Basic Islamic Finance and Islamic Contracts

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In today's day and age, banking is a highly substantial factor of our society. It provides an opportunity to the household with surplus capital to select the best mix of investments in terms of return, tenors, and security along with the opportunities to do businesses and for the governments to finance their respective activities through obtaining surplus funds.

While banking is essential to our society, it comes with a set of issues as well. For example, a key fundamental function of conventional banks is to lend money and get it back with compounding interest (the investor is assured of a predetermined rate of interest) which has become the most undesirable way of borrowing money. The operating modes of conventional banking are based on man-made principles which aim at maximizing profit without any restriction and as such do not take into account ethics and morality which in turn creates real life problems for people indulging in conventional banking as their remains no control over the conventional banks as they indulge in legal yet unfair practices to make the borrowers pay more i.e. encouraging credit card holders to make minimum payments so that they could earn compounding interest which interest charges on interest.

Coherent with the world of finance, a recent phenomenon to hit the banking circuits is Islamic Finance. Although of late, Islamic Banking & Finance has garnered a strong foothold in the banking industry, the practice dates back to the newly Islamic era which had emerged some 1,400 years ago.

What is Islamic Finance

Islamic Finance refers to conducting businesses and banking, and finance transactions in accordance with Shariah Principles. If banking or financial institutions are not governed by Shariah Principles, they cannot be called Islamic Banks and/or Islamic Financial institutions.

Islamic Banking in Sultanate of Oman

Islamic Banking in Oman is governed by the Islamic Banking Regulatory Framework issued by the Central Bank of Oman in 2012. The Islamic Banking Regulatory Framework provides the rules for regulating the operations of Islamic Banks and Islamic windows operating in Oman.

Islamic Banking in Oman differs from other jurisdictions as it follows more stringent rules provided of Audit and Accounting Organization for Islamic Finance Institutions of Bahrain which take a conservative approach when dealing with Sharia rules which is evident from the fact that Islamic Banking Regulatory Framework prohibits *Tawaruk* transactions in Oman, which are allowed in other jurisdictions such as in Malaysia and UAE. *Tawaruk* or as commonly known as Commodity *Murabaha* is seen to have an element of *Riba* by some scholars and hence, has been deemed as Un-Islamic by Audit and Accounting Organization for Islamic Finance Institutions.

Key Principles in Islamic Finance

Islamic Finance is governed by Shariah Principles which are derived from the Quran, Hadiths and Sunnah (teachings of Prophet Muhammad PBUH).

Key factors that distinguish Islamic Banking from Conventional Banking

The following are the main factors which distinguish Islamic Banking and Finance from Conventional Banking:

- *Riba'*- Interest/ Usury
- *Gharar'*- Uncertainty/ Deception
- *Maisir'*- Gambling/ Speculation
- Prohibited-Activities/ Commodities

Riba

The word *'Riba'* means excess, increase, or addition which when correctly interpreted according to Shariah terminology, implies any excess compensation without due consideration.

Here are some examples with '*Riba'* elements underlining certain transactions:

- Advancing a term loan with an increase over and above the principle amount and thereby earning interest
- Periodic payment of increase, principle payment at maturity or rescheduling with new increase
- Allowing additional time against additional amount in deferred payment sale

Why is Riba termed as "Haram"

It can be explained by way of the following quotation. Referring to the practice of '*Riba*' back in 2000 at the G8 Summit, the Nigerian President had commented: "All that we had borrowed up to 1985 or 1986 was around $5 billion and we have paid about $16 billion yet we are still being told that we owe about $28 billion. That $28 billion came about because of the injustice in the foreign creditors' interest rates. If you ask me what the worst thing in the world is, I will say it is compound interest."

Gharar

Gharar means delusion, risk, or uncertainty. It is an ambiguous situation which has a chance of non-agreement or dispute upon disclosure of details. Some examples that could be considered *Gharar* are: a sale of fish which are still in the sea, sale of unborn animals, or sale of birds in the air.

Maisir / Qimar (Gambling)

Gambling has been strictly prohibited due to the inherent aspect of uncertainty and chance. Prize bonds and lotteries are modern day examples that fall under the category of *Qimar*

Prohibited Activities / Commodities

The following transactions are prohibited in Islamic Banking and Finance:

- Transactions where the parties involved are incompetent to enter in to agreements
- Sale of something non-existing or weak existence
- Sale of something which is not deliverable easily
- Sale of debt to someone other than the debtor
- Sale with '*Jahalah'* (subject matter or price or time is unknown)
- Sale with two different prices
- Transactions involving contingent & future sale
- Sale before taking possession
- Sale with '*Haram'* money or consideration
- Transactions involving hording (sale containing harm to the society)
- Sale of '*Haram'*or '*Najis'* subject matter
- Sale of grabs to the producer of wine
- Sale with wrong condition
- Transactions combining sale with loan

The Islamic way of banking differs from the traditional style of banking on many fronts. It adheres to certain aspects of social, moral, and economic values that are engrained in *Shariah* principles and the religion itself.

One few differences between both banking styles are that Conventional Banking does not involve itself in trade and business and the depositors get a fixed rate regardless of the bank's profitability, thus, insulating them from the bank's true performance. Whereas, Islamic Banking actively participates in trade and production, in which, the profit is shared with the depositors and higher the profit earned by the bank, the higher the depositors' income is set.

Evidently, Conventional Banking prices money and is based on fixed return on both sides of the balance sheet, whereas, Islamic Banking is based on profit & loss sharing on deposits side, on profit & loss sharing, or profit on assets side; thus creating real wealth in our society, leading to a state of economic well-being through its goods and services.

Kinds of Islamic Contracts

Essentially there are two kinds of Islamic Financial Contracts i.e. Commutative and Non- Commutative.

Commutative *(Uqood Muawadha)*: Contracts that include exchange of counter value by both the transacting parties, such as a contract of sale and Ijara and Non Cummutative are non compensatory contracts where the donor, donates his property without consideration e.g. *Qard-e-Hasan, Aariya, Hiba* etc.

Islamic Contract

The Islamic Contract essentially has the following 4 elements for it to be valid:

- Contract (Aqd - عقد);
- Subject matter (Mabee'e - مبيع)
- Price (Thaman -ثمن)
- Possession (Qabdh -قبض)

We will deal with each of the elements above in detail below.

Contract

A Contract is a combination of offer and acceptance in a manner that results in the desired consequence (transfer of ownership) in the subject matter. The following elements are required to form a valid contract under the sharia rules:

- Offer and Acceptance (Ijab-wa-Qabool) can be:
  - Explicit (Oral or Written)
  - Implied (Hukmi)
- Buyer and Seller (Muta'aquedan) must be:
  - Sane
  - Mature
- Sale Contract must be:
  - Non-contingent
  - Immediate (Exceptions)

Subject Matter

The thing that is being sold and purchased by the parties under any Islamic contract is called "Subject Matter". The subject matter must be:

- Existing (Exception of Salam & Istisna')
- Seller must have title/ownership and possession
- Valuable (in the eyes of Shariah)
- Usable
- Specified and Quantified
- Delivery must be certain and non-contingent

Price

The price in, any Islamic contract should be certain, quantified, specified and should be valuable in the eyes of Shariah.

Fundamental Contracts in Islamic Banking and Finance

Some of the major Islamic Banking products that are offered to customers are:

- *Mudaraba* (direct equity participation)
- *Musharaka* (partnerships/joint ventures)
- *Murabaha* (cost plus profit mark-up)
- *Ijarah* (leasing)
- *Sukuk* (islamic bonds)
- *Istisna&Salam* (long & short term project financing)
- *Wakala*

Mudaraba

Mudaraba is an investment contract in which one party (*Rabul-Mal*) contributes capital while the other party (*Mudarib*) makes efforts for generation of profit. It is a contract in which the capital is provided by the depositor/fund provider and the bank acts as the *Mudarib* and the profit of the Mudaraba are then shared in pre-agreed ratio and loss (if any) unless caused by negligence or violation in terms of the contract by the *Mudarib*, is then borne by the depositor. It is pertinent to note that *Mudaraba* is predominantly used by the Islamic banks as the vehicle for offering savings accounts to its customers / depositors.

Musharaka

- Musharaka means coming-ling by two or more persons either their money or work to earn a profit or appreciation in value and to share the profit and loss.

Musharaka refers to the practice of commingling by two or more persons with either their money or work to earn a profit or appreciation in value and sharing profit and loss in the business of the Musharaka. It is pertinent to note that the loss in the Musharaka is shared according to the partners' proportionate share in the *Musharaka*, however, it is possible for the profit to be shared in any ratio between the parties, if the said persons are active/working partners in the Musharaka arrangement. In case one of the partner(s) is a sleeping partner, then the sleeping partner(s) cannot have a profit sharing ratio higher than the share contributed by the said partner(s).

The most common form of *Musharaka* used by financial institutions is Diminishing *Musharaka;* which is a form of a partnership in which, one of the partners promises to buy the equity share of the other partner in a *Musharaka* asset gradually, until the title to the *Musharaka* asset is completely transferred to the other partner and until such time, the partner using the asset pays the rent for use of the financial institutions share in the *Musharaka* asset.

Murabaha

Murabaha is a sale contract in which a seller sells his goods/assets at cost inclusive of an agreed profit. The sale price could be paid on the spot or deferred to be paid in lump sum, or in installments. Normally in Murabaha, the goods/assets are purchased after a customer requests the bank to purchase the goods/assets in order to sell the same to the customer on *Murabaha* (cost plus profit) basis on deferred payment to the customer.

Ijara

Ijara is leasing of an asset under which a specified permissible benefit, in the form of a usufruct, is obtained for a specified period in return for a rental payment. Islamic Banks commonly use *Ijara Muntahiya Bit Tamleek* (MBT), which is a lease that includes a promise from the lessor to transfer the asset to the lessee. The asset of Ijaraha (MBT) can be transferred at the end of the lease term to the customer by way of a gift or sale for an agreed price.

Sukuk

- An Islamic investment instrument that is asset-backed, structured in accordance with Shariah, and registered in the name of the holders (Sukuk holders).
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Sukuk is an Islamic investment instrument that is asset-backed, structured in accordance with *Shariah*, and is registered in the name of the holders (*Sukuk* holders). Accordingly, a *Sukuk* certificate is a proof of partial ownership or beneficial interest in an asset or enterprise (it is always linked with an underlying asset (tangible or intangible). *Sukuk* can be either bought from the issuer (primary market) or from its holders (secondary market) either directly, or via intermediaries (brokers).

Invariably, *Sukuk* funds are raised based on the value of the underlying asset. Any increase or decrease in the value of the underlying asset would be reflected in the value of the *Sukuk*. Additionally, the return on *Sukuk* is directly proportionate to the performance of the underlying asset/project.

Istisna and Salam

Istisna is an advance sale of a specific commodity not yet manufactured or constructed/processed. Although the buyer may make progress payments, no advance payment is required. An *Istisna* is only valid if (1) the price is fixed with the consent of both parties and (2) the to-be-manufactured commodity's specifications are fully agreed upon by both buyer and seller/manufacturer.

Salam is an advance sale of specific goods which are to be supplied at a later date and for which advanced payment is required. In contrast to a *Murabaha* sale where goods are delivered and payment is deferred at a price higher than the spot price, in a *Salam* transaction, the agreed-upon price is paid in full in advance and the delivery of the goods is deferred.

Wakala

Wakalah is a contract, whereby the principal appoints the agent to substitute him or perform on behalf of the principal. The principal is called "*Aseel/Muwakkil*" and the agent is called "*Wakeel*."The profit/loss earned/ sustained is solely of the principal and the agent may take a fixed remuneration against its services. *Wakala* is commonly used by the Islamic Banks for inter-bank lending.

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