sometimes associated with both *mukhātarah* and *gharar*.³⁵⁴ For Islamic banks, it may incur the same risks that are those of any banking activity such as credit risk, market risk, liquidity risk and operational risks, which in most cases are higher in conventional banks because of some of their speculative activities. Nevertheless, there are certain risks that are specific to Islamic banks. These risks which are peculiar to the Islamic banking activities are due to the incorporation of participative financing in the portfolio of Islamic banks and which also carry the highest risk for the simple reason that they are based on the confidence in the contractor. Thus, PLS financing makes Islamic banks more vulnerable.

Risk analysis on one hand is the process of identifying, recognising and characterising risks; determining their magnitude; and identifying suitable courses of action to mitigate them. Risks are assessed in various ways: likelihood, positive and negative impacts, individually and by category, their effect on organizational units, and on an inherent and a residual basis.³⁵⁵ Risk management, on the other hand, involves classifying and identifying organisation practices, processes and threats to control, track and measure them as an operational concern in the organisation

In recent years, banks have been increasingly involved in new information-based activities, such as trading in financial markets and generating income through fees, securitisation and variety of other volatile and risky financial activities. These developments have posed complex problems for measurement, management and control of risk. Islamic banks have not been immune to these challenges.³⁵⁶

The following are some of general and specific risks which Islamic banks have to manage in the course of their operations:³⁵⁷

³⁵⁴Elgari, M., M., (2003). Credit Risk in Islamic Bank and Finance. *Islamic Economic Studies*, Vol. 10, No. 2, pp. 1-25.

³⁵⁵Romney, M. B. & Steinbart, P. J. (2012). Accounting information systems. England: Pearson-Prentice Hall.

³⁵⁶Hennie, V. G. & Zamir I. (2008) Risk Analysis for Islamic Banks. The World Bank, Washington, D.C. 2008, 309.

³⁵⁷Ahmed, H. & Khan, T. (2009). Risk Management in Islamic Banking in Handbook of Islamic Banking, edited by Hassan , K. & Lewis , M., [Edward Elgar Publishing](#). Also, see: Galloux, M. (1993), Egypte: Réforme Bancaire Et Finance Islamique." *Monde arabe: Maghreb Machrek*, no. 141, 53-62.

1. ***Sharī'ah* Non-Compliance Risk:** *Sharī'ah* non-compliance risk connotes the likelihood that Islamic financial transactions may be resisted based on *Sharī'ah* non-compliance. It is a risk of financial losses experienced by an Islamic financial institution as a result of non-compliance during operations with the dictates of *Sharī'ah*, as determined by the supervisors/advisors in the *Sharī'ah* board or the appropriate authority in the relevant jurisdiction.³⁵⁸

Sharī'ah non-compliance risk falls under operational considerations. To mitigate this kind of risk, Sections 2(a) and 3(c) as well as Principle 1:1:11 of the IFSB-10,³⁵⁹ and AAOIFI's Governance Standards³⁶⁰ GS-1:3,³⁶¹ GS-3:2-3³⁶² require IFIs to put in place a sound internal *Sharī'ah* governance structure to ensure that the level of compliance with *Sharī'ah* rules and principles in all aspects of operations is satisfactory and incidents of non-compliance are recorded and reported, and possibly addressed and rectified.³⁶³ Furthermore, AAOIFI GS-1:3³⁶⁴ and Principle 1.1:10³⁶⁵ of IFSB-10 require IFIs to put in place an external *Sharī'ah* compliance process. The external *Sharī'ah* governance structure should consist of, among others, a *Sharī'ah* Supervisory Board also called *Sharī'ah* Advisory Committee that will assist in ensuring that the activities and operations of IFIs are in compliance with the *Sharī'ah*. In Nigeria, Section 4 of the NIFI guidelines requires all licensed NIFIs to establish an Advisory Committee of Experts (ACE) to ensure compliance of its IFI with the rules and principles of the *Sharī'ah*.³⁶⁶

It is therefore necessary for IFIs to ensure that operations are carried out in line with applicable *Sharī'ah* rules and principles based on the *fatwā*, policies and procedures approved by the IIFS's *Sharī'ah* Committee.³⁶⁷ It is the duty of the *Sharī'ah* board of a bank to ensure that the internal *Sharī'ah* review processes and *Sharī'ah*

³⁵⁸ Ginena, K. and Hamid, A. (2015). *Foundations of Sharī'ah Governance of Islamic Banks*. West Sussex: John Wiley & Sons, p. 82.

³⁵⁹ Islamic Financial Services Board - IFSB (2009). Guiding Principles on Shari'ah governance system for institutions offering Islamic financial services (IFSB-10), pp. 1 & 7.

³⁶⁰ Accounting and Auditing Organisation for Islamic Financial Institutions – AAOIFI (2015). *Governance Standard*, Bahrain: AAOIFI.

³⁶¹ AAOIFI (2015), p. 885.

³⁶² AAOIFI (2015), pp. 909-910.

³⁶³ IFSB-10 (2009), p. 3.

³⁶⁴ AAOIFI (2015), p. 885.

³⁶⁵ IFSB-10 (2009), p. 7.

³⁶⁶ Central Bank of Nigeria – CBN (2015). Guidelines on the Governance of Advisory Committees of Experts for Non-Interest (Islamic) Financial Institutions in Nigeria, pp. 1-2.

³⁶⁷ Islamic Financial Services Board (2005). *The Guiding Principles of Risk*. Available online: www.ifsb.org.

compliance reporting are carried out effectively. This is in order to monitor the NIFI's consistency in compliance with the principles of this model and effectively manage *Shari'ah* non-compliance risks that may arise over time.³⁶⁸

2. **Credit risk:** The loss of income, which occurs as a result of the other partner's delay in payment on time or in full as agreed from the onset of the contract is known as credit risk. Such an eventuality can underlie all Islamic modes of finance. For instance, in *Murābaha* contracts, credit risk occurs when the counterparty fails to pay the debts in full and in time. The non-performance can be due to internal financial reasons, external systematic sources or because of some moral hazard (wilful default). In *Mudārabah* and *Mushārahah*, that is the case of profit-and-loss sharing modes of financing, the credit risk will be non-payment of the share of the bank when it is due by the business partner. Because of the asymmetric information problem (where the banks do not have sufficient information on the actual profit of the business), these kinds of problems do arise for banks in some cases.
3. **Market risk:** Market risks can be characterised by order and planning (i.e. systematic), arising from macro sources, or characterised by unmethodical ways (i.e. unsystematic), being asset or instrument-specific. For instance, under the systematic group, there is currency and equity price risk while the assets the bank is dealing with, or movement in prices of commodity, fall under specific market risk. Because of fluctuations in the prices of commodities and equity instruments, market risks happen.
4. **Mark-up risk:** Non-interest financial institutions apply a benchmark rate to price diverse financial instruments. In a *Murābaha* contract, for instance, the mark-up is ascertained by adding the risk premium to the benchmark rate (usually the LIBOR). *Murābaha*'s nature is such that the mark-up is stable and cannot be changed for the duration of the contract. As a result, any changes in benchmark rate will not affect the mark-up rates on these fixed income contracts because they cannot be adjusted. Consequently, non-interest banks are confronted with risks arising from movements in market interest rates. Mark-up risk can also appear in profit-sharing modes of financing like *Mudārabah* and *Mushārahah* as the profit-sharing ratio depends on, among other things, a benchmark rate like LIBOR.
5. **Commodity/asset price risk:** The commodity/asset price risk is associated with the trading process. It arises as a result of the bank holding commodities

³⁶⁸ Hamman, A. M. (2018). Effects of Advisory Committee of Experts' Role on Product Development of Non-Interest Financial Institutions in Nigeria, A PhD thesis (Unpublished), Department of Accounting, Ahmadu Bello University, Zaria, p. 53.

or durable assets as in *Salam*, *Ijārah* and *Mudārabah/Mushārah*. It should be noted that both mark-up risk and commodity/asset price risk can occur in the same contract. Under leasing for instance, the fixed or overdue rentals are exposed to mark-up risks while the equipment itself is exposed to commodity price risk.

6. **Liquidity risk:** Liquidity risk arises mainly from the difficulty of acquiring liquidity at a reasonable cost either by borrowing or by selling the assets. The liquidity risk of these two channels is important for Islamic banks. Since interest-bearing loans are prohibited by the *Sharī'ah* law, on the one hand, Islamic banks will not be able to solve their liquidity needs by borrowing financial resources and, on the other hand, the *Sharī'ah* does not allow the sale of debt except at face value. As a result, Islamic banks will not be able to use these financing instruments to increase financial capacity. Again, Islamic banks are not capable of raising funds swiftly from the markets because of slow and gradual development of *Sharī'ah* compliant financial instruments. To avoid liquidity risks by Islamic financial Institutions, it is important for Islamic banks to hold more securities in form of *Sukūk* which can place them in a better liquidity position and avoid illiquidity.
7. **Reputational Risk:** Reputation demonstrates the public's perception about the actions of an Islamic bank. Therefore, reputational risk is the risk of having negative publicity or negative perception in relation to the activities of the bank. It occurs when an Islamic financial institution fails to meet the expectations of its customers. When a client becomes disappointed with the services of an Islamic bank, reputational risk occurs. Other factors that affect the reputation of an Islamic bank include *Sharī'ah* non-compliance, high financing rates, bad services, insufficient employees' knowledge about the dynamics of some products and services and so on.³⁶⁹ Islamic Banks can avoid reputational risk by training their employees excellently to carry out operations in line with *Sharī'ah* dictates and volunteer to train their customers by creating awareness on the dynamics of their products and services.
8. **Operational risk:** the risk of direct or indirect loss, damage or injury consequential from people, inefficient or failed internal processes, technology or from external events is known as operational risk. As non-interest banks may not have adequate experienced employees who have both capacity and capability to conduct Islamic financial operations, operational risk in this respect particularly arises. Furthermore, given the different nature of business

³⁶⁹ Azrak, T. (2014). Reputational Risk in Islamic Banking. *ISRA Journal of Islamic Finance* Issue 2, December, Social Science University of Ankara, p. 50.

in non-interest banks, the computer software obtainable in the market for traditional banks may not be appropriate for non-interest banks. So, it gives rise to system risks of developing and using informational technologies in Islamic banks.

9. **Legal risk:** Legal risk comes from the lack of standardised contracts and the absence of a legal system to intervene in the case of a dispute related to Islamic contracts. Legal risks for non-interest banks happen for several reasons. First, the legal systems of many countries do not have specific laws/statutes that support the unique features of Islamic financial products because most of these jurisdictions have embraced either the civil law or the common law framework for their use. For instance, current banking laws and regulations in many countries forbid commercial banks from undertaking activities such as trading and investing in equities whereas they are the main activities of Islamic banks (e.g. *Murābaha*, *Mushārakah* and *Mudārabah*). From this perspective, Islamic finance implies a specific risk taking that is completely different from the instruments used by conventional banks. In addition, Islamic financial intermediation is characterised by entanglement of risks given the tripartite transactions linking the three following actors; the depositor/investor, the bank and the client/customer. Secondly, the procedure of negotiating different aspects of a transaction becomes more difficult and costly due to non-standardisation of contracts. So, banks are not protected against risks that they cannot anticipate or that may not be forceable. Use of standardized contracts can also make transactions easier to administer and monitor after the contract is signed. Lastly, dearth of Islamic courts that have jurisdiction on cases relating to Islamic contracts raises the legal risks of using these contracts.
10. **Risk of Arbitration:** The diversity, the difference and the lack of standardisation of the financial contracts used by Islamic banks represent an obstacle, which often causes arbitration risk. In practice, each Islamic bank defines, independently of the others, its own instruments according to the *fatwā* of its *Sharī'ah* scholars, its internal regulations, and its needs. Such a situation may give rise to a form of differences related to the application of religious principles on some products and services. For instance, one Islamic bank may view, as not permissible, dealing in *Tawarruq* while another Islamic bank may not see anything wrong with it. In order to mitigate the risk of arbitration, there is a need to work towards greater *Sharī'ah* standardisation for Islamic financial institutions.
11. **Fiduciary risk:** Fiduciary risk can be triggered by breach of contract by a non-interest bank. For instance, an Islamic bank may not be able to observe fully the *Sharī'ah* requirements of numerous contracts. Consequently, inability to fully

comply with Islamic *Sharī'ah*, both knowingly and unknowingly, leads to a lack of confidence among the customers or depositors and hence results in withdrawal of deposits. In the same way, a lower rate of return than the one obtainable in the market can also lead to fiduciary risk particularly when depositors/investors literalise a low rate of return as breaching an investment contract or mismanagement of funds by the bank.³⁷⁰

12. **Displaced commercial risk:** This is the risk that a lack of return on the assets of the Islamic bank will translate into a liquidity crisis, a consequence of the dissatisfaction of the depositors. This risk is defined by the Islamic Financial Services Board (IFSB) as the one referring to the losses that the Islamic bank absorbs to ensure that the holders of the investment accounts are remunerated at a rate of return equivalent to a rate of reference to ensure that depositors of the bank will not withdraw their funds if their income is lower than that paid by other banks.³⁷¹ Displaced commercial risk suggests that an Islamic bank may be operating fully in line with the *Sharī'ah* dictates, nevertheless, it may not be able to pay rates of return that are competitive as compared to its competitors and conventional counterparts. To prevent withdrawal, the owners of the bank will need to apportion part of their own share in profits to the investment depositors, so that investors will not have the incentive to withdraw their funds particularly when Islamic banks pay investors less than their peers.
13. **Bundled risk:** It is rare for several risks to be packed together usually. Though, more than one risk does exist together in the case of most Islamic modes of finance. In *Salam*, for instance, once an advance payment is made by the bank, then the bank has begun to take the counterparty risk regarding delivery of the correct product on time, the market risk of the commodity, the liquidity risk of its conversion into cash, the operational risk of its storage and movement from one location to another, and so on. The same process applies in the case of other products like *Istisnā'*, *Ijārah*, *Mushārakah/Mudārabah* and *Murābaha*.

³⁷⁰ AAOIFI (1999). Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks, Bahrain: AAOIFI.

³⁷¹ Ibid.

3.7 Challenges of the Islamic Banking System

Although Islamic banking is in its era of growth and is being recognised as an important integral part of the global financial system, the industry is facing many challenges.³⁷² Some of the challenges identified³⁷³ include the following:

a) Dearth of Expertise

The continued existence of Islamic banking and finance very much depends on sufficiently qualified human resources in teaching, research and training in Islamic Finance with knowledge in economics and both Islamic and conventional finance as well as knowledge in the *Sharī'ah*. In Nigeria, for instance, only a handful of universities teach courses or train manpower on Islamic finance. Research in the areas of Islamic finance is also negligible. There is also a disconnect between *Sharī'ah* scholars and promoters of Islamic finance. On the one hand, most Islamic scholars are not conversant with the nature and dynamics of modern financial transactions and how to apply their vast knowledge of *Sharī'ah* principles and rules to innovative financial products and services. On the other hand, most of the advocates and promoters of Islamic banking lack the basic knowledge of Islamic jurisprudence and its application to the products and operations of Islamic banking.

The way forward for the Islamic finance industry in Nigeria is for NIFIs to support the institutions that teach Islamic finance and encourage the emergence of Islamic finance research and training centers as well as fund research efforts in various aspects of Islamic finance. NIFIs should also support the effort of *Sharī'ah* scholars towards understanding the application of *Sharī'ah* rules and principles to modern financial transactions. NIFIs can also provide financial support to postgraduate students, lecturers and researchers working in the field of Islamic finance.

b) Inadequate liquidity management instruments

Islamic banks cannot invest their excess liquidity in interest-based instruments like treasury bills and other conventional bonds, which, in most countries, are the available liquidity management instruments in the capital market. Because of this constraint, the Islamic financial institutions are placed at a competitive disadvantage with respect to their conventional counterparts. In Nigeria, despite effort by the CBN to accommodate the peculiarities of NIFIs in its policies including liquidity management issues, the interbank market and the instruments

³⁷²Cohan, M. N. & Cohan, M. W. (2011). Analysis of Law Relating to Establishment of Banking Courts in Pakistan. *Pakistan Law Journal*, pp. 25-32.

³⁷³Karimi, A. J. (2009), Challenges Facing Islamic Banks. *Islamic Economic and Finance Pedia*. See also, Muttalip (2008). Practical Legal Issues in Islamic Banking. Azmi & Associate – Advocates & Solicitors Bulletin No. 00116640 \ 020508.

used for monetary policy operations are mostly interest-based with very few equivalent government securities or other money market instruments that are *Sharī'ah*-compliant. Therefore, more *Sharī'ah*-compliant liquidity management instruments are needed by NIFIs in order to avoid liquidity bottlenecks for Islamic banking operations.³⁷⁴

c) Regulatory Challenges

Islamic banking is currently lacking adequate legal support in many jurisdictions. For instance, Uganda has for long been carrying out Islamic banking operations but does not have proper legislation guiding it.³⁷⁵ Most company laws still refer to interest and bonds with total disregard for participation deeds and profit. In fact, the provisions of company and commercial banking laws sparsely define Islamic banking activities and even restrict its scope within the conventional limits. These laws were formulated based on conventional banking systems before the commencement of Islamic banking and finance and no serious attempts have been made to change them, except for some few cosmetic changes introduced in some aspects in some countries³⁷⁶. Another country suffering regulatory setback is The Gambia. Despite its several issuances of *Sukūk*, The Gambia has an inadequate regulatory framework for Islamic financial institutions. Scaling up Islamic Finance in The Gambia, for example, requires overcoming important legal, regulatory, and institutional challenges.³⁷⁷ On the contrary, NIFIs in Nigeria enjoy adequate and sufficient regulation. Their operations are regulated by all the relevant regulatory authorities in the country.

Islamic and conventional banking systems and financial products are not the same and should not be regulated by the same legal framework if the objectives of Islamic banking and finance are to be achieved. Therefore, Islamic banking laws and regulations need to be amended with consideration for the international standards

³⁷⁴Iweama, V. O. & Eze, P. C. (2017). Challenges and Marketing of Islamic Banking System in Nigeria, *Polac International Journal of Economics and Management Science*, Vol. 3, No. 1, p. 6.

³⁷⁵Mastulah, N. (2018). Towards Islamic Banking in Uganda: An Analysis of its regulation, Prospects and challenges in a secular Legal Environment. An unpublished Masters Thesis in Commercial Law submitted to Kampala International University, Kampala, Uganda, p. 11.

³⁷⁶Iqbal, Z. (2007). Challenges Facing Islamic Financial Industry. Paper Presented at Financial Management Association's Annual Meeting.

³⁷⁷Infrastructure Financing through Islamic Finance. A presentation by the Ministry of Transport, Works and Infrastructure, Gambia, p. 6.

in order to accommodate exponential growth in number of Islamic banking institutions and emerging new concepts in international banking.³⁷⁸

d) Jurisdiction – Civil or *Sharī'ah* Court

The common practice in many countries is to subject Islamic banks' disputed cases to the same legal system as the conventional counterparts under the adjudication of the same civil court and Judges without considering the unique nature of the Islamic legal system. This is the situation in most countries. This, in many cases, presents a challenge to Islamic banks in view of the fact that most of the civil courts are not *Sharī'ah* based and the Judges who adjudicate are not versed in Islamic jurisprudence and its application in modern financial transactions.

In Nigeria, for instance, *Sharī'ah*/Area Courts deal with many cases that generally constitute a greater percentage of the purview of the courts' litigations. This has been established due to a number of reasons such as; easy accessibility, cost effectiveness, time saving and minimal technicalities etc. Thus, in general civil cases and matters, Area Courts are empowered to apply Laws as laid down in section 20 of the Area Courts Edict, 1968 which include: "The native Law and custom prevailing in the area of jurisdiction of the Court or binding between the parties." In essence, the phrase "Native Law and Custom" includes Islamic Law as presently covered by provisions of *Sharī'ah* Courts Laws of various States where *Sharī'ah* is adhered to.

Sequel to the above, it is within the jurisdiction of *Sharī'ah*/Area Courts to entertain disputes between litigants in all aspects of Islamic Civil litigation including financial transactions. This is especially between individuals and groups in respect of their day to day economic and commercial activities which entail buying and selling, leasing out properties or equipment, giving out loans and mortgages and so on. However, with the novel developments in Islamic financial parlance, whereby *Sharī'ah* compliant financial institutions are being created and introduced, the position is taking another dimension.

With this, the question arose as to which of the courts can formally and validly entertain questions on Islamic banking and finance (IBF) in Nigeria. Banking and

³⁷⁸ Tun Arifin, B. Z. (2013). Recent Reforms in the Legal Framework of Islamic Finance in Malaysia: Court's Perspective." Speech delivered by Chief Justice of Malaysia at Ahmad Ibrahim Memorial Lecture, Moot Court, Ahmad Ibrahim Kulliyah of Laws, IIUM on 4th December. See also, Agnelio, M. P. & Chicava, P. (2014). Some Issues to Consider when Regulating Islamic Banking Business in Secular Countries. *Journal of Islamic Banking and Finance*, Vol. 2, No. 1, pp. 389 – 405.

finance is rightly on the Exclusive Legislative List of the Constitution.³⁷⁹ As such only the Federal Government can legislate on such items, just as the federal judiciary has also been conferred with judicial powers over them. Section 251(1)(d)³⁸⁰ vests exclusive Jurisdiction with the Federal High Court (FHC) on matters relating to Banks and other financial institutions, paragraph (d) specifically states that it shall exercise powers to determine matters,

connected with or pertaining to banking, banks, other financial institutions, including any action between one bank and another, any action by or against the Central Bank of Nigeria arising from banking, foreign exchange, coinage, legal tender, bills of exchange, letters of credit, promissory notes and other fiscal measures: provided that this paragraph shall not apply to any dispute between an individual customer and his bank in respect of transactions between the individual customer and the bank.

Where the matter relates to disputes between banks, only the FHC has the exclusive jurisdiction. However, what the provision does is to limit the extent of the exclusivity of jurisdiction of the FHC over banking and finance matters. The relationship between the customer and the banker is contractual and disputes cannot be reasonably delimited to only the FHC. The Supreme Court affirmed the preservation of the jurisdiction of the State High Court (SHC) and High Court of the FCT over transactions involving individual customer and his banker. In the same breath, although the FHC has jurisdiction over such disputes, it is not to the exclusion of the SHCs. Both courts, therefore, can exercise concurrent jurisdiction.³⁸¹ In the light of this, jurisdiction over IBF cases is constitutionally placed under the common law styled High Courts. Appeals from the decisions of these courts go to the Court of Appeal and then subsequently to the Supreme Court, hierarchically. Based on the doctrine of judicial precedent (*stare decisis*), whatever pronouncement made by these superior courts is binding on those at the lower level.

³⁷⁹Part I, Exclusive Legislative List, Item 6 of the Constitution of the Federal Republic of Nigeria, 1999 (as amended).

³⁸⁰CFRN, 1999.

³⁸¹Per Katsina-Alu, JSC, in *Nigeria Deposit Corporation (Liquidator of Allied Bank of Nigeria PLC.) v. Okem Enterprises LTD. & Anor* (2004) LPELR - SC 92/2003.

The courts' jurisdiction is limited regarding the adjudication of *Sharī'ah* issues raised by the contracting parties. This brings the discussion to the question of whether as English styled high courts are adorned with the requisite competence to entertain IBF matters competently, or the *Sharī'ah* Court of Appeal (SCA)³⁸² can be utilised for such purpose as obtained in Indonesia where civil court have no authority to try Islamic banking cases.³⁸³

The SCA is thus clearly constrained in delving into questions on IBF as no clear constitutional provision confers such powers on it. With the introduction of Islamic criminal law, the jurisdiction of the SCA Court was expanded by some states to include issues of Islamic law of crime and Islamic commercial transactions both as a court of first instance and as court of appellate jurisdiction.³⁸⁴ But whether this extends to disputes between the customer and the bank has not been tested in the current regime of IBF, especially in the light of "any other question" under S. 262 (2) (f) that seems to permit the extension of jurisdiction to other matters not specifically mentioned therein. Earlier, however, the Court of Appeal, while answering a question of additional jurisdiction to the SCA under the 1979 Constitution,³⁸⁵ stated in the case of *Ummara Fannami v. Bukar Sarki*³⁸⁶ that the increment of the jurisdiction of the SCA must remain within the confines of issues relating to Islamic personal law. Until an intervention by the NASS is sought in increasing the jurisdiction of the SCA,³⁸⁷ the position remains that it cannot entertain questions on IBF.

Conferring jurisdiction on matters relating to IBF on Islamic courts is a perilous proposition. Since Islamic banking is open to both Muslims and non-Muslims alike, any attempt to exclusively confer jurisdiction on SCA will negate the voluntariness with which non-Muslims participate in IBF. *Sharī'ah* courts have jurisdiction only over persons professing the Islamic religion, which refers to natural persons and not juristic persons. Many related laws such as bankruptcy law, company law, and

³⁸² S. 260 (1) establishes *Sharī'ah* Court of Appeal of the Federal Capital Territory, Abuja. While S. 275 (1) establishes *Sharī'ah* Court of Appeal for States.

³⁸³Barlinti, Y. S. (2014). Absolute Competence of Courts on Islamic Banking Dispute Resolution in Indonesia, being a paper presented at the 2nd Annual Conference on Islamic Economics and Islamic Finance at Chestnut Conference Center, Toronto University, Canada on 30th October, 2014.

³⁸⁴For instance, Kano, Kaduna and Zamfara States. See Bello, S. A, & Yasin, N. M. (2015). Jurisdiction of Courts over Islamic Banking in Nigeria and Malaysia. *Journal of Islam, Law and Judiciary*, Vol. 1, Issue 3, p. 64.

³⁸⁵ S. 242(2) (e) of the CFRN, 1979.

³⁸⁶(1961- 1989) 1 SH.L.R.N. 194.

³⁸⁷ S. 262(1) CFRN, 1999.

land law are outside the jurisdiction of the *Sharī'ah* courts. Thus, even if judgment is given in favour of a judgment creditor, he may not be able to resort to the remedies under those laws.³⁸⁸

The various shortcomings exhibited by common law courts and controversies emanating from adjudication of IBF disputes raise the question of whether distinct and specialised courts for Islamic banking may be a solution. At the early stages of IBF in Malaysia, similar questions were asked and indeed such a proposition was put in place. Another alternative may be the provision of *Sharī'ah* divisions in both Federal and States High Courts to handle matters of Islamic Banking and Finance just like we have criminal division, commercial division, etc in some jurisdictions like Lagos. It is obvious that Judges on the High Court bench may not be learned in *Sharī'ah* principles as the Kadis of *Sharī'ah* Court of Appeal. There is, therefore, the need for training and retraining in order to equip them with the necessary knowledge and skills to effectively discharge the duty of adjudication in matters involving Islamic Financial Transactions.

Some cases adjudicated under conventional courts and in advanced jurisdictions that buttress the points made and will serve as examples of the above challenge are:

- (i) The case of *Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems and others*³⁸⁹ in the United Kingdom which involved a question on *Murābaha* agreement. In this case, the defendant contended that the contractual agreement was not within the restrictions of *Murābaha* agreement acceptable under the *Sharī'ah*, depending on a clause in the agreement which states “whether or not” the goods are transferred to the purchaser, the buyer is obligated to fulfill his end of the bargain. Similarly, relying on another clause which purportedly excluded the bank’s liability in case of any damage to the goods even before the buyer takes possession of the goods. Thus, on grounds of these clauses the defendant maintained that the agreement was not *Sharī'ah* compliant. This argument was backed by the witness and verification of two experts. However, Tomlinson J., held that the contract was governed by English law, and thus, on that reason he rejected the contention.

³⁸⁸ Foreign Judgments (Reciprocal Enforcement) Act Cap F. 35, Laws of the Federation of Nigeria, 2004, only contemplates the judgments of high courts. See Hamid-Mohamad, T. A. (2009). Interlink/Interface Between Civil Law System and *Sharī'ah* Rules and Principles and Effective Dispute Resolution Mechanism, paper presented at the Islamic Financial Services Industry Legal Forum 2009, Kuala Lumpur, 28-29 September.

³⁸⁹[2002] WL 346969 (Queens’s Bench Division, Commercial Court, 13 February 2002).

- (ii) In *Shamil Bank of Bahrain EC v. Beximco Pharmaceuticals Ltd & Others*,³⁹⁰ the compliance of the *Murābaha* financing agreements under *Sharī'ah* was raised. Two expert witnesses were summoned as two opposing expert witnesses gave different opinions, one saying that the agreements were not *Sharī'ah* compliant, while the other contending the opposite. In spite of the clause subjecting the contract to the principles of the *Sharī'ah* and English law, Morrison J., and later on, the Court of Appeal, refused to adjudicate on the *Sharī'ah* issues, explaining that the contract cannot be governed by two systems of laws at the same time, and that they can only decide the case according to the English law.

Although the Court of Appeal refrained from applying *Sharī'ah* principles in deciding the case, it indicated that it may be possible for the court to apply *Sharī'ah* principles only if they are clearly and identifiably incorporated into a contract, and as such they could be enforced as contractual terms.³⁹¹ This bares some bias of common law courts in favour of English law for reasons not entirely clear. It may be a matter of reluctance for want of requisite competence or the fear of clash of ideals.³⁹²

e) Lender of Last resort

Studies have shown that, like their conventional counterparts, Islamic banks are also prone to liquidity problems, but they do not enjoy the same facility in the form of Lender of Last Resort in most countries, which is available to the conventional banks for overcoming a financial crisis when it suddenly occurs as a result of unanticipated financial problems. This is because such a facility is mostly based on interest which is unacceptable in Islamic finance because of its incompatibility with the *Sharī'ah* principles. Thus, in most countries with the presence of Islamic finance, Islamic banks and other NIFIs are rendered financial security disadvantaged and more exposed to liquidity problems than their conventional counterparts. However, recently in Nigeria, the BOFIA (2020) has recognised CBN as lender of last resort for all NIFIs in the country.

³⁹⁰[2004] 4 All ER 1072.

³⁹¹ Trakic, A. (n.d). The Adjudication of Issues in Islamic Financial Contracts: “Is Malaysian Islamic Finance Litigation a Solution?” *Humanomics*, Vol. 29 Issue, 4, p. 264, retrieved from <http://doi.org>, 23/05/2022, 730am.

³⁹² Foster, N. H. D. (2006). Encounters between Legal Systems: Recent Cases Concerning Islamic Commercial Law in Secular Courts. *Amicus Curiae*, Issue 68 November/December 2006, p. 4.

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TAKĀFUL (ISLAMIC INSURANCE)

4.1 Introduction

The commercial insurance contract with a fixed periodical premium, which commercial insurance companies commonly use, is a contract that contains major elements of deceit, high degree of contractual uncertainty (*gharar*), speculation (*maysir*), both direct and indirect *ribā* which make it prohibited by the *Sharī'ah*. The alternative contract, which is compliant to the *Sharī'ah*, is *Takāful* (Islamic insurance) that is founded on the basis of charity and mutual cooperation.

In this chapter, the concept, principles and types of *Takāful* are explained. A brief explanation on Re-*takāful* (re-insurance) is also given.

4.2 Definition

The term '*Takāful*' is a derivative of the term '*Kafālah*'³⁹³ which connotes the fostering of a person as in the case of providing guardianship over a ward. Allah, Most High, states in His narration of the story of the Prophet Zakariyya (AS) and Maryam (AS): "*Wa Kaffalaha Zakariyya*" ["...And put her in the care of Zechariah..."].³⁹⁴

The term, '*Kafālah*' may also be legitimately extended, in its technical meaning, to mean guarantee or, in more specific terms, "joint-guarantee."³⁹⁵ The four leading Sunni Imams considered the term *Kafālah* to mean the guarantee of the payment of money (*kafālah al-damān*) or the guarantee of the appearance of a person (*kafālah al-badan*).³⁹⁶ It is probably in this sense that Sheikh Abu Zahrah postulated a Social Solidarity Scheme (*Takāful Ijtimā'ī*). In his work, *al-Takāful al-Ijtimā'ī fī al-Islam*, perhaps the earliest effort at *Takāful*, wherein he advocated the idea of bringing individual citizens under the guardianship of the entire society.³⁹⁷ In this light, the

³⁹³ISRA (2010). *ISRA Compendium for Islamic Financial Terms (Mu'jam Isra)*, Arabic-English, International Sharī'ah Research Academy for Islamic Finance, p. 158.

³⁹⁴*al-Qur'ān*, 3:37.

³⁹⁵ISRA *Compendium for Islamic Financial Terms (Mu'jam Isra)*, p. 158; Sabbagh, A.M. (2016), *Takaful Insurance Theoretical and Practical Framework (Training Guide, Islamic Research and Training Institute (IDB Group))*, p. 6.

³⁹⁶ISRA Op. cit., p. 158.

³⁹⁷Abu Zahrah, M. (1974). *al-Takāful al-Ijtimā'ī fī al-Islām*, Dār al-Fikr, (Cairo) as referred to in: Jalil, A. et. al., The Concept of Social Security in Islamic Economy, a 2015 Conference Paper (<http://www.researchgate.net>) 3120 accessed on 30th May, 2022.

terms *Kafālah* and *Takāful* meet but, technically, the meanings crystalise into distinct concepts. *Takāful* has been marked as an alternative term for ‘Islamic Insurance’ even though we must be quick to add that conventional insurance is better seen as a mutilated form of some of the essential values of Islam such as *al-ta’āwun* (mutual assistance); *jalb al-masālih* (seeking to draw good); *al-tausi’ah* (relief measures); and *al-nusrah* (coming to the rescue of one another).

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), in its *Sharī’ah* Standard No. 26 (2), defines Islamic Insurance as: “An agreement between persons who are exposed to risks to protect themselves against harm arising from risk by paying contributions on the basis of a commitment to donate.”³⁹⁸ This definition has been re-echoed by Sabbāgh in his statement that: “*Takāful* is a type of Islamic insurance where members contribute sums of money (subscriptions) into a pooling system in order to guarantee each other against loss or damage.”³⁹⁹ It is based on three main relationships; the *Mushārah* between participants of the joint fund, the *Wakālah* between the Islamic insurance company and the insurance policy holders and a *Mudārabah* between the insurance policy holders and the fund itself.⁴⁰⁰

4.3 Historical Development of *Takāful*

Right from the days of ignorance (*jāhiliyyah*), Arabs had been in the practice of mutual support. The slogan “Come to the aid of your comrade be he the oppressor or the victim” created a collectivism that demanded mutual assistance between members of a clan. Tribal sentiments, regardless of who was right, were strong. Long standing blood feuds were frequent, but they were subject to settlement, usually by means of the payment of blood money sourced from contributory members. The contributions were non-refundable.⁴⁰¹ Islam adopted this culture with positive modifications. To this end, the Prophet (peace be upon him) explained that the oppressor shall be restrained, and that is how to come to his aid.⁴⁰²

Before the revelation of the *Qur’ān*, the Prophet (peace be upon him) joined the *Hilf al-Fudūl*, a pact by resolute persons who swore to defend oppressed people. The Prophet (peace be upon him) declared that he would not exchange that status of his in the *hilf* for anything. According to Al-Shātībī, Islamic law is based upon

³⁹⁸Faruq, A. U. (2016). Islamic Insurance: A Comparative Model, *Islamic Commercial Law Report*, 2016, ISRA & Thomson Reuters, p. 90.

³⁹⁹Sabbāgh, A. M. Op. cit., p. 6.

⁴⁰⁰Ethica Institute of Islamic Finance (2019). *Handbook of Islamic Finance*, p. 352.

⁴⁰¹INCEIF (2012) *Takaful Realities and Challenges*, Pearson Malaysia, p. 55.

⁴⁰²Bukhārī (Hadīth no. 2444).

Arab norms and practices that were adopted or reviewed by Islam.⁴⁰³ It can be safely stated that the concept of *Takāful* is taken out of a plethora of ideals that are appealing to the *Sharī'ah*. The *Qur'ān* instructs us to help one another in righteousness and piety and not to aid one another in sin and transgression.⁴⁰⁴ The *Qur'ān* strongly urges good treatment and spending of wealth in the catering for parents, blood relations, neighbours, wives and the wayfarer.⁴⁰⁵

In the *Hadīth*, we see that the Prophet (peace be upon him) prevented Sa'd ibn Abi Waqqās (may Allah be pleased with him) from donating his wealth in excess of one-third and went on to explain to Sa'd (may Allah be pleased with him) that: "It is better for you to leave your heirs wealthy than to leave them poor, begging others."⁴⁰⁶ This order was made by the Prophet (peace be upon him) as a measure to curtail poverty or risk to the financial well-being of one's heirs by giving out all or the greater part of one's property. Similarly, the Prophet (peace be upon him) declared that the Ash'ariyyūn were a part of him and he a part of them because they would, in difficult times, place all their foodstuff upon a sheet and then ration it out for the common benefit of all members.⁴⁰⁷ During the time of 'Umar ibn al-Khattāb (may Allah be pleased with him), a decree was sent out to the provinces requiring each one of them to produce a list of the Muslim comrades in arms and a list of the outstanding cases of compensation for payments in matters involving mistaken homicides.⁴⁰⁸

During the early days of Islam, the '*āqilah* were the paternal relations ('*asabah*) of the offender and they contributed to the payment of the *diyah* in cases of mistaken homicide and quasi intentional (*shibh al-'amd*) homicide. Later on, it became clear to 'Umar (R.A) that the '*āqilah* had to be enlarged to include members of the army and, later on, all persons on the state payroll (*ahl al-dīwān*).⁴⁰⁹ The Mālikis have followed this opinion and they call in the relations only when the comrades in arms cannot settle the amount.⁴¹⁰

⁴⁰³ Al-Shātibi, I. M. (2006). *Al-Muwāfaqāt fi Usūl al-Sharī'ah*, Dār al-Hadīth, Cairo, Vol. II, pp. 197-200.

⁴⁰⁴ *al-Qur'ān*, 5:2.

⁴⁰⁵ *al-Qur'ān*, 4:37.

⁴⁰⁶ Bukhārī (Hadīth no. 2744); Muslim (Hadīth no. 1628).

⁴⁰⁷ Bukhārī (Hadīth no. 2486); Muslim (Hadīth no. 2500).

⁴⁰⁸ See the INCEIF *Takaful Realities and Challenges*, p. 56.

⁴⁰⁹ al-Qaradawī, Y. A. (1397H). *Sharī'ah al-Islām: Khulūduha wa Salāhuha li al-Tatbīq fi Kullī Zamānin wa Makānin*, al-Maktabah al-Islāmī, (Beirut), p. 146.

⁴¹⁰ Al-Dasūqī, M. A. (n.d) *Hāshiyah 'alā Sharh al-Kabīr li al-Dardir*, Dār Ihyā al-Kutub al-'Arabī, Vol. IX, p. 284.

In recent times, Muslims, the world over, have justified Islamic cooperative finance. The Islamic Fiqh Academy and the Saudi Council of Senior Scholars have validated *Takāful*, just as several prominent scholars have. Some of these scholars who have given backing and credence to *Takāful* are Sheikh Muhammad Abu Zahra, Sheikh Mustafa Zarqā, Dr. al-Siddīq Muhammad al-Darīr and Dr. Wahbah al-Zuhailī.⁴¹¹

The Islamic Insurance Company, Sudan, was the first *Takāful* Company to be established in Khartoum by the Sudanese Islamic Faisal Bank in 1979. This was closely followed by the Islamic Arab Insurance Company of Dubai and the Khaleej *Takaful* Insurance & Reins Co. of Qatar both established in the same year. Since then, several Islamic Insurance companies have sprung up in countries especially in Saudi-Arabia, Bahrain, Jordan, Kuwait, the UAE, Egypt and, in recent times, even in Nigeria where there are four *Takāful* companies today. The first to be established was the Jaiz *Takaful* Insurance Company in January, 2014; the Noor *Takaful* Company in April, 2016; *Salam* Takaful in June, 2016; and the *Hilal Takaful*-Cornerstone Insurance in March, 2020.

It should be stated here that the Islamic *Takāful* system emerged out of the need to avoid the unethical elements in the Conventional Insurance system.

4.4 Conventional Insurance versus Islamic Insurance

The *Takāful* mode of business is distinguishable from Conventional Insurance in several ways. Here are some basic differences:⁴¹²

⁴¹¹Sabbāgh, A. M., Op. cit. pp. 18-19.

⁴¹² Ethica Institute of Islamic Finance (2019). *Handbook of Islamic Finance*, p. 351. Also, see: International Islamic Fiqh Academy, Resolution No. 200 (6/21), p. 472-480.

Conventional Insurance	Islamic Insurance (<i>Takāful</i>)
The insured and the insurer are two separate entities; the seeker of insurance and its provider.	The insurer and the insured are the same; members of a mutual fund seeking to indemnify each other against loss. The participants pool together their risk and their premiums to share them.
Contract is a purely financial contract involving uncertainty	Contract is based on cooperation and seeks mutual benefit through contributions to a common fund.
The insurance company executes the contract in its own name.	The insurer serves as the insured's agent to manage operations and invest premiums based on <i>Mudārabah</i> . The insured has equity in the pooled funds.
The insurer owns the premiums in return for being obliged to pay insurance claims	The cooperative insurance account is the owner of funds.
Returns from investment of premiums go to the shareholders	Returns on excess premiums go to the policy holders after deducting the Company's <i>Mudārabah</i> share
The premium belongs totally to the Company	Premiums are paid into the <i>Takāful</i> Fund. The surplus is to be distributed among the policy holders after deducting the expenses and compensation paid in the insured year based on their contribution ratios or any other method agreed upon in the insurance policy.
Deals which are based on <i>ribā</i> , <i>gharar</i> , and <i>maysir</i> are permitted	The Company is prohibited from partaking in <i>ribā</i> , <i>gharar</i> and <i>maysir</i> related deals
Only one capital account is employed	There are two distinct capital accounts: the Shareholders' account; and the Policy holders' Account
Provides protection against speculative risk in addition to pure risk.	Only provides protection against pure loss exposures.
The amount left over in the insurance account at the time of liquidation is kept by the insurance company.	The amount left over in the insurance account is disbursed to charity at the time of liquidation.
The Company's business does not require a specialised board	The Company's business is by regulation supervised by a <i>Shari'ah</i> Board

4.5 Principles of *Takāful*

We have seen that *Takāful* is a scheme that aims at insulating policyholders from certain risks in accordance with the ideal of mutual assistance (*al-Ta'āwun*). *Takāful* subscribes to the idea of seeking profit or the measures adopted by the conventional insurance companies. Islamic Insurance or *Takāful*, however, tends to take into consideration the Islamic core values of mutual assistance, coming to the aid of those in distress, and avoiding of risks but without falling into the trap of *ribā* (usury), *gharar* (uncertainty in the subject matter of the transaction) and *maysir* (gambling).

The following are the main principles of *Takāful*:

1. It is essential that, in a case of *Takāful*, there is full compliance with the provisions of the *Sharī'ah* in terms of adherence to the supervision of the *Sharī'ah* Advisory Board of the Company, which is an advisory committee that ensures that the company, in all its transactions, policy drafts, and management issues, follows the principles enshrined in the *Sharī'ah*. Besides compliance with the general principles of the *Sharī'ah*, the *Takāful* operators are expected to comply with the requirements of the relevant statutory laws of the land. For example, in Nigeria, the National Insurance Commission (NAICOM), pursuant to its powers contained in its Act (1997), issued its Guidelines for *Takāful Insurance* Operators in 2013 in order to provide for the elements of mutuality, ethical finance, among others, and to regulate the operations of the *Takāful Insurance* industry, desiring the enhancing of financial inclusion in Nigeria and to ensure that *Takāful Insurance* providers are not disadvantaged.⁴¹³ The Guidelines also prescribe that “These Guidelines are to be read in conjunction with all other relevant legislations, guidelines and circulars as determined to be applicable to *Takāful Insurance* Operators by the Commission. The Guidelines will represent the primary regulatory framework with regards to *Takāful Insurance*.”⁴¹⁴
2. All participation is based upon two key principles: *Tabarru'* (donation in the contribution); and *Ta'āwun* (cooperation).⁴¹⁵ The *Takāful Insurance* Guidelines identify the key elements of *Takāful Insurance* to be:
 - a) Mutual Guarantee as all policyholders agree that the pooled funds shall be used for assistance in specified circumstances of loss;

⁴¹³Article 1.2 of the NAICOM guidelines.

⁴¹⁴Article 1.3. of the Guidelines.

⁴¹⁵See Article 1.11. of the Guidelines.

- b) Ownership of fund - the participants are the main owners of the *Takāful* Insurance Fund;
 - c) Management of the *Takāful* Insurance Fund –The management role is performed by the *Takāful* Insurance Operator in consonance with International best practices;
 - d) Investment Conditions – Any investment activity performed using the Participants’ contributions must be in line with the governing principles of *Takāful* Insurance (e.g., avoiding investment in select unlawful industries that are deemed to be harmful to the society and avoiding interest).⁴¹⁶
3. In running a *Takāful* Insurance company, justice must be ensured between the Shareholders and the Participants. The purpose behind the separation of the accounts is to ensure that the hard-earned investments of people are not embezzled. This safety net also ensures that the monies in the distinct accounts are not mixed up. Therefore, there is a Participants’ (or Policyholders’) Account, and a Shareholders’ Account.

The Participants’ Account

Policyholders pay their premiums into the Participants’ Account just as profits earned by policyholders in *Mudārabah* contracts and reinsurance acquisition costs and returns on reinsurance profits are paid into it. In the same manner, the Insurance Surplus shall be distributed to policyholders exclusively. The Account takes charge of payments of claims, reinsurance expenses documentation expenses, commissions, expenses from premium reserves earmarked for charitable activity after the company has settled all obligations and liabilities upon the *Takāful* Insurance venture.

The Shareholders’ Account

This account undertakes the expenses required for promoting the company, such as corporate registration fees and expenses relating to the payment of salaries, rents, administrative and capital investments. Similarly, the Legal Financial Reserve as determined by the local statutory requirements shall be paid from the Shareholders’ Account. The Account also pays out the capital investment profits and the profits gained upon the investment of Insurance premiums.

4. It is also expected that Shareholders and Participants of a *Takāful* company shall strive to maintain the principle of solidarity between them. Therefore, good loans, free of financial benefits, should be promoted in times of need. Other

⁴¹⁶See Article 1.12. of the Guidelines.

forms of solidarity may take the form of *Takāful* between policyholders such as Social *Takāful* Insurance or supporting orphans left behind by members.

5. Promoting equality and justice between the policyholders in terms of how they are indemnified against risks suffered. The company shall not segregate between the members in their entitlements to payment and other corporate rights.
6. It is also a cardinal principle of *Takāful* to spread the insured risk across the cognate *Takāful* companies. This is obviously aimed at solidifying the *Takāful* industry. In the same way, sharing information through seminars and conferences is a form of solidarity within the *Takāful* companies.
7. Protecting Re-*Takāful* Insurance companies from fraudulent measures that will undermine the strength of the relationship between *Takāful* companies and Re-*Takāful* companies by maintaining the principle of integrity and transparency in their practices.⁴¹⁷

4.6 *Takāful* Models and Structures

There are basically two different types of *Takāful* models for the management and investment of funds by *Takāful* operators, namely, the *Mudārabah* model and the *Wakālah* model. However, some *Takāful* operators have also adopted other business models such as combination of the two main models (commonly known as hybrid model) and *Waqf* model to a lesser extent. The first three operating models are recognised in Nigeria. Section 2.2 of the 2013 NAICOM Guidelines for *Takāful* Operators provides: “The *Takāful*-Insurance participant and *Takāful*-Insurance Operator enter a contractual relationship for *Takāful* -Insurance service for a fee. The *Takāful* Insurance Operator will establish and document one of the following operating models aligned with international best practices, to conduct *Takāful* – Insurance business.”

a) *Takāful*-Insurance based upon *Mudārabah* (profit sharing) contract

In this model, the *Takāful*-Insurance Operator holds the role as the *Mudārib* (Entrepreneurial Partner) and the *Takāful*-Insurance Participants are the *Rabb al-Māl* (Owner of capital). The key aspects of the model are set out in the contract and shall include:

- i) *Takāful*-Insurance Operator manages investment and underwriting activities.

⁴¹⁷Sabbāgh, A. M., op. cit. pp. 35-39.

- ii) The percentage share of investment gains and operating surplus for the *Takāful-Insurance Operator*.
- iii) Financial losses to be borne by *Takāful-Insurance* participants.

b) *Takāful-Insurance* based on *Wakālah* (Agency) Contract.

In this model, the *Takāful-Insurance* Operator holds the role of the *Wakīl* (the Agent) acting on behalf of the *Takāful-Insurance* Participants in return for a fee. The key aspects of the model are set out in the contract and will include:

- i) *Takāful-Insurance* Operator manages investment and underwriting activities.
- ii) *Takāful-Insurance* Operator for performing this service will receive a *Wakālah* (Agency) fee that is set out in the contract.
- iii) *Takāful-Insurance* Operator is also permitted to a performance related fee as per the contract.

c) *Takāful-Insurance* based on Hybrid *Wakālah-Mudārabah* (Agency-Profit sharing) contract.

In this model, a *Wakālah* (Agency) contract is in place between the *Takāful-Insurance* Operator and the *Takāful-Insurance* participants for the management of underwriting activities and a *Mudārabah* (Profit sharing) contract is between the *Takāful-Insurance* Operator and the *Takāful-Insurance* participants for the investment activities.

4.6.1 The *Mudārabah* Model

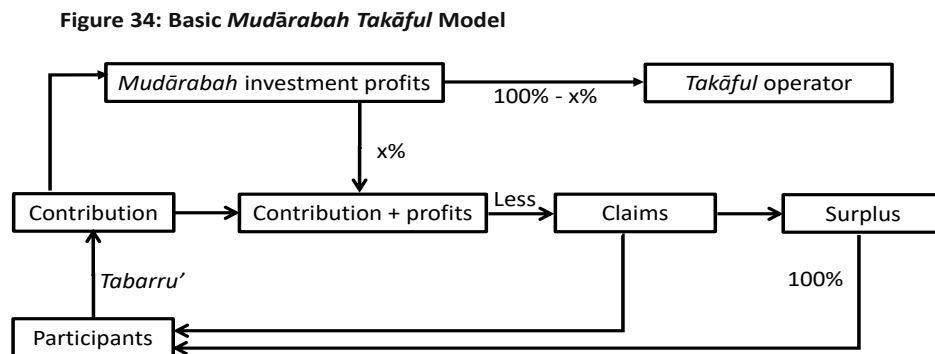
The *Mudārabah* model is based upon the participants providing the capital as the *Rabb al-māl* and the *Takāful-Insurance* Operator functioning as the *Mudārib* through its expertise as a manager of funds. The provider of funds has no say in the manner in which the Manager operates the business. In this arrangement, the two sides will share profit according to a predetermined percentage ratio.⁴¹⁸ In the case of loss, both parties suffer as well: the *Rabb al-māl* by his lost investment; and the manager by his loss of anticipated profit, time and effort.

⁴¹⁸INCEIF, Op. Cit. p.97.

After contribution of profit, the company's share shall be deposited into the Shareholders' Account. The share of the insured members is deposited into the Participants' Fund. The following points should be noted:⁴¹⁹

- i) The distribution of profit should be on a proportional basis and not upon a fixed figure or a guaranteed return;
- ii) The *Rabb al-māl* is not liable for losses beyond his capital contributed;
- iii) The *Mudārib* does not share losses suffered by the business in the way that the *Rabb al-māl* does. He merely loses his expected profit, time and effort.
- iv) There is no salary or periodic payments for the *Mudārib* except the pre-agreed shares of profit.
- v) In the *Mudārabah* model, the shareholders and their appointed managers are the *Mudārib*, on the one hand, and the participants who pay contributions are considered the *Rabb al-mal*.

Figure 34 illustrates a *Mudārabah* operational model in a *Takāful* scheme.



Source : Engku and Scott, 2008, p.45

The *Mudārabah* model is based upon the practice of the Makkah merchants even before the advent of Islam, but which was later practised by the Prophet (peace be upon him) and his companions (may Allah be pleased with him).

⁴¹⁹ Nazarov, I. & Dhiraj, N. (2019). A Conceptual Understanding and Significance of Takaful (Islamic Insurance): History, Concept, Models and Products. *International Journal of Innovation, Education and Research*. Vol. 7, No. 4, p. 290.

4.6.2 The *Wakālah* Model

The structure of this model is based on agency contract (*Wakālah*). The Principal (the participants) delegates the Agent (the *Takāful* operator) to act on his behalf in a known and permissible dealing.⁴²⁰ AAOIFI *Sharī'ah* Standard No. 23 defines *Wakālah* as “the act of one party delegating the other to act on its behalf on what can be a subject matter of delegation.”⁴²¹

The legal basis for this practice is to be found in the *Qur'ān* and *Sunnah*. In the words of the *Qur'ān*: “Now send you then one of you with this money of yours to the town: let him find out which is the best food (to be had) and bring some to you that (ye may) satisfy your hunger therewith.”⁴²² By the companion being sent to the town to perform a task on behalf of the others, we find justification for the matter of agency, and we may safely deduce that one can be delegated to perform a task on behalf of another either voluntarily or with imposition of a fee. In the *Sunnah*, a *Hadīth* was narrated by ‘Urwah Al-Bāriqī (may Allah be pleased with him) who said that the Prophet (peace be upon him) had given him one *dīnār* to purchase a sacrificial sheep for the Prophet (peace be upon him),⁴²³ an incidence that involves *Wakālah* (agency).

In the *Wakālah* model, the Shareholders’ Fund is managed distinctly from the Participants’ Fund. The *Wakīl* (agent) invests the Participants’ funds into ventures that are permissible and the returns will be remitted into the Participants’ Fund. It is also permissible to give an additional fee to the agent (i.e. the *Takāful* Operator) known as performance fee that is charged to the surplus, if any, as incentive for managing the investment of the *Takāful* fund. The expenses over the investment activities shall be charged to the Shareholders’ Fund.⁴²⁴

The following points should be noted:⁴²⁵

⁴²⁰Ibid, p. 8.

⁴²¹ AAOIFI (2015), p. 610.

⁴²²*Qur'ān*: 18:19.

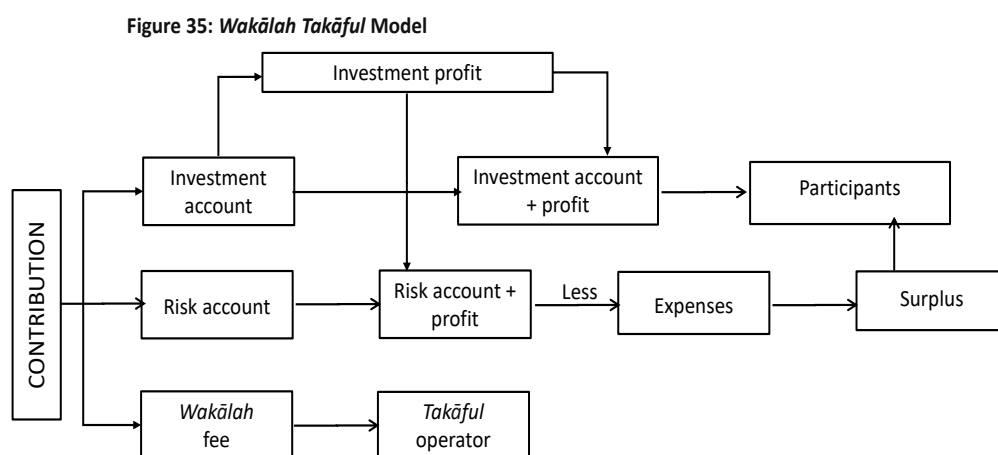
⁴²³ Bukhāri (Hadīth 3642)

⁴²⁴Sabbāgh, A. M., op. cit. p. 41.

⁴²⁵ Nazarov, I. & Dhiraj, N. (2019). A Conceptual Understanding and Significance of Takaful (Islamic Insurance): History, Concept, Models and Products. *International Journal of Innovation, Education and Research*. Vol. 7, No. 4, p. 290. Also, see: Salman, S. & Htay, S. (2013). Introducing Waqf Based Takaful Model in India. *Tazkia Islamic Finance and Business Review*, Vol. 7, No. 2, p. 247; Akhter, W. (2010). Takaful Models and Global Practices, pp. 7-9. Online at <https://mpira.ub.uni-muenchen.de/40010/> and <https://islamicmarkets.com/education/takaful-wakalah-model>

- i) The *Takāful* Operator acts as an agent of the Participants to manage and invest collected funds in permissible ventures;
- ii) The realised profits and losses from investments and operations solely belong to the Participants;
- iii) The *Takāful* Operator, as an agent, is responsible for distributing shares of profits to the Participants as per their contribution to the fund;
- iv) The *Takāful* Operator does not share directly in the risk, deficit or surplus, but is compensated based on a pre-agreed service (*Wakālah*) fee which is deducted from the collected funds.

The *Wakālah* operational model in a *Takāful* scheme is illustrated in Figure 35



Source: Engku & Scott, 2008, p. 75

It should be noted that where payment of an incentive fee to the *Takāful* Operator is provided in the contract, the model is called *Wakālah* model with performance incentive or modified *Wakālah* model. This model is different from the pure *Wakālah Takāful* model because the net underwriting surplus in the pure *Wakālah* model is not to be shared with the Operator. In the *Wakālah* with performance incentive, a *Wakālah* fee is not only charged upfront but is also charged as a proportional share in the underwriting surplus. Some scholars including members of the National *Sharī'ah* Council of Malaysia have approved it on the premise that the performance incentive can be in the form of gift (*hiba*), performance fee (*Ju'alah*) or waiver (*tanāzul*) where the participants can waive part of their surplus shares. Other scholars including members of the Islamic Fiqh Academy have rejected it on the ground that the *Takāful* Operator is not entitled to the fee, which

is part of the surplus that belongs entirely to the participants. They also argued that the model practices an inequitable system because the profits of underwriting surplus are shared between the *Takāful* Operator and the participants even though the Operator is not responsible for any capital loss.⁴²⁶

4.6.3 The Hybrid *Wakālah-Mudārabah* (Agency-Profit sharing) Model

In this model, we see a mixture of *Mudārabah* and *Wakālah* in action. This system enables the participants to employ the *Takāful* Operator. Therefore, the *Wakīl* (Agent) collects donations for the *Takāful* Fund, manages the underwriting operations and invests the Participants' Fund. He shall be paid an agreed fee for this; and he shall also receive a share in the profits as a *Mudārib*. In this arrangement, the *Takāful* Operator is bound by a *Wakālah* contract for managing the fund and also a *Mudārabah* contract for investing the fund.

It should be noted that the Operator, as a *Mudārib*, can partake in the sharing of the operating surplus as an incentive for managing underwriting on behalf of the Participants. Here, the *Takāful* Fund belongs to the Participants and not the Operator. In the event of loss, the Operator shall only lose in terms of effort and time.

In the *Wakālah* model, however, there is a difference between the *Takāful* Fund and the *Takāful* Operator. The Agent only charges a fee based upon his performance, and does not partake in the underwriting. Therefore, the operational costs are reported to the Policyholders' fund.

The following points should be noted regarding the hybrid *Takāful* model:⁴²⁷

- i) The model is a combination of *Mudārabah* and *Wakālah* models where *Wakālah* contract is used for underwriting activities while *Mudārabah* contract is adopted for investment activities;
- ii) The *Takāful* Operator has three sources of income: agency fee and the profit share from the investment of the funds; and incentive fee (where it is provided in the arrangement);
- iii) The Operator has no right to reserved amounts that remain after redeeming all claims;

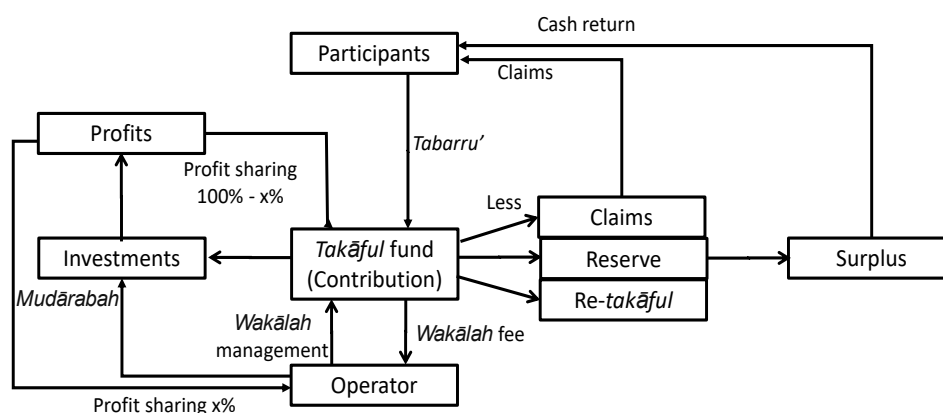
⁴²⁶ Salman, S. & Htay, S. (2013), p. 248.

⁴²⁷ Akhter, W. (2010). *Takaful Models and Global Practices*, p. 9.

- iv) All losses are entirely borne by the *Takāful* participants provided that the Operator did not act negligently; if proven otherwise, the Operator bears the losses.

Figure 36 illustrates the flow of transactions in the hybrid (*Mudārabah-Wakālah*) operational model in a *Takāful* arrangement.

Figure 36: Hybrid (*Mudārabah-Wakālah*) *Takāful* Model



Source: Nazarov and Dhiraj, 2019, p. 292

4.6.4 The *Waqf Takāful* Model

The need to develop a model that could work towards building the creditability of *Takāful* Operators as welfare institutions rather than purely profit-oriented entities has led to the formation of *Waqf* model based mostly on *Wakālah*. The model is a modified form of *Wakālah* model where a *Waqf* fund is created by initial donation of shareholders. Participants' contribution goes directly to the *Waqf* fund. The *Takāful* Operator deducts its *Wakālah* fees upfront from the *Waqf* fund. The remaining amount is then invested in *Sharī'ah*-compliant investment avenues. The net profit from investment is shared, according to an agreed sharing ratio, between the *Takāful* Operator (as *Mudārib*) and the Fund's special account for the purpose of implementing the goals of the *Waqf*.⁴²⁸

A common feature of *Wakālah* with *Waqf Takāful* model is that the *Waqf* Fund will lay down the rules for distribution of its proceeds to the beneficiaries and will determine how much compensation to be paid out to a participant. In addition, the *Waqf* will be the owner of the contributions and has the right to act as a legal entity and deal with its surplus. According to some scholars such as Muhammad Taqi

⁴²⁸ Ibid, p. 12. Also, see: Salman, S. & Htay, S. (2013), p. 251.

Usmani, the *Waqf* model is more in line with the basic concept of *Takāful* which describes a protection plan based on human brotherhood, a sense of mutual responsibility and cooperation among participants.⁴²⁹

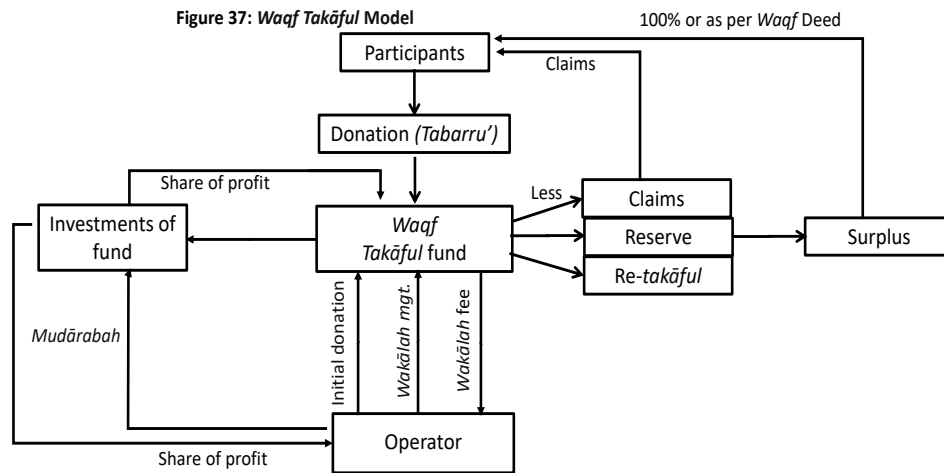
The structure of a *Wakālah* with *Waqf* model can be illustrated as follows:⁴³⁰

- i) The Shareholders make an initial donation to establish the *Waqf* Fund; thereafter, they shall lose their ownership rights on the *Waqf* fund except the right to administer and develop rules and regulations for the fund;
- ii) The donations received from the participants, seeking *Takāful* protection, would also be a part of the *Waqf* fund;
- iii) The combined amount is invested in a *Sharī'ah*-compliant investment after deducting *Wakālah* fee;
- iv) *Takāful* Operator is responsible for all the management expenses from shareholders' fund while operating costs, Re-*takāful* expenses and claim payments are made from participants' fund;
- v) Returns are used for the benefit of the participants.

In Figure 37, the flow of transactions in the *Wakālah* with *Waqf* operational model in a *Takāful* arrangement is presented.

⁴²⁹ Abdullah, A. & Yaacob, H. (2012). Legal and Shariah Issues in the Application of Wakalah-waqf Model in Takaful Industry: An Analysis. *Procedia - Social and Behavioral Sciences*, 65, 1040–1045.

⁴³⁰ Abdul Wahab, A. (2006). Takaful Business Models - Wakalah based on WAQF: Shariah and Actuarial concerns and Proposed Solutions. Presented at the Second International Symposium on Takaful, Malaysia, pp. 9-11.



Source: Nazarov and Dhiraj, 2019, p. 291

4.7 Takāful Insurance Services

Takāful services are divided into two broad categories: Family *Takāful*; and General *Takāful*.

4.7.1 Family *Takāful*

Family *Takāful* entails the insuring of human life and this extends to temporary or permanent disability. It does not cover the insuring of other things that are outside human life. Therefore, taking out a cover against fire to house or theft, or accident to motor vehicle and even personal accidents and health insurance is outside the scope of family *takāful*; it falls under the purview of general insurance.

Family *Takāful* is based upon the text of the *Qur'ān*: “Allah intends all ease for you, and He does not intend to put you into difficulty.”⁴³¹ Family *Takāful* policies are usually long-term. The contributions into the dedicated account serve as protection for the policyholders and also a savings scheme. Where a family policyholder dies before the end of his contract, the specific benefits that a deceased Policyholder’s next of kin will receive are:

- i) All the contributions made by the Policyholder right from the inception of the policy up to the last instalment. His family shall also claim the profits from investments upon his contributions credited into the Participants’ Account.

⁴³¹ *Qur'ān*, 2:185.

- ii) Furthermore, the total outstanding contributions that he would have made up to the end of the contract will be paid out of the Participants' Special Account.

On the other hand, where the Policyholder survives the term of the contract, he shall receive the following:

- i) From the Participants' Account, he shall receive the total of all the contributions made by him during the period of his *Takāful* contract. This amount shall be added to his profits derived from the investments upon his contributions.
- ii) He shall also claim, from the Participants' Special Account, the net surplus allocated to him as derived from the latest valuation of the account.

It is essential to state that the overall product is dependent upon the disposition of the company in terms of its conditions, warranties and, especially, exclusions. It should also be borne in mind that the *Takāful* model to be used will also be a significant player in the final determination of the product.

Family *Takāful* can also be broken down into Individual and Group plans.

a) Individual Plans

Individual plans are limited to individuals. The individual is prompted to make savings by his contributions and to invest his money and to provide for a cover over his next of kin should he die before the policy ends.

b) Group Plans

The group plan usually covers persons who are in an organisation. The distinctions between the players such as difference in age or rank are not of the essence because members of the group can make contributions peculiar to their unique interests in terms of age, health status and so on.

4.7.2 General *Takāful*

This type of cover is a joint guarantee contract of short-term duration, usually not exceeding one year or less.⁴³² However, terms that are slightly higher are also possible, especially in contract works.

⁴³²INSEIF *Takāful Realities and Challenges*, p.377.

General *Takāful* may take various forms. Motor *Takāful* policies, fire policies, marine *Takāful* policies, aviation policies are well established forms of general *Takāful*.

4.8 Re-Takāful

Re-*takāful* is embedded into the concept that Islam encourages Muslims to come together under one umbrella materially and spiritually. Islam champions collectivism and eschews individualism. Re-*takāful* is the Islamic form of reinsurance.

Reinsurance happens when companies that are engaged in the insurance business insure with a company or companies that specialise in reinsurance for the purpose of distributing the risks among them.⁴³³ In effect, the insurance company transfers part of the insured against risks to a reinsurance company. This may occur when the insurance company is offered a business to insure against a risk for an amount of wealth that is beyond its financial capacity. With reinsurance, that company can accept the offer and maintain part of it while it spreads the other part to the reinsurance company in order to ameliorate the risk at hand, in which case, if a risk occurs, both companies will indemnify the insured within the same year the two companies agreed to share risk.

The *Black's Law Dictionary* defines re-insurance as “Insurance of all or part of one insurer’s risk by a second insurer, who accepts the risk in exchange for a percentage of the original premium.”⁴³⁴ Therefore, the reinsured is the insurer that transfers all or part of the risk it underwrites to a reinsurer usually along with a percentage of the original premium (also called ceding). The Reinsurer, on the other hand, is an insurer that assumes all or part of a risk underwritten by another insurer usually for a percentage of the original premium.

In *re-takāful*, the Operator usually receives the net risk contributions, which is a fraction of the gross contribution the ceding partner allows from the participant, representing its management fees and also its expenses incurred in acquiring the business.⁴³⁵ It may be helpful to state, here, that the *re-takāful* operator’s model may not be the same as that of the *takāful* operator even though both models must be compliant with the *Sharī’ah*.

⁴³³Sabbagh, A. M. Op. cit. p. 145.

⁴³⁴Garner, (2004). *Black's Law Dictionary*, Thomson West, 8th Edition, p. 1312.

⁴³⁵INSEIF, *Takaful Realities and Challenges*, p. 515.

Furthermore, any surplus after the payment of reserves and provisions will be passed back to the *Takāful* Fund at the operator's level. The surpluses shall not be given directly to the Operator. The Operator may only partake in the *Re-takāful* surplus should its contract with the participants allow it to do so.⁴³⁶

4.9 Risk Management

Risk Management can be justified in Islamic law in many ways. Primarily, jurists have stated that Islamic law is based upon prudence and safety nets. Imam Al-Shātibī has expounded this precept admirably. To him, the notion of *Sadd al-Dharī'ah*, is a clear example of how the *Sharī'ah* takes clear steps to avoid harm just as it does to promote good.⁴³⁷ He further postulates that *al-'urf* (local customs/practices and conventions), *Sadd al-dharī'ah* (blocking inroads to harm) and *al-istihsān* (juristic equity) are all cognates of the same web.⁴³⁸ It is obvious that entering crowded places with unsheathed, sharp-edged objects is prohibited in order to forestall injury to others. Allah (the Most High) has prohibited Muslims from insulting the objects of worship of the disbelievers because they could insult Allah in ignorance.⁴³⁹ Similarly, despite the fact that there is a consensus over the permissibility of hiring out male slaves, it is prohibited to hire out female slaves because of the risk of immorality associated with that. It is also prohibited for a person to dig a pit on the pathway of others even if it is located within premises owned by him.

The jurists have settled upon the maxim "*al-dararu yuzāl*" (injury shall be removed) to further justify risk management. In the narration of the story of Prophet Yusuf (peace be upon him) his father, Ya'qūb (peace be upon him), said to the brothers of Yusuf (peace be upon him): "O my sons! Do not enter together by one gate, but enter by different gates, and I cannot avail you against Allah at all, verily, the decision rests only with Allah. In Him I put my trust and let all that trust put their trust in Him."⁴⁴⁰

In the same chapter, the interpretation of the King's dream displays risk management methods against the anticipated famine that struck and, if it had not been for the steps taken, Egypt would have certainly been stooped into famine just as Palestine was. This strategy brought about great authority not only for Egypt but for Yusuf (peace be upon him) himself and the Jewish community.

⁴³⁶Ibid, p. 522.

⁴³⁷Al-Shātibī, Op. cit. Vol. II, p. 253.

⁴³⁸ Ibid, pp. 197-200.

⁴³⁹ *Qur'ān*, 6:109.

⁴⁴⁰ *Qur'ān*, 12:67.

We may even venture to cite the battle strategies adopted by the Prophet Muhammad (peace be upon him) in several of his campaigns. It is reported that, before the Battle of Badr, the Prophet (peace be upon him) stationed his army in a particular position but reviewed the strategy after Hubab bin al-Mundhir (may Allah be pleased with him) suggested another strategy which the Prophet preferred over his initial stance.⁴⁴¹ Similarly, Allah mentions in *Surah Āli Imrān* that the Prophet (peace be upon him) should recall when he was preparing the ranks of the believers for the Battle of Uhud.⁴⁴² We see in these references clear examples of how the Prophet (peace be upon him) took proactive measures to prevent harm befalling the Muslims.

The texts also denounce a blind and fatalistic approach to risks. Islam clearly enjoins Muslims to take positive steps towards removing risks and realising the optimal benefits from resources. The Bedouin who left his camel untied in the mosque on the grounds that he had put his trust in Allah was instructed by the Prophet (peace be upon him) to tie up his camel and then put his trust in Allah.⁴⁴³ In the same way, the Prophet (peace be upon him) declared that the Muslim is not stung in the same hole twice,⁴⁴⁴ meaning that, by the teachings of Islam, one should not repeat the same mistake twice. He shall take pre-emptive and proactive steps to avoid harm and realise the best options for him.

According to Sabbāgh, the modern concept of risk management entails: “A probability or threat of damage, injury, liability, loss or any other negative occurrence that is caused by external or internal vulnerabilities and that may be avoided through pre-emptive action.”⁴⁴⁵ Risk management has grown to be a major science in global corporate affairs. An insurance company will, therefore, assess the probability of risk as a priority before deciding to insure a specified thing.

Ordinarily, risks abound in all cases. However, where the probability of a risk is certain, insurance companies will refrain from such a risk, just as clients will not insure where a risk is non-existent, such as insuring against risk on the high seas after the ship has reached its destination.

⁴⁴¹al-Qattān, M. (1996). *Tarīkh al-Tashrī' al-Islāmī*, Maktabah al-Ma'ārif, (Riyadh), pp. 112-113.

⁴⁴² *Qur'ān*, 3:121.

⁴⁴³al-Tamīmī, M. H. (1994). *Sahīh ibn Hibbān, Mu'assasah al-Risālah*, (Beirut), Second Edition, Vol. II, p. 510.

⁴⁴⁴Bukhārī (Hadīth no. 6133) and Muslim (Hadīth no. 7498).

⁴⁴⁵Sabbāgh, A. M., Op. cit., p. 126.

The risk must be subjected to being measured. The reason for this is in order to assess the quantum to be charged as premium. An insurance company will, therefore, indemnify against material damages that are measurable such as treatment of injuries or repairs of vehicles damaged; but not those injuries that are not subject to being measured or evaluated such as pain, suffering fear, etc.

The indemnity shall be in relation to accidents and unintentional acts. It is also a condition that the insured thing is legitimate by law. Therefore, to insure stolen or smuggled goods is not lawful. Insurance shall also not cover traffic violations; and acts involving recklessness such as accidents caused by a person labouring under the influence of intoxicants or narcotics or a driver found to have exceeded the speed limits imposed by law.

There are five steps to take in a sound risk management process. The magnitude of the risk is based upon two factors: the impact; and the outcome of the event. The processes as postulated by Sabbāgh are as follows:

- i) Identify the risk;
- ii) Analyse the risk;
- iii) Evaluate or rank the risk;
- iv) Treat the risk;
- v) Monitor or review the risk.⁴⁴⁶

⁴⁴⁶ Ibid, pp. 130-131.

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ISLAMIC CAPITAL MARKET

5.1 Introduction

Capital market is a place or market where individuals, corporate entities or other forms of organisations in need of long-term capital converge with those that provide the needed funds. Essentially, capital market extends to the various economic sectors like individuals and corporate entities fixed finance, medium-term finance, as well as working capital finance and to the central, state and local governments. The capital market comprises the primary segment (which can be the Initial Public Offering IPO market) and secondary market. In the former, the market creates the atmosphere for raising fresh capital from the public for corporations, while in the latter as a secondary market; it creates the environment for exchange of existing financial assets. The overwhelming purpose of traditional capital market is to connect surplus units and deficits in the financial system through structured products and services.

The products exchanged through the market are the financial instruments/assets, through which the funds are channelled from the investors/surplus to the deficit/users in order to make economic gains or to manage financial risks. Financial instruments mean monetary contracts through which papers exchange hands in the market. On the one hand it becomes an asset or to an entity; on the other hand, it becomes a liability to another entity. The financial assets include ordinary stock, shares, debentures and bonds of corporations and bonds and securities of governments. Thus, the mobilised funds that flow into the capital markets come from individuals who have surplus funds to invest, the merchant banks, the commercial banks and non-banking financial intermediaries (insurance companies, finance houses, unit trusts, investment trusts, venture capital, leasing finance, mutual funds, building societies, pension funds, cooperatives, etc). The capital market functions through the stock exchange market. The stock exchange market is a market that facilitates the buying and selling of shares, stocks, bonds, securities and debentures. It is indeed a market for both old and new instruments.

The conventional capital market operates as a network of parties with competing needs as to how to generate funds in order to satisfy or upgrade their developmental needs or economic growth. It thus provides them a channel to access funds from various sources or parties who have surplus and seek capital gains or returns. In contrast, the Islamic Capital Market mode of operation considers certain steps

beyond conventional structural regulatory requirements. This chapter covers some of the essentials of Islamic capital market.

5.2 Islamic Capital Market and its Modes of Operation

The unique nature of Islamic Capital Market (ICM) dictates its manner of operations or functions. Due to certain attributes, ICM threads through several steps and these steps determine the critical role it plays before it launches its products and services in the financial system. ICM, as a constituent of Islamic financial system, functions on a structured manner on a non-interest basis designed to provide ethical products and services on short-term, medium-, and long-term funding. Thus, Islamic capital market provides opportunities for all players which could be individuals or general investors, institutions, and governments in a *Shari'ah* compliant style from start to finish based on *maslaha 'ammah* (public interest). The legal maxim of *Al-Masalih al-'Ammah muqaddamah ala al-Masalih al-Khassah*⁴⁴⁷ is relevant here.

ICM operation displays a special value system, which differentiates it from its conventional counterpart through a systematic process and the procedure that must be consistently adhered to. In principle, Islamic capital market goes beyond funding and extends to entrenching ethical values in all the services it renders to the society. As such, through specific activities in pursuit of the value system, it focuses on procurement of benefits or its increase to the society, and prevention of harm or decreasing them.

In practice, ICM carefully follows the universal traditional inherited practices of conventional capital markets although with an addition that displays the unique *Shari'ah* value system. The *Shari'ah* value system prevents all harmful economic activities but encourages and emphasizes all beneficial economic activities, which will address the yearnings of the society. In sum, due to the specific nature of ICM, it attempts to provide not only the financial benefits of the conventional capital market but transcends to consider moral and ethical values for the society.

Therefore, ICM provides an opportunity to showcase its ethical underpinnings in all its products and services due to Islamic finance special attributes and underlying ethical principles. Thus, ICM offers a value addition alternative to the conventional arrangement while providing traditional services of financial intermediation. It satisfies the local regulatory compliance requirements applicable to all capital market players, regulated by the Securities and Exchange Commission (SEC) in

⁴⁴⁷Al-Shātibi, I. M. (1997). *Al-Muwāfaqāt fi Usūl al-Ahkām*, Dār Ibn Affan, Beirut 1st Edition, Vol. 3, p. 57.

Nigeria and then also complies with strict *Sharī'ah* dictates and principles. Issues covered by the principles include *Sharī'ah* requirements, *Sharī'ah* underlying contracts, and *Sharī'ah* screening vetting and certification. As part of its mode of operations, the areas which ICM would channel funds must be *Sharī'ah* compliant and must be strictly verified. The structure upon which the funds would be attracted has to also be compliant.

Under the *Sharī'ah* platform, ICM shall ensure that it meets the *Maqāsid al-Sharī'ah* (the objectives of the *Sharī'ah*) in the network, products and services. The higher *Sharī'ah* objectives as in the *Maqāsid al-Sharī'ah* framework, are to protect the society in terms of life, religion, wealth, mind and progeny. While a traditional capital market provides all the means to fulfil clear developmental goals regardless of the underlying objectives, the ICM ensures that, while it provides such services, care is exercised in the maintenance of the objectives of the *Maqāsid al-Sharī'ah* identified above. Even the governance architecture remains almost similar but with additional *Sharī'ah* governance as a fundamental requirement. Thus, due to certain unique requirements and inherent restrictions, the Islamic capital market enjoys limited ability and freewill unlike its conventional counterpart regarding how it earns its money. Therefore, some traditional practices often conducted in conventional markets could be forbidden in ICM and hence their modes of operations differ.

One of the initial prerequisites of ICM operation is certification of the market by *Sharī'ah* Advisory Board scholars who scrutinize and carefully review it. Once the system is approved and certified compliant with Islamic ethics, the market would be ready to take in all the necessary prerequisites. The next phase requires the Scholars to review the underlying contracts that would be fed into the system, and that the scholars will ensure the suitability of the contract and its alignment to the objective of the funds needed. Once the underlying contract is certified suitable, the regulatory, legal and economic ends would be scrutinised.

In all, each layer in the approval phases is often normally issued a certificate of *Sharī'ah* compliance (CSC). These certificates would carry details on the extensive work carried out and corrections made, if any, with regard to the system safety nets. This requirement of CSC would safeguard that the underlying contract complies with *Sharī'ah* in each of its executional stages and does not derail in its mandate. All these would ensure the business along with the contractual stages does not either introduce sharp practices or those prone to *harām* (unlawful) activities.

A Certificate of *Sharī'ah* Compliance actually increases people's confidence in the institution, infrastructure and the other stakeholders managing them for its *Sharī'ah* compliance. The certificate also encourages potential investors and increases their faith in a new safe haven for their monies that would be managed in the most ethical manner. This reassurance on the *Sharī'ah* compliance status of the product could translate into more endeared trust, more subscription and participation from the public and entities and the undecided observers. Similarly, CSC also provides some level of comfort for sceptical observers and reinforces ICM commitment towards engagement in *halāl* business. Such confidence carefully prevents sharp practices in the whole process due to the layers of certification and exhaustive hours of review *Sharī'ah* advisors dwell on. The dictates of *Sharī'ah* naturally make ICM unique in its mode of operation as every step must be *Sharī'ah* compliant in both theory and practice and must be consistent with risk sharing rather than risk transferring attributes, while the certificate will ensure no undue advantage is taken against the customer.

Another operational requirement is that ICM shall not provide products or instruments structured on interest-based value system. ICM must also avoid engaging behind the public eye on forbidden practices such as prevalence of *gharar*, *maysir* and *jahāla* in the market operations by ensuring that the forms over the substance equally fit into *Sharī'ah* principles. These forbidden elements enumerated above must not have their ways into the instruments especially when structuring the inbuilt terms and conditions of each contract. In addition, ICM shall provide for channelling the funds between the parties on the principles of *fiqh al-Mu'āmalāt*.

Since *ribā* (interest) is forbidden, it shall not be seen to run in the Islamic financial system or replicated behind the back door in the form of legal tricks or *hīlah*. *Sharī'ah* has never forbidden an issue without suggesting or providing a better alternative. As a better alternative to the risk transfer method of financing, Maghrebi and Mirakhor argue that risk allocation between economic agents in a financial system, far outweighs risk transmission in the system as seen in conventional financial markets; as such risk sharing is a unique mechanism, which incentivizes financial inclusion of all the parties and ensures a structured social betterment of the society.⁴⁴⁸

Since this is so, the designers of ICM should extend such alternative into ICM, which, in turn, will spread the wealth among all stakeholders. To achieve this feat

⁴⁴⁸Maghrebi & Mirakhor (2015). Risk Sharing and Shared Prosperity in Islamic Finance. *Islamic Economic Studies*, pp. 85-115.

on a non-interest structure, an ICM introduces the alternative structures, free from interest-bearing characteristics. Where conventional capital market provides products on the basis of equity contribution, debt financing, derivatives and units fund scheme, structured on interest components, the Islamic capital market presents alternative similar structures, albeit on genuine equity or shared risks basis. To achieve this noble goal, contracts based on *Sharī'ah* structured financing modes such as *Ijārah*, *Mushārah*, *Mudārah* and *Wakālah bil Istithmār* have dominated the scene and are clearly tied to real assets in the economy. These forms of contracts split the risks and returns generated in the economic activity evenly possible between the partners in the market rather than the skewed transfer of it to an independent third party such as the conventional insurance companies based on interest rate incentives. In the *Sharī'ah*, the principle of risk and profit sharing is inbuilt in all *Sharī'ah* nominate contracts under the dictates of the *Sharī'ah* Legal maxim “*al-ghunmu bi al-ghurmi*” “return goes with risk” in its real sense.

An additional attribute of the ICM mode of operation is its adoption of extra regulatory requirements. This is achieved with the intervention of *Sharī'ah* Scholars who serve as advisors to the whole business. Part of their legal and regulatory responsibility is to constantly ensure that the whole market process, from start to finish, is in compliance with the *fatwā* often issued, and complies with the principles of Islamic commercial law. In order to prevent fraud in the Islamic financial system, and thus avoid bypass of the regulations in any form, the Scholars and the staff of relevant units in SEC which regulates Islamic capital market, the Central Bank which oversees the banks as intermediaries in the financial system, the Ministry of Finance, which ensures the financing aspect of governance works well, should all have relevant knowledge which helps them in judgment and review of the daily dealings in the markets.

The *Sharī'ah* advisors monitor the ICM for any breach of *Sharī'ah* law or rules. As part of the regulatory requirements peculiar to Islamic finance model, when errors occur, *Sharī'ah* remedies would be activated as quickly as possible. It would be put in place to correct the wrongs or errors that have occurred and, therefore, the earned income from such errors would be disposed of to charity.

As stated earlier, a clear feature of ICM is the embodiment of Islamic commercial law (*Fiqh al-Mu'āmalāt*) in the market arena. Hence, ICM distinguishes itself and shall distinctively exhibit Islamic commercial law spirit and ensures it meets its requirements at every stage in its operational phase. Aside from the fact that it comprises *Sharī'ah* principles, it, nonetheless, has to exhibit additional operational difference or style in order to exude *Sharī'ah* fundamentals. As such, an ideal ICM

operates or strives to operate within a worldview guided by *Shari'ah* principles and efforts to earn *halāl* (permissible) earnings at every given stage. Therefore, any errors must be cleansed in order to maintain the *halāl* status. This status is expected to be much more ethical, efficient as possible as it can, while ensuring that the value propositions it personifies in its products, offerings and services are visible and credibly verifiable across the stages of its application. These fundamentals and principles differentiate ICM from its conventional counterpart. Therefore, while the form might look the same as that of the conventional, ICM is distinguished in substance by being *halāl* and *Shari'ah* compliant.

5.3 Operational Success Factors in ICM

The following discussion presents factors that facilitate successful operations of Islamic Capital Markets and differentiate it from operations of the conventional capital market.

5.3.1 ICM Product Design Stage

First, on a conceptual level, ICM starts its operation from the product literatures, which have to be presented to a constituted body known as the Advisory Committee of Experts (ACE) for scrutiny and review. The ACE, as required by law, is constituted by a number of key players comprising competent scholars with vast knowledge in the *Shari'ah*, lawyers with solid background in the local and international legal requirements and financial experts conversant with the financial markets and institutions. The committee receives the product literature, then critically reviews it starting from conceptual level, thoroughly discusses it from all angles (concept and practice) and makes recommendations to the business team after exhaustive examination, either to retain the structure of the products as it is or redesign it in order to fully comply with the *Shari'ah*, the local regulations, and international standards.

However, if the product literature does not comply with all these relevant requirements, the business team shall have to revert to the ACE for further filtering, verification, vetting and issuing of certificate of compliance. This is one of the steps that distinguish the *modus operandi* of Islamic capital market from the conventional one. In all these processes, the *Maqāsid al-Shari'ah* guides all the decisions of the committee. The next filter is the identification of the contracting parties to obtain capital in the market and the sector it would be deployed to. Issues such as where it shall be utilized are a critical basis for the determination of whether it is *halāl* or *harām*. The intention of the contracting parties in the market must be hinged upon the *maslaha* or overall public interest and be in tune with the *Maqāsid al-Shari'ah* (*Shari'ah* objectives).

The objectives of the *Sharī'ah* are primarily geared towards protecting five essentials of life and therefore any financing arrangement must be structured to procure *maslaha* or increase and prevent *mafsada* (harm) or decrease it. Essentially, the sector, where the funding would be applied to, and the objective desired must be in consonance with the ethical *Sharī'ah* values and identity which would display a compliant Islamic Capital Market. Therefore, funding and channelling of it must be to satisfy *Sharī'ah* yearnings in improving the wellbeing of the *Ummah* (society) and not directing it into that which harms the morals. This filter is very strategic to the critical success factors of Islamic capital market operations.

In addition, part of the fundamentals required is that this literature (product concept paper) must be carefully designed under a clearly guided pattern such as the fundamentals of Islamic commercial law, up to the execution phase. As such, every aspect of the literature will also ensure it is free from the forbidden elements in sales or partnership transactions, such as *gharar*, *ribā*, *maysir* and *jahālah*. Once this design stage meets the fundamental requirements, it subsequently moves onto the second layer. The second filter or layer, which underscores the level, shall be governed by the concept that harm must be eliminated across the product concept, design or structure up to its implementation, starting by evaluating its means (product design) to its objectives, (funding needs). Once the key *Sharī'ah* requirements are met at this level, it becomes much easier in the subsequent layer.

An intention and the means to achieve it carry similar *Sharī'ah* ruling. In this regard, the *Sharī'ah* maxim declares that; “*wasīlah*” (means) takes the ruling of the intention “*maqāsid*”. What this maxim stresses or implies is that the objective, which a capital seeks to achieve, shall determine the *hukm* (ruling) to be applied to the underlying contract, which stands as the means to it. Thus, if the capital formation is structured to achieve a forbidden end, then the underlying contract, even though *halāl*, shall be declared *harām*. Consequently, the underlying contract as a means, which binds the agreement between parties in the capital market, would be void if the capital generated would be deployed towards a forbidden venture. For example, suppose the objective of the fund raising in the Islamic capital market is to finance a forbidden lucrative business such as recapitalizing a thriving conventional bank or financing a solar energy need of a conventional entity such as an insurance company or a gambling arena, then, even though the underlying contract or nominate contract is permissible, for example *Mudārabah* in this case, the *Mudārabah* contract shall automatically become forbidden because, while the means is permissible, the end is impermissible. This unique mode of operation in ICM is another astonishing difference between the style upon which ICM operates as opposed to how conventional capital market CCM does or would do without any

retribution. Clearly, the latter has no obligation or divine filter to constrain its operations, even if it fulfils the regulatory and governance conditions as stipulated by the regulating body in the financial system.

5.3.2 Information Disclosure and Transparency

Accountability in the Islamic financial system goes beyond the human and transcends towards Allah (the Most High). Before any stakeholder, Islamic capital market is accountable to Allah and then humans. What this means is that before earning material gain, ICM strives to enforce *Sharī'ah* in the transaction so as to please Allah (the Most High). If it does not constructively engage in that direction, its earnings would be *harām*. Therefore, one of the critical differentiating factors of Islamic capital market is that every activity must be executed to reflect the pleasure of Allah including information disclosure and transparency in all dealings. It would not achieve such feat without being transparent in all its dealings, first, in order to attain Allah's pleasure and, subsequently, fulfil the mandate of IFS. With such consciousness behind the scene, ICM makes a serious difference in its operations, structures, products and services.

Financial markets naturally grow efficiently and succeed organically through the concrete market culture of transparency.⁴⁴⁹ Therefore, without honesty between the parties in information disclosures and honest accurate price discoveries, etc., markets would often certainly crash.⁴⁵⁰ This crash in market is often inevitable because information is hidden from the public that needs it in order to actively participate in the market with total trust. Aside general lack of information disclosure in the market and hidden sharp practices, agency problems hamper general market growth, increase asymmetry problems, cost of doing business and sharply undermine the transparency of the market.

Agency issue happens when the agent's interest deviates from that of the principal such that the two interests would not converge in order to share prosperity but clearly diverge and shared prosperity would not happen. This certainly hampers the market growth and participation. The implication in this situation is that information distortion denies those who need accurate information for informed decision making. Information asymmetries exist in financial markets because no proper checks and balances exist. Accordingly, without the adequate disclosures and transparency, markets are headed towards total failure. Therefore, the fact that

⁴⁴⁹Huang, Y. S. Mengyu, L. & Carl, R. C. (2019). Financial Market Development, market transparency, and IPO performance, *Pacific-Basin Finance Journal*, Vol. 55, pp. 63-81.

⁴⁵⁰Bamir, A. Y. (2008). Issues of Transparency and Disclosure in the Saudi Stock Market. *Arab Law Quarterly*, pp. 63-87.

earnings are wrongly usurped from people unjustly is a potential risk to the earner. With the nature of Islamic capital market, which emphasises consciousness before Allah and man, the market ought not to be worried about lack of transparency and honesty due to the teachings of Islamic finance.

5.3.3 *Sharī'ah* Inputs in Fraud Prevention

As stated earlier, market fails when there is inadequate information on all the operations happening between the principals and their agents. It also fails when vital information is hidden from stakeholders in the market.⁴⁵¹ What this information starvation implies is that markets are weakened because sellers conceal critical information about their products and services from potential buyers who need them more in order to make proper strategic decisions based on available data.

Islamic law of commerce requires complete disclosure of the facts of the products and transparency and, hence, institutes a free will ability of customers to stipulate favourable terms and conditions when they consummate a contractual relationship. At this level, or even much higher, the *Sharī'ah* seriously abhors cheating or engaging in fraud in any form. The Prophet (peace be upon him) said, “Whoever cheats us is not one of us.”⁴⁵² In another *Hadīth*, Prophet Muhammad (peace be upon him) said, “If they (the seller and the buyer) speak the truth and disclose any defects, their transaction will be blessed for them; but if they tell a lie and conceal any defects, the blessing will be erased.”⁴⁵³ This means *Sharī'ah*-compliant capital market must be devoid of cheating by those entrusted with it or concealment of vital critical information about the true health of the market and final outcome in terms of gain or loss.

5.4 Conventional versus *Sharī'ah* Compliant Capital Market

Capital markets are an important part of the global financial infrastructure. In contrast to the money market, where short-term fund-raising takes place, the capital market is where corporations and governments raise long-term funds. These funds are typically required for periods in excess of one year and take the form of both debt and equity. The capital market functions through the stock exchange market. The stock exchange market is a market which facilitates buying and selling of shares, stocks, bonds, securities and debentures. It is a market for both old and new

⁴⁵¹Vertinsky, I. & Zhou, D. (2000). Product and process certification – Systems, regulations and international marketing strategies. *International Marketing Review*, Vol. 17, No. 3, pp. 231-253. <https://doi.org/10.1108/02651330010331606>.

⁴⁵² Sahīh Muslim, Hadīth 146.

⁴⁵³ Sahīh al-Bukhārī, Hadīth 2079 and Sahīh Muslim, Hadīth 1532.

instruments. A financial instrument is a monetary contract which binds those who supply funds in the market with those who utilize the funds.

The intermediaries in the financial system help create those financial instruments; make it attractive as asset classes for some but liability or equity to others. ICM is one of the two important aspects of the broader Islamic Financial Market. The other branch constitutes Islamic Banking and Islamic Insurance better known as *Takāful*. Instruments of ICM are contracts which create assets or liabilities or equities, which can be traded, exchanged in the market for either economic gains or hedging purposes for monetary policies. Some examples of these instruments are shares, bonds, futures and options. *Sharī'ah* compliant instruments may exclude some of these types of financial assets.

Every market has got its unique characteristics, specificity and purpose, where buyers and sellers meet and exchange goods and services. As a facilitator, every market got its products and services to facilitate the convergence between demand and supply in the system and to help in the optimal allocation of scarce resources for efficient use through these instruments. As indicated earlier, much of the available conventional instruments would fail the test of whether they are free from *ribā* because the concept is highly imbedded in them. As such, an equivalent alternative for each of the conventional instruments has to be structured for the market.

Most ICMs function in a dual financial system environment even though with constraints. Since this is not an ideal financial system operating free of interest rate dominance, ICM is constrained on many fronts to either adopt or adapt. The fundamental *Sharī'ah* ruling is permissibility in transactions. It implies that ICM might make significant or insignificant changes in the existing structure before it can adapt the conventional or fit into the system. In this regard, all the regulations applicable to conventional capital market with the exception of interest requirements in its functions, structures, financing, equally apply to ICM.

In addition to the normal regulatory capital requirements, the ICM must have in place an Advisory Committee of Experts ACE, which will oversee the structure of all the products, vet all the legal contracts, approve the underlying contracts before they may be deployed on a practical phase. The mode of operation of ICM is that it follows a strict procedure from inception or conceptual stage up to the applied phase of the deal. The prospectus would have to be approved by the ACE on a number of areas. The relevant areas include the content, the obligations and rights,

the underlying assets and the potential area of deploying the assets. This is an indication of the moral ground which the ICM emphasises.

Another aspect of ICM operation is strict adherence to a certified index screening process where a threshold in products is screened from the inception to consummation. Therefore, before the product is finally deployed in the market, the tradability of the product in the secondary market must be vetted by the ACE Board to ensure it passes the test of the *Shari'ah* specific requirements. Similarly, it must comply and be seen to be free from *ribā*, *gharar*, *maysir* and *jahālah*. During the screening, a capital market product must be extremely clear in its content and process. There is no ambiguity in the details provided and there are safety nets or redress for the contracting parties when issues arise.

Furthermore, the product shall be duly certified by the ACE members. They shall certify that the product does not contain hidden or open elements such as *gharar* or deception and that there is a clear exposure or disclosure of all the facts in the product. *Gharar* means uncertainty and confusion. Although the conventional regulatory requirement would have ensured that the product is free from elements which create confusion and non-disclosure, the product shall be subjected to additional requirements to ensure that it has fully abided by the spirit of *Shari'ah*.

Moreover, the ICM is unique in the sense that it is tied to the Islamic creed and that all the transactions are intended to satisfy Allah's pleasure. Therefore, in the process of consummating the product in the capital market, all omissions or mistakes which generate returns or wrongfully generate income to the market are properly accounted for and segregated.

5.5 Instruments of Islamic Capital Market

ICM products that are currently available in the market include the following:

a) *Shari'ah*-compliant Stocks/Equity Securities

Shari'ah-compliant equity securities are typically the common shares of quoted companies which have been certified as *Shari'ah* compliant for investment, having passed the screening exercise based on prescribed criteria. *Shari'ah* compliance means avoiding involvement through investing in proscribed activities such as leasing premises to a conventional bank or a casino, or an insurance company for its business, publication of propaganda tracts for non-Islamic evangelical organization, leasing of premises or equipment for holding idol worship, providing commercial transportation or printing cartons or labels for liquor bottles etc.

Equities are known to be risk prone as investors could either enjoy capital appreciation and dividends or suffer losses.

b) Islamic Unit Trust/Mutual Funds

An Islamic unit trust fund is a collective investment scheme that offers investors the opportunity to invest in a diversified portfolio of *Sharī'ah*-compliant equity securities, *Sukūk*, Islamic money market instruments and other *Sharī'ah*-compliant asset classes. However, many Islamic unit trust funds invest mainly in equity securities.

c) Islamic Real Estate Investment Trusts (REITs)

A REIT is an investment vehicle that invests the majority of its total assets in real estate either in the form of direct ownership or a single-purpose company whose principal assets comprise real estate assets. REITs typically offer competitive dividend yields, low correlation with common stocks and a potential hedge against inflation. The key difference between a conventional and Islamic REIT is the requirement for the income of the latter to be sourced from *Sharī'ah*-compliant rental and related activities. The operation of an Islamic REIT must also comply with the *Sharī'ah*, including its deposit and financing activities, as well as the acquisition and disposal of real estate.

d) Islamic Private Equity

Islamic private equity focuses on investments in privately owned *Sharī'ah*-compliant companies. In situations of significant investment size, such investors may opt for board representation in the investee company. A private equity investment provides investors with potential for relatively high returns as they also would assume higher risks due to the higher probability of failure. One exit mechanism for the investors when the company performs well is through a public listing.

e) *Sukūk*

One of the most popular Islamic capital market instruments is the *Sukūk*. *Sukūk* are an alternative to bonds as long-term debt instruments. Islamic stocks and bonds (*Sukūk*) are the two key securities in the Islamic capital markets. However, the Islamic bonds (*Sukūk*) dominate the Islamic capital markets. *Sukūk* holders claim an undivided beneficial ownership in the underlying assets. There are two basic processes and structures of the Islamic bonds (*Sukūk*) involved in its issuance depending on whether the borrower needs the funding for a new venture or for an existing one. These *Sukūk* come in varying modes such as *Ijārah*, *Mushārah*, *Mudārah*, *Wakālah bil Istithmār*, etc. The purpose of these unique products is to

have positive, visible impact on the real economy where there is a shared prosperity among the *Ummah*. All these instruments can either be asset based or asset backed. In designing these instruments, a key requirement and *Shari'ah* noble goal is the attribute of *Ihsan* (goodness) in equitable distribution of the proceeds of the venture amongst the parties, avoidance of *ribawi* activities, and prohibition of speculative behaviour.

Sukūk issuers may include governments, quasi-governments, public listed companies, private corporations and multilateral organisations. *Sukūk* holders are entitled to share in the revenues generated by the *Sukūk* assets as well as being entitled to share in the proceeds of the realization of the *Sukūk* assets. The claim embodied in *Sukūk* is not simply a claim to cash flow but an ownership claim and it confers a beneficial interest to the holder in terms of holding a proportional ownership of the underlying asset as well as the income that it generates. The *Sukūk* holder also assumes all rights and obligations for the maintenance of the asset. They are structured based on a *Shari'ah*-compliant contract of exchange of assets or services, or a contract of participation or partnership. Such contracts can be made through the sale and purchase of assets based on deferred payment, leasing of specific assets or participation in joint-venture businesses, hence, the issuance of *Sukūk* does not mean an exchange of paper for money with the imposition of interest but, rather, an exchange of *Shari'ah*-compliant assets for some financial consideration applying various products, such as *Musharakah*, *Mudarabah*, *Ijarah*, *Murabaha* and *Wakalah*, which allow investors to derive profits from the transactions. Diversity of structures and Islamic financial contracts used for the issuance of *Sukūk* provides flexibility to issuers in managing their distinct financing requirements – for example, for expansion of business, working capital, refinancing or project financing.

The relationship between the parties in *Sukūk* is governed by the relevant contracts selected by the obligor upon the issuance of *Sukūk* such as *Ijarah*, *Mudarabah*, etc. Therefore, the parties can have a partnership relationship if the contract is a *Musharakah* or lessor and lessee relationship if the contract is *Ijarah*. Hence the certificate holders who are the investors stand as the owners of the underlying asset. The return in *Sukūk* is either fixed or floating depending on the selected structure by the issuer; for example, the return is fixed if the structure is based on *Ijarah* and not fixed if the structure is equity based. The liability of the issuer depends on the performance of the underlying asset; in *Ijarah*, for example, it depends on the demand and supply of the leased asset in the market.

5.6 Regulatory and *Sharī'ah* Issues in Islamic Capital Market

There are some issues in the operational aspects of ICM bordering on regulation and *Sharī'ah* matters that merit attention.

a) Appointment of *Sharī'ah* Boards

Even though there are jurisdictions that specify the regulatory requirements for the appointment of *Sharī'ah* boards, there is a lack of standardised uniform requirements across all jurisdictions having ICM activities on who is eligible and with what specific qualifications to be appointed as a member of ACE. More so, in some jurisdictions, no formalized approach for *Sharī'ah* certification of ICM products exists.⁴⁵⁴

b) Monitoring of *Sharī'ah* compliance

Sharī'ah compliance for financial services typically means adherence to prescriptions related to structure of the ICM product and the underlying business. Almost all jurisdictions are unanimous in their position about prohibited transactions and businesses, although some differing positions exist with respect to weapons-related activities. However, despite these similarities, there is a widespread view that differences in screening methodologies for equities for example would prove to be a barrier to cross-border transactions – and so a barrier to development of the market.⁴⁵⁵ This therefore manifests as an issue for regulatory and *Sharī'ah* stakeholders in ICM.

c) Protection of Islamic Bank Depositors

Owing to the fact that Islamic banks with assets and liabilities different from conventional banks and being major participants in ICM operations, this poses some implication for the regulators of ICM. Real life experiences on policy issues are not widely made public due to caution being exercised by Central banks and finance ministries who try to avoid creating the impression of being hostile to Islamic banks with respect to protection of depositors.

As most of the liabilities of Islamic banks consist of investment deposits placed on a profit-sharing basis, this arguably reduces the banks' risk in comparison to deposits where interest must be paid regardless of the profitability or losses of the bank. Furthermore, in Islamic banks, the value of deposits is not even guaranteed, and their value may be reduced in the case of severe losses. Depositors may regard this as preferable to the bank going into liquidation, which could result in the

⁴⁵⁴IOSCO (2004).

⁴⁵⁵IFSB.

complete loss of all their funds with the bank. This therefore presents an issue for Islamic bank regulation.

d) Approval Process for *Sukūk* issuance

The involvement of *Sharī'ah* scholars in ICM is critical as mentioned earlier. For *Sukūk*, the approval process can demand considerable knowledge of legal and economic structures before certification can occur. This places considerable demands on the availability and expertise of *Sharī'ah* scholars, and this has been seen as an impediment to the wider acceptance of Islamic finance.⁴⁵⁶

e) Beneficial Ownership in Asset Based *Sukūk*

Among the contentious issues in *Sukūk* structuring is the issue of ownership of the *Sukūk* holders in a particular asset or a business venture. *Sukūk* is generally defined as “certificates with each *Sakk* representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a *Mudārabah*). These assets may be in a specific project or investment activity in accordance with *Sharī'ah* rules and principles. Since the *Sukūk* represents its holders' ownership over a certain underlying asset, some *Sharī'ah* scholars and practitioners have debated over whether the ownership status of the *Sukūk* holder is in accordance with *Sharī'ah* requirement.⁴⁵⁷

f) Purchase Undertaking (*Wa'd*) in *Sukūk*

There are a few issues relating to application of *wa'd* in *Sukūk* structure such as *wa'd* (unilateral undertaking) or *wa'dān* (two unilateral undertakings) vis-a-vis *muwā'adah* (bilateral undertaking), enforcement of *wa'd* etc. However, the most controversial issue regarding *wa'd* is the undertaking by the manager or partner in *Sukūk* *Mushārahah*, *Mudārabah* and *Wakālah bil Istithmār* structures to purchase the underlying asset upon the event of default or at maturity date at a pre-determined formula.⁴⁵⁸ An issue that arises here, also, is that the underlying asset may not have an existing market at maturity time. More so, a clear and fair valuation mechanism for the underlying asset, and by who, may not have been made available before maturity of the *Sukūk*.⁴⁵⁹

⁴⁵⁶IFSB.

⁴⁵⁷Ellias, M. R. F., Haron, M. N. & Mohammed, M. F. (2013). *Sharī'ah* issues in Sukuk. Presented at the *Sharī'ah* Forum, KLIFF, 23 September 2013, Istana Hotel, Kuala Lumpur, p. 1.

⁴⁵⁸Ibid, p. 8.

⁴⁵⁹ Abozaid, A. (2021). The Critical *Sharī'ah* Issues of Sukuk. *Journal of Islamic Economics*, Vol. 1, pp. 32-33.

g) Disclosure requirements for Islamic equity funds

Islamic screening is of course important for equity funds with the aim of excluding forbidden business activities such as breweries, manufacturers or distributors of pork products, gaming clubs and casinos and, of course, conventional banks. Thus, compliance to *Sharī'ah* is assured where companies that have over 1/3 outstanding debt to assets/market value are excluded. In the same vein, companies that have their cash and interest-bearing securities exceeding 1/3 of assets are to be excluded. In addition, where receivables and cash account for more than 50 percent of assets, the company stands excluded.

It should be noted here that, in many respects, the regulatory issues are like those with ethical funds in the Western world, where regulators, due to their inability, fail to endorse the stated criteria, instead strive to make clients of the fund feel assured that their wishes are fulfilled by the operation of the fund. Minimally, each fund should provide investors with information on what type of fund it is and whether its prime objective is capital growth or provision of a regular income. There should be regular statements provided of assets held in the portfolio and some indication of historical performance data.

Specifically, Islamic investor assurance should include details of the procedures to ensure *Sharī'ah* compliance and an indication of whether *Sharī'ah* advisors are reactive or proactive. The frequency of monitoring by the *Sharī'ah* Committee should be spelt out and a statement of *Sharī'ah* compliance in reports to investors is desirable.

Other Unresolved Issues on *Sharī'ah* Compliance of some Clauses and Structures in *Sukūk*

There are a few other unresolved issues related to compliance to *Sharī'ah* in some clauses and structures in *Sukūk*. These include issues of guaranteeing of capital or return to *Sukūk*-holders by other than a third party that is genuinely independent from all *Sukūk* parties;⁴⁶⁰ recourse to the underlying assets in *Sukūk*;⁴⁶¹ foregoing of one's rights (*tanāzul*);⁴⁶² and tradability of sale-based *Sukūk*.⁴⁶³

⁴⁶⁰ See: Abozaid, A. (2021). The Critical *Sharī'ah* Issues of Sukuk, pp. 36-37.

⁴⁶¹ See: Ellias et. al. (2013). *Sharī'ah* issues in Sukuk, pp. 4-7.

⁴⁶² Ibid, pp. 9-13.

⁴⁶³ Ibid, pp. 16-19. Also, see: Abozaid, A. (2021). The Critical *Sharī'ah* Issues of Sukuk, pp. 41-43.

5.7 Issues in *Sukūk* Default

As the *Sukūk* market continues to develop and spread to many parts of the world, the Islamic capital market has witnessed a series of *Sukūk* defaults in some countries for a variety of reasons. *Sukūk* default can be described as "the breach of any binding obligations under the original terms of the agreement between the issuer and holders of the *Sukūk* including credit and counter party risk; coupon payment risk; principal amount reimbursement risk; asset redemption risk; and *Sharī'ah* risk."⁴⁶⁴

Up until the end of 2009, at least 15 cases of *Sukūk* default were recorded worldwide. The cases of default rose to 21 in 2010 and by 2012 the cases increased to 31.⁴⁶⁵ Statistics have further shown that, from the late 1990s to 2016, of the estimated total 11,500 tranches amounting to USD 1.12 trillion of *Sukūk* issuances, 129 tranches amounting to USD 1.85 billion (representing about 17% of total *Sukūk* volume) had either nearly or outrightly defaulted. In Malaysia alone, 123 tranches of corporate *Sukūk* defaults by 23 issuers were recorded between January 2001 and September 2016.⁴⁶⁶

This section provides a brief analysis of some *Sukūk* default events, their factors and implications on the Islamic capital market in particular and Islamic finance industry in general. The objective is to draw attention to the lessons learned from the default cases and the way forward especially for emerging Islamic finance industries such as that of Nigeria.

5.7.1 Some High-profile Cases of *Sukūk* Default

Some high-profile cases of *Sukūk* default and their causes are outlined and briefly discussed below:

⁴⁶⁴ Kamarudin, M. F., Kamaluddin, N., Ab. Manan, S. K. & Mat Ghani, G. (2014). Defaulters profile in Malaysia Sukuk market. *Procedia - Social and Behavioral Sciences*, No. 145, p. 278.

⁴⁶⁵ Biuomy, M. A. M. (2021). Develop the Formal Protection Frameworks and the Insolvency and Liquidation Systems for the Islamic Financial Institutions. *Institute of Banking Studies Research*, p. 32. Available at <https://kibs.edu.kw/wp-content/uploads/2021/10/Develop-the-Formal-Protection-Frameworks-and-the-Insolvency-and-Liquidat....pdf>

⁴⁶⁶ Abu Umar Faruq, A., Muneeza, A., Omar Farooq, M. & Hasan, R. (2019). Post-Default Sukuk Restructuring: An Appraisal of Shari'ah Issues. in Hassan, M. K. and Rashid, M. (eds.). *Management of Islamic Finance Principle, Practice, and Performance. International Finance Review*, Emerald Publishing, Vol. 19, No. p. 115.

United States of America

The first case of *Sukūk* default revolves around East Cameron Partners (ECP). The *Sukūk* was launched in July 2006 as the first *Sukūk* in the US to raise around \$165.67 million based on *Mushārakah Sukūk* structure.

At a point, ECP found itself struggling with the periodic payments to the *Sukūk*-holders because of the shortfall of oil and gas production due to the damage done by a Hurricane in the area in September 2008. Some analysts alluded to the fact that it seems the intention of ECP was simply to access and raise cheap funds from the excess liquidity in the Muslim world which are considered as “a largely untapped resource.”⁴⁶⁷ To buttress the point, it was alleged that ECP attempted to wrap the *Sukūk* assets that were royalty interests on oil and gas revenues kept by the SPV, East Cameron Gas Company (ECGP) - a company registered offshore - into its domain, while the *Sukūk*-issuer had been publicised as bankruptcy tool.

The *Sukūk* was certified *Sharī'ah*-compliant by two prominent scholars. However, with the famous declaration of Mufti Taqi Usmani in November 2007 that 85% of the *Sukūk* issuances were not *Sharī'ah*-compliant, especially *Sukūk al-Mushārakah*, a development that backlashed the Islamic capital market industry, ECP used that to cover up its inability to meet its obligation towards the *Sukūk*-holders.⁴⁶⁸ ECP filed for bankruptcy protection under the US Bankruptcy Code for a reorganisation plan. However, the Bankruptcy Court rejected ECP's request to re-categorise the outstanding *Sukūk* as a secured loan facility and upheld that *Sukūk*-holders have a legal claim to the ownership of the underlying assets. Consequently, the re-organisation plan involved the exchange of the *Sukūk* Certificates for common stock of newly formed companies (East Cameron Offshore Properties, Inc). At the end, the *Sukūk*-holders became common equity holders.⁴⁶⁹

United Arab Emirates (UAE)

A few cases of *Sukūk* default have been reported in the UAE. Two famous cases are summarised hereunder:

- a) In November 2009, a near-default on a \$3.5 billion *Sukūk* issued by Dubai's state-owned property developer, Nakheel, occurred after the government of

⁴⁶⁷ Siddiquee, E. A. (2022). Case Studies of Sukuk Defaults: Lessons Learnt. p. 3. Available at https://www.zbw.eu/econis-archiv/bitstream/11159/520416/1/EBP083985956_0.pdf Ibid

⁴⁶⁸ Ibid, p. 4.

⁴⁶⁹ Biuomy, M. A. M. (2021). Develop the Formal Protection Frameworks and the Insolvency and Liquidation Systems for the Islamic Financial Institutions. *Institute of Banking Studies Research*, p. 36-37.

Dubai requested a 6-month standstill for its parent company, Dubai World. The case of Nakheel represented the fourth on the list of *Sukūk* defaults. Due to the high profile of the default and its being the largest ever *Sukūk* default, when it happened, investors became jittery. The fear of investors about the default led to the freezing of the entire Islamic debt market in the country due to uncertainty about how the default would be handled if it happened because the Islamic financial market was still quite young then, and there was no precedence.

There appeared to be no issue with *Sharī'ah* compliance as the *Sukūk* was issued using the *Ijārah Mawsūfah fi al-Dhimmah* (forward-lease) concept. However, the default was attributed primarily to the global financial crisis of 2007-2009, which caused Dubai to be at a standstill as its property market burst. Also, poor *Sukūk* structuring, insensible utilisation of funds and mismanagement of the assets further exacerbated the fallout from the global financial crisis.⁴⁷⁰ As an "asset-based" *Sukūk*, the structure gave the *Sukūk*-holders only the right to the stream of income generated by the assets but not on the assets themselves. In the end, the government of Abu Dhabi repaid the *Sukūk* in a last-minute intervention.

- b) Dana Gas, in the UAE also missed a payment on a *Sukūk* it issued. The *Sukūk* was issued in October 2007 with a maturity of 5 years. Initially, the proposed size was \$750 million but because of the compelling call from investors, the size reached \$1 billion.⁴⁷¹ The default occurred in October 2012. In December 2012, Dana Gas proposed a restructuring plan which was completed in May 2013. The plan included a cash payment of \$70 million to *Sukūk*-holders and the issuance of new *Sukūk* worth \$850 million.⁴⁷²

In June 2016, subsequent to its failure to get its *Sukūk*-holders to agree with the proposed restructure, Dana Gas announced that, based on legal advice, the *Sukūk* issued by the company did not comply with *Sharī'ah* in its current form and thus a restructuring was necessary. The reason given by the company for the restructuring raised a lot of concern and tension in the *Sukūk* market. According to the company, due to the absence of a central *Sharī'ah* board, the *Sukūk* were structured on a *Mudārabah* contract at a pre-determined purchase price, which allows the capital provider to share profit between themselves at an agreed ratio or percentage at the expense of the *Sukūk*-holders. It was also found that the *Sukūk* promised a fixed profit rate at the beginning of the contract. Consequently, it made an application to

⁴⁷⁰ Abu Umar Faruq *et. al.*, pp. 123-124.

⁴⁷¹ Siddiquee, E. A. (2022). Case Studies of Sukuk Defaults: Lessons Learnt. p. 6.

⁴⁷² Biuomy, M. A. M. (2021). Develop the Formal Protection Frameworks and the Insolvency and Liquidation Systems for the Islamic Financial Institutions, p. 35.

declare its debt “unlawful and unenforceable” and halted its *Sukūk* payments. It sought to replace the *Mudārabah* structured *Sukūk* with bonds paying less than half of the *Sukūk* profit rate.⁴⁷³

Subsequent to a 2018 High Court ruling in favour of the *Sukūk*-holders, the *Sukūk* were restructured and reduced to \$530 million from the outstanding \$700 million using an *Ijārah* structure maturing in October 2020. Dana Gas also paid \$235 million on redemptions.⁴⁷⁴

Kuwait

Two cases of *Sukūk* default occurred in Kuwait in May, 2009 and April, 2010:

- a) The Investment Dar (TID) defaulted on its two tranches of *Mushārah* *Sukūk* worth \$100 million and \$150 million in 2009. The TID cases, which marked the first *Sukūk* default in the Gulf region and the second on the list of *Sukūk* default globally, were issued in 2005 and 2006, respectively, each for a five-year period.⁴⁷⁵

The global financial crisis of 2007 through 2009 undermined the Kuwait financial market as a result of which TID faced financial distress and became the first Kuwaiti *Sukūk* to default the first in the Gulf region which occurred in 2009 following its failure to honour the periodic disbursements on the \$100 million *Sukūk* and later the second *Sukūk* defaulted in the same year. TID asked the Court to issue a standstill on all of its debt for a provisional period.⁴⁷⁶

Even though the *Sukūk* was structured based on *Mushārah*, which on the face value did not violate the principles of *Sharī'ah*, in the contract, it was observed that TID promised to buy back the share from the investors at the end of the period or in case of insolvency at nominal or par value rather than market value. This amounted to guarantee of capital in a *Mushārah* contract similar to conventional bonds but contrary to the *Sharī'ah* principles as it violates the concept of risk-sharing.⁴⁷⁷

⁴⁷³ Abu Umar Faruq *et. al.*, pp. Ibid, 124-125.

⁴⁷⁴ Biuomy, M. A. M. (2021). Develop the Formal Protection Frameworks and the Insolvency and Liquidation Systems for the Islamic Financial Institutions, p. 35.

⁴⁷⁵ Ibid, p. 36.

⁴⁷⁶ Siddiquee, E. A. (2022). Case Studies of Sukuk Defaults: Lessons Learnt, p. 4.

⁴⁷⁷ Ibid, pp. 5-6.

TID agreed with *Sukūk*-holders and shareholders to restructure the debt over a six-year period. The approved plan included the repayment of the debt in tranches, the conversion of a proportion of debt into equity in the company, and a liquidity injection by the shareholders within a year.⁴⁷⁸

- b) International Investment Group (IIG), based in Kuwait also defaulted on a \$3.35 million payment on its \$200 million *Mudārabah Sukūk* in April, 2010. The company sent a non-payment notice to the *Sukūk*-holders. Like TID, the global financial crisis that undermined the Kuwait financial market also affected IIG. However, despite the defaults and the non-payment notice, IIG claimed that it and its businesses were continuing to trade on a normal basis and the day-to-day operations of its businesses had not been affected by the non-payment notice. Another irony observed by Islamic finance experts was the fact that both IIG and TID defaulted *Sukūk* issuances took place, presumably offshore, despite the fact that Kuwait had no *Sukūk* or trust laws in place at that time. This exposed *Sukūk*-holders to unmanageable legal and regulatory risks.⁴⁷⁹

At the end, IIG sought to establish a forum to enable it to engage in a constructive dialogue with all of its creditors with a view to ensuring that its businesses continue to operate on a normal basis. In September 2010, the shareholders of IIG voted to reduce its capital by 55.8 percent to cover losses. The company developed a restructuring plan for a newly adjusted and manageable repayment schedule for *Sukūk*-holders.⁴⁸⁰

Malaysia

In Malaysia, information from RAM, the Malaysia rating agency, has confirmed that no fewer than 24 *Sukūk* defaults were recorded over the period 2002-2010 out of which nine were considered high-profile cases.⁴⁸¹

⁴⁷⁸ Biuomy, M. A. M. (2021). Develop the Formal Protection Frameworks and the Insolvency and Liquidation Systems for the Islamic Financial Institutions, p. 36.

⁴⁷⁹ Parker, M. (2010). Sukuk defaults turn spotlight on governance process. *Arab News*, 09/08/2010. Available at <https://www.arabnews.com/node/352244>

⁴⁸⁰ Biuomy, M. A. M. (2021). Develop the Formal Protection Frameworks and the Insolvency and Liquidation Systems for the Islamic Financial Institutions, p. 36.

⁴⁸¹ Ibid, p. 34.

Table 3 presents a summary of the high-profile *Sukūk* default cases that occurred in Malaysia up until 2010.

Table 3: High-profile default cases in Malaysia 2002-2010

Issuance Date	Issuer	Type of <i>Sukūk</i>	Amount (RM in million)	Default Date
25/01/1999	Johor Corporation	Murābaha Islamic Debt Securities	500	27/06/2022
28/10/2005	Memory Tech Sdn Bhd	Bai' bi Thaman 'Ājil Islamic Debt Securities	320	07/06/2007
22/02/2001	Maxisegar Sdn Bhd	Bai' bi Thaman 'Ājil Islamic Debt Securities	300	10/03/2006
21/09/2000	Europlus Corporation Sdn Bhd	Bai' bi Thaman 'Ājil Islamic Debt Securities	250	10/03/2006
31/01/2006	Nam Fatt Corporation Berhad	Murābaha ICP/IMTN	250	06/04/2010
17/05/2007	Malaysian International Tuna Port Sdn Bhd	Bai' bi Thaman 'Ājil Islamic Debt Securities	240	18/11/2009
01/04/2004	Pesaka Astana (M) Sdn Bhd	Bai' bi Thaman 'Ājil Islamic Debt Securities	200	30/09/2005
13/04/2007	Straight A's Portfolio Sdn Bhd	Murābaha Underwritten Notes Issuance Facility	200	11/12/2009
24/07/2003	Perspektif Perkasa Sdn Bhd	Murābaha Underwritten Notes Issuance Facility	188	10/03/2006

Source: Ab Majid, H., Shahimi, S. & Abdullah, S. H. S. B (2021). Sukuk Defaults and Its Implication: A Case Study of Malaysian Capital Market. 8th International Conference on Islamic Economics and Finance, Qatar, pp. 11-12.

A further breakdown of *Sukūk* default events shows that from 1990 to 2012, there were at least 36 cases of corporate *Sukūk* defaults by 33 issuers with the defaulted

value amounting RM 6.848 billion in Malaysia market.⁴⁸² In 2006, three corporate *Sukūk* defaulted and increasing to five instances each in 2007 and 2008. In 2009, the number of corporate defaulted *Sukūk* in Malaysia rose to nine instances before dropping to two instances in 2010.⁴⁸³ A more recent report shows that from 2008 to 2019, a total of 49 *Sukūk* defaults were recorded. Within this period, 2009 had the highest cases of default with 15 default events while 2008, 2010, 2011, 2012 and 2013 recorded nine, eight, three, eight and two cases respectively. One case each was reported for 2014, 2016, 2017 and 2019.⁴⁸⁴

Overall, the first *Sukūk* default in the Malaysian capital market was Murābaha Islamic Debt Securities issued by Johor Corporation (JCorp), a market-driven Johor State Government-linked Corporation. The RM500 million *Sukūk* was issued in January 1999 and defaulted after three years in June 2002 representing the largest amount of *Sukūk* default in the history of the Malaysian capital market. In 2016, 1Malaysia Development Berhad (1MDB) defaulted on two *Sukūk* it had issued for a combined value of 7.4 billion-ringgit. This followed a financial scandal that led to the disappearance of billions of dollars from state fund. The US Justice Department estimated about \$4.5bn was diverted from 1MDB, \$1bn of which may have been laundered in the country with the purchase of real estate, yachts, jewellery and works of art among other goods. For its role in the scandal the Securities Commission Malaysia reprimanded Deloitte because it failed to report irregularities detected in the *Sukūk* Murābaha Programme. Goldman Sachs had to reach a \$3.9bn settlement with the Malaysian government for its role in the scandal.⁴⁸⁵

It is worth noting that, unlike the default that occurred in Kuwait and UAE, Malaysian *Sukūk* defaults did not cause too many problems to the capital market. According to Islamic finance experts, this is not unconnected to the fact that Malaysia has a developed legal framework that lets banks handle defaults in a manner similar to conventional bonds.

Saudi Arabia

In Saudi Arabia, Sād Group, a Saudi conglomerate, defaulted on periodic disbursements on its Bahrain's \$650 million Golden Belt Sukuk in November 2009.

⁴⁸² Kamarudin, M. F., Kamaluddin, N., Ab. Manan, S. K. & Mat Ghani, G. (2014). Defaulters profile in Malaysia Sukuk market, p. 278.

⁴⁸³ Ibid, p. 281.

⁴⁸⁴ Lim, J. (2022). How does a bond or sukuk default affect your portfolio? <https://www.imoney.my/articles/bond-sukuk-default>

⁴⁸⁵ <https://www.islamicfinance.com/2020/08/sukuk-went-bust/#/?playlistId=0&videoId=0>

The default represented the third on the list of *Sukūk* defaults. The originator company was found providing improper and misleading information that was never delivered to the regulators. As a result, the Saudi Arabian Monetary Authority froze the group's assets in May, 2009, leading to a severe internal liquidity crisis.⁴⁸⁶ Corruption and fraud charges of \$10 billion were filed against the owner of Sād Group for misuse of funds. This led to the *Sukūk* default.⁴⁸⁷

As investors sought to take enforcement action, the *Sukūk* structure was found not to be bankruptcy proof as a signature on a legal document was not genuine and unenforceable under Saudi Arabian law. This means sufficient steps were not taken by the Trustee to ensure that it had security over the assets of the *Sukūk*.⁴⁸⁸

A royal commission was created to restructure debts of the *Sukūk* issuer, Sād Group. However, in the end, the Commission only addressed the amount owed to local investors and ignored claims made by foreign creditors. The Saudi authority failed to facilitate Golden Belt's foreign investors' access to assets held by the *Sukūk*'s sponsor, or enforce a promissory note that the Sād Group's owner had provided those investors.⁴⁸⁹

The outcome of the Golden Belt 1 *Sukūk* default clearly showed that investors are ultimately subject to decisions made following the *Sukūk* issuer's home jurisdiction, regardless of whether it contravened international best practices or any other country's laws. The case demonstrated the importance for *Sukūk* arrangers (parties who are responsible for implementation and management of issuance in accordance with the provisions of law in force in the capital market) to ensure that they fulfil their obligations, which the industry recognised as being inherent to the transaction, including ensuring proper execution of transaction documents. It also highlighted the need for arrangers and other relevant parties to revisit the scope of the

⁴⁸⁶ Lukonga, I. (2015). Islamic Finance, Consumer Protection, and Financial Stability. IMF working paper, WP/15/107, p. 18. Available at <https://www.imf.org/external/pubs/ft/wp/2015/wp15107.pdf>

⁴⁸⁷ Wijnbergen, S. & Zaheer, S. (2013). Sukuk Defaults: On Distress Resolution in Islamic Finance. Duisenberg school of finance - Tinbergen Institute Discussion Paper, p. 27.

⁴⁸⁸ Al-Mahmoud, H., Bakhsh, M. & Aref, S. (2017). Sukuk defaults – Country wise analysis. Available at <https://ifinanceexpert.wordpress.com/2017/08/17/sukuk-defaults-country-wise-analysis/>

⁴⁸⁹ The Editor (2013). Special Focus: Islamic Finance - Clearing the air on sukuk defaults. The Edge weekly edition of Aug 26-Sept 1. Available at <https://theedgemaalaysia.com/article/special-focus-islamic-finance-clearing-air-sukuk-defaults>

disclaimers which are typically relied upon in offering documents and the description of risk factors in offering documents.⁴⁹⁰

5.7.2 Key Factors of *Sukūk* Default

In general, the key factors of *Sukūk* defaults are:⁴⁹¹

- a) ***Failure to pay on time:*** If the issuer fails to make a timely payment as agreed upon, then, it leads to a possibility of default on that issue.
- b) ***Lack of strict regulations supportive of avoiding *Sukūk* defaults:*** This is also considered a cause that leads to *Sukūk* defaults. Where the laws and regulations of a country regarding Islamic capital market are not robust as to be able to prevent *Sukūk* defaults, the likelihood of default to occur is high. The presence of strict laws and regulations that regulate the *Sukūk* market was what protected Malaysia from the negative impact of the tens of *Sukūk* defaults witnessed in the country.
- c) ***Absence of structural integrities:*** This is another factor for *Sukūk* default. Many *Sukūk*-holders have the perception that all *Sukūk* contracts are “asset-backed” and therefore give them a claim on the assets in the event of a default. However, *Sukūk* that are asset-based, provide investors with only an ownership interest in the cash flows but not of the assets themselves. Lack of structural integrities in structuring *Sukūk* in the form of shared risk and real asset backing is considered mainly responsible for some *Sukūk* default cases such as the case of Kuwait’s Investment Dar and Global Investment House, Sād Group in Saudi Arabia, and the UAE’s Dubai World.
- d) ***Mimicking conventional bonds:*** The cases of outright and near default of East Cameroon Sukuk and Nakheel Sukuk respectively were attributed to mimicking of conventional bonds in their structure with regard to the risk of default, which necessitated issuers (like borrowers in conventional bonds) to guarantee both fixed income as well as capital instead of a third party that had no interest in the issuance. The debt-like structure of conventional bonds was incorporated to the *Sukūk* through the inclusion of income and capital guarantees in the structures, thus making failure to make a periodic payment on time or to redeem the principal amount on the due date to show up the way of “default”.

⁴⁹⁰ Trowers & Hamlins (2018). Missing Wet Ink Signature in the Golden Belt Sukuk. <https://www.trowers.com/insights/2018/may/missing-wet-ink-signature-in-the-golden-belt-sukuk>

⁴⁹¹ For a detailed discussion on the key factors of *Sukūk* default, see: Abu Umar Faruq *et. al.*, pp. 116-119.

- e) **Ambiguity and confusion:** The existence of ambiguity in some *Sukūk* contracts has contributed to the failure of some *Sukūk*. For example, the prospectus of Nakheel Sukuk in Dubai included an ambiguous statement that “judicial precedents in Dubai have no binding effect on subsequent decisions.” Even though by definition the *Sukūk* was *Sharī’ah*-compliant, the desire of the Nakheel *Sukūk* issuers to attract both investors who were looking for an Islamic product and the community of global investors led them to adopt most features of conventional interest-bearing bonds. There was also a confusion about potential claims such as Dubai as a part of UAE was responsible for the debts of companies it owned, such as Dubai World, which turned out not to be the case. In addition, although the *Sukūk* was a *Sharī’ah*-compliant product, it was being governed by English law.
- f) **Breach of contract:** This is another factor that could lead to *Sukūk* default. Breach of *Sukūk* contract occurs where the issuer breaches its fiduciary responsibilities concerning the original terms of the agreement between itself and the *Sukūk*-holders.

5.7.3 Implications of *Sukūk* Default

Sukūk defaults have triggered numerous questions about the underlying structures and capability of the *Sukūk* as an alternative source of funding. The questions include: were the principles of *Sharī’ah* followed properly in the first place? Is it possible for *Sukūk* to default as it has characteristics of equity? Do investors have any option for *Sukūk* assets? Did the defaults occur because of flaw in the Islamic finance approach or the non-compliance of principles of Islamic finance?⁴⁹²

The defaults therefore raised serious questions not just about the internal controls and business governance of the defaulting institutions but also of the Islamic financial and capital market regulators. In addition, the defaults question the business models of the institutions especially their models for generating cash flows to meet their future obligations such as the periodic payments for their *Sukūk* issuances.

Most of the questions are considered very crucial since they affect the welfare of all stakeholders. The defaults also laid down more emphasis on the need to identify default risk in *Sukūk* in order to better supervise and manage its affiliated risks.

⁴⁹² Siddiquee, E. A. (2022). Case Studies of Sukuk Defaults: Lessons Learnt, p.1.

5.7.4 Way Forward for *Sukūk* Market

Despite the tens of *Sukūk* defaults recorded in the past years in several countries, it seems *Sukūk* is still in demand and actually growing and becoming very popular. The increasing demand can be attributed to the growing awareness about its potentials and viability.

According to Islamic finance experts, the defaults and potential defaults of *Sukūk* in Malaysia as well as in most countries that experienced default was not caused by the fact that they are Islamic financial products, but driven by the market and credit risks. In other words, *Sukūk* defaults were not caused by faulty structures, but mainly due to the deteriorating credit positions of the issuers or companies' failure.⁴⁹³

The way forward to protect *Sukūk* from default and eventual liquidation is to ensure that basic principles of the *Sharī'ah*, irrespective of the types, structure, and jurisdictions of *Sukūk* are strictly adhered to. Also, the approval of *Sharī'ah* Advisory Board must be obtained after the Board members' thorough review of the *Sukūk* proposed structure and all transaction documents.⁴⁹⁴

⁴⁹³ Kamarudin, M. F., Kamaluddin, N., Ab. Manan, S. K. & Mat Ghani, G. (2014). Defaulters profile in Malaysia Sukuk market, p. 278.

⁴⁹⁴ Abu Umar Faruq *et. al.*, p. 126.

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6

ISLAMIC INVESTMENT FUNDS

6.1 Introduction

Beside the traditionally dominant institution of Islamic banks in the Islamic finance plane, some other not widely noticed platforms for raising and disbursing funds exist and progress in leaps and bounds across jurisdictions. One of such is the Islamic investment funds in different structures and for varying purposes. For instance, although the Glorious *Qur'ān* did not specifically address the issue of equity financing, it is definite and firm in denouncing and forbidding all forms of interest-based financial transactions - regardless of any terms or pretexts that might be illicitly employed to justify or validate their use, or to suggest that they are, in any way, Islamic.

It suffices to mention here that a joint pool where investors make a contribution of their surplus money for the purpose of its investment to earn lawful (*halāl*) profits in strict conformity with the precepts of *Sharī'ah* law is known as an Islamic investment fund. This chapter focuses on Islamic investment funds, their distinguishing features, types, and dynamics.

6.2 Concept of Islamic Investment Funds

Islamic Investment Funds (IIFs) also called Islamic mutual funds (IMFs) or *Sharī'ah*-compliant investment funds (SCIIFs) are investment funds governed by the requirements of *Sharī'ah* principles and rules. It has been defined as “a joint pool wherein the investors contribute their surplus money for the purpose of its investment to earn *halāl* profits in strict conformity with the precepts of Islamic *Sharī'ah*.”⁴⁹⁵

The subscribers of the Fund may receive a document certifying their subscription and entitling them to the pro-rated profits actually accrued to the Fund. The documents evidencing subscription may be called "certificates", "units", "shares", or may be given any other name. However, their validity in terms of *Sharī'ah* is subject to fulfilling two basic conditions. Firstly, that the certificate carries a pro-rated profit actually earned by the Fund such that neither the principal nor a rate of profit is guaranteed. On their part, the subscribers must enter into the fund with a clear understanding that the return on their subscription is tied up with the actual profit earned or loss suffered by the Fund. This means, if the Fund earns huge

⁴⁹⁵ Usmani, M. T. (1998). *An Introduction to Islamic Finance*, p. 140.

profits, the return in their subscription will increase to that proportion; and, in case the Fund suffers loss, they will have to share it also, unless the loss is caused by negligence or mismanagement, in which case the management, and not the Fund, will be liable to compensate it. Secondly, the amounts so pooled together must be invested in a business acceptable to the *Sharī'ah*. It means that, not only the channels of investment, but also the terms agreed with them, must conform with Islamic principles.⁴⁹⁶

IIFs are considered to be a type of socially responsible investing. Like most social investments, IIFs will care about both financial return and social impact created for beneficiaries. In addition, similar to other socially responsible funds within the environmental, social and governance (ESG) universe, the funds screen potential portfolio investments for specific requirements desired by subscribers. IIFs arose only in the mid-1980s even though the concept was first developed in the late 1960s. Its aim was to offer particularly Muslim investors alternative investment vehicles that would operate in line with the principles and rules of *Sharī'ah*.⁴⁹⁷

6.3 Distinguishing Features of Islamic Investment Funds

Islamic investment funds are similar to conventional funds in terms of the common objectives that they share, such as pooled investment, capital preservation and returns optimisation. The two sets of funds are also similar in the areas of (i) determining clients' financial needs and objectives; (ii) financial analysis of investments; (iii) selection of assets and securities; (iv) investment planning and strategies; and (v) portfolio monitoring and periodic rebalancing. The distinguishing feature between the two types of funds is that IIFs must always comply with *Sharī'ah* rules and principles in terms of their operations, activities and investments.⁴⁹⁸

For IIF to be a *Sharī'ah*-compliant one, it must avoid investments in businesses that violate Islamic laws such as those involved in tobacco, alcohol, biotechnology for human cloning, arms/weapons,⁴⁹⁹ as well as in companies that have their capital

⁴⁹⁶ Ibid.

⁴⁹⁷ Hariri, M. (2022). Characterization of Islamic Investments Funds: A Systematic Literature Review. *International Journal of Economics and Finance*, Vol. 14, No. 5, p. 14.

⁴⁹⁸ COMCEC (2018). Islamic Fund Management. The COMCEC Coordination Office, p. 13.

⁴⁹⁹ Some scholars based the prohibition on sale of weapons during *fitnah* (sedition) on a *Hadīth* transmitted by Al-Bazzār (3333) and others from Imrān bin Husayn (may Allah be pleased with him) that the Prophet (peace be upon him) "forbade the sale of weapons during strife." However, this *Hadīth* has been declared very weak by *Hadīth* experts. In place of it, many scholars relied on a statement attributed to Imrān bin Husayn (may Allah be pleased with him) himself that he disliked the selling of weapons during *fitnah*. The report occurred in *Sahīh al-*

structures relying heavily on debt to avoid dealing in interest.⁵⁰⁰ The investors who contribute their money are entitled to profits when earned in permissible ways, that are devoid of fixed return based on a face value, but pro-rated as earned by the Fund. Where losses arise, unless it is established that mismanagement or negligence is the cause, the losses are to be shared accordingly.

Consequent upon this main difference, COMCEC outlined six key differentiating criteria that distinguish IIFs from conventional funds as adopted from ISRA:⁵⁰¹

(a) *Contractual relationship*

The relationship can be based on either *Wakālah* (agency) or *Mudārabah* (profit-sharing) contracts. Under a *Wakālah* contract, investors are the *muwakkil* (principal) while the fund manager is the *wakīl* (agent). The agent manages the investors' funds on a fee basis. Under a *Mudārabah* contract, the investors are the *rabb al-māl* (capital providers) and the fund manager is the *mudārib* (manager of the fund).

(b) *Sharī'ah compliant portfolios*

The portfolios that the fund invests in should comply with *Sharī'ah* requirements. The *Sharī'ah* screening of investments such as stocks and real assets is essential to determine their acceptability or otherwise.

(c) *Role of Sharī'ah Board/Advisor*

Bukharī. A similar statement was reported by Ibn Abī Shaybah from both Al-Hasan Al-Basari and Ibn Sīrīn. The wisdom behind the warning against the sale of weapons during strife is to prevent the uncontrolled proliferation of weapons and its falling in the hands of unauthorised persons who could in turn use it to breach peace, oppress and/or terrorise others, spill the blood of innocent people, violate the sanctity of life, and spread mischief and anarchy in the land. Therefore, financing the purchase or sale of weapons to unauthorised persons during *fitnah* amounts to helping or cooperating in sin and transgression, which Allah (the Most High) forbade in *Qur'ān*, 5:2. The ruling would change from prohibition to permissibility if the financing is meant to facilitate the purchase of weapons by constituted authority to use it to justly maintain law and order, restore peace and build peaceful co-existence, combat insurgency, insurrection, anarchy, and banditry, etc. In this case, the purchase and acquisition of weapons is a means to a noble cause and hence the ruling would change since the reason behind the prohibition has changed.

⁵⁰⁰ Naveed, F., Khawaja, I. & Maroof, L. (2020). Are Islamic mutual funds exposed to lower risk compared to their conventional counterparts? Empirical evidence from Pakistan. *ISRA International Journal of Islamic Finance*, Vol. 12, No. 1, p. 71.

⁵⁰¹ Ibid, p. 14. Also, see COMCEC (2018). Islamic Fund Management. Proceedings of the 11th Meeting of the COMCEC Financial Cooperation Working Group. <https://www.comcec.org/wp-content/uploads/2021/07/11-FIN-PRO.pdf>

The Fund is required to appoint a *Sharī'ah* board or advisor to monitor, evaluate and ensure that the fund's activities comply with *Sharī'ah* principles and rules, particularly on the investment aspects. For instance, it sets out the methodology of assessing *Sharī'ah*-compliant stocks or ensures that existing *Sharī'ah* screening guidelines are followed. The board/advisor also advises the fund on the stock disposal process in case the stocks become non-*Sharī'ah* compliant. Rulings issued by the *Sharī'ah* board are binding on the fund and its manager except where an error is proved.

(d) *Sharī'ah governance process*

IIFs must ensure that there is constant monitoring of its investments and activities through *Sharī'ah* reviews and audits of its processes to ensure its compliance with *Sharī'ah* principles. The exercise can be undertaken by either the *Sharī'ah* board/advisor or a recognised and qualified third party.

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(e) *Purification of impure income*

Due to unavoidable market conditions, *Sharī'ah* scholars have set a limit on the percentage of impure income that is allowed to be accrued in IIFs. To cleanse the fund of any non-*Sharī'ah* compliant income generated from investments in companies that have exceeded the tolerable benchmark of the *Sharī'ah* screening process, the non-compliant amounts should be donated to charitable organisations approved by the *Sharī'ah* board/advisor. Investors seeking a fully *Sharī'ah*-compliant investment need to cleanse their share of impure income that has accrued in the company's account to the extent of their share of investment in the company.

(f) *Fee structure*

Under a *Wakālah* structure, a management fee is applicable. At times, the investment manager may deduct the fee upfront before the investors' funds are invested. *Wakālah* may also include a performance related fee. Under a *Mudārabah* structure, the profit is shared, as determined in the investors' agreement.

Basically, there are two types of assets which investors can invest in, namely, real assets and financial assets (i.e., securities).⁵⁰² *Sharī'ah*-compliant securities are not associated with only *halāl* or lawful practices, but also related to good image in the physical context of the company that issues the stock. For example, quality, safety, environmental friendliness, and process efficiency are factors that are considered in deciding whether or not to invest in a stock. These considerations further

⁵⁰² Zainudin, N. B., Miskam, S. B. & Sulaiman, M. B. (2014). Revised Shariah Screening Methodology for Shariah-Compliant Securities: New Standard to Meet Global Expectation, p. 77.

underscore the importance of having a proper *Sharī'ah* screening process in the financial market to enable investors invest in companies that operate permissible business activities.⁵⁰³

According to Hariri, two criteria for selecting the portfolio for IIFs, namely, positive screening and negative screening have been documented in the literature. Positive screening, on the one hand, emphasises investment in companies with higher standards in matters of corporate governance or environmental protection, and have a positive impact on the economy and other relevant areas of the society. In practice, this type of screening is rarely used to choose investment outlets or decide whether to invest in a company or not. Negative screening, on the other hand, aims to identify “bad” companies to avoid investing in them. It establishes the first stage in eliminating non-*Sharī'ah*-compliant sectors or industries and, at the second level, eliminates companies with financial ratios that exceed the acceptable level.⁵⁰⁴

Sharī'ah screening criteria are categorised mainly into qualitative criteria and quantitative criteria. Two groups exist under qualitative measures (business activities) namely (i) financial activities orientation; and (ii) indices with non-financial activities orientation. The measures focus on sector and activity-based screening. Quantitative measures (financial ratios) are further categorised into several groups based on different adoption in the nominator, denominator and tolerate percentage used. The measures focus on financial screening. The screening involves two major activities. First, is to ensure that a company's main assets are neither predominantly cash or cash-related in order to avoid trading of cash for cash at a discount or premium (which amounts to dealing in *ribā*}; nor in the form of debts (receivables) in order to avoid *ribā* in debt trading (*bay' al-dayn*). Second, is to ensure that a company is not involved directly or indirectly in interest-related activities (interest-based borrowing or investment) that exceed the tolerable benchmark specified within the criterion.⁵⁰⁵

Over the years, several *Sharī'ah*-screening methodologies and indices have been developed by organisations/institutions. Nine of such screening methodologies are: (i) Accounting and Auditing Organization for Islamic Financial Institutions

⁵⁰³ Ibid.

⁵⁰⁴ Hariri, M. (2022). Characterization of Islamic Investments Funds: A Systematic Literature Review. *International Journal of Economics and Finance*, Vol. 14, No. 5, pp. 19-20.

⁵⁰⁵ Ayedh, A. M. A., Shaharuddin, A. & Kamaruddin, M. I. H. (2019). Shariah Screening Methodology: Does It 'Really' Shariah Compliance? *IQTISHADIA Jurnal Kajian Ekonomi dan Bisnis Islam*, Vol. 12, No. 2, pp. 148-150.

(AAOIFI); (ii) Dow Jones Islamic Market Indexes (DJIMI); (iii) Kuala Lumpur *Shariah* Index (KLSI); (iv) Financial Times Stock Exchange *Shariah* Global Equity Index (FTSE); (v) Standard & Poor's *Shariah* Indices (S&P); (vi) Morgan Stanley Capital International World Islamic Indices (MSCI); (vii) Thompson Reuters Ideal Ratings Islamic Indices; (viii) STOXX Europe Islamic Index; and (ix) ISRA Bloomberg *Shariah* Stock Screening Indices.⁵⁰⁶

The AAOIFI screening criteria are used by index providers more than the others. This is because, as a standard-setting body for Islamic financial institutions, its standards have gained acceptance across many jurisdictions on either mandatory or recommended basis. Even in countries where they have not been fully adopted, like Malaysia and Pakistan, they are still heavily relied upon. Its *Sharī'ah* screening criterion is therefore crucially important for many index providers. Many stock exchanges, like Oman, Maldives, Philippines, and institutions, like Azzad, Alfa Bank have adopted AAOIFI's *Sharī'ah* screening criteria for developing index or investing in stocks.⁵⁰⁷

Table 4 presents a summary of the screening criteria for six out of the nine organisations with *Sharī'ah*-screening criteria. The contents are adapted from Ayedh *et. al.*⁵⁰⁸

Table 4: Summary of the *Sharī'ah*-screening criteria for six organisations

	% level of mixed contributions from activities that are clearly prohibited	Qualitative criteria	Quantitative criteria
AAOIFI	5%	Company should not be mainly involved in any impermissible business activities such as activities based on <i>ribā</i> (like conventional banks), trading in <i>gharar</i> (like insurance companies), <i>maysir</i> (like casinos), manufacturers or traders of impermissible	Interest taking deposits less than 30% to market capitalisation of total equity; (ii) Interest bearing debt less than 30% to market capitalisation of the corporation; and (iii) Total market value of illiquid assets more than

⁵⁰⁶ Ibid, p. 150.

⁵⁰⁷ Ibid, 151.

⁵⁰⁸ Ibid, pp. 151-162.

		products or services (like liquor, pork and prostitution)	30% to market value of the total assets.
Dow Jones Islamic Market Indexes (DJIMI)	5%	Company should not belong to any of the following six sectors, which are identified as forbidden (<i>harām</i>) sectors by the DJIMI <i>Sharī'ah</i> Supervisory Board: (i) alcohol; (ii) pork-related products; (iii) conventional financial services (interest-based banking, conventional insurance, etc.); (iv) entertainment services (hotels, casinos/gambling, cinema, pornography, music, etc.); (v) tobacco; and (vi) weapons and defense.	(i) The ratio of total debt to trailing 24-month average market capitalisation; (ii) The ratio of cash and interest-bearing securities to trailing 24-month average market capitalisation; and (iii) The ratio of accounts receivables to trailing 24-month average market capitalisation.
Kuala Lumpur Shariah Index (KLSI)	5% and 20%	Companies involved in the following core activities are classified as <i>Sharī'ah</i> non-compliant: (i) Financial services based on <i>ribā</i> ; (ii) Gambling and gaming; (iii) Manufacture or sale of non- <i>halāl</i> products or related product (iv) Conventional insurance; (v) Entertainment activities that are non-permissible according to <i>Sharī'ah</i> ; (vi) Manufacture or sale of tobacco-based products or related products; (vii) Stockbroking or share trading in <i>Sharī'ah</i> non-compliant securities; and	Three financial ratios are used to screen out firms with high leverage, and interest income and expense. More specifically, each of the following two financial ratios must be less than 33%: (i) The ratio of total debt to total asset; and (ii) The ratio of cash and interest-bearing securities to total asset In addition, companies with activities comprising both permissible and non-permissible elements, are subjected to two additional criteria:

		(viii) Other activities deemed non-permissible according to the <i>Sharī'ah</i> .	(i) The public perception or image of the company must be good; and (ii) The core activities of the company are important and considered <i>maslaha</i> ('benefit' in general) to the Muslim <i>ummah</i> and the country.
Standard and Poor's (S&P) Dow Jones Shariah Indices (S&P) -	5%	Company's main business activities should not be impermissible.	<i>Liquidity ratios</i> should be less than 49% of account receivable divide by 36-month market average market capital and less than 33% of cash plus interest bearing securities divide by 36-month average market capital. <i>Debt ratio</i> – less than 33% of total debt divide by 36-month market average market capital.
Morgan Stanley Capital International World Islamic Indices (MSCI)	5%	Qualitative screenings exclude shares of all such companies engaged in activities strictly prohibited (<i>harām</i>) in Islam.	Financial ratios are used to further screen companies with core activities as permissible (<i>halāl</i>) under <i>Sharī'ah</i> but have a portion of revenue from non-permissible activities. Companies with less than 33.33% of each of the following financial ratios are condoned: (i) Total debt to total assets; (ii) Cash and interest-bearing securities to total assets; and (iii) Account receivables and cash to total assets.
ISRA Bloomberg Shariah Stock Screening Indices		(i) If a company's activities in a sector are not known whether they are <i>Sharī'ah</i> compliant or not, for example, the category of "Food and Beverages", its activities in the sector are regarded as <i>Sharī'ah</i> non-compliant	Each of the following financial ratios must be less than 33%: (i) The ratio of total debt to trailing 24-month average market capitalisation; and

	5%	unless transparently declared otherwise by the company through a supplementary document. (ii) The business activity of a company that belongs to a sector whose activities are mixed part of which may be regarded as <i>Sharī'ah</i>-non-compliant such as hotel (where its activities include accommodation, which is <i>Sharī'ah</i>-compliant; and non-<i>halāl</i> food and beverages and liquor bar, which is <i>Sharī'ah</i> non-compliant) will be regarded as <i>Sharī'ah</i> non-compliant except if transparently declared otherwise by the company.	(ii) The ratio of cash place in conventional account to assets.
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6.4 Types of Investment Funds by Investment Portfolio

IIFs can be used for a number of investment opportunities. COMCEC identified seven types of funds by investment portfolio and asset class. These are equity fund, commodity fund, money market fund, fixed-income fund, balanced or mixed fund, index fund, fund of funds, and Real Estate Investment Trust (REIT).⁵⁰⁹

Equity fund principally invests in *Sharī'ah*-compliant stock of listed companies either as growth fund or equity income fund or both. Commodity fund invests in *Sharī'ah* permissible commodities such as precious metals, energy resources (e.g., oil and gas), agricultural goods (e.g., wheat), livestock (e.g., animals) or stocks of companies involved in the commodity markets. Money market fund invests in short-term money market securities (one year or less) and aims mainly to preserve its principal capital and generate a modest income for the unit holders. The main objective of fixed income fund is to generate a flow of fixed income through investment in outlets such as *Sukūk*. Balanced or mixed fund is used to attain a mix of safety, income and capital appreciation/growth while avoiding excessive risk. *Sharī'ah*-complaint stocks and *Sukūk* are examples of this type of fund. Index fund is a type of fund that falls within the category of passive investing. Fund of funds invests in units/shares of other investment funds instead of investing directly in *Sharī'ah*-compliant stocks or *Sukūk*. This strategy is also known as a multi-manager investment. In REIT, the fund invests in a diversified pool of properties, e.g.,

⁵⁰⁹ COMCEC (2018). Islamic Fund Management. COMCEC Coordination Office, pp. 18-19.

commercial buildings, student accommodations, retirement homes, shopping malls, housing complexes, land and plantations. Returns take the form of rental payments.⁵¹⁰

Some of the types of funds outlined above are briefly explained below:

6.4.1 Islamic Equity Funds

Equity funds generally invest in common shares of companies that are into *Shari'ah*-compliant activities. An Islamic equity fund earns profits in form of capital gains (difference between selling price and purchase price of shares) that the shares generate. In addition, dividends earning from the shareholdings are also profits for the equity fund to be distributed to investors in the fund. There are however risks in this investment which include not earning any dividend or earning less than expected, no capital gain earning or earning less than expected capital gain, and even in extreme cases suffering capital loss. There can also be situations where the performance of the equity is not competitive compared to other equities. These risk situations in an equity investment are managed using strategies of retention, adaptation, avoidance, reduction and transfer that reflect Islamic perspective.

Equity funds or equity-based mutual funds are the financial institutions which mobilise investments from the public against the units of their fund and invest all these funds in listed equity shares. They calculate the NAV (Net Asset Value) of the fund units on a daily basis and may allow investors to exit or enter the fund at or around NAV. The fund may declare dividends periodically and even liquidate itself at a certain stage and pay off the investors on the basis of the final break-up value of the units. The expenses of this fund and the remuneration of the fund Manger are defrayed from the earnings of the fund.⁵¹¹

For an Islamic equity fund, investments are only allowed to be made in the shares of companies that pass the quantitative and qualitative screening as well as their adherence to *Shari'ah*-compliant accounting principles. Where it is established that a company's major line of business violates *Shari'ah* injunctions, investments through purchase, holding or sale of its shares is prohibited.

There are two (2) broad Juristic opinions on the permissibility or otherwise of investing and trading in shares of companies that are into *halāl* activities but take

⁵¹⁰ Ibid.

⁵¹¹ Khatkhatay, M. H. & Nisar, S. (2007). *Shari'ah Compliant Equity Investments: An Assessment of Current Screening Norms. Islamic Economic Studies*, Vol. 15, No. 1, p. 51.

part in interest-based transactions. The first opinion sees prohibition while the second opinion adopts permissibility with restrictions. In respect of the views supporting prohibition, it is mentioned in the Islamic *Fiqh* Academy recommendation issued in November, 1991 that 'in principle, subscription in companies that occasionally deal in *ribā* is prohibited'.⁵¹² Individual scholars who hold the view of prohibition include Bin Bayyah who opined that the prohibition covers those companies that clearly indicate their involvement in activities not in accordance with *Sharī'ah* by dealing in interest; those who do not make clear indication of involvement in non-permissible transactions but are known for that; and those companies that are under the control and management of non-believers who pay no attention to permissibility or otherwise of their activities in *Sharī'ah*.⁵¹³ Other scholars who subscribe to the view of prohibition on investment in companies that deal in interest even if their main business activities are *halāl* include al-Darīr, al-Sālūs, al-Zarqā and Al-Marzūqī.⁵¹⁴

While acknowledging the prohibition view, Taqi Usmani⁵¹⁵ remarked that a group of *Sharī'ah* experts was of the view that it is not allowed for a Muslim to deal in the shares of such a company, even if its main business is *halāl*. The main basic argument of this group of scholars is that every shareholder of a company is a *sharīk* (partner) of the company, and every *sharīk*, according to Islamic jurisprudence, is an agent for the other partners in the matters of the joint business. This means the mere purchase of a share of a company embodies an authorisation from the shareholder to the company to carry on its business in whatever manner the management deems fit.

The second opinion sees the permissibility of such investment. A group of scholars including Al-Qarradāgī, Abu Ghuddah and 'Abdullah bn Mani' held the opinion that it is permissible to invest in the stocks of such companies subject to certain conditions and restrictions.⁵¹⁶ Their opinion revolved around the argument that a joint stock company differs from a simple partnership, in the sense that an individual shareholder does not make decisions on all matters related to the business operations of the company. Hence, it will not be realistic to ascribe consent to individual shareholders for every transaction even where there is an intention to

⁵¹²Ahmed, O. B. (2001). Islamic Equity Funds: The Mode of Resource Mobilisation and Placement. Islamic Research and Training Institute IRTI Occasional Paper, p. 12.

⁵¹³ Ibid, p. 13.

⁵¹⁴ Ibid, pp. 13-14.

⁵¹⁵Usmani, T. (1998). *An Introduction to Islamic Finance*, p. 141.

⁵¹⁶ Ahmed, O. B. (2001). Islamic Equity Funds: The Mode of Resource Mobilisation and Placement. Islamic Research and Training Institute IRTI Occasional Paper, p. 14.

avoid it by a shareholder. Thus, if a company is engaged in a *halāl* business, but also keeps its surplus money in an interest-bearing account, wherefrom a small incidental income of interest is received; or where the dealings of such a company is that it sometimes borrows money from financial institutions and these borrowings are mostly based on interest, it does not render all the business of the company unlawful. Accordingly, if a person acquires the shares of such a company with clear intention that he will oppose this incidental transaction also, and will not use that proportion of the dividend for his own benefit, it cannot be said that he has approved the transaction of interest and therefore that transaction cannot be attributed to him.⁵¹⁷

To support the second view, some scholars opined that there is a strong element of *maslaha* in permitting equity investment under *Sharī'ah*, provided the nature of the business and the way it is carried out are such that even in case there is a violation of *Sharī'ah* stipulations, it is kept within certain limits. The permission could be conditioned on the absence of sufficiently prevalent and credible Islamic investment alternatives in the given environment.⁵¹⁸

Generally, scholars have outlined the following conditions for investment in shares:⁵¹⁹

- (i) The main business of the company does not violate the rules and principles of *Sharī'ah*. In this regard, the contemporary *Sharī'ah* experts are almost unanimous on the point that if all the transactions of a company are in full conformity with the *Sharī'ah*, its shares can be purchased, held and sold without any hindrance from the *Sharī'ah* side. On the contrary, it is not permissible to invest in shares of companies whose main business violates the *Sharī'ah*, such as companies providing financial services on interest (e.g., conventional banks and insurance companies), or companies involved in any of the businesses not approved by the *Sharī'ah* such as companies manufacturing, selling or offering liquors, pork, *harām* meat, or involved in gambling, night club activities, pornography, etc.
- (ii) If the main business of the company is permissible (*halāl*), like automobiles, textile, etc. but they deposit their surplus money in interest-bearing accounts or borrow/lend money on interest, the existing shareholders of the company have

⁵¹⁷ Usmani, T. (1998). *An Introduction to Islamic Finance*, p. 142.

⁵¹⁸ Khatkhatay, M. H. & Nisar, S. (2007). *Sharī'ah Compliant Equity Investments: An Assessment of Current Screening Norms. Islamic Economic Studies*, Vol. 15, No. 1, pp. 50-51.

⁵¹⁹ Usmani, T. (1998). *An Introduction to Islamic Finance*, pp. 143-144.

a responsibility to express their disapproval against such dealings by the company, preferably by raising their voices against such activities in the annual general meeting of the company. However, it is permissible to invest in the stocks of such company provided that the unlawful part of its dealings is negligible. A number of legal maxims have been used to explain the legality of investing in this type of companies. One of the legal maxims says, "That which is independently impermissible becomes permissible when done in conjunction with the permissible." The import of the legal maxim is that since the unlawful activities such as borrowing from conventional banks or extending interest-bearing loans are negligible compared to its lawful activities, the negligible unlawful dealings, which independently carry the ruling of impermissibility become permissible when mixed with the lawful activities, which significantly outweigh the unlawful.⁵²⁰

- (iii) If some income from interest-bearing deposits or other impermissible activities is included in the income of the company, the proportion of such income in the dividend paid to the shareholder must be calculated and given out to socially beneficial activities and charity. The shareholder must not retain any portion of it with him. This is called cleansing or purification of income. For example, if 5% of the whole income of a company has come out of interest-bearing deposits or other non-permissible activities, 5% of the dividend must be given in charity.⁵²¹
- (iv) The shares of a company are negotiable only if the company owns some illiquid assets. Where all the assets of a company are in liquid form, i.e., in the form of money, the shares cannot be purchased or sold except at par value because, in this case, the share represents money only and the well-known and established principle of the *Sharī'ah* is that money cannot be traded in except at par except in the case of exchange of money in different currencies. Contemporary scholars have different opinions regarding the exact proportion of illiquid assets of a company for warranting the negotiability of its shares. Two opinions seem to dominate discussion in the extant literature. One opinion is that the proportion of illiquid assets must not be less than 51% to qualify it to be the majority component of the company's assets. The second is that if the proportion of the illiquid assets of a company is up to one-third (33%) of its

⁵²⁰ Yaquby, N. (2000). Trading In Equities: A Sharī'ah Perspective. *Proceedings of the Fourth Harvard University Forum on Islamic Finance*, Center for Middle Eastern Studies, Harvard University, p. 122.

⁵²¹ Usmani, T. (1998). *An Introduction to Islamic Finance*, p. 144.

total assets, its shares can be treated as negotiable since the proportion of illiquid assets cannot be said to be in a negligible quantity.⁵²²

6.4.2 Islamic Commodity Funds

Another possible type of Islamic investment funds may be a commodity fund. In this type of funds, the subscription amounts are used in purchasing different commodities for the purpose of their resale. The profits generated by the sales of the commodities are the income of the fund which is distributed pro rata among the subscribers.

Usmani outlined the main rules governing the transactions of sale to which the utilisation of Islamic commodity funds would be subjected.⁵²³

- (i) The commodity must be owned by the seller at the time of sale, because short sales in which a person sells a commodity before he owns it are not allowed in *Sharī'ah*.
- (ii) Forward sales are not allowed except in the case of *Salam* and *Istisnā'*.
- (iii) The commodities must be *halāl*. Commodity funds must not be used to deal in what is not allowed in Islam such as to deal in wines, pork or other prohibited materials.
- (iv) The seller must have physical or constructive possession over the commodity he wants to sell. This includes any act by which the risk of the commodity is passed on to the purchaser.
- (v) The price of the commodity must be fixed and known to the parties. Any price which is uncertain or is tied up with an uncertain event renders the sale invalid.

To attract additional subscriptions, the fund could issue *Sukūk al-Mushārah* or *Sukūk al-Mudārabah* certificates for participation of those interested to participate in the fund's activities and/or profit.

Commodity funds utilise the forward sale contract of *Salam*, trade-based contracts of *Istisnā'* and *Murābaha* or the lease based *Ijārah* means of transaction. Under the *Salam* and *Istisnā'* transactions, the underlying commodity is not available for delivery at the time of entering the contract, but the price must be known to both parties and any income earned is to be shared among the fund subscribers. In

⁵²² Ibid.

⁵²³ Ibid, pp. 148-149.

Murābaha means of transaction, the subscription amount generated is deployed to purchase of commodities (food and other *halāl* commodities) which are resold to buyers on agreed mark up prices and the profit generated is the income for the fund. This income is shared on prorated basis among the fund's investors. Where a fund is established for this purpose, it is regarded as a closed-end fund as its units are not to be sold in the secondary market. This is due to the fact that, as a *Murābaha* based arrangement, the payment for the commodity may be deferred and thus it is a debt that should not be sold in the secondary market. In the case of *Ijārah*, the acquired commodity can be leased if it falls into the category of items that can be rented.

6.4.3 REIT Islamic Fund

Another type of Islamic Fund may be REIT fund for deployment in *Ijārah* based activities. In this fund the subscription amounts are used to purchase assets like real estate, motor vehicles, or other equipment for the purpose of leasing them out to their ultimate users. The ownership of these assets remains with the Fund and the rentals are charged from the users. These rentals are the source of income for the fund which is distributed pro-rated to the subscribers. Certificates evidencing subscription, which may be called *Sukūk* are given to subscribers of the fund. The *Sukūk* represent the pro-rated ownership of their holders in the tangible assets of the fund. The tangible assets not the liquid amounts or debts are fully negotiable and can be sold and purchased in the secondary market. Anyone who purchases these *Sukūk* replaces the sellers in the pro-rated ownership of the relevant assets and all the rights and obligations of the original subscriber are passed on to him.⁵²⁴

It is important to keep in mind that the contracts of leasing must conform to the principles and rules of *Sharī'ah* guiding *Ijārah* contracts. The *Sharī'ah* rules and principles relevant to *Ijārah* have been discussed in chapter three of this book. Usmani has outlined some of them as follows:⁵²⁵

- (i) The leased assets must have some usufruct, and the rental must be charged only from that point of time when the usufruct is handed over to the lessee.
- (ii) The leased assets must be of a nature that their *halāl* (permissible) use is possible.
- (iii) The lessor must undertake all the responsibilities consequent to the ownership of the assets.
- (iv) The rental must be fixed and known to the parties right at the beginning of the contract.

⁵²⁴ Ibid, p. 147.

⁵²⁵ Ibid, p. 148.

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CORPORATE AND *SHARI'AH* GOVERNANCE IN ISLAMIC FINANCE

7.1 Introduction

The need for an effective corporate and *Sharī'ah* governance system for Islamic Financial Institutions (IFIs) cannot be overemphasised. This is because the success of IFIs depends largely on the confidence and trust depositors, investors, shareholders and the general public have in them with regard to their compliance with *Sharī'ah*. Accordingly, a robust corporate and *Sharī'ah* governance system is needed not only for the purpose of strengthening the credibility of Islamic financial system in the eyes of patronising the community but also for the continued corporate existence of IFIs.

In this chapter, an attempt has been made to explain the nature, scope and dimensions of *Sharī'ah* and corporate governance for Islamic financial institutions. The role of Islamic social finance as an important tool of achieving social justice in Islamic finance and the role of standard setting and international regulatory bodies for Islamic financial institutions have also been highlighted.

7.2 *Sharī'ah* and Corporate Governance for Islamic Financial Institutions

There is no universally accepted definition of corporate governance (CG). The term has been used in different ways and the boundaries of the subject vary widely. Definitions mostly depend on the goal corporate governance is designed to achieve in different contexts and jurisdictions. Two definitions are considered here.

According to the Securities Commission Malaysia, corporate governance, as originally defined in Malaysia's High Level Finance Committee Report of 1999, is "the process and structure used to direct and manage the affairs of an institution towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value while taking into account the interest of other stakeholders."⁵²⁶ On its part, Bank for International Settlement (BIS) defined it as "a set of relationships between a company's management, its board, its shareholders and other stakeholders guided by a

⁵²⁶Securities Commission Malaysia (2021). *Malaysian Code on Corporate Governance*, Securities Commission Malaysia, p. 1.

structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."⁵²⁷

It can be understood from the above definitions that corporate governance is a means to reduce inefficiencies, and a process of monitoring performance and mitigating agency problems between owners and managers; improving long-term shareholder value; and accounting for the interest of other stakeholders through efficient utilisation of societies' resources. Good corporate governance is considered vital as it establishes a harmonious relationship among concerned parties; promotes prudent and transparent management practices; protects the interest of all stakeholders; ensures proper discharge of corporate social responsibility role; and promotes a sound, stable, and competitive financial industry.

The objectives of corporate governance for both conventional and Islamic financial institutions seem to be similar in terms of providing efficient, effective management, adequate disclosure and long-term corporate stability except that, under Islamic finance, the issue of compliance with the *Sharī'ah* is also fundamental. The main objectives of CG are to safeguard stakeholders' interest in conformity with public interest on a sustainable basis, and help define the way authority and responsibilities are allocated and how corporate decisions are made.

In addition to good corporate governance practice, Islamic financial institutions are required to include and observe *Sharī'ah* governance by ensuring strict compliance with the *Sharī'ah* in all activities carried out by stakeholders because the two are inextricable in IFIs. Scholars and experts in Islamic finance have long declared that *Sharī'ah* governance is the most essential and unique feature of the Islamic financial system which is completely lacking in conventional financial institutions.⁵²⁸

Sharī'ah governance is defined as "the internal mechanism which helps to ensure that an Islamic financial institution complies with the *Sharī'ah* in its operations and activities and which helps it to achieve the objectives of the *maqāṣid al-*

⁵²⁷Bank for International Settlement (2015). Corporate governance principles for banks. Basel Committee on Banking Supervision, p. 1 available at <https://www.bis.org/bcbs/publ/d328.pdf>.

⁵²⁸Mizushima, T. (2013). Corporate Governance and *Sharī'ah* Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia. *Reitaku Journal of Interdisciplinary Studies*, pp. 60-61.

Shari'ah.⁵²⁹ It is a mechanism used by Islamic financial institutions to ensure *Shari'ah* compliance and also to mitigate *Shari'ah* non-compliance risk, which is costly and also adversely affects their reputation and business continuity. Ginena and Hamid defined it as “the overall system that manages the conformity of the activities of Islamic banks and financial institutions to the precepts of *Shari'ah* pertaining to transactions.”⁵³⁰ It is “a system conducted by *Shari'ah* principles and controlled by an effective religious board to ensure that the activities of IFIs are in accordance with the *Shari'ah* principles and conducts.”⁵³¹ The International Association of Deposit Insurers (IADI) defined *Shari'ah* governance as “the structures and processes adopted by an organisation to ensure compliance with the *Shari'ah*. It complements the corporate governance of an organisation.”⁵³²

The Islamic Financial Services Board (IFSB), in its governance standard known as IFSB-10, conceptualised *Shari'ah* governance for IFIs as a set of institutional and organisational arrangements through which Islamic financial institutions ensure that there is an effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review.⁵³³ In line with the definition provided in IFSB-10, three main features of *Shari'ah* governance system have been identified. These are governance, control and compliance.

It is clear from the above that IFIs have a responsibility to ensure compliance with the *Shari'ah* principles in their products, instruments, operations, practices, management, etc. in addition to the existence of a proper framework of corporate governance. *Shari'ah* governance is, therefore, another component that is exclusive to IFIs. The uniqueness of corporate governance for IFIs stems from the fact that it

⁵²⁹ Grassa, R. (2013). *Shari'ah Governance System in Islamic Financial Institutions: New Issues and Challenges*. *Arab Law Quarterly*, p. 172.

⁵³⁰ Ginena, K. and Hamid, A. (2015). *Foundations of Shari'ah Governance of Islamic Banks*. United Kingdom: John Wiley & Sons Ltd, p. 80.

⁵³¹ Grassa, R. (2013). *Shari'ah supervisory system in Islamic financial institutions - new issues and challenges: a comparative analysis between Southeast Asia models and GCC models*. *Humanomics*, Vol. 29, No. 4, p. 335.

⁵³² International Association of Deposit Insurers - IADI (2018). *Shari'ah Governance for Islamic Deposit Insurance Systems*, p. 8. See https://www.iadi.org/en/assets/File/Papers/Approved%20Research%20-%20Discussion%20Papers/Discussion_Paper_Shari'ahh_Governance_for_IDIS_Final_For_Publication.pdf.

⁵³³ Islamic Financial Services Board - IFSB (2009). *Guiding Principles on Shari'ah governance system for institutions offering Islamic financial services (IFSB-10)*, pp. 2-3. <http://www.ifsb.org/standard/IFSB-10%20Shari'ahh%20Governance.pdf>.

is a faith-based approach that mandates conduct of the business in accordance with *Shari'ah* principles; and profit-motive based that recognises business and investment transactions and maximization of shareholder's wealth. *Shari'ah* governance is thus the backbone of Islamic finance.

The key goals of *Shari'ah* governance for IFIs are to:⁵³⁴

- a) ensure the legitimacy of products and services, contracts and modalities through *Shari'ah* compliance;
- b) build, boost and sustain confidence of depositors, investors, shareholders and the public that all the practices and activities are in compliance with the *Shari'ah* at all times;
- c) optimise IFIs' corporate value and ascertain corporate sustainability;
- d) facilitate effective implementation of the Islamic financial system; and
- e) assist in mitigating the consequences of *Shari'ah* non-compliance risk that may expose IFIs to certain risks, namely reputational, legal and financial.

In practice, *Shari'ah* governance of Islamic financial institutions is guided by a document called *Shari'ah* policy document. The document provides, among other things, details on qualification, appointment, roles and responsibilities, processes and procedures of *Shari'ah* governance to strengthen the effectiveness of its implementation and reinforce a closer integration of *Shari'ah* considerations in the business and risk strategies of the institutions.

7.3 Basis of Corporate and *Shari'ah* Governance in Islamic Financial Institutions

Corporate and *Shari'ah* governance for IFIs is based on a number of Islamic texts on particularly the issue of accountability, transparency, responsiveness, justice and fairness, and mutual consultation. These are discussed hereunder.

(A) Accountability

The perceived relationship of individuals and firms with Al-Mighty Allah as taught in the religion of Islam affects greatly the concept of accountability. For example, Muslims believe that all resources are Allah-given, and the absolute ownership of wealth belongs to Al-Mighty Allah. Individuals are only trustees over the share of resources given to them as owners or as overseers and that they shall be held

⁵³⁴International Association of Deposit Insurers - IADI (2018). *Shari'ah* Governance for Islamic Deposit Insurance Systems, pp. 10-11.

accountable to Al-Mighty Allah in respect of how they acquire and how they spend their resources. It is in the light of this that people need to question their actions or hold themselves accountable before being held accountable by Allah on the Day of Judgment. This is what is commonly referred to as accountability.

Accountability in the context of corporate governance in Islamic finance means an obligation of IFIs to provide an account to the depositors, investors, shareholders, regulators and indeed the general public about its *Shari'ah* compliance and the effect of its operations on the well-being of all stakeholders.⁵³⁵ According to Taufiq,⁵³⁶ it is the evaluation of the operations, contracts, processes and procedures of an IFI to ensure its compliance with *Shari'ah* thereby making it accountable and responsible to all stakeholders.

One of the unique characteristics of the corporate and *Shari'ah* governance system in IFIs is that SSB/SAC commits and guarantees that all the operations, contracts and procedures of the institution are *Shari'ah* compliant.⁵³⁷ Since one of the main objectives of accounting and reporting for IFIs is to ensure that the business discharges the Islamic concept of accountability, it is critical for IFIs to emphasise its compliance with Islamic principles in all their transactions and products. This further requires that, for accountability purpose, SSB/SAC should ensure that reports of IFIs should include information that meet *Shari'ah* ethics and morals in order to not only continue to maintain the confidence of ethically conscious stakeholders who require assurance on the compliance of their products and operations with *Shari'ah*, but also as it reflects its accountability to Al-Mighty Allah.⁵³⁸

Allah (the Most High) says: "To Allah belongs all that is in the heavens and all that is on the earth, and whether you disclose what is in your own selves or conceal it, Allah will call you to account for it..."⁵³⁹ The Prophet (peace be upon him) said: "Everyone of you is a guardian and is responsible for everything under his care.

⁵³⁵ Aribi, Z. A., Arun, T. & Gao, S. (2019). Accountability in Islamic Financial institution: The Role of the *Shari'ah* Supervisory Board Reports, *Journal of Islamic Accounting and Business Research*, Vol. 10, No. 3, p. 6.

⁵³⁶ Taufiq, I. (2015). Transparency and Accountability in the *Qur'an* and its Role in Building Good Governance. *International Journal of Business, Economics and Law*, Vol. 6, Issue 4, p. 78.

⁵³⁷ Aribi, Z. A., Arun, T. & Gao, S. (2019). Accountability in Islamic Financial institution: The Role of the *Shari'ah* Supervisory Board Reports, *Journal of Islamic Accounting and Business Research* 10(3), p. 4.

⁵³⁸ Ibid.

⁵³⁹ *Qur'an*, 2:284.

The ruler who has authority over people, is a guardian and is responsible for them; a man is a guardian of his family and is responsible for them; a woman is a guardian of her husband's house and children and is responsible for them; a slave is a guardian of his master's property and is responsible for it; so all of you are guardians and each one is responsible for everything under his care."⁵⁴⁰ Also, the Prophet (peace be upon him) said: "Allah shall ask everyone about his stewardship whether honoured or betrayed."⁵⁴¹

Management, BoD and SSB/SAC should always be conscious of their responsibilities and remember to discharge their functions in the best of manners. The position they occupy is a trust that should be rendered back, not to be betrayed. Allah (the Most High) says: "O you who believe! Betray not Allah and His Messenger, nor betray knowingly things entrusted to you."⁵⁴² Allah (the Most High) also says: "Verily! Allah commands you to render back your Trusts to those to whom they are due..."⁵⁴³

(B) Transparency

Transparency is one of the most fundamental elements of corporate and *Shari'ah* governance. It is defined as the disclosure of information in an accurate and accessible manner that allows stakeholders to better assess the performance of an organisation and make informed investment decisions. It reflects regulated organisation-level disclosure, private acquisition of organisation-level information, and dissemination of information in an appropriate way. Greater transparency and disclosure keep corporate stakeholders better informed about the way an organisation is managed and governed and prevent it from taking excessive risks.⁵⁴⁴ Sekreter⁵⁴⁵ defined it as reporting reliable information about the status of the agreed Islamic contracts, investments, or operations that are being practised.

IFIs are required to disclose all information necessary to inform the stakeholders about their operations and this requirement is related to the concepts of transparency and disclosure. For IFIs to be transparent, they should disclose adequate and reliable information that will enable the assessment of its financial

⁵⁴⁰Sahīh al-Bukhārī, Vol. 3, Book 46, *Hadīth* 730.

⁵⁴¹Sunan al-Tirmidhī, Vol. 3, Book 21, *Hadīth* 1705.

⁵⁴²*Qur'ān*, 8:27.

⁵⁴³*Qur'ān*, 4:58.

⁵⁴⁴Srairi, S. (2019). Transparency and bank risk-taking in GCC Islamic banking. *Borsa Istanbul Review*, Vol. 19, Supp. 1, p. S64.

⁵⁴⁵ Sekreter, A. (2013). Importance of Transparency in Islamic Finance. *Journal of Business*, p. 47.

performance, profitability and risk exposure. Transparency reduces moral hazard, fosters accountability by facilitating monitoring, enhances efficiency and integrity of the market and strengthens market discipline.⁵⁴⁶

According to Radwan,⁵⁴⁷ transparency is important because it is the primary element in ensuring consumer protection and financial literacy, which are considered essential components that go hand in hand. Without transparency, customers cannot be fully informed on the complete consequences of their financial transactions and financial literacy of consumers cannot increase significantly to the extent of protecting customers from falling further into debt. Transparency, therefore, provides customers and the general public with all relevant information, experiences, policy decisions and products and services in a clear and open manner that will enable existing and potential customers and investors to make informed financial decisions that avoid harm.

Transparency and accountability are two of the most fundamental principles of corporate and *Shari'ah* governance. Without transparency, there is no accountability, and, without accountability, transparency becomes meaningless. Transparency is a precondition for the implementation of the principle of accountability.⁵⁴⁸ Transparency and openness aim at explaining how the responsibility will be carried out, what methods are used to carry out the task, how the reality of its implementation is and what impact it has. Through transparency, IFIs provide both existing and potential clients with the opportunity to know all necessary information about its operations including benefits and risks associated with products and services. The existence of transparency and accountability contributes to the effectiveness, efficiency and fairness in the management of IFIs.⁵⁴⁹ This is because they are likely to be the products of good corporate governance and seem to be considered as the benchmark sought by the stakeholders.

⁵⁴⁶Srairi, S. (2019). Transparency and bank risk-taking in GCC Islamic banking. *Borsa Istanbul Review*, Vol. 19, Supp. 1, p. S64.

⁵⁴⁷ See Radwan, S. (2017). Islamic Banking: Why Transparency Matters. <https://journal.wahedinvest.com/islamic-banking-why-transparency-matters/>.

⁵⁴⁸ Taufiq, I. (2015). Transparency and Accountability in the Qur'ān and its Role in Building Good Governance. *International Journal of Business, Economics and Law*, Vol. 6, Issue 4, p. 73.

⁵⁴⁹Ibid, p. 76.

According to the Islamic Financial Services Board,⁵⁵⁰ the need for transparency is, above all, an important *Shari'ah* consideration because any form of concealment, fraud or attempt at misrepresentation violates the principles of justice and fairness in the *Shari'ah*. The *Qur'an* declares, "Woe to those who give less [than due]. Who, when they take a measure from people, take in full. But if they give by measure or by weight to them, they cause loss." Another basis for transparency is contained in the statement of Allah (the Most-High): "O you who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties..."⁵⁵¹

(C) Responsiveness

Accountability also implies responsibility and responsiveness. As a concept, it relates to external standards that determine the truth of an action by IFIs and can be assessed by persons within and outside the organisation. It is in this respect that it is also called objective responsibility. IFIs are called accountable when they are assessed objectively by stakeholders and are held accountable for all actions, attitudes, and behaviours to depositors, investors and shareholders. Objective responsibility is part of external control that encourages or motivates IFIs to work hard towards achieving the overall objective of the business.⁵⁵²

In corporate and *Shari'ah* governance, responsiveness implies that SAC/SSB, management and BOD of IFIs should work diligently and sincerely for the betterment of all stakeholders. They should be concerned about *Shari'ah* compliance of the operations, contracts and procedures of the institution; protection of the interest of depositors, investors, employees and general public; and at the same time strive for the maximisation of shareholders' wealth. The following statements from the Prophet (peace be upon him) underscore the importance of responsiveness as an essential element of corporate and *Shari'ah* governance in IFIs.

The Prophet (peace be upon him) said: "Any servant, whom Allah has given the authority of ruling some people and he does not look after them in an honest manner, will never feel even the fragrance of Paradise."⁵⁵³ The Prophet (peace be upon him) also said: "A ruler who, having control over the affairs of the Muslims,

⁵⁵⁰Islamic Financial Services Board (2007). Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services, p. 1.

⁵⁵¹*Qur'an*, 2:282.

⁵⁵²*Ibid*, p. 78.

⁵⁵³*Sahih al-Bukhari*, Vol. 9, Book 89, *Hadith* 264.

does not strive diligently for their betterment and does not serve them sincerely, will not enter *Jannah* (Paradise) with them.”⁵⁵⁴ In another *Hadīth*, the Prophet (peace be upon him) said: “O Allah! Treat harshly those who rule over my *Ummah* with harshness and treat gently those who rule over my *Ummah* with gentleness.”⁵⁵⁵

(D) Justice and Fairness

Islam’s standards of justice transcend considerations of race, religion, colour, and creed. Muslims are commanded to be just to their friends and foes alike, and to be just at all levels. The concept of justice also extends to being a personal virtue and one of the standards of moral excellence, which a believer is encouraged to attain as part of his Allah-consciousness. Thus, the concept of justice, as defined in the *Qur’ān* and *Sunnah*, requires Muslims to behave in a fair and just manner in all circumstances, and in all situations, to protect the rights of others, to be fair and just with people, to side with the one who is under oppression, to help and be fair with the needy and orphans, and to be just and not go beyond the boundaries set by Allah, even with the enemies.

Allah (the most High) says: "O you who have believed, be persistently standing firm for Allah, witnesses in justice, and do not let the hatred of a people prevent you from being just. Be just; that is nearer to righteousness. And fear Allah; indeed, Allah is Acquainted with what you do."⁵⁵⁶ He also says: “O you who have believed, be persistently standing firm in justice, witnesses for Allah, even if it be against yourselves or parents and relatives. Whether one is rich or poor, Allah is more worthy of both. So, follow not [personal] inclination, lest you not be just...”⁵⁵⁷ In addition, He says: "Do not let your hatred of a people incite you to aggression."⁵⁵⁸

Islam obligates justice and fairplay in all business dealings. It does not tolerate the view that all is fair in business and that every kind of cleverness and deceit is justifiable in business transactions. It regards business or commerce as an economic activity to be carried on in the spirit of humanity and justice. There is no room for cut-throat competition in Islam. In the context of Islamic financial transactions in IFIs, the customer and service provider are required to look upon each other as brothers or fellow human beings who are trying to benefit, serve and help each other. Accordingly, if in the course of transacting a business the IFIs happen to short-change or overcharge the customer, the institution, instead of feeling proud

⁵⁵⁴ Sahīh Muslim, Book 1, *Hadīth* 264.

⁵⁵⁵ Sahīh Muslim, Book 20, *Hadīth* 4494.

⁵⁵⁶ *Qur’ān*, 5:8.

⁵⁵⁷ *Qur’ān*, 4:135.

⁵⁵⁸ *Qur’ān*, 5:2.

of its cleverness in doing so, should compensate him for the excessive payment received. Similarly, any clenched-based bargain in any transaction that does not give the customer a fair chance to examine, assess or make informed decision is not allowed because this amounts to denying him a right that was his due. In the same vein, forcible transactions or transactions in which the IFI takes undue advantage of the helplessness or misery of the customer are strongly discouraged.⁵⁵⁹

Islam abhors any financial dealing that involves injustice and lack of fairplay. It prohibits acquiring wealth or any kind of profit through blackmail, fraud, bribery, or by monopolising the necessities of life thus unjustly consuming people's wealth.⁵⁶⁰ Allah (the Most High) says: "And do not consume one another's wealth unjustly or send it [in bribery] to the rulers in order that [they might aid] you [to] consume a portion of the wealth of the people in sin, while you know [it is unlawful]."⁵⁶¹ Islam also prohibits exploiting the needs of the people or profiting from one's status of authority or power, which usually results in an illegal increase of wealth. Injustice is one of the reasons for the prohibition of interest (usury) in Islam as indicated in the *Qur'ān*, "...deal not unjustly, and ye shall not be dealt with unjustly."⁵⁶² The Prophet (peace be upon him) said: "Whoever cheats my nation is not one of us."⁵⁶³

The *Qur'ān* stresses the importance of fairness in all business dealings. Narrating the conversation between Prophet Shu'aib (peace be upon him) and his people, Allah (the Most High) says: "And, O my people, give full measure and weight justly, and defraud not men of their things, and act not corruptly in the land making mischief. What remains with Allah is better for you, if you are believers."⁵⁶⁴ The above verse enunciates some fundamental principles of financial transactions in Islam: to give just measure and weight; not to withhold from the people the things that are their due; not to commit evil on the earth with the intent of doing mischief; and to be contented with the profit that is left with us by Al-Mighty Allah after paying other people their due.⁵⁶⁵

⁵⁵⁹See Translation of Sahīh Muslim, Book 10: https://www.iium.edu.my/deed/hadith/muslim/010_smt.html.

⁵⁶⁰ See Wafy, A. A. W. (n.d). Human Rights in Islam. <https://www.islambasics.com/chapter/establishing-justice-in-financial-dealings-and-in-the-distribution-of-wealth>.

⁵⁶¹ *Qur'ān*, 2:188.

⁵⁶² *Qur'ān*, 2:279.

⁵⁶³ Sunan al-Tirmidhī, Vol. 3, Book 12, *Hadīth* 1315.

⁵⁶⁴ *Qur'ān*, 11: 85-86.

⁵⁶⁵See: Translation of Sahīh Muslim, Book 10: https://www.iium.edu.my/deed/hadith/muslim/010_smt.html.

For example, in the *Mudārabah* arrangement, Islam requires both the financier and the entrepreneur to equitably share the profit as well as the loss. In a contract of sale (such as *Murābaha*) or lease (*Ijārah*), the seller (or lessor) is required to share a part of the risk to be able to get a share in the return. Once the seller (financier) acquires ownership and possession of the goods for sale or lease, he automatically bears the risk. For this purpose, one of the basic principles of Islamic finance is 'no risk, no gain'. The idea here is to instil justice and fairplay in all commercial dealings.⁵⁶⁶

(E) Mutual Consultation

Two organs have power to decide for corporate organisations, namely the BoD and General Assembly. In the case of IFIs, SSB/SAC plays very important advisory role with respect to *Sharī'ah* compliance. As entities which have no physical personality, IFIs, like their conventional counterpart cannot decide on their own. Those who have power to decide are expected to follow a decision-making structure/process that guarantees well informed decisions. In Islamic Law, the decision structure/process is called *Shūrā* (mutual consultation).⁵⁶⁷

Shūrā is a process of the social participation in the opinion or the resolution and a scope for the responsible social relationships. In the *Qur'ān*, mutual consultation in decision making process has been strongly emphasised. Allah (the Most High) says: And those who have responded to their Lord and established prayer and whose affair is [determined by] consultation among themselves."⁵⁶⁸ He also says: "And consult them in the matter (affair). And when you have decided, then rely upon Allah. Certainly, Allah loves those who put their trust [in Him]."⁵⁶⁹

In the context of corporate and *Sharī'ah* governance, *Shūrā* is a way to ensure that management, BOD and SAC/SSB of organisations use means of consultation that are not contrary to the principles of the *Sharī'ah* in decision making process for the purpose of achieving business and social objectives. This may include consideration for public concerns regarding some aspects of business operations, and community engagement either for information sharing or feedback generation on *Sharī'ah* compliance issues with the aim of realising the interest of, and

⁵⁶⁶ <https://www.islamic-banking.com/explore/islamic-finance>.

⁵⁶⁷ Abd Ghadas, Z. A., Abd Aziz, H. & Ramli, N. (2016). Promoting *Sharī'ah* Governance in Corporation: Special Reference to Shura. *Advances in Social Science, Education and Humanities Research*, Vol. 84, p. 205.

⁵⁶⁸ *Qur'ān*, 42:38.

⁵⁶⁹ *Qur'ān*, 3:159.

preventing harm to, the community in harmony with the general principles of "do good" and "do no harm."

7.4 Structure of *Sharī'ah* Governance

The structure of *Sharī'ah* governance for IFIs is easily traceable to AAOIFI and IFSB, which are the two most recognised international standard setting bodies. According to Grassa,⁵⁷⁰ *Sharī'ah* supervision in IFIs started with the establishment of Faisal Islamic Bank of Egypt in 1976 as the bank was known to be the first to create an internal religious board comprising selected scholars and experts in *Fiqh al-Mu'āmalāt* for *Sharī'ah* compliance purposes. Jordan Islamic Bank and the Faisal Islamic Bank of Sudan in 1978, the Kuwait Finance House in 1979, and the Bank Islam Malaysia Berhad in 1983 followed the footsteps of Faisal Islamic Banks by creating internal *Sharī'ah* units in their financial institutions.⁵⁷¹

Thereafter, the involvement of famous *Sharī'ah* scholars in internal *Sharī'ah* governance became part of the development of the Islamic financial industry. For example, the International Association of Islamic banks (replaced with the General Council for Islamic Banks and Financial Institutions (GCIBF) set up a *Sharī'ah* governance board while the Council of the Islamic Fiqh Academy continued to issue *fatwās* and rulings on matters related with Islamic financial transactions including *Sharī'ah* governance issues for the OIC countries.⁵⁷²

In 1999, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) published and adopted the *Sharī'ah* Standard 1 on *Sharī'ah* governance for IFIs. The Standard covers the issues of appointment of SAB/SAC, composition of members and their reporting responsibility. So far, from 1999 to the end of 2021, the AAOIFI has released a total of 10 governance standards for IFIs. In essence, AAOIFI *Sharī'ah* standards that imply how *Sharī'ah* governance for IFIs should be structured are Governance Standards (GS 1-10) which cover the aspects of appointment and composition of *Sharī'ah* supervisory board; *Sharī'ah* review; internal *Sharī'ah* review; audit and governance committee; independence of *Sharī'ah* board; governance principles for IFIs; CSR for IFIs; central *Sharī'ah* boards; *Sharī'ah* compliance function; and *Sharī'ah* compliance and fiduciary ratings for IFIs.

⁵⁷⁰ Grassa, R. (2013). *Sharī'ah* supervisory system in Islamic financial institutions - new issues and challenges: a comparative analysis between Southeast Asia models and GCC models. *Humanomics*, Vol. 29 No. 4, p. 336.

⁵⁷¹ Malkawi, B.H. (2010). *Sharī'ah governance of Islamic financial institutions: issues and challenges*. Working Paper, Hashemite University, Jordan.

⁵⁷² Ibid.

On its part, the Islamic Financial Service Board (IFSB) published in 2006 the first corporate governance standard for IFIs known as IFSB-3 to serve as guiding principle on corporate governance for IFIs excluding *Takāful* financial institutions and Islamic mutual funds. The guidelines cover four areas namely general governance approach of IFIs; rights of investments account holders; compliance with Islamic *Sharī'ah* principles; and transparency of financial reporting in respect of investment accounts. Later, another Standard was published to serve as principles on governance for *Takāful* companies. In December 2009, the IFSB published and released a robust corporate governance standard popularly known as IFSB-10 to address the strong diversity in the implementation of *Sharī'ah* governance in IFIs all over the world. IFSB-10 Standard covers five guiding principles⁵⁷³ on approach of *Sharī'ah* governance; competence of members of SSB/SAC in terms of qualification and appointment; independence of SSB/SAC; confidentiality in the work of SSB/SAC; and consistency in terms of the professionalism of members of the SSB/SAC under the headings Parts I-V.⁵⁷⁴

IFIs are required to put in place a sound internal and external *Sharī'ah* governance structure that will include among other things a robust internal *Sharī'ah* control system and/or internal *Sharī'ah* audit, external *Sharī'ah* committee, and governance and compliance committee.⁵⁷⁵ Sections 2(a)⁵⁷⁶ and 3(c) as well as Principle 1:1:11⁵⁷⁷ of the IFSB-10 are very clear about that. Similarly, AAOIFI's GS-1:3,⁵⁷⁸ GS-3:2-3⁵⁷⁹ and several parts of GS-9 speak volumes on these requirements.

The Internal *Sharī'ah* review/*Sharī'ah* audit unit is an integral part of *Sharī'ah* governance that has clearly assigned duties and responsibilities as required by sections 3(b) and (3c) of IFSB-10.⁵⁸⁰ AAOIFI's GS-3:3 and 3:5⁵⁸¹ require IFIs to carry out internal *Sharī'ah* review/*Sharī'ah* audit function through either an internal control department or a part of the internal audit division based on the process

⁵⁷³ See IFSB-10 (2009), p. 5.

⁵⁷⁴ Grassa, R. (2013). *Sharī'ah* supervisory system in Islamic financial institutions - new issues and challenges: a comparative analysis between Southeast Asia models and GCC models. *Humanomics*, Vol. 29, No. 4, p. 337.

⁵⁷⁵ Ginena, K. & Hamid, A. (2015). *Foundations of Sharī'ah Governance of Islamic Banks*. United Kingdom: John Wiley & Sons Ltd, p. 82.

⁵⁷⁶ IFSB-10 (2009), p. 1.

⁵⁷⁷ IFSB-10 (2009), p. 7.

⁵⁷⁸ AAOIFI (2015), p. 885.

⁵⁷⁹ AAOIFI (2015), pp. 909-910.

⁵⁸⁰ IFSB-10 (2009), pp. 2-3.

⁵⁸¹ AAOIFI (2015), p. 910.

explained in GS-4:4(a-j),⁵⁸² and submit the report to the SSB/SAC. According to section 3(c) of the IFSB-10, the purpose of the internal *Sharī'ah* review is to verify and ensure that compliance level is satisfactory and incidents of non-compliance are recorded and reported, and possibly addressed and rectified.⁵⁸³ The guiding principles, structure and procedure for internal *Sharī'ah* review are covered by AAOIFI GS 3:9-25⁵⁸⁴ and IFSB-10 3(d).⁵⁸⁵

The objective of internal *Sharī'ah* review is to ensure that the management of IFIs is carrying out their responsibilities in relation to the implementation of the *Sharī'ah* rules and principles as determined by the SAC/SSB. In order to achieve independence and objectivity of the internal *Sharī'ah* review, AAOIFI suggests that the status of the internal *Sharī'ah* review should not be lower than the internal audit department or internal control department of the financial institution in addition to the requirement that the unit must have full and continuous support from the management and board of directors. With regard to capacity and professional proficiency, it is required that the staff members of the internal *Sharī'ah* review must be proficient and have adequate educational background and training relevant to internal *Sharī'ah* review. They should also be exposed to continuing education and training to maintain their technical competence.⁵⁸⁶

The provisions of AAOIFI GS-1:3⁵⁸⁷ and Principle 1.1:10⁵⁸⁸ of IFSB-10 further require that an external *Sharī'ah* compliance process should be put in place by IFIs. The external *Sharī'ah* governance structure that should consist of SSB also called SAC, external audit firms and possibly advisory firms from outside, should assist in ensuring that the activities and operations of IFIs are in compliance with the *Sharī'ah*. The guiding principles, structure and procedure for external *Sharī'ah* review are covered by AAOIFI GS-2:7-15⁵⁸⁹ and IFSB-10 3(d).⁵⁹⁰

Ginena and Hamid defined the *Sharī'ah* board as “a board that is comprised mainly of Islamic jurists who are well-versed in Islamic transactional jurisprudence (*fiqh*

⁵⁸² AAOIFI (2015), pp. 924-925.

⁵⁸³ IFSB-10 (2009), p. 3.

⁵⁸⁴ AAOIFI (2015), pp. 911-915.

⁵⁸⁵ IFSB-10 (2009), p. 3.

⁵⁸⁶ Kasim, N., NuHtay, S. N. & Salman, S. A. (2013). Comparative Analysis on AAOIFI, IFSB and BNM *Sharī'ah* Governance Guidelines. *International Journal of Business and Social Science*, Vol. 4, No. 15, p. 222.

⁵⁸⁷ AAOIFI (2015), p. 885.

⁵⁸⁸ IFSB-10 (2009), p. 7.

⁵⁸⁹ AAOIFI (2015), pp. 900-902.

⁵⁹⁰ IFSB-10 (2009), p. 3.

al-mu'āmalāt), as well as other relevant Islamic banking and finance disciplines. The members are appointed by shareholders of the Islamic Financial Institution (IFI) at its inception, and are responsible for providing *Sharī'ah* guidance to the institution, its management and board of directors throughout the lifespan of the organisation. In doing so, the SSB issues binding resolutions, which assist the organization in discerning appropriate Islamic rulings on matters, and enables it to maintain *Sharī'ah* compliance with respect to its products, documentation, operations, and other activities.⁵⁹¹ Different titles are used to refer to the SSB. These titles include: *Sharī'ah* Supervisory Committee; *Sharī'ah* Council; *Sharī'ah* Board; *Fatwā* and *Sharī'ah* Supervisory Board; *Sharī'ah* Control Committee; Religious Board; *Sharī'ah* Committee; and *Sharī'ah* Advisory Council. In some cases, reference is made to the *Sharī'ah* Controller or the *Sharī'ah* Advisor instead of the Board.⁵⁹²

7.5 *Sharī'ah* Governance for Islamic Financial Institutions in Nigeria

The Central Bank of Nigeria (CBN) also has a policy framework for *Sharī'ah* governance for non-interest financial institutions (NIFIs) in order to strengthen the regulatory and supervisory oversight of the Islamic finance industry and nurture a pool of competent experts in the field. The framework, titled *Guidelines on the Governance of Advisory Committees of Experts for Non-Interest (Islamic) Financial Institutions in Nigeria* sets out the rules, regulations and procedures for the establishment and operations of the Advisory Committee of Experts (ACE) of a NIFI; defines the role, scope of duties and responsibilities of the Committee and its members towards the NIFI; defines the role, scope of duties and responsibilities of the NIFI towards the ACE; outlines the functions relating to *Sharī'ah* review and audit processes; and defines the working relationship between the ACE and the CBN's Financial Regulation Advisory Council of Experts (FRACE).⁵⁹³

Section 4 of the Guidelines requires all licensed NIFIs to establish an Advisory Committee of Experts (ACE) to be approved. The section provides that members of the ACE for each NIFI are to be appointed by its Board of Directors subject to the approval of CBN.⁵⁹⁴ Section 5 covers issues relating to appointment;

⁵⁹¹Ginena, K. & Hamid, A. (2015). *Foundations of Sharī'ah Governance of Islamic Banks*. United Kingdom: John Wiley & Sons Ltd, p. 251.

⁵⁹²*Ibid*, p. 252.

⁵⁹³Central Bank of Nigeria – CBN (2015). *Guidelines on the Governance of Advisory Committees of Experts for Non-Interest (Islamic) Financial Institutions in Nigeria*, pp. 1-2.

⁵⁹⁴*Ibid*, p. 2.

qualification; composition; confirmation of appointment; disqualification; and resignation, termination and dismissal of the ACE members.⁵⁹⁵

To avoid conflict of interest in the discharge of their responsibilities, Section 6 of the Guidelines states that no one individual should belong to more than one ACE of NIFIs under the supervisory purview of the CBN belonging to the same category. This means an individual could be an ACE member for a non interest deposit money bank (DMB) and a microfinance bank (MFB) at the same time since they do not belong to the same category of NIFIs even though both are under the supervisory purview of the CBN. The same person cannot be a member of ACE for two DMBs or two MFBs at the same time. The Section further places a restriction against the membership of one person in the ACE of a DMB and FRACE at the same time. In the same vein, a member of the ACE of a NIFI is not allowed to be a member of the NIFI's board of directors, executive management or significant shareholder of the same institution.⁵⁹⁶

Section 7 of the Guidelines outlines the following duties and responsibilities of the ACE:⁵⁹⁷

- a) Be accountable for all *Sharī'ah* decisions, opinions and views provided by it;
- b) Advise the NIFI's board and management on jurisprudence-related matters so as to ensure the institution's compliance with principles of Islamic Commercial Jurisprudence at all times;
- c) Review and endorse policies and guidelines related to the principles underpinning non-interest (Islamic) finance. This shall include a periodic review of products and services to ensure that operational activities and transactions of the institution are made in accordance with those principles.
- d) Endorse and validate relevant documents for new products and services to ensure that they comply with the principles of Islamic Commercial Jurisprudence with respect to terms and conditions contained in forms, contracts, agreements or other legal documentation used in executing the transactions; and the product manual, marketing materials, sales illustrations and brochures used to describe the product or service.

⁵⁹⁵ Ibid, pp. 2-4.

⁵⁹⁶ Ibid, p. 5.

⁵⁹⁷ Ibid, pp. 5-6.

- e) Ensure that the necessary ex-post considerations are observed after the product offering stage, namely the internal *Sharī'ah* review processes and *Sharī'ah* compliance reporting. This is in order to monitor the NIFI's consistency in compliance with the principles of this model and effectively manage *Sharī'ah* non-compliance risk that may arise over time.
- f) Assist or advise related parties to the NIFI, such as its legal counsel, external auditors or other consultants on Islamic jurisprudence-related matters upon request;
- g) Provide written *Sharī'ah* opinion to the NIFI in respect of new products and other issues referred to it;
- h) Provide support to the NIFI in respect of questions or queries that may be raised regarding the compliance of its products to the principles of the model including queries from consumers of the NIFI's products
- i) Issue recommendations on how the NIFI could best fulfil its social role as well as promote non-interest banking and finance;
- j) Provide checks and balances to ensure compliance with the principles of Islamic Commercial Jurisprudence;
- k) Assist the internal audit of the NIFI on *Sharī'ah* Compliance Audit; and
- l) Carry out any related duties assigned to it by the NIFI.

On their part, NIFIs are required to refer all Islamic jurisprudence issues that relate to their business operations to the ACE for advice and decision; implement the ACE's advice and decisions; obtain validation of the ACE relating to *Sharī'ah* issues in all product documentations; prepare and obtain the ACE's endorsement on a *Sharī'ah* Compliance Manual that will provide general guidelines on the operational procedures of the ACE as well as a code of ethics and conduct for its members; provide the ACE with the necessary assistance and access to all relevant records, transactions, manuals or other information that it may require to perform its duties; provide the ACE with required financial resources, independent expert consultation, reference materials, training and development or any other support the ACE may require to perform its duty effectively; and remunerate the members of the ACE based on expected duties and functions of the Committee.⁵⁹⁸

⁵⁹⁸ Ibid, pp. 6-7.

7.6 Shari'ah Governance Process

Shari'ah review process covers the planning of the review programme itself including the objectives, scope, reporting and follow-up actions; documentation process involved in the review, communicating the outcome of review to *Shari'ah* committees and management; and rectifying any instances of non-compliance with the *Shari'ah* to prevent such events from recurring is a must.⁵⁹⁹

According to AAOIFI, *Shari'ah* review should follow a standard process and be carried out in line with the following procedures:⁶⁰⁰

- (i) Planning review procedures to ensure that the review is completed in an effective and efficient manner. The plan must also be properly documented including the sample selection criteria and sizes, taking into consideration of its complexity, and frequency of transactions.
- (ii) Executing *Shari'ah* review procedures and preparation and review of working papers - This can be done by (1) obtaining an understanding of the management's awareness and commitment, (2) reviewing contracts, agreements, etc., (3) ascertaining whether transactions entered during the year are for products authorised by the *Shari'ah* supervisory board, (4) reviewing other information and reports in detail, and (5) discussing the findings with management of the IFIs.
- (iii) The *Shari'ah* supervisory board should implement adequate quality control policies and procedures in reviewing all work papers to ensure that the review is conducted in accordance with the standard on *Shari'ah* review.

In terms of the structure of *Shari'ah* Board Report, at least seven elements are required namely title, addressee, opening or Introductory paragraph that will state the purpose of the engagement, scope and nature of the work performed, opinion on the NIFI's compliance with *Shari'ah* rules and principles, date of report, and signature of the members.⁶⁰¹

⁵⁹⁹Kasim, N., NuHtay, S. N. & Salman, S. A. (2013). Comparative Analysis on AAOIFI, IFSB and BNM *Shari'ah* Governance Guidelines. *International Journal of Business and Social Science*, Vol. 4, No. 15, p. 226.

⁶⁰⁰Ibid, p. 222.

⁶⁰¹Kasim, N., NuHtay, S. N. & Salman, S. A. (2013). Comparative Analysis on AAOIFI, IFSB and BNM *Shari'ah* Governance Guidelines. *International Journal of Business and Social Science*, Vol. 4, No. 15, p. 221.

On its part, the internal *Sharī'ah* unit should plan, execute and document its review activities review. The planning and documentation should include minimum of the following:

- (a) Background information about the activities to be reviewed, such as locations, products, services, branches etc.
- (b) *Sharī'ah* supervisory board's *fatwās*, guidelines, instructions, prior year internal and external *Sharī'ah* review result to be communicated to all levels of people who required knowing about the internal *Sharī'ah* review.
- (c) Approval documents from the concerned authorities including *Sharī'ah* supervisory boards of the IFIs.
- (d) Examining and evaluating internal *Sharī'ah* review information by collecting, analysing, interpreting and documenting information to support internal review reports.

7.7 Standard Setting Bodies for Islamic Financial Institutions

The Islamic financial institutions make up the Islamic finance industry at domestic and global levels. Those institutions are the banks (including Islamic micro finance banks), Islamic capital market operators, the *Takāful* (Islamic insurance) companies, Islamic investment funds, and Islamic finance companies among others. These institutions all have their unique scope of activities and operations and thus seek to fulfil their respective mandates. For their effective operations and responsible conducts, there is the need to put in place some mechanisms for regulation, and provision of guiding principles as common bases for the Islamic financial institutions.

The regulations that seek to bring the institutions to operate under the ambit of the law usually come from central banks and other regulatory institutions in each jurisdiction. However, those regulations are inadequate to accommodate every aspect of operations of the institutions due to among other reasons, the dual nature of the financial system that is predominantly interest based. Hence a gap exists that can be filled only through the enactment of the complementary set of standards for the adoption of the IFIs. This led to the formation of the three most robust global standard setting bodies for their adoption.

7.7.1 Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

As the oldest standard setting body for the Islamic finance industry since 1991, the AAOIFI headquartered in Manama, the Kingdom of Bahrain is a leading not-for-profit standard setting body for the IFIs. The three areas of coverage of the

standards that AAOIFI is responsible for are the *Sharī'ah*, Accounting and auditing, as well as ethics and governance issues.

There are a number of objectives that the organization seeks to achieve. These include:⁶⁰²

- 1) Developing the needed accounting and auditing, *Sharī'ah*, as well as ethics and governance standards that set the guiding posts for Islamic finance institutions operations pertaining to these activities. This is done in consideration of other international standards and practices that comply with the *Sharī'ah*.
- 2) Disseminating the thoughts arising from the developed standards on accounting and auditing, the *Sharī'ah*, ethics and governance that relate to the activities of the IFIs, as well as the implementation strategies through seminars, issuance of publications, reports preparations, and research outputs presentation.
- 3) Seeking to harmonise the accounting policies and procedures that Islamic financial institutions adopt through the preparation and issuance of exclusively accounting standards. More so, it seeks to improve the quality and establish uniformity of auditing and governance procedures and practices related to the activities of IFIs through the standards that it issues and interprets to the institutions. Furthermore, AAOIFI seeks to champion the cause of imbibing ethical conducts among Islamic finance professionals through the issuance of relevant codes of ethical conduct in the industry.
- 4) Working towards achieving conformity and similarity in the concepts and application of fatawas issued by *Sharī'ah* advisory boards of the IFIs with the view to avoidance of incidences of contradictions and inconsistencies in the application of *Sharī'ah* rulings. This is to be achieved through the development, issuance and provision of interpretations of *Sharī'ah* standards for the IFIs.
- 5) Offering educational and training programs that include professional development programmes in the areas of *Sharī'ah*, accounting and auditing, and ethics and governance, with the aim of promoting knowledge and enhanced professionalism in Islamic banking and finance among Islamic finance professionals.
- 6) Consolidating further on achieved objectives through certification of compliance of issued standards to be issued to IFIs with a view to obtaining enhanced awareness and acceptance of the standards in the Islamic finance industry.

⁶⁰²<http://aaofii.com/?lang=en>.

With respect to membership, AAOIFI draws its membership from founding, associate, regulatory and supervising authorities, observer, and supporting categories. The founding members are those Islamic financial institutions that were the original signatories to the agreement establishing the organization in 1989. In addition to these are other institutions that were subsequently accepted to be members such as the Islamic development bank, al-Rajhi Banking and Investment Corporation, and Kuwait Finance House. The associate membership category comprises of those Islamic financial institutions that comply with *Sharī'ah* rules and principles in their transactions as well as Islamic *fiqh* academies and learning institutions. For the regulatory and supervisory category, it is made up of those institutions that supervise and regulate the activities of the IFIs. The observer member category is composed of organisations and associations that regulate accounting and auditing profession including those that prepare accounting and auditing standards. Other members in this category include financial institutions that are engaged in activities of IFIs, users of financial statements of IFIs, and practicing certified accounting and auditing firms that are interested in the accounting and auditing activities of IFIs. The last category of supporting members is those financial and other institutions that are related with Islamic financial institutions.

In terms of standards development and implementation, it is noteworthy to mention that a robust process that accommodates stakeholders' views is usually followed before final adoption of any standard attained. This ensures a well thought out and articulated standard is always arrived at and, where deemed necessary, revisions are carried out to reflect emerging situations and realities.

To date, a total number of 57 standards have been issued in the *Sharī'ah* category. The standards cover, among other issues, trading in currencies, procrastinating debtor, conversion of conventional bank to an Islamic bank, *Ju'alah*, *Murābaha*, loan concession contracts, banking services in Islamic banks, controls on *gharar* in financial transactions, arbitration, and trading in gold, etc. In the accounting standards category, a total of 38 standards have been issued covering matters such as *Mudārabah* financing, *Zakāh*, investment funds, segment reporting, investments in *Sukūk*, shares and similar instruments among others. For the auditing and governance category, a total of 13 standards and 3 codes of ethics have been issued. The standards cover, among others, appointment into *Sharī'ah* supervisory board including its composition and reporting mechanism, internal *Sharī'ah* review, corporate social responsibility, *Sharī'ah* compliance function and *Waqf* governance.

7.7.2 The Islamic Financial Services Board (IFSB)

The Islamic Financial Services Board (IFSB), based in Kuala Lumpur, began operations on 10th March 2003 after its inauguration on 3rd November 2002. It is another international standard-setting body that focuses its activities on regulatory and supervisory agencies whose primary mandate revolves around ensuring conformity to established prescriptions aimed at attaining the soundness and stability of the Islamic financial services industry.⁶⁰³ The IFIs comprise of banking, capital market and insurance. In the pursuit for attainment of its set mission, the IFSB seeks to promote an Islamic financial services industry that has prudence and transparency as its major features. This is done through the enactment of various standards that cover issues that are consistent with *Shari'ah* principles. In the quest for formulation and recommendation of the standards, the Basel Committee on Banking Supervision (BCBS), the inputs from the International Organisation of Securities Commissions, and the International Association of Insurance Supervisors (IAIS) are considered.

The IFSB as an organization is composed of 187 members, as at June 2021, comprising 81 regulatory and supervisory authorities, 10 international inter-governmental organisations, and 96 market players (financial institutions, professional firms, industry associations and stock exchanges) operating in 57 jurisdictions. There are a total of 36 full members in the organization, 36 associate members, and 115 observer members. The full membership category is composed of the supervisory authorities that engage in the supervision of the banking industry, securities and/or insurance/*Takāful* industries of each of the sovereign jurisdictions that grant recognition to Islamic financial services, through relevant legislations or regulations or by established practices. In this category are also international inter-governmental organisations having the promotion of Islamic finance as their explicit mandate. The associate membership category is composed of any central bank, monetary authority or financial supervisory or regulatory organisation or international organisation that is involved in the setting or promotion of standards that assure stability and soundness of international and national monetary and financial systems but which does not qualify or is not desirous of becoming a full IFSB member. For the observer membership category, national, regional or international professional or industry association, institutions that offer Islamic financial services, firms or organisations that provide professional services (including accounting, legal, rating, research or training services to any aforementioned institutions) are the members.

⁶⁰³<https://www.ifsb.org/published.php>.

From its inception to date, the IFSB has published a number of standards, technical notes and guidance notes that undergo stages and cover different matters relevant to IFIs. The standards include IADI-IFSB (July 2021) on Core Principles for Effective Islamic Deposit Insurance Systems, IFSB-24 (December 2020) on guiding principles on investor protection in Islamic capital markets, IFSB-22 (December 2018) on Revised Standard on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services [Banking Segment], IFSB-18 (April 2016) on Guiding Principles for Re-*takāful* (Islamic Reinsurance), and IFSB-16 (March 2014) on revised guidance on key elements in the supervisory review process of institutions offering Islamic financial services (Excluding Islamic Insurance (*Takāful*) institutions and Islamic collective investment schemes) etc. The technical notes issued include TN-3 (December 2019) on Technical Note on Financial Inclusion and Islamic Finance, TN-2 (December 2016) Technical Note on Stress Testing for Institutions Offering Islamic Financial Services (IIFS), TN-1 (March 2008) on Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets. Guidance notes were also issued including GN-7 (December 2019) guidance Note on *Shari'ah*-compliant Lender-Of-Last-Resort Facilities, and GN-5 (March 2011) Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIS) on *Takāful* and Re-*Takāful* Undertakings.

To facilitate the implementation of the standards, technical notes and guidance notes were developed and issued. The IFSB also employed other means including FIS workshop, e-learning and train the trainers.

7.7.3 International Islamic Financial Market (IIFM)

IIFM is yet another global standard-setting body of the Islamic Financial Services Industry (IFSI) also headquartered in Bahrain and established in the year 2002 with royal legal backing under decree no 23. Its membership cuts across categories of founding and permanent members, associate members, and observer members.⁶⁰⁴ The founding members were the signatories to the agreement establishing the institution and which are the Central bank of Bahrain, the Islamic Development Bank, Bank Negara Malaysia, Bank Indonesia, Central bank of Sudan, as well as the Autoriti Monetari Brunei, Darussalam (formerly Ministry of Finance Brunei Darussalam). Apart from its founding and permanent members, IIFM is made up of a Board of Directors consisting of Islamic and international banks namely Kuwait Finance House, Dubai Islamic Bank, National Commercial Bank, Bank

⁶⁰⁴<https://www.iifm.net/standards/>.

ABC Islamic, Gulf Finance House, Standard Chartered, Credit Agricole CIB and National Bank of Kuwait. The institution also enjoys support of some regulatory and governmental bodies including State Bank of Pakistan, National Bank of Kazakhstan and DIFC Authority as well as from by a number of international and regional financial institutions and other market players active in Islamic finance.

The organization is guided by a vision to attain an active and well-regulated trading and capital flows across the full spectrum of *Shari'ah*-compliant financial instruments at international levels. Its mission is geared to achieve its vision by catalysing both the available national and international trading infrastructure, product innovation and information flow that emanates from within strong, transparent and well-regulated standards and guidelines. Furthermore, IIFM is mandated to sustainably develop and issue a standardized *Shari'ah*-compliant financial documentation, product confirmations and guidelines for the Islamic Financial Services Industry (IFSI). Thus, the IIFM is a non-profit and neutral international Islamic infrastructure development institution that focuses primarily on ensuring standardization of *Shari'ah*-compliant financial contracts and product templates through a variety of standards it develops and publishes.

The IIFM publishes standards, which are related to hedging, liquidity management, *Sukūk*, trade finance, and IBOR transition that are practical and ready-to-use globally. Some of the published standards in this category are IIFM standard No. 2 on Tahawwut Master Agreement (TMA), IIFM standard no 3 on ISDA/IIFM *Mubādalatul Arbāh* (MA) (Profit Rate Swap) – Single Sale, IIFM standard no 7 on ISDA/IIFM Islamic Cross-Currency Swap (ICRCS), IIFM standard no 9 on ISDA/IIFM Islamic Foreign Exchange Forward (IFX Forward) – Two Unilateral and Independent *Wa'd*-based Standards. For liquidity management, the issued standards are the IIFM standard no 1 on Master Agreements for Treasury Placement (MATP), IIFM standard no 5 on Inter-Bank Unrestricted Master Investment *Wakālah* Agreement (UMWA), and IIFM standard no 6 on Master Collateralized *Murābaha* Agreement (MCMA). For the *Sukūk* related issues, the standards issued include IIFM standard no 1 on Master Agreements for Treasury Placement (MATP), IIFM standard no 6 on Master Collateralized *Murabaha* Agreement (MCMA). In the trade finance standards category, the issued standards are the IIFM standard no 11 on IIFM-BAFT Master Unfunded Participation Agreement, and IIFM standard 12 on IIFM-BAFT Master Funded Participation Agreement. In the last category of IBOR related issues, the only issued standard is the IIFM standard no 15 on IIFM Risk-Free Rate (RFR) Solutions, while two others are under development.

In terms of dissemination of the standards and implementation, this is done through the creation of industry awareness and sharing of technical knowledge on the IIFM Standards by organising specialised seminars, technical workshops and standardization specific industry consultative meetings. The IIFM also publishes an annual *Sukūk* report and periodic concept papers on specific topics.

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8

ISLAMIC SOCIAL FINANCE

8.1 Introduction

Islamic Social Finance (ISF) is viewed as making available resources to the vulnerable members of the society through arrangements that empower recipients.⁶⁰⁵ The term encompasses those modes of finance anchored on Islamic ethics which aim at the attainment of social benefits. Unlike the Islamic commercial contracts, which banks enter into, in which the main objective is to generate returns in form of profit among others, Islamic social finance is primarily a not-for-profit effort, but fundamentally a charitable and philanthropic gesture to the less endowed.

The primary focus in Islamic social finance is to solidify cohesion among members of the society by extending empathy, compassion and sympathy from the wealthy members of society to the less wealthy in different manners. The sector is made up of the traditional Islamic institutions based on philanthropy which are the *Zakāh*, *Waqf*, *Sadaqah*, and those on mutual cooperation such as *Qard* (loan) and *Kafālah* (guarantee).⁶⁰⁶

8.2 *Zakāh*

Zakāh is the third of the five pillars of Islam that has profound socio-economic implications on the society, particularly in reducing poverty levels among other outcomes. In al-Qaradāwī's work,⁶⁰⁷ it is mentioned that '*Zakāh* in the Arabic language is an infinitive of the verb *Zakāh*, which means to grow and to increase. When it is said in relation to a person, it means to improve, to become better. Consequently, *Zakāh* is blessing, growth, cleanliness, and betterment.

Zakāh is seen to have three different dimensions of its understanding with respect to linguistic, theological and legal phases. Linguistically, *Zakāh* means to cleanse or purify something from dirt or filth; theologically, it means to spiritually purify as a consequence of giving of *Zakāh*; while legally it means to transfer ownership

⁶⁰⁵Lawal, I. M & Ajayi, J. M. A. (2019). The role of Islamic social finance towards alleviating the humanitarian crisis in North-East Nigeria Jurnal Perspektif Pembiayāndan Pembangunan Daerah 6 (5), p. 547.

⁶⁰⁶Islamic Social Finance Report (2014). Islamic Research and Training Institute, Islamic Development Bank, Jeddah.

⁶⁰⁷Qaradāwī, Y. A. (2011). *Fiqh al-Zakāh: A Comprehensive Study of Zakāh Regulations and Philosophy in the Light of the Qur'ān and Sunnah*. Islamic Book Trust, Kuala Lumpur, pp. 3-10.

of specific property to specified individuals under stated conditions.⁶⁰⁸ In a broader sense, *Zakāh* is defined as “a compulsory payment of a specified amount from specific kinds of wealth, under certain conditions, by those who own a specific amount to specified categories of recipients.”⁶⁰⁹

There are numerous verses in the *Qur’ān* that direct Muslim individuals to give *Zakāh* (charity) and recognise it as important as prayer.⁶¹⁰ According to al-Qaradāwī, the *Qur’ān* mentions *Zakāh* in about 30 places of which in 27 places it was joined with *Salah*.⁶¹¹ In addition, the *Hadīth* of Angel Jibril’s question to the Prophet (peace be upon him) about Islam,⁶¹² and the *Hadīth* of Ibn Umar on the pillars of Islam,⁶¹³ both mention *Zakāh* as one of the five pillars of Islam. Also, when the Prophet (peace be upon him) sent Mu’adh bn Jabal (may Allah be pleased with him) to Yemen to call to Islam, he instructed him to tell them about *Zakāh* after calling them to the *Kalimatush shahādah* and the five daily prayers.⁶¹⁴

Abubakar⁶¹⁵ maintains that “*Zakāh* represents a system of wealth redistribution from those considered to be capable of contributing their excessive wealth to those lacking enough. *Zakāh* in Islam is therefore a right of the poor over the rich; it is never considered a favour by the rich to the poor.

⁶⁰⁸ AbdulWahab, N. & Abdul Rahman, A. (2011). A framework to analyse the efficiency and governance of zakat institutions. *Journal of Islamic Accounting and Business Research*, Vol. 2, No. 1, 43-62.

⁶⁰⁹ Dogarawa, A. B. (2022). The Importance of *Zakāh* and *Waqf* in Poverty Alleviation, Job Creation and Tackling Insecurity, p. 2. https://www.researchgate.net/publication/361151272_THE_IMPORTANCE_OF_ZAKAH_AND_WAQF_IN_POVERTY_ALLEVIATION_JOB_CREATION_AND_TACKLING_INSECURITY.

⁶¹⁰ Ismail, A., Tohirin, A., & Ahmad, M. A. J. (2013). Debate on Policy Issues in the Field of Zakat on Islamic Bank Business. IRTI Policy Paper.

⁶¹¹ For example, *Qur’ān*, 73:20 and *Qur’ān*, 2:43. See Dr. Yūsuf al-Qaradāwī’s *Fiqh al-Zakāh*, 1/51.

⁶¹² Muslim (8).

⁶¹³ Bukhārī (Hadīth, 8) and Muslim (Hadīth, 16).

⁶¹⁴ Bukhārī (Hadīth, 1496) and Muslim (Hadīth, 19).

⁶¹⁵ Abubakar, M. (2020). Social Empowerment through Islamic Finance In: Rafay, A. (2020). Handbook of Research on Theory and Practice of Global Islamic Finance (pp. 1-888). Hershey, PA: IGI Global.

8.2.1 Zakatable Items and their *Nisāb*

The payment of *Zakāh* is obligatory on all Muslims who meet the stipulated conditions, from five kinds of wealth:⁶¹⁶

- a) Gold and Silver, modern currencies and bank-notes held in cash or in the bank if they attain *nisāb* (the minimum amount of wealth on which *Zakāh* is due) and one full year passes from the day they reach the *nisāb*. The *nisāb* for silver is 200 *dirhams* which is worth 595 grams of silver and for gold is 20 *dīnārs* which is worth 85 grams from which 2.5% is to be paid for lunar year or 2.577% for solar year.
- b) Agricultural produce (grains such as wheat, barley, dates and dried grapes as well as their equivalents such as maize, corn, millet, rice, beans, sorghum and soya beans) are subject to *Zakāh* at harvest. The minimum amount of crop liable to payment of *Zakāh* is 300 *sā'i* (about 653 grams or approx. 6½ bags); one-tenth (10%) is paid if the seeds were watered by rain, half of the tenth (5%) if watered by irrigation, or three quarters of the tenth (7.5%) if partially watered by irrigation.
- c) Grazing livestock and cattle (that is cows, goats and sheep, and camel) are also subject to payment of *Zakāh* if they attain *nisāb* and one full year passes from the day they reach the *nisāb*. Al-Qaradāwī⁶¹⁷ outlines a number of conditions to be satisfied before *Zakāh* is levied on livestock. These conditions are; the *nisāb*, passage of a year holding by the owner, natural pasturing of the livestock, and that the zakatable livestock should not be the working type. *Zakāh* on animals is dependent on the progression in numbers, for example, one goat on five camels; two goats on ten camels; three goats on 15 camels; four goats on 20 camels; one *bint makhād* on 25 to 30 camels, etc. For cows, the popular upheld opinion of the four schools of law is that 30 is the *nisāb* for levying a one-year-old cow as *Zakāh*. For sheep/goat, the minimum number is 40 up to 120 upon which one sheep/goat is levied as *Zakāh*.
- d) Trade goods or assets (including company shares) purchased with the intention of trading in it (*'urūd al-tijārah*) are subject to *Zakāh* if one full year passes and it reaches *nisāb* either by itself or when added to other cash excluding the value of tools, equipment, vehicle, buildings used for operations. The cash equivalent of trade goods is determined based on market value of the goods at the time of

⁶¹⁶Dogarawa, A. B. (2022). The Importance of Zakah and Waqf in Poverty Alleviation, Job Creation and Tackling Insecurity, pp. 3-6.

⁶¹⁷ Qaradāwī, Y. (2011). *Fiqh al-Zakāh: A Comprehensive Study of Zakah Regulations and Philosophy in the Light of the Qur'ān and Sunnah*. Islamic Book Trust, Kuala Lumpur, pp. 110-136.

assessment of *Zakāh* NOT their historical cost. Similarly, earned income (*al-māl al-mustafād*) such as salaries, wages, professional fees, bonuses, windfalls, up-fronts, inheritance and gifts are subject to *Zakāh* if some of it is saved and the amount reaches the *nisāb* either by itself or when added to other cash at the time of *Zakāh* assessment. The *nisāb* for trade goods and earned income is the same with the *nisāb* of gold, silver and currencies from which 2.5% is to be paid based on lunar year or 2.577% based on solar year.

- e) Minerals (*ma'din*)⁶¹⁸ are also subject to *Zakāh* if it attains *nisāb* either by itself or its value reaches the equivalent of the *nisāb* of gold, silver and currencies from which 2.5% is to be paid based on lunar year or 2.577% based on solar year. Similarly, *Rikāz* (treasures), which are all those substances upon which one-fifth (*khums*) is payable at the time they are found regardless of a *nisāb* are counted among zakatable items.

The condition of the passing of one full lunar year of zakatable wealth from the date of taking possession of the *nisāb* does not apply to the case of (1) business profit; (2) babies of livestock; (3) farm produce; and (4) minerals and treasures:

- a) Profit made from a business is added to the original amount (principal) at the time of paying *Zakāh*
- b) Babies of livestock due for payment of *Zakāh* are added to the flock and counted together with their mothers.
- c) *Zakāh* of farm produce is due for payment on the day of its harvest, in line with *Qur'ān*, 6:141.
- d) *Zakāh* on minerals and treasures is due for payment on the day of extraction.

8.2.2 Beneficiaries of *Zakāh*

The *Qur'ān* has categorically mentioned eight (8) categories of *Zakāh* recipients namely: the poor, the needy, those collecting and distributing *Zakāh*, those whose hearts are inclined (towards Islam), those in captivity, those in debt, for Allah's cause, and wayfarers.⁶¹⁹

- 1) The poor: A poor person is one who does not have enough to meet his and his dependents' needs of food, drink, clothes and home. He may have nothing, or may not have enough.

⁶¹⁸ Scholars differ about minerals (*ma'din*) which are subject to *Zakāh*.

⁶¹⁹ *Qur'ān*, 9:60.

- 2) The needy: A needy person is one who gets half what he needs for living, or even more than half.
- 3) Administrative workers: This refers to anyone assigned by the Muslim ruler to collect *Zakāh*. The ruler gives him what he needs during his travel until he returns, even though he may be rich.
- 4) Those whose hearts are to be won over: These are people who may be unbelievers and they are given money out of *Zakāh* to win their goodwill towards Islam.
- 5) The freeing of people in bondage: This refers to Muslim slaves who may be bought to give them their freedom. Their price may be paid out of *Zakāh* funds.
- 6) Debtors: This applies to a person who has incurred a debt for a legitimate purpose, whether it is for personal reasons or to help others.
- 7) To further Allah's cause: This applies to fighters for Allah's cause who volunteer to join the Muslim army and they have no salary.
- 8) The traveller in need: This refers to a traveller who is unable to continue his journey to his place of residence.

There is also preference for distribution of *Zakāh* proceeds in the location it was earned as stated in the *Sunnah*. The Prophet (peace be upon him) said to his companion, Mu'ādh bn Jabal (may Allah be pleased with him), "...then teach them that Allah has made it obligatory for them to pay the *Zakāh* from their property and it is to be taken from the wealthy among them and given to the poor."⁶²⁰ However, it is permissible to take the whole of *Zakāh* proceeds to other locations in the absence of (willing) recipients in its location; similarly part of the proceeds could be taken to other locations where its recipients are either relatives (in the case of individual payers) or have dire need.

Islamic financial institutions can play an important role in *Zakāh* administration in two ways. Firstly, IFIs can commit to reminding shareholders and investors about the obligation on them to pay *Zakāh* from the value of their shares and/or investment account that fulfill its requirements. Secondly, IFIs can on behalf of shareholders and/or investors pay *Zakāh* on the value of shares and investment if authorised to do so.

It should be noted, however, that owners of company shares that are zakatable are individually responsible for the payment of *Zakāh* because they are the true owners

⁶²⁰Bukhāri (Hadīth, 1395).

of the money, and the company handles the shares on their behalf and the fact that, despite its being an independent entity, some conditions of *Zakāh* being obligatory cannot be met by a company. In addition, *Zakāh* is an act of worship which requires an intention when it is done.

Notwithstanding the above, a company can pay *Zakāh* on behalf of shareholders in any of the following cases as contained in resolution 28:3/4 of the OIC Fiqh Academy and *Sharī'ah* standard 35:2/2/1 of AAOIFI:⁶²¹

- i) the Law of the State obliges companies to pay *Zakāh*;
- ii) stipulation of commitment to pay *Zakāh* in the articles of association;
- iii) resolution by the general assembly; or
- iv) a shareholder authorises the company to pay *Zakāh* on his behalf.

Where the company's governance pays *Zakāh* on its shares, it is required to do so in the same manner as a person pays *Zakāh* on his wealth by assuming that the capital of all shareholders is the property of a single person. Where none of the aforementioned cases applies, payment of *Zakāh* remains the responsibility of shareholders; however, the company is required to indicate the amount of *Zakāh* payable per share or per a given balance of an investment account. If some of the shareholders authorise the company to pay *Zakāh* on their behalf and some do not, then the company should pay the *Zakāh* of only those who give authorisation.⁶²²

According to the more correct scholarly view, *Zakāh* funds cannot be used for payment of scholarships, building of mosques or funding its activities, building of hospitals and construction of roads. However, resolution 165:3/18 of the OIC Fiqh Academy permits giving assistance to poor students who are outside their countries and have no scholarships.⁶²³

8.3 Waqf

Since the dawn of Islam, Islamic philanthropy proliferated globally in parallel to the spread of Islam. One of such philanthropic institutions is *Waqf*, which has proven to be an effective instrument in funding impactful community empowerment initiatives, and has significant potential of solving many of the

⁶²¹Dogarawa, A. B. (2022). The Ruling on Zakah for Salary Earners and Business Men and Women, p. 28.

⁶²² Dogarawa, A. B. (2022). The Ruling on Zakah for Salary Earners and Business Men and Women, p. 29. See: Ibn Al-Uthaimīn in *Majmū' Fatāwā*, 18/217.

⁶²³Ibid, p. 40.

present-day challenges of poverty, insecurity and other social maladies. *Waqf*, as a form of charity, is a mechanism of continuous giving and is defined literally as holding, confining and prohibiting the use of something. Technically, *Waqf* means holding an asset and preventing its consumption for the purpose of repeatedly extracting its usufruct for the benefit of an objective representing righteousness and/or philanthropy for as long as its principal is preserved by its own nature or from arrangements and conditions prescribed by the *Waqf* founder.⁶²⁴

The term *Waqf* is not specifically mentioned either in the *Qur'ān* or *Hadīth* but Islamic jurists deduced its legitimacy and its rules, primarily from the *Qur'ān*, authentic *Hadīth* and *Ijmā*. In the *Qur'ān*, *Waqf* is based on a number of verses that cover the subject matter of philanthropic spending.⁶²⁵ In the *Hadīth*, the Prophet (peace be upon him), said:

“The rewards of the good deeds that will reach a believer after his death are: knowledge which he taught and spread; a righteous son whom he leaves behind; a copy of the *Qur'ān* that he leaves as a legacy; a mosque that he built; a house that he built for wayfarers; a canal that he dug; or charity that he gave during his lifetime when he was in good health. These deeds will reach him after his death.”⁶²⁶

The Prophet (peace be upon him) also said: “When a man dies, his deeds come to an end except for three things: *Sadaqah Jāriyah* (ceaseless or continuing charity); knowledge that others benefit from, or a righteous son who prays for him (for the deceased).”⁶²⁷

Ibn Rushd, al-Jadd,⁶²⁸ reported an *Ijmā*' (consensus) regarding the legislation of *Waqf*.⁶²⁹ In addition, Jābir, the Prophet's companion stated that he was not aware of any of the Prophet's companions who was capable of making an endowment

⁶²⁴Dogarawa, A. B. (2022). The Importance of Zakah and Waqf in Poverty Alleviation, Job Creation and Tackling Insecurity, pp. 6-7.

⁶²⁵ See for example, *Qur'ān* 2:262; 2:267; 3:92; 64:15-17.

⁶²⁶Transmitted by Ibn Mājah (242).

⁶²⁷Transmitted by Muslim (3084).

⁶²⁸In his book *Al-Muqaddimāh Al-Mumahidāh*, 2/407.

⁶²⁹ See: Dogarawa, A. B. (2022). The Importance of Zakah and Waqf in Poverty Alleviation, Job Creation and Tackling Insecurity, p. 7.

(*Waqf*) except that he did.⁶³⁰

Waqf generally provides the material infrastructure and creates a source of revenue for use in, among others, social welfare enhancing activities at all levels such as education, skills and micro entrepreneurial development, health care, famine and water and sanitation facilities in rural areas.

8.3.1 Types of *Waqf*

Resolution 181 (7/19/1) of the OIC Islamic *Fiqh* Academy states that *Sharī'ah* texts on *Waqf* are absolute and therefore can encompass the diverse types of *Waqf*, including perpetual versus temporary; specific versus common; assets and benefits versus money; and real estate versus moveable property. Based on the above OIC Islamic *Fiqh* Academy resolution, *Waqf* may be classified into two categories: based on its nature/kind and its purpose/beneficiaries bearing in mind that it may be perpetual or temporary.⁶³¹

- i) Based on its nature/kind, *Waqf* is further classified into property, corporate and cash *Waqf*. In property *Waqf*, the assets involve physical assets such as mosques, plots of land, orchards, farmlands, houses, hospitals, offices, buildings, bridges, and other properties that can benefit the beneficiaries. The donor cannot reclaim back such *Waqf* assets. Corporate *Waqf* is a contemporary type of *Waqf* that is in line with resolution 181 (7/19/2) of the OIC Islamic *Fiqh* Academy. The assets in this type of *Waqf* are in the form of corporate shares of a company that are issued and managed by a corporate body such as Islamic banks, *Takāful* companies, *Sharī'ah*-compliant investment companies, etc.⁶³² Cash *Waqf* is a contemporary type of *Waqf* which differs from the popular immovable properties and lands of *Waqf* in that its original capital consisted purely or partially, of cash.⁶³³ Resolution 140 (6/15/1) of the OIC Islamic *Fiqh*

⁶³⁰ Transmitted by Abubakr Al-Khassāf in *Ahkām al-Awqāf* (15).

⁶³¹ Dogarawa, A. B. (2022), op cit., pp.7-9.

⁶³² This is based on a more correct scholarly view. Resolution 181 (7/19/2) of the OIC Islamic *Fiqh* Academy states that “*Waqf* of company shares, that are permissible to own, is permissible. Also, permissible is *Waqf* of *Sukūk*, abstract/intellectual rights, usufructs, and investment units, since all these are *Sharī'ah*-recognizable properties.”

⁶³³ This is based on the more correct scholarly opinion regarding the permissibility of using money/cash to establish *Waqf* as held by the Mālikī school and one of the reported opinions in the Hanbalī school. Some Shāfi'ī and Hanafī scholars also held the opinion. Ibn Taymiyyah and Al-'Uthaymīn argued in its favour. They all considered cash *Waqf* permissible provided it would be used as a revolving fund for granting soft benevolent loans or to prudently invest in profitable ventures so that the profit realised would be used for the benefit of the specified beneficiaries while the capital/principal amount is retained as *Waqf* asset. This is in line with resolution 140 (6/15/2) of the OIC Islamic *Fiqh* Academy.

Academy states that “creating cash *Waqf* is permissible since it satisfies the *Shari’ah* objective of *Waqf*, that is, retaining the principal and offering its benefits and because units of money have no specific merits that prevent units from standing for and replacing each other.” Cash *Waqf* was used during the Ottoman Empire to finance entrepreneurs for their businesses, and then the return was used for public services.

- ii) Based on its purpose/beneficiaries, *Waqf* is categorised into public or philanthropic, family and mixed or joined *Waqf*. Public *Waqf* (*Waqf Khayrī*) is created for religious or charitable and philanthropic purposes. Its main purpose is to support the welfare of poor and vulnerable people. It is used as an investment for building mosques, sheltering homes, schools, healthcare facilities, elderly care, environmental protection, microfinance, colleges and universities to help and uplift economically challenged individuals. Family *Waqf* (*Waqf Ahlī*) is created for the benefit of the donor's own family, his descendants and/or relatives or other specific individuals. The nominees do not have a right to sell or dispose of the property which is the subject-matter of *Waqf*. This kind of *Waqf* is transferred to benefit the public if the donor's specified beneficiaries of the *Waqf* are deceased. Joined or Mixed *Waqf* (*Waqf Mushtarak*) is a type of *Waqf* where the donor dedicates a part of it to his family and another part to the public, so that both receive the benefits.

A *Waqf* bank, particularly microfinance bank, can be established using *Waqf* fund provided the bank's intrinsic utility is in the interest of the *Waqf*, its beneficiaries, Muslims and the society in general; and provided its structure and operations are *Shari’ah*-compliant. The purpose and functions of a *Waqf* bank can be the same with cash *Waqf*. Apart from using its entrusted capital for investment on *Mushārah* or *Mudārah* basis and in other income generating businesses that such a bank can go into with the aim of making profit that can be used to achieve the purpose of the original *Waqf*, the bank can also, subject to regulatory provisions, use cash deposits made by depositors to invest in short term *Sukūk* and provide financing for *Murābaha*, *Ijārah* and *Salam* in order to subsequently use the profit for the benefits of the *Waqf* beneficiaries such as granting of *Qard-hasan* (benevolent loans). Furthermore, *Waqf* can be used to establish *Takāful* institutions.

8.4 Importance of *Zakāh* and *Waqf* in Muslim Society

Zakāh and *Waqf* are the main mechanisms of Islamic social finance that provide a social safety net (SSN) to Muslim society through wealth redistribution in line with its social and economic welfare system to achieve social cohesion, mutual

cooperation and self-sufficiency. Scholars have identified five reasons for using *Zakāh* and *Waqf* as SSN mechanisms in Islam.⁶³⁴

1. It serves as a means of establishing a natural and practicable economic system, and helps in achieving efficiency by transferring surplus resources to those who lack capital. In the *Qur'ān*, Allah, the Most High says, “Is it they who distribute your Lord’s mercy? We [alone] have distributed their [very] livelihood among them in this worldly life and raised some of them in rank above others so that some may employ others in service...”⁶³⁵
2. It inculcates in a Muslim the fact that man has created nothing; but he adds to the utilities of things, thus must give a portion of it as the right of the poor and needy for Allah’s sake. Allah the Most High says, “And give them some of Allah’s wealth which He has granted you.”⁶³⁶ He also says, “Do they not see that We singlehandedly created for them, among other things, cattle which are under their control?”⁶³⁷ Furthermore, Allah the Exalted, says: “...and spend from what He has entrusted you with.”⁶³⁸
3. It enables everyone to get what is rightfully his thus reducing the possibility of jealousy to the barest minimum between the haves and the have-nots. Allah, the Most High, says, “And those within whose wealth is a known right. For the one who asks and the one who is deprived.”⁶³⁹ In another place, He says, “...and give its due [*Zakāh*] on the day of its harvest.”⁶⁴⁰
4. It helps in avoiding concentration of wealth in a few hands, and encourages its circulation in the society as widely as possible to narrow the gap between the rich and the poor. Allah the Exalted says, “...so that wealth may not merely circulate among your rich.”⁶⁴¹
5. It creates an atmosphere of love, cooperation, goodwill and fellow feeling.

Both *Zakāh* and *Waqf* are wealth redistribution mechanisms that can be used to improve the quality of life for those people currently living in poverty and to permanently lift people out of poverty. To achieve the objective of poverty alleviation, some contemporary scholars opine that proceeds of *Zakāh* could be

⁶³⁴ Dogarawa, A. B. (2022), op cit., pp. 9-10.

⁶³⁵ *Qur'ān*, 43:32.

⁶³⁶ *Qur'ān*, 24:33.

⁶³⁷ *Qur'ān*, 36:71.

⁶³⁸ *Qur'ān*, 57:7.

⁶³⁹ *Qur'ān*, 70:24-25.

⁶⁴⁰ *Qur'ān*, 6:141.

⁶⁴¹ *Qur'ān*, 59:7.

given to its beneficiaries in the following ways:⁶⁴²

- a) Start-up capital for small business;
- b) Establishment of skills acquisition centers for training of beneficiaries and acquisition of relevant tools for those who are trained on some particular skills;
- c) Scholarship to acquire basic/higher education in areas of need;
- d) Support to hospitals for free treatment of less privileged members of the society;
- e) Support to charitable organisations that carry-out their activities in Muslim minority countries/communities; and
- f) Payment of salaries of those engaged in *Da'awah* activities.

Waqf can also be used to address socio-economic issues of the society, which include satisfaction of the basic economic needs of the poor; education; skills and micro entrepreneurial development; health care, and water and sanitation facilities; defence of the Muslim *Ummah* and its ideology; and solving dangerous problems such as poverty, unemployment and catastrophes.

Zakāh and *Waqf* not only improve the welfare of the poor, but also evolve as a sustainable practical mechanism to manage the socio-economic gap in any society. As veritable tools of poverty alleviation, *Zakāh* and *Waqf* represent a mechanism for (a) increasing income, (b) increasing the fairness of income distribution, and (c) providing equal opportunity for all social segments.⁶⁴³ They are also meant to help the needy and to boost people's economic ability to fulfil basic needs. They act as tools of strengthening the social economy of Muslim societies such that, once effectively managed and administered, they will function to reduce the gaps between the rich and poor through fair welfare distribution.⁶⁴⁴

8.5 Sadaqah (Voluntary Charity)

The word *Sadaqah* means to voluntarily give charity out of the goodness of one's heart. It may be defined as an act of "giving something without seeking a substitute

⁶⁴²International Islamic Fiqh Academy, Resolutions 15 (3/3) and 165 (3/18).

⁶⁴³ Ariyani, N. (2016). Zakat as a Sustainable and Effective Strategy for Poverty Alleviation: from the Perspective of a Multi-Dimensional Analysis. *International Journal of Zakat*, Vol. 1, Issue 1, pp. 91-92.

⁶⁴⁴ Zulkifli, M. F., Taha, R., Awang, R. N., Mohammed Nor, M. N. & Ali, A. (2021). Combating Poverty in Malaysia: The Role of Zakat. *Journal of Asian Finance, Economics and Business*, Vol. 8, No. 5, p. 507.

in return and with the intention of pleasing Allah.”[5] It is an act of “benevolence”, which its broader umbrella of charity comprises *Zakāh*, *Qard al-hasan* and *Sadaqah jāriyah* (ceaseless charity such as *Waqf*).

In Islam, it is required of a believer to give *Sadaqah* as an act of personal devotion to Almighty Allah. However, giving *Sadaqah* is not an Islamic obligation on those who have the means, but rather a practice conducted to help those in need or the deprived, which goes to show the strength of the believer’s faith and increases it further.⁶⁴⁵ Generally, the scope of *Sadaqah* is not limited to giving money; it can be anything as small as flashing a smile towards a stranger or removing an obstacle or thorn from a path. It generally covers any deed that helps someone else, in any way.

Sadaqah is given to individuals who are genuinely poor and can barely make ends meet or those who cannot make ends meet at all such as the poor, the needy, the deprived, the homeless and the widowed as well as people who are sick and cannot find employment, those who have been out of work for too long and cannot sustain a full-time job and those who are disabled. The main objective of giving *Sadaqah* is to reduce financial inequality, maintain social welfare in the society and provide for those who cannot provide for themselves. Therefore, in addition to purifying the wealth of the giver and serving as a shield to him against calamities, *Sadaqah* also helps to establish a flow of wealth in the society and facilitates economic stability that flows through the society with the distribution of wealth.

Some of the merits of *Sadaqah* are:

- i) *Sadaqah* is an investment in this life and the hereafter. According to a *Hadīth*, Allah takes a *Sadaqah* (whether little or big) given from legitimate wealth in His right hand and tends it for the one who gave it until it becomes like a mountain.”⁶⁴⁶
- ii) *Sadaqah* purifies the soul and facilitates the attainment of 'righteousness'. Allah the Most High says, ‘By no means shall you attain righteousness unless you give (freely) of that which you love. And whatever you spend; indeed, Allah knows it well.’⁶⁴⁷

⁶⁴⁵See Qur’ān, 2:254; 2:261-262; 2:267; 2:271; 2:273; 57:7; 64:16.

⁶⁴⁶Bukhārī (1344) and Muslim (1014).

⁶⁴⁷*Qur’ān*, 3:92.

- iii) There is no day on which the people get up but an angel comes down and supplicates for the giver of *Sadaqah* seeking Allah to give in compensation to the one who spends (in charity).⁶⁴⁸
- iv) Allah the Most High spends on the person who spends (in charity).⁶⁴⁹
- v) *Sadaqah* removes sin and extinguishes it as water extinguishes fire.⁶⁵⁰ In another *Hadīth*, the Prophet (peace be upon him) said, "O people of trade! Indeed Shaitan and sin are present in buying and selling activities, so mix (purify) your sales with charity."⁶⁵¹
- vi) *Sadaqah* allows only those believers who were charitable to enter Paradise through the gate of *Bāb as-Sadaqah* - one of the eight gates of *Jannah*.⁶⁵²
- vii) The person who gives hidden *charity* will be one of the seven people to be sheltered under Allah's shade on the Day of Judgment.⁶⁵³ According to the Prophet (peace be upon him), "Everybody will be shaded by his *Sadaqah* (on the Day of Judgment) until he has been judged between the people."⁶⁵⁴
- viii) *Sadaqah* protects the believer who spends in charity from the heat of the grave and shades him on the Day of Judgment.⁶⁵⁵
- ix) *Sadaqah* is a means of curing the sick. The Prophet (peace be upon him said), "Cure your patients with charity."⁶⁵⁶
- x) *Sadaqah* facilitates the fulfilment of the giver's needs; it eases hardships and removes discomfort and calamities.
- xi) *Sadaqah*, like *Zakāh*, enhances the well-being of the people in Islamic society, helps in fulfilling the needs of poor members of Muslim community, and lightens the debt of the Muslim debtors.

8.6 *Qard al-Hasan* (Benevolent Loan)

The unconditional prohibition of interest in all lending activities is one of the main principles of Islamic finance. This means any debt or loan which carries a monetary reward tied to the time of lending is not allowed. However, Islam recognises and

⁶⁴⁸Bukhāri (Hadīth, 1374) and Muslim (Hadīth, 1010).

⁶⁴⁹Bukhāri (Hadīth, 5073) and Muslim (Hadīth, 993).

⁶⁵⁰Ibn Mājah (Hadīth, 4108).

⁶⁵¹Tirmidhī (Hadīth, 1208).

⁶⁵²Tirmidhī (Hadīth, 4037).

⁶⁵³Bukhāri (Hadīth, 1423) and Muslim (Hadīth, 1031).

⁶⁵⁴Ahmad (28/568), Ibn Hibbān (Hadīth, 3310) and Hākim (Hadīth, 1537).

⁶⁵⁵Sahīh al-Targhīb wa al-Tarhīb (Hadīth, 873).

⁶⁵⁶Sahīh al-Jāmi' al-Saghīr (Hadīth, 3358).

permits a loan from one party to another with a promise to pay back the principal but without any interest or return or rent. This generally implies a no-cost loan often granted to consumers and businesses on a goodwill basis.

Qard-al-hasan (benevolent loan) is a type of loan meant to provide help to community members who are under financial distress. It is a voluntary loan that is extended to those in need without any expectation by the creditor of any return on the principal. Daher defined it as “an Islamic finance term that essentially refers to a loan that is interest free.”⁶⁵⁷ In *Sharī’ah* Standard 19/2, AAOIFI defined *qard* as “the transfer of ownership in fungible wealth to a person on whom it is binding to return wealth similar to it.”⁶⁵⁸

Benevolent loan has been described in the *Qur’ān* as “beautiful” (*hasan*) probably because, in all the verses in which this loan is mentioned, it is stipulated that it is made directly to Allah the Most High and not to the recipient. This probably explains why Allah, the Most High, promises multiple returns to the givers of the “beautiful loan.”⁶⁵⁹ *Qard al-hasan* enables Muslims to further the social justice ethos that underpin Islamic finance. In practice, Islamic finance facilitates loans from those with the funds to those who need financial assistance without breaching *Sharī’ah* rules. In this regard, *Qard al-hasan* can be viewed as a loan agreement that is akin to giving charity.⁶⁶⁰

According to Daher,⁶⁶¹ *Qard al-hasan* is a key concept that acts as a crucial redistributive instrument. The distribution of funds from the rich to the poor, which *Qard al-hasan* facilitates, aims at reinforcing social unity and cooperation. In recent times, it has been identified as an important tool in the fight against poverty and the drive to ensure there is more financial freedom and equity for poorer communities.

Iqbal and Shafiq⁶⁶² identified some key characteristics of *Qard al-hasan* to include the following:

⁶⁵⁷Daher, H. (2021). *Qard Al-Hassan - Benevolent Lending*. <https://www.qardus.com/news/qard-al-hassan-benevolent-lending>.

⁶⁵⁸ AAOIFI *Sharī’ah* Standards, p. 518.

⁶⁵⁹ See for example *Qur’ān*, 64: 17, 2:245; 5:12; 57:11; 57:18; 73:20.

⁶⁶⁰Daher, H. (2021). *Qard Al-Hassan - Benevolent Lending*, op cit.

⁶⁶¹Ibid.

⁶⁶²Iqbal, Z. & Shafiq, B. (2015). Islamic Finance and the Role of Qard-Al-Hassan (Benevolent Loans) in Enhancing Inclusion: A Case Study of Akhuwat. *ACRN Oxford Journal of Finance and Risk Perspectives: Special Issue of Social and Sustainable Finance*, Vol. 4, Issue 4, pp. 26-27.

- i) It is a non-worldly rewarding loan, but the borrower is under moral obligation to repay the principal depending on his financial capacity to do so. The creditor would forego the demand for payment of principal if, despite best efforts and good intentions by the borrower; he/she cannot repay the principal due to economic hardships.
- ii) The incentives for lenders to extend credit based on *Qard al-hasan* are clearly benevolent and spiritual as they are abiding by Allah's Command to supply such loans for benevolent purposes. The element of benevolence and expectation of reward from the Creator in this world or hereafter is the expected return instead of any monetary reward.
- iii) The primary objective of *Qard al-hasan* is to help the poor, who often do not have any material collateral, get on their feet to become part of economic activities in a dignified and cost-effective manner.
- iv) The practice of *Qard-al-hasan* has also been associated with enhancing harmony among poor and rich segments of the society which leads to a more cooperative, collaborative, and caring society.
- v) The institution of *Qard al-hasan* can be effectively used to eradicate extreme poverty through opportunities to the poor to create new jobs market and business ventures by using their merits, skills and expertise.
- vi) *Qard al-hasan* also serves as a tool to enhance financial and social inclusion in the society by bringing the poor out of poverty, facilitating their integration into the formal financial sector and making them better included in the society. In this regard, *Qard al-hasan* serves as an important tool of achieving economic and social justice as envisioned by Islam.

It is important to note that, according to AAOIFI *Sharī'ah* Standard 19/4/1, in benevolent loan arrangement:

any stipulation of an excess for the lender in loan is prohibited, and it amounts to *ribā*, whether the excess is in terms of quality or quantity or whether the excess is a tangible thing or a benefit, and whether the excess is stipulated at the time of the contract or while determining the period of delay for satisfaction or during the period of delay and, further, whether the

stipulation is in writing or is part of customary practice.”⁶⁶³

However, “an excess over *qard* is permissible in terms of quantity or quality, or offering of tangible property or extending of a benefit, at the time of satisfaction when it is not stipulated or is part of custom, irrespective of the subject-matter of *qard* being cash or kind.”⁶⁶⁴ Where *qard* is granted by an IFIs, it is permissible for it, according to AAOIFI *Shari’ah* Standard 19/9/1, to charge for services rendered in processing the request equivalent to the actual amount directly spent on such services.⁶⁶⁵

8.7 *Kafālah* (Guarantee)

The term *Kafālah* is an Arabic word that has a wide scope. It literally means to feed, support, to be responsible, or answerable. It refers to bail, guaranty, security or sponsorship, suretyship, or conjoining responsibility to another.⁶⁶⁶ It may be defined as an act of someone adding himself to another person, and making self-liable to perform the responsibility, together with the person.⁶⁶⁷ This is in line with the definition of Ibn Qudāmah, which says it is the conjoining of the guarantor’s liability to the liability of the guaranteed so that the debt would be established on both of them.⁶⁶⁸

The *Shari’ah* Advisory Council of Bank Negara Malaysia defined *Kafālah* as a guaranteed contract on certain asset, usufruct and/or services provided by a guarantor to the parties involved.⁶⁶⁹ According to AAOIFI *Shari’ah* Standard No. 5, “*Kafālah* are guarantees that are intended to secure obligations and protect amounts of debts, either from being uncollectible or from being in default.”⁶⁷⁰

⁶⁶³Ibid, p. 519.

⁶⁶⁴ See AAOIFI *Shari’ah* Standard 19/5/2, p. 519.

⁶⁶⁵Ibid, p. 520.

⁶⁶⁶Jureidini, R. & Hassan, S. F. (2019). The Islamic Principle of *Kafala* as Applied to Migrant Workers: Traditional Continuity and Reform. Issues of Residence, Naturalization and Citizenship Series. *Studies in Islamic Ethics*, Vol. 2, p. 93.

⁶⁶⁷ See: <https://islamicmarkets.com/education/hawalah-vs-wakalah-vs-kafalah>.

⁶⁶⁸Suhaimi, M. S. M., Fauzi, M. S. M., Noryatim, N., Noh, N. M., Shuhaimin, N., Jāfar, Q., Maulan, S. M., Johan, Z. F. & Muneeza, A. (2016). Service Based Contracts Used in Islamic Finance: A Comparison of Hawalah, Wakalah, and Kafalah. *International Journal of Management and Applied Research*, Vol. 3, No. 4, p. 162.

⁶⁶⁹Bank Negara Malaysia, 2015.

⁶⁷⁰(AAIOFI, 2010).

In the Islamic tradition, *Kafālah* has a number of social, moral and business dimensions. Socially and morally, it represents a form of legal guardianship whereby a formal agreement to voluntarily take care of the maintenance, protection and education of a child in the same way as the biological parents of the child would do until adulthood is reached. Businesswise, its meaning extends to a business contract where someone formally guarantees somebody else by providing an assurance of the fulfilment of an obligation of the guaranteed person in terms of delivering goods or carrying financial responsibilities such as payment of the guaranteed person's financial liability. *Kafālah* could also take the form of guaranteeing the presence of a certain person at a specified time and place or the appearance of a certain person, as in the case of a lawsuit.⁶⁷¹

Kafālah has been widely accepted and is being practised in the business of Islamic banks. On the one hand, banks issue customers a guarantee to cover the safe custody of their deposits with the banks. On the other hand, customers are asked to provide personal guarantee to safeguard benevolent loans or financings granted to them. Letters of bank or shipping guarantee that Islamic banks issue to guarantee the liability of customers who mostly engage in international trade also fall under *Kafālah*.

The legality of *Kafalah* is confirmed in the *Qur'ān*, *Sunnah* and *Ijmā'*. In the *Qur'ān*, Allah the Most High, narrates the story of Prophet Zachariah (peace be upon him), into whose care (*kafālah*) Mary, the mother of Prophet Īsa (peace be upon him), was given. Allah the Most High says, "...entrusting her to the care of Zachariah..."⁶⁷²

Among the strongest points in support of *Kafālah* is the story of Prophet Yusuf (peace be upon him), who stood as the guarantor for a reward to whoever could return the King's bowl of measure.⁶⁷³ They said, "We are missing the measure of the king. And for he who produces it is [the reward of] a camel's load, and I am responsible for it."⁶⁷⁴ According to Ibn Abbas (may Allah be pleased with them), "*za'im*" (being responsible) means "*kafīl*" (guarantor).⁶⁷⁵

⁶⁷¹Op cit, pp. 93-94.

⁶⁷²*Qur'ān*, 3:37.

⁶⁷³International Association of Deposit Insurers (2014). *Shari'ah Approaches for the Implementation of Islamic Deposit Insurance Systems*. Discussion Paper, pp. 21-22.

⁶⁷⁴*Qur'ān*, 12:72.

⁶⁷⁵ See: <https://al-maktaba.org/book/5463/407>.

In one *Hadīth*, the Prophet (peace be upon him) indicated the magnitude and virtue of the person sponsoring orphans (*kāfil al-yatīm*). Sahl bn Sa'ad reported that the Prophet (peace be upon him) said; "I and the one who looks after an orphan will be like this in Paradise," showing his middle and index fingers and separating them."⁶⁷⁶

In another *Hadīth*, Salamah bin al-Akwa says:

Once we were with the Prophet (peace be upon him), then a group of people came with a funeral procession and said "O prophet (peace be upon him), please conduct the funeral rites for this corpse." He asked: "Has he left anything?" They replied: "Nothing." Then he asked: "has he left any debt?" They replied: "Yes, three dinars," then the Prophet (peace be upon him) said: "You should pray for him." Then Abu Qatādah said: O Prophet (peace be upon him) please pray for him, I bear the liability of the debt" Then the Prophet (peace be upon him) prayed for the corpse.⁶⁷⁷

Also, the Prophet (peace be upon him) said, "That which is borrowed is to be returned, and the guarantor is responsible, and the debt is to be repaid."⁶⁷⁸ The *hadith* shows that, having agreed to be a guarantor for someone, the person will be held responsible to the extent of what he has undertaken to guarantee.

‘Abdullah ibn Abbās (may Allah be pleased with them) also narrated that:

A man seized his debtor who owed him ten *dīnārs*. He said to him: I swear by Allah, I shall not leave you until you pay off (my debt) to me or bring a surety. The Prophet (peace be upon him) stood as a surety for him. He then brought as much (money) as he promised. The Prophet (peace be upon him) asked: From where did you acquire this gold? He replied: From a mine. He said: We have no need of it; there is

⁶⁷⁶Bukhāri (Hadīth, 6005).

⁶⁷⁷Bukhāri (Hadīth, 2289).

⁶⁷⁸Abu Dawūd (Hadīth, 3565) and Tirmidhī (Hadīth, 1265).

no good in it. Then the Messenger of Allah (peace be upon him) paid (the debt) on his behalf.⁶⁷⁹

Furthermore, Muhammad bin 'Amr Al-Aslamī narrated that his father, Hamza, said:

'Umar (may Allah be pleased with him) sent him (i.e. Hamza) as a *Sadaqah/Zakāh* collector. A man had committed illegal sexual intercourse with the slave girl of his wife. Hamza took (personal) sureties for the adulterer till they came to 'Umar. 'Umar had lashed the adulterer one hundred lashes. 'Umar confirmed their claim (that the adulterer had already been punished) and excused him because of being Ignorant.⁶⁸⁰

The objective of *Kafālah* is to provide a framework of social solidarity based on trust and cooperation among people in various realms of their interactions. It is used to protect the weak and vulnerable by instituting the patronage of a prominent local who provided whatever protection is required. *Kafālah* is, therefore, a form of community responsibility for financial, legal or political representation.⁶⁸¹

According to the classical *fiqh* books, *Kafālah* is given to those who need it as an act of charity with no intention to have any financial benefit. Both AAOIFI and the OIC International Islamic Fiqh Academy permit IFIs to charge fee on *Kafālah* provided that the guarantee is not in the form of a loan (*Qard*). Accordingly, Islamic banks normally charge fees for the guarantee given to their customers as *Wakālah*/service. Charging the fee is considered permissible on the basis of *maslaha* and public need because, in the current context, it is difficult and impractical to obtain free-of-charge guarantee.⁶⁸²

8.8 Benefits of Islamic Social Finance

Islamic social finance refers generally to the active investment practice that strives towards any form of measurable social, cultural or environmental progress and

⁶⁷⁹ Abu Dawūd (Hadīth, 3328).

⁶⁸⁰ Bukhārī (Hadīth, 2290).

⁶⁸¹ Ibid, p. 94.

⁶⁸² Ab Rahman, S. (2018). Development of the Classical Islamic Guarantee through Fatwa in Modern Islamic Banking. *International Journal of Business and Society*, Vol. 19, issue S3, pp. 375-381.

which is in compliance with the *Sharī'ah* and Islamic ethical beliefs. Fadzillah identified the main benefits of ISF, which include among others the following:⁶⁸³

- i) ISF connotes added CSR initiatives that Islamic financial institutions can participate in the form of predefined *Sharī'ah* based humanitarian or social-development programmes such as *Zakāh*, *Waqf*, *Sadaqah* and *Qard al-hasan*. These financing options have a clear humanitarian element, which aims to foster long-term social improvements in various ways whether for building resilience for communities at risk, facilitating social and economic inclusion, or optimising sectors for better efficiency. ISF therefore, gradually encourages and cultivates a philanthropic climate from both corporate and individual perspectives.
- ii) ISF promotes better cooperative measures in line with the social finance dictum of “*ta'āwun*”, which may be translated as “mutual assistance” or mutual help. *Ta'āwun* forms the basis of various economic relationships that rely on cooperation such as those between customers and merchants, banks and individuals, or institutions and the state. It also covers concepts like *Qard al-hasan* (benevolent loans) and *Kafālah* (guarantees). For example, *Qard al-hasan* is usually offered for welfare purposes, but it is still a loan that must be paid back in full. However, the borrower only needs to pay back the amount borrowed without any interest. This demonstrates a sense of *ta'āwun* between the lender and the borrower.
- iii) ISF covers standard practices like *Sadaqah* (voluntary charity), *Waqf* and *Zakāh* which can help to alleviate many socio-economic problems such as lack of access to education, rise of unemployment, malnutrition among impoverished communities and health issues caused by financial strain or societal neglect. ISF can help to mend these vulnerabilities through philanthropic and charitable initiatives either from corporate or individual benefactors.
- iv) ISF also involves the use of other Islamic financial services like microfinance, *Sukūk* and *Takāful* to add to types and quantity of financial offerings which, once properly utilised, can contribute to social progression and sustainability in the society.

⁶⁸³ See: 5 Major Benefits of Social Finance in Islam. <https://ethis.co/blog/5-major-benefits-social-finance-islam/>.

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