

The Shari'ah Foundation of Islamic Banking

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ABSTRACT

Islam prescribes a complete code of conduct for human life including economic activities. The prescribed Islamic code of conduct generally refers to Shari'ah, on which Islamic banking was founded. The most important characteristic of Islamic banking is to maintain its products and operations according to the principles of Shari'ah, which is based on the Holy Qur'an, Hadith, Ijma, Qiyas, and Ijtihad. Islamic banking has rapidly been growing in the modern economic world as an alternative to conventional banking. It is expected that Islamic banking operations will not only comply with the Shari'ah but also contribute towards achieving the Maqasid-al-Shari'ah (objectives of Shari'ah), which is the ultimate welfare of the Muslim Ummah and the human being. The findings of several studies showed that Shari'ah compliance is the single most important factor for choosing Islamic banking. Unfortunately, many recent studies revealed that many Islamic banks are violating their obligation of Shari'ah compliance. Hence, the paper aims at understanding the Shari'ah foundation of Islamic banking to examine that the modes of Islamic banking are based on the principles of Shari'ah. It also incorporates the major components of Shari'ah and its concept of economic tools such as ownership, wealth, money, capital, trust, and accountability to have a comprehensive idea about the Shari'ah foundation of Islamic banking. The methodology used in this conceptual study is a critical analysis of the literature survey. The literature on the concept of Shari'ah basis of Islamic banking is read to understand the basic components of Shari'ah and its principles to govern economic practices to examine its application in the Islamic banking industry and identify the Shari'ah foundation of the modes and contracts used by the modern Islamic banking industry.

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1. INTRODUCTION

Islam is not only a religion confined to worshipping activities of individuals, but also a system of life in its entirety, which prescribes a complete code of conduct to govern every sphere of human life and society. The prescribed Islamic code of conduct generally refers to Shari'ah. The principal basis of every code of conduct in Islam including economic and banking activities is the Shari'ah. The ultimate objective of Shari'ah (Maqasid al-Shari'ah) is to attain the total welfare of the Muslim nation in particular and the human beings at large. The aim of Islamic economics and banking is also to secure the welfare of the society by establishing just and balanced economic order based on the principles of Shari'ah. The best use of economic activities through permissible methods of Islam has resulted in the development of Islamic banking. It is the system that conducts banking operations, products, and services according to the laws of Shari'ah. Islamic banking has already been mainstreamed within the global financial system. Currently, Shari'ah-compliant financial assets are estimated at roughly US\$2.6 trillion, covering bank and non-bank financial institutions, capital markets, money markets, and insurance (World Bank, 2017).

Besides having a well-established conventional interest-based banking system, the emergence and expansion of Islamic banking indicates that there has been a growing demand for an alternative financial system to the Muslim people in particular, whose preference is for financial products compliant to the Shari'ah. Essentially, Islamic banks have a strict requirement to follow the principles of Shari'ah. But unfortunately, many recent studies found that several Islamic banks are violating their obligation of Shari'ah compliance. For example Yusof & Fahmy (2008) urged that there is no difference at all without changing the name and using 'profit rate' instead of 'interest rate'. Meera & Larbani (2009) discovered that the current modes of operations in Islamic banking are similar to conventional banking, violates Shari'ah, therefore, hinders the attainment of the objectives of Shari'ah. Yousef (2004), Abozaid & Asyraf (2007), Meera & Dazuljastri (2005) and Kuran (2004) have also expressed doubts about the Islamicity of the current operations of Islamic banks.

Within this context, the paper aims to understand the Shari'ah foundation of Islamic banking to examine its operations and products based on the principles of Shari'ah. It also includes studying the major components of Shari'ah, its sources, objectives, ethics and restrictions towards economic behavior, the Islamic concept of ownership, distribution of wealth, money, capital, trust and accountability to have a clear concept towards the Shari'ah foundation of Islamic banking. The methodology used in this conceptual study is a critical analysis of literature survey. The literature on the concepts and studies pertaining to Shari'ah basis of Islamic banking are read to understand the basic components of Shari'ah and its principles to govern economic practices to examine its application in the Islamic banking industry and identify the Shari'ah foundation of the modes and contracts used by the modern Islamic banking system.

2. FINDINGS AND DISCUSSION

2. *Shari'ah*: Definition and Basic Components

Shari'ah means 'the path that leads to the spring' (Ramadan, 2004). Figuratively, it is 'a clear path to be followed and observed' (Visser, 2009: 10). *Shari'ah* is system of divine law; a way of belief and practice in the Qur'an (Omar, 2010). It is a set of provisions and rules that govern every aspect of a Muslim's life (Schoon, 2009: 19). *Shari'ah*, though understood narrowly by some as Islamic law, is, in reality, a complete and comprehensive code of behavior, governing the moral, ethical, spiritual, social, economic as well as legal dimensions of a Muslim's private and public dealings (Anwar & Millar, 2008: 3). *Shari'ah* is the main guiding principle for all operations and products of Islamic banking (Ahmad, 2000).

2.1 The Sources of *Shari'ah*

The provisions of *Shari'ah* are derived from several sources, including primary or divinely revealed sources, and secondary or human sources (Izzi Dien, 2004: 51). The Qur'an and *Sunnah* serve as the primary sources of *Shari'ah*, while, *Ijtihad* serves as the basis of all secondary and minor sources. As the primary sources do not cover every issue clearly, the *Shari'ah*, therefore, often has to resort to secondary and minor sources i.e. *Ijma*, *Qiyas* and other branches of *Ijtihad*.

2.1.1 Qur'an: It is the first and foremost important primary source of *Shari'ah* and is the main guiding principles in all aspects of life including economic and banking activities. It is the principal Islamic text and agreed by all Muslims as being the original words of Allah as revealed to the Prophet Muhammad (pbuh) and that is infallible (Anwar & Millar, 2008: 3). "We have sent down to you the Book (Qur'an) as an exposition of everything, a guidance, a mercy, and glad tidings for those who have submitted themselves (to Allah as Muslims)" (Al-Qur'an, 16: 89). It specifies the moral, philosophical, social, political and economic basis on which an Islamic society should be constructed (Ahmad, 2002: 49-50).

2.1.2 Sunnah: It is the deeds, utterances and tacit approvals of the Prophet (pbuh), as related in the *Ahadith* or traditions (the plural of *Hadith*), handed down through a dependable chain of transmitters (Visser, 2009: 10). *Hadith* is the record of the *Sunnah*. It is a verbal tradition, transmitted from person to person and from generation to generation by word of mouth, of what Prophet (pbuh) said or did, or his reaction to something said or done by others (Ahmad, 2002: 52). The Holy Qur'an appreciated the acceptability of *Sunnah*.¹ *Hadith Sahih* or sound is the primary source of *Shari'ah*. *Hadith Hasan* or fair are not considered quite strong, but to establish points of law. *Hadith Da'if* or weak, dealing with matters of law will be rejected (Ahmad, 2002: 53-54). The famous six compilations of *Hadith* are: *Sahih-al-Bukhari*, *Sahih Muslim*, *Sunan Ibn-Majah*, *Sunan Abu-Dawood*, *Jami al-Tirmidhi*, and *Sunan al-Nasai*.

2.1.3 Ijma: It is the unanimous consensus of the *Mujtahidun* (scholars), of Muslim community of any period following the demise of the Prophet (pbuh) on any matter (Kamali, 1989: 156). *Ijma* originated from the Qur'an and *Sunnah*.² It begins with the personal *Ijtihad* of individual jurist and culminates in the universal acceptance of a particular opinion over some time (Kamali, 1989: 157). Once an *Ijma* is established it tends to become an authority in its own right (Ahmad, 2002: 56).

¹ "Nor does he say (anything) of (his own) desire. It is no less than inspiration or revelation sent down to him" (Al-Qur'an, 53: 3-4)

² "Those who have responded to their lord and established prayer and whose affair is [determined by] consultation among themselves" (Al-Qur'an, 42: 38). The Prophet (pbuh) said that: "My community shall never agree on an error" (Esposito, 2003).

2.1.4 Qiyas: It is the close similarity between two things, one of which is taken as the criterion for evaluating the other. It is the extension of a *Shari'ah* ruling from an original case, or *Asl*, to a new case, because the latter has the same *Illah* or effective cause as the former. The original case is regulated by a given text, and *Qiyas* extends the same ruling to the new case based on the commonality of the effective cause between the two cases (Kamali, 1989: 180).

2.1.5 Ijtihad: It is the most important source of Islamic law next to the Qur'an and *Sunnah*. It is the application by a jurist of all his faculties either in inferring the rules of *Shari'ah* from their sources, or in implementing such rules and applying them to particular issues (Kamali, 1989: 315). *Ijtihad* is a continuous process of development of Islamic law whereas Qur'an and *Sunnah* discontinued with the demise of the Prophet (pbuh). It is the main instrument relating divine message with the changing circumstances of the society. The various sources of *Shari'ah*, next to the Qur'an and the *Sunnah*, i.e. *Ijma*, *Qiyas*, *Istihsan*, *Istislah*, are all manifestations of *Ijtihad*. The development of Islamic banking is mostly contributed by the application of *Ijtihad*.

2.1.6 Istihsan: It is a method of exercising personal opinion in order to avoid any rigidity and unfairness that might result from the literal enforcement of the existing law. 'Juristic preference' is a fitting description of *Istihsan*, as it involves setting aside as established analogy in favor of an alternative ruling which serves the ideals of justice and public interest in a better way (Kamali, 1989: 218). *Istihsan* played a prominent role in developing Islamic banking products by adapting Islamic law to the changing needs of society.

2.1.7 Istislah: It refers to unrestricted public interest. It consists of considerations which secure a benefit or prevent harm but which are, simultaneously, harmonious with the objectives of the *Shari'ah*. *Istislah* derives its validity from the norm that the basic purpose of *Shari'ah* is to secure the welfare of the people by promoting benefit and protecting harm (Kamali, 1989: 235).

2.1.8 Urf: It is the collective practice of a large number of people. The custom, in order to constitute a valid basis for legal decisions, must be sound and reasonable. Hence, recurring practices having no benefit or which partake in prejudice and corruption are excluded from the definition of *Urf* (Kamali, 1989, p. 248). It should also not contravene the principles of *Shari'ah*.

2.2 *Maqasid al-Shari'ah*

Maqasid al-Shari'ah (objectives of *Shari'ah*) are designed to 'promote benefits and repel harms' (Zuhayli, n.d.). Nyazee (2005) quoted al-Shatibi's view on the objectives of *Shari'ah* as 'to free man from the grip of his own whims and fancy, so that he may be the servant of Allah by choice, as he is one without it'. Al-Shatibi singled out *Maslahah* (welfare) as the overall *Maqasid al-Shari'ah* (Kamali, 2008). These have been categorized into three broad categories: a) The *Daruriyyat* (essentials): are the basic needs of people which they depend on to live, and the absence of which will lead to chaos. These are the protection of *Deen* (belief), *Nafs* (life), *Nasl* (lineage), *Aql* (intellect), and *Maal* (wealth). Al-Qardawi (1993: 55) and many other scholars have added a sixth essential, namely *Ird* (dignity). B) The *Hajiyyyaat* (complements): are required for the betterment of society, the absence of which may not create chaos, but lead to difficulty. Anything that complements the basic needs can also be categorized under *Hajiyyyaat* (Kamali, 1989: 190). C) The *Tahsiniyyaat* (embellishments): that nourishes the current values of an individual and lead to a desirable status. So, it is a matter of desirability at this level of interest, since they seek to attain refinement and perfection in conducts of people (Kamali, 1989: 233).

These classifications can serve as a checklist in formulating the decisions and setting appropriate priorities in accordance with the objectives of *Shari'ah*. The overall aim of the Islamic banking is the realization of *Maqasid al-Shari'ah* (Siddiqi, 2004). The concept of *Maqasid al-Shari'ah* has been applied in the context of Islamic banking system in various dimensions, particularly for classifying Islamic financial products (Ahmed, 2011).

3. Concept of Ownership, Distribution of Wealth and Zakat in Shari'ah

Ownership is the inherent right of a person to exercise his rights over the property within his possession. It involves four rights, the right of using the property, excluding others from using it, its disposal and destruction (Mahajan, 1991: 327). In Islamic law, *Milkiyah* or ownership is 'the relationship between a person and a thing that gives absolute control and right of disposal over it to the exclusion of others' (Nyazee, 1998: 237). In Islam, the absolute ownership of everything belongs to the Almighty Allah.³ Man is the caliph or Allah's vicegerent on earth,⁴ and thus the man enjoys certain rights of usufruct of certain things as a trustee. Ownership, in essence is that of God while some rights only, under specific conditions, vest on man so that he may fulfill the purpose of God by acting as a trustee (Muslehuddin, 1978). The trustees are answerable before Allah for how they discharge the trust reposed in them (Al-Qur'an, 16: 71). Khan (1994) describes the concept ownership in Islam saying that:

"Islam recognizes the right of absolute ownership for God only. Man has been granted the right to benefit from the resources of the earth. He can earn his livelihood through lawful (Halal) means. He is not free to consume, save or invest his earnings in any way he likes. There are definite moral limits on his right to earn, consume, save and invest. Within this general framework, Islam accepts the right of a person to sell, bequeath and leave for his heirs the property which he happens to own. Thus the Islamic concept of property limits human freedom to the use of the resources of the earth. It holds everyone accountable to God for the proper use of those resources."

The use and distribution of wealth in Islam should also be following the guideline of *Shari'ah*. It should be earned and spent following the guidelines of *Shari'ah*.⁵ From Islamic point of view, two kinds of people have a property right: a) Primary right: a right to wealth having direct participation in the process of production. b) Secondary right: who have not direct participation in the production, but it has been enjoined upon the producers to make them co-sharers in the wealth (Usmani, 2002a: 7-8).

From an Islamic point of view, the distribution of wealth envisages three objectives: a) It would be the means of establishing a natural and practicable system of economy without any compulsion. Everyone can function according to his ability and choice.⁶ b) To enable everyone to get his rights, who have primary rights as well as those to whom Allah has made it obligatory upon others to help.⁷ c) Wealth should not be concentrated in a few hands, rather should be circulated in the society as widely as possible⁸ (Usmani, 2002a: 12-13).

Zakat, one of the five pillars of Islam, is 'giving a specified percentage on certain properties to certain classes of needy people' (Khair, Gupta & Shanmugan, 2008). Generally accepted minimum amount of *Zakat* is one fortieth (2.5 %) of a Muslim's annual income in cash or kind from all forms of assessed wealth exceeding *Nisab* (a threshold figure) (Visser, 2009: 27). It should be distributed to certain recipients specified in the Qur'an, which include: the poor and the needy, debtors in financial difficulty, persons who have recently accepted Islam and are in

³ See Al-Qur'an, 2:25, 107; 3:189; 5: 17,18,40,120; 7:158; 9:116; 10:38; 24:42; 44:39; 49:42; 85:43.

⁴ I am making a caliph (human being) on the Earth. (Al-Qur'an, 2: 30).

⁵ "Seek the other world by means of what Allah has bestowed upon you, and do not be negligent about your share in this world. And do good as Allah has done good to you, and do not seek to spread disorder on the earth" (Al-Qur'an, 28:77).

⁶ "We have distributed their livelihood among them in worldly life, and have raised some above others in the matter of social degrees, so that some of them may utilize the services of others in their work" (Al-Qur'an, 32:43).

⁷ "In their wealth there is a known right for those who ask for it and those who have need for it" (Al-Qur'an, 70: 24-25)

⁸ "So that this wealth should not become confined only to the rich amongst you" (Al-Qur'an, 59: 7).

need of basic necessities that would benefit from encouragement by Muslims, volunteers who have dedicated their effort and time in spreading the Islam, and the people appointed to collect *Zakat* (Al-Qur'an, 9: 60). It is in the light of promoting social justice that Islamic business organizations (such as Islamic banks) should pay *Zakat* annually on behalf of the shareholders and depositors (Gambling & Karim, 1991). *Zakat* system narrows down the gap between the rich and the poor, decentralizes the flow of economy and thus, ensures redistribution of wealth on the concept of Islamic social justice.

4. *Shari'ah* Concept towards Money and Capital

Islam does not treat money as a commodity; rather as a medium of exchange and a store of value. *Money itself has no intrinsic value, it becomes useful only when it is exchanged with a real asset or used to buy a service.* Therefore, money in Islam can only be exchanged for goods and services; it cannot be sold or bought on credit. It can only be generated through lawful trade and investment where parties share the risks and rewards. Money only becomes capital when combined with other factors of production. Money, by itself, has no opportunity cost (Ayub, 2002). Islam totally negates the idea of time value for money (Usmani, 2002b: xvi). Islam recognizes capital and its role in the process of production. Islam recognizes its share in national wealth only to the extent of its contribution, to be determined as a variable percentage of the profits earned rather than a fixed percentage of the capital. Because, in Islam, capital is productive in the sense that labor with capital produces more than without capital. Thus, the Islamic concept of capital is realistic, comprehensive and ethical. It takes note of all variables like currency, population, inventions, habits, tastes, living standards, time-lag and so on. The capital in an Islamic society must be just and equitable and must be free of exploitation of other agents of production (Mannan, 1980: 165).

5. *Shari'ah* Concept towards Trust and Accountability

In Islamic view, human, as the vicegerent of Allah, is responsible for the resources entrusted to him as a trustee. In the context of Islamic banking, the stakeholders trust Islamic banks to employ the resources in accordance with the principles of *Shari'ah*. The expectation of the bank's stakeholders towards the management is seen as a form of trust. Thus, trust is believed as a divine symbol in the context of Islamic banking (Triyuwono, 2004).

Another concept that arises from the responsibilities entrusted to mankind is accountability. In Islam, all are accountable to Allah on the Day of Judgment for their deeds; good or evil and will be rewarded or punished.⁹ So, humans are accountable for the use of the resources. This represents a different dimension of accountability beyond private and societal accountability unlike in the Western economic system (Haniffa, Hudaib, & Mirza, 2004). Thus, accountability in Islam is not limited to the immediate stakeholders but is extended towards the society, and finally to the Almighty Allah. Human being is also responsible for the universe, environment, wealth and other creatures and this responsibility should be based on trust and justice (Abu-Sulayman, 1993). In the context of Islamic banking, its management is accountable to the depositors in this world and to the Almighty Allah in the Hereafter (Samad & Hassan, 1999).

6. *Shari'ah* Principles for Economic and Banking Activity

⁹ "On the Day when every person will be confronted with all the good he has done, and all the evil he has done, he will wish that there were a great distance between him and his evil" (Al-Qur'an, 3: 30) "Then he who is given his records in his right hand soon will his account be taken by easy reckoning" (Al-Qur'an, 84: 7-8).

Based on the above concepts, *Shari'ah* laid down some basic principles to conduct economic and banking activities. The general *Shari'ah* principle of the rulings of *Ibadah* (worshipping activities) is that anything which is not validated by the *Shari'ah* is taken as prohibited, whereas the opposite is true for *Mua'malat* (social activities) in which everything is permitted except those explicitly forbidden by the *Shari'ah* (Kamali, 1989: 20). Kamali (2000) explained that all commercial laws should be accepted on the basis of permissibility as long as they are not in contradiction to the principles of *Shari'ah*. These principles prohibit from certain forms of transaction, while they promote transactions within the permissible framework.

6.1 Economic Prohibitions in Islam

"Allah has permitted trade and forbidden interest" (Al-Qur'an, 2: 275) approves the freedom to engage in business transactions unless it is clearly forbidden by *Shari'ah*. The transactions having following ingredients are prohibited in Islam.

6.1.1 Prohibition of *Riba* (Usury/Interest): *Riba* means excess, increase or addition. It is translated by Muslim jurists as interest or usury (Khalil, 2006: 54). It implies any excess compensation without due consideration (Usmani, 2002a: 7). *Riba* is defined as the increase over the original wealth without trading (El-Sharif, 1990). *Riba* also represents any fixed or predetermined return in a financial transaction (Aggarwal & Yousef, 2000). The most comprehensive meaning on what constitutes *Riba* could be derived from the *Hadith*: "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" (Al-Hajjaj, 1999: 4063). The *Hadith* introduces two elements of *Riba*: deferment in time of exchange, and different counter values in exchanging two similar commodities mentioned in the *Hadith*. *Riba* by virtue of deferment in the time of exchange is defined as *Riba al-Nasihah*, and *Riba* by virtue of excess in terms of the quantity of the counter values as *Riba al-Fadl*. *Riba al-Nasihah* includes interest-based lending; compensation for lending; selling money for profit; or a predetermined payment for a loan, which may be a loan of money or a loan of goods, which in modern times is known as money lending (Venardos, 2005: 73). *Riba al-Nasihah* relates to loan transactions and *Riba al-Fadl* relates to exchange transactions. The six commodities mentioned in the *Hadith* are known as *Amwal-i-Ribawi* or usurious items. Majority Islamic scholars opined that the commodities having same characteristics which are common amongst these six items should also be considered as usurious items. Imam Abu Hanifa discovered weight and volume as common characteristics, Imam Shafi'I discovered medium of exchange and eatable, while Imam Malik found eatable and preservable (Usmani, 2002a: 47-49).

Riba has explicitly been prohibited in the Holy Qur'an and *Sunnah*. "Ye, who believe, fear God and leave up what remains of your demand for *Riba* if you are indeed believers. If you do not do it, take a notice of war from God and his apostle, but if you turn back, you shall have your principal" (Al-Qur'an, 2: 278-279).¹⁰ The Prophet (pbuh) prohibited *Riba*, whether paying, taking, charging or even acting as a witness, and he ordered Muslims to avoid all amounts arising out of *Riba* (Yahia, 2010). He said: "They are all alike in guilt" (Al-Hajjaj, 1999: 4093).¹¹ There is no difference of opinion among the Muslim jurists about the prohibition of *Riba*. Though some scholars say that *Riba* is usury, but the majority of them view it as interest (Chong & Liu, 2009: 128). *Riba* involves a transfer of wealth from the poor to the rich,

¹⁰ See for more, Al-Qur'an, 3:129; 30:39; 2:275-276; 2:278.

¹¹ The Prophet (pbuh), in his last sermon on his last pilgrimage said that: "Every form of *Riba* is cancelled; capital indeed is yours which you shall have. Wrong not, and you shall not be wronged. God has given His injunctions that interest is totally forbidden. I first start with (the amount of) interest (which people owe) to Abbas and declare it all cancelled" (Abu-Dawood, 1999: 3334). The Prophet (pbuh) said, "Avoid the seven great destructive sins." Then (the people) asked, "O Allah's Apostle, what are they?" He mentioned the worst seven things, and one of them was to eat up *Riba*" (Al-Bukhari, 1999: 6857).

turns people away from productive enterprise, encourages a tendency for wealth accumulation to be in fewer hands and leads to unjust enrichment (Visser, 2009: 38).

6.1.2 Prohibition of *Gharar* (Uncertainty): *Gharar* means chance or hazard. It refers to the uncertainty, hazard, chance or risk caused by lack of clarity regarding the subject matter or the price in a contract or exchange (Rosly, 2005). It is the sale of a thing which is not present at hand, the sale of a thing whose consequence is not known or a sale involving hazards in which one does not know whether it will come to be or not, e.g. the sale of fish in water, or a bird in the air (Iqbal & Mirakhor, 1999). *Gharar* relates to uncertainty or contingency in the basic elements of any agreements such as buyer and seller, price, object, delivery and quality (Khair, Gupta & Shanmugan, 2008). If there is any kind of *Gharar* or uncertainty in a contract, the contract is void (Jabbar, 2009: 3). The Prophet (pbuh) said: "He who buys food grain should not sell it until he has taken possession of it" (Al-Hajjaj, 1999: 3640). No doubt, transactions involving *Gharar* are highly risky and could lead to undesirable consequences.

6.1.3 Prohibition of *Maisir/ Qimar* (Gambling/Games of Chance): *Maisir* and *Qimar* are used for gambling and games of chances. Gambling is the wagering of money or something which is gained by games of chance (Jabbar, 2009: 4). It is forbidden by the ethical framework governing Islamic finance (Schoon, 2009: 133). The Holy Qur'an says (2:219): "They ask you about wine and gambling. Say, in them is great sin and yet, some benefit for people. But their sin is greater than their benefit." It clearly prohibits gains made from gambling. This prohibition means that a contract is void if it has an element of *Qimar* or *Maisir* because 'it involves speculation and an attempt to amass wealth without putting in any productive effort' (Jabbar, 2009: 4).

6.1.4 Prohibition of Dealing in Certain Forbidden Commodities: In Islamic *Shari'ah*, there are some commodities such as alcoholic product, drugs and pork that are forbidden. People, individuals, institutions including Islamic banks cannot use, exchange, trade, finance, enterprises that include or deal in forbidden items (Lewis & Algaoud, 2001). The aim of *Shari'ah* in this regard is to promote ethical investment that does not affect the people and society.

6.2 Ethics for Acceptable Economic Forms in Islam

Besides the major prohibitions, the *Shari'ah* developed a set of principles for economic activities. Principles enunciating justice, mutual help, free consent and honesty on the part of the parties to a contract, avoiding fraud, misrepresentation and misstatement of facts and negation of injustice or exploitation provide grounds for valid contracts (Ayub, 2007: 64). Islamic ethical principles for economic activities and financial transactions are discussed below:

6.2.1 Trade-based Activities: Economic activities in Islam should be based on trade-oriented activities. Trade is a means of business transactions to avoid *Riba*. "Allah has permitted trading and forbidden *Riba*" (Al-Qur'an, 2: 275). Trading activities are not only permitted in Islam but also encouraged. Prophet (pbuh) said: "The trustworthy, honest Muslim merchant will be with the Prophets, the honest men, and martyrs on the Day of Resurrection" (Ibn-Majah, 1999: 2139). It assumes acquiring profits through equivalent counter-value (*Iwad*), consists of risk, work, effort and liability; while acquiring profits from a loan (i.e., *Riba*) rejects the idea of risk-sharing and risk-taking (Rosly, 2005). With the several modes of Islamic banking, trade-based activities are used to replace interest-based activities through various underlying principles of *Shari'ah*.

6.2.2 Profit and Loss Sharing: *Shari'ah* promotes a profit-loss sharing framework as an ideal mode of financing. Both capital provider and entrepreneur should jointly share the risks of the business (Pramanik, 1993). *Shari'ah* does not allow gain from business unless the beneficiary is subject to the risk. Profit should not be predetermined, but be uncertain and variable, and may even be negative (Qureshi, 1991). It should consist of risk, work, effort and liability (Rosly, 2005). It is expected that the capital

provider on a profit-and-loss-sharing basis will be more concerned than who lends money at fixed interest (Karsten, 1983).

6.2.3 Halal Instruments: The people should trade and invest only in *Halal* (legal in Islam) commodities, and should not use, trade, finance, enterprise or manufacture the items which are forbidden in *Shari'ah* such as the alcohol, gambling, casino activity, drug, pork, pornographic production etc. The aim of *Shari'ah* in this regard is to promote ethical investment.¹²

6.2.4 Honesty, Gentleness and Welfare Approach: The economic activities in Islam should be dealt with honesty to carry out trading activities in a faithful and beneficial manner (Haron, 2000: 55-58). Any business activity that aims at earning profit through hoarding, profiteering, black-marketeering, short weighting and hiding the defects of merchandise are prohibited.¹³ Cheating others and telling lies are considered among the great sins in Islam.¹⁴ Defrauding others in specifying the good and its prices is prohibited. A good businessman should avoid harshness and be gentle with other parties. The Prophet (pbuh) said: "May Allah have mercy on a person who is gentle when he sells, when he buys and when he demands his rights" (Ayub, 2007: 66).

6.2.5 Justice and Fair Dealing: Every dealing and transaction in Islam should be conducted with Justice and fairness.¹⁵ All revelations require Muslims to uphold justice and virtue as principles in managing their business dealings (Haron, 2000: 55-58). The Islamic financial system can be introduced by adopting the Islamic principles of social justice and introducing laws, practices, procedures and instruments which help in the maintenance, dispensation of justice, equity and fairness (Haron, 1997: 11). Justice can be achieved by prohibiting all sources of unjustified transactions (Nawawi, 1999).

6.2.6 Free-Marketing and Fair Pricing: Islamic business ethics only accept a free market where prices are determined fairly and justly without any interference.¹⁶ The price of commodity should be rational so that none of buyer or seller is to be cheated. If a person sells his goods at less than the cost price, he will be creating problems for others, which may hamper the supply of the commodity. That is why Caliph Umar (R) asked a trader who was selling at less than the market price to raise the rate to the market level or leave the market. Bidding up the price without an intention of buying the commodity (Najash) and misguiding unconscious clients by over-projecting the quality of a commodity (Khalabah)

¹² "O you who have believed, indeed, intoxicants, gambling, [sacrificing on] stone alters [to other than Allah], and divining arrows are but defilement from the work of *Satan*, so avoid it that you may be successful" (Al-Qur'an, 5: 90-91).

¹³ "And measure full when you measure. And weigh with a perfectly right balance. This is better and its end is good" (Al-Qur'an, 17: 35). Prophet (pbuh) said: "No one hoards but the traitors (i.e. the sinners)"; "The importer [of an essential commodity] into the town will be fed [by Allah], and the hoarder will have [Allah's] curse upon him" (Al-Hajjaj, 1999: 1605); "Whosoever sells a defective product without disclosing its defect to the purchaser, shall earn the permanent anger of Allah and the angels continuously curse such a person" (Ibn-Majah, 1999: 2247).

¹⁴ "Woe to those that deal in fraud. Those who, when they have to receive by measure from men, exact full measure. But, when they have to give by measure or weight to men, give less than due. Do they not think that they will be called to account?" (Al-Qur'an, 83: 1-4).

¹⁵ "Be just, that is nearest to piety" (Al-Qur'an, 5: 8). "And eat up not one another's property unjustly, nor give bribery to the rulers that you may knowingly eat up a part of the property of others sinfully" (Al-Qur'an, 2: 188). "Then make peace between them with justice, and be fair: for Allah loves those who are fair and just." (Al-Qur'an, 49: 9). "O Believers! Whenever you lend money for a particular period, write and someone among you must write it justly. And the one who can write must not refuse" (Al-Qur'an, 2: 282).

¹⁶ The Prophet (pbuh) said: "The seller and the buyer have the right to keep or return the goods as long as they have not parted; and if both the parties spoke the truth and described the defects and qualities (of the goods), then they would be blessed in their transaction, and if they told lies or hid something, then the blessings of their transaction would be lost" (Al-Bukhari, 1999: 2079).

are strictly prohibited.¹⁷ Misleading advertisements are prohibited. Islam only promotes the genuine businesses (Ayub, 2007: 69).

6.2.7 Disclosure, Transparency and Facilitating Inspection: The client must be provided with enough genuine information of the commodity. False, misleading or deceitful information is forbidden. The client must be given enough opportunity to see and check the commodity. The Prophet (pbuh) said: "Deceiving a *Mustarsal* (an unknowing entrant into the market) is *Riba*" (Suyuti, n.d.: 205).¹⁸ Concealing any vital information is considered as tantamount to the violation of contract and the disadvantaged party has the right to rescind the contract.

6.2.8 Fulfilling the Covenants and Paying Liabilities: "And keep the covenant. Lo! Of the covenant it will be asked" (Al-Qur'an, 17: 34).¹⁹ The Prophet (pbuh) said that one of the symbols of hypocrites is that they do not fulfill their promises. He also said: "After the major sins which must be avoided, the greatest sin is that someone dies in a state of debt and leaves behind no asset to pay it off" (Malik-ibn-Anas, 1999: 1494). So, the fulfillment of liabilities by the liable parties as per the contract is compulsory in Islam.

7. Modes of Islamic Banking and Their *Shari'ah* Foundation

In Islamic banking, both the customer and bank should make a contract in all modes of finance and transaction. Primarily, Islamic banks offer two types of contracts: contract of exchange and contract of profit-loss sharing. Contract of exchange can be divided into two types: exchange of goods for money and exchange of services for money. Contracts of exchange of goods for money are comprised of spot sale (i.e. Bai' al-Musawaammah)²⁰, deferred sale by credit (i.e. al-Murabahah, Bai' al-Muajjal) and deferred sale by order (i.e. Istisna, Salam). Contracts of exchange of services for money are: *Ijarah*, *Kafalah*²¹ and *Wakalah*²². Profit-sharing contracts are *Mudarabah* and *Musharakah*. Anwar (2003: 63) calculated twenty one operational modes of Islamic banking which includes *Musharakah Mutnaqisah*,

¹⁷ The Prophet (pbuh) said: "A *Najish* (one who serves as an agent to bid up the price in an auction) is a cursed taker of *Riba*". "If anyone interferes in the market to create a rise in prices, God has right to cast him face down in Hell" (Ayub, 2007: 66). "It is forbidden for a person to offer to buy anything for which another person has already made an offer" (Kamali, 1989: 427). "Do not go in advance to meet *Rukb'an* (grain dealers coming to the town to sell goods) to buy their goods, nor should one of you sell over the head of another nor increase the price to excite another to buy *Najash*" (Ayub, 2007: 67).

¹⁸ The Prophet (pbuh) once was passing by a man who was selling grain. He asked him: "How are you selling it?" The man then informed him. The Prophet (pbuh) then put his hand in the heap of grain and found it wet inside. Then he said: "He who deceives other people is not one of us" (Ayub, 2007: 68).

¹⁹ "Then for having broken their covenant, We rejected them and caused their hearts to harden" (Al-Qur'an, 5: 13). "And so (We punish them) for the breaking of their covenant" (Al-Qur'an, 4: 155).

²⁰ This is a normal sale where the parties bargain on price, a sale is executed and goods are delivered while payment is deferred (Ayub 2007).

²¹ *Kafalah* means guarantee. It refers to the guarantee provided by a person to the owner of the goods, who has placed or deposited his goods with a third party; whereby any subsequent claim by the owner with regards to his goods must be met by the guarantor, and not by the third party (Sudin, 1997).

²² This refers to a situation where a person nominates another person to act on his behalf (Sudin, 1997).

Ijarah wa Iktina, *Bai' al-Inah*²³, *Muzara'a*²⁴, *Musaqah*²⁵, *Qardh al-Hasan*, service charge, sale on installments, development charges, equity participation, sale and trade bills, and financing through *Awqaf*.²⁶ The major modes of Islamic Banking are elaborated here with their *Shari'ah* basis:

7.1 Mudarabah and its Shari'ah Foundation: *Mudarabah* contract is one of the most widely used financial instruments in the Islamic banking. It is a partnership where one partner gives money to another for investing it in an enterprise. The partner, who invests money, is called '*Rabb-ul-mal*', and the partner, who is responsible for managing the enterprise, is called '*Mudarib*'. The *Mudarib* contributes his time, efforts and expertise and the *Rabb-ul-mal* provides capital. *Mudarabah* contract could be made on two methods. In one method, the bank will supply capital as *Rabb-ul-mal* and the client will be a *Mudarib*, while in another, the bank will be a *Mudarib* and client will be *Rabb-ul-mal*. There are three forms of *Mudarabah* contract: simple or one-tier *Mudarabah*, two-tier *Mudarabah* and multilateral *Mudarabah*. In Islamic banking, depositors act as *Rabb-ul-mal* and the bank acts as *Mudarib* on its liability side, when someone deposits money in an Islamic bank. With respect to the end users of the funds, the bank acts as *Rabb-ul-mal*. In two-tier *Mudarabah*, the bank acts as an intermediary between the depositor and the bank's clients to whom it provides money.

The *Shari'ah* basis of *Mudarabah* is found in the Holy Qur'an, *Sunnah* and *Ijma*. Several Qur'anic verses²⁷ imply the general permissibility of commercial ventures indirectly including *Mudarabah*. Ibn Abbas reported that: "When our leader Abbas Ibn Abd al-Mutallib gives his property to someone for *Mudarabah*, he stipulated conditions for his partner not to bring the capital throughout the sea; and not to bring with him the capital crossing a valley; and not to buy livestock with the capital; and if his partner violates the conditions, he should guarantee the loss occurred. These conditions have been brought to the attention of Prophet (pbuh) and he approved them" (Al-Bayhaqi, 2013). The Prophet (pbuh) said: "Three matters that have the blessing (of Allah): A deferred sale, *Muqaradah* (*Mudarabah*), mixing the wheat with barley for domestic use and not for sale" (Ibn-Majah, 1999: 2289). The companions of the Prophet (pbuh) such as Umar, Uthman, Ali placed the property of orphans under *Mudarabah* contract with no objections from other companions. The Muslim jurists made *Ijma* on the permissibility of *Mudarabah* contract. For a *Shari'ah* compliant *Mudarabah*, the profit should be shared between the two parties on a pre-agreed ratio, not the fixed amount (Ayub, 2007: 322).

7.2 Musharakah and its Shari'ah Foundation: *Musharakah* refers to a joint partnership where two or more persons combine their capital or labor or both, to form an enterprise in which all partners share the profit according to a specific ratio, while the loss is shared according to the ratio of the contribution (Usmani, 2002a: 87). By *Musharakah* contract, the Islamic bank and a client agree to combine their financial resources for the establishment of a business (Ayub, 2007: 307). Several modes of Islamic banking developed on the basis of *Musharakah* contract (Ahmad, 2010: 187). There

²³ *Bai' al-Inah* refers to an arrangement that involves sale of an asset to the purchaser on a deferred basis and subsequent purchase of the asset at a cash price lower than the deferred sale price or vice versa, and which complies with the specific requirements of *Bai' al-Inah*." (Bank Negara Malaysia, http://www.bnm.gov.my/documents/SAC/03_Bai%20Inah.pdf)

²⁴ *Muzara'a* is a partnership in crops whereby one party (land owner) presents a piece of land to another (agricultural worker) for the latter to cultivate and maintain in return for a common defined share in the crop. In essence, *Muzara'a* is a form of *Mudarabah* which is confined to agricultural activities, specifically sharecropping.

²⁵ *Musaqah* is a partnership in which one party presents designated plants/trees that produce edible fruits to another (irrigating worker) who undertakes irrigation works in consideration for a common defined share in the fruits. In essence, *Musaqah* is a form of *Mudarabah* which is confined to irrigation activities.

²⁶ *Waqf* is "the permanent endowment by a Muslim of any of his property for a purpose recognized by the Muslim Law as religious, pious or charitable." (Article 2 of the Mussalman Waqf Validating Act, 1913, Accessed May 28, 2018, <http://bdlaws.minlaw.gov.bd>)

²⁷ "...others travelling through the land, seeking of Allah's bounty..." (Al-Qur'an, 73: 20); "And when the Prayer is finished, then may ye disperse through the land, and seek of the Bounty of Allah..." (Al-Qur'an, 62: 10).

are two basic categories of *Musharakah*; *Shirkat-ul-milk* (Partnership based on joint ownership of a particular property) and *Shirkat-ul-aqd* (Partnership based on a contractual relationship) (Rosly, 2005: 183). *Shirkat-ul-Aqd* is further divided into three kinds: a) *Shirkat-ul-Amwal* (Partnership in capital): where all the partners invest some capital. 2) *Shirkat-ul-Aamal* (Partnership in services): where all the partners undertake the services. C) *Shirkat-ul-Wujooh* (Partnership in goodwill): A partnership based on the creditworthiness of one or both parties in which the ratio of profit and loss is based on the liability borne (Abd Jabbar, 2009: 4).

7.3 Each of the above three types of *Shirkat-ul-Aqd* are further divided into two types: a) *Shirkat-al-Mufawada* (universal partnership): All partners share capital, management, profit, and risk in absolute equals. B) *Shirkat-ul-Ainan* (restricted partnership): Where equality in capital, management or liability might be equal in one case but not in all respect meaning either profit is equal but not labour or vice versa. It is considered the most used type of *Musharakah* in Islamic banking (Abd Jabbar, 2009: 4).

7.4 *Musharakah Mutanaqisa* (Co-ownership) is a form of *Musharakah*, which is being widely used in modern Islamic banking. It is a partnership contract between the bank and beneficiary to own an asset, on the condition that the bank will gradually sell his share to the beneficiary at an agreed price within an agreed schedule. As a result, the withdrawing partners share gradually diminishes along with the share in profit, in line with their declining equity stake. All the partners should maintain the following principles to form a valid *Musharakah* contract: a) The partners must be sane and mature. The contract must take place with free consent of the parties without any fraud (Ayub, 2007: 312). C) All the partners will share in profit and loss. The ratio of profit should be pre-determined. In case of loss, all partners will have to share the loss in proportion (Ayub, 2007: 316). C) The capital invested by each partner must be in the form of liquid assets (Ayub, 2007: 313). *Imam Malik* views that the liquidity is not a condition (Usmani, 2002b: 8).

The legality of *Musharakah* is based on the Qur'an, *Sunnah* and *Ijma*. In the verse underlining the principles of inheritance, the Holy Qur'an said (4: 12): "...but if more than two, they share in a third...." Muslim jurists have regarded the text as containing the general permissibility of any form of partnership. "Verily many are the partners (in business) who wrong each other except those who believe and work deeds of righteousness and how few of them...." (Al-Qur'an, 38: 24) clearly indicates the validity of partnership. During the early time of Islam, *Musharakah* was widely practiced and the Prophet (pbuh) did not forbid from it. After *Hijra*, the *Muhajireen* and the *Ansar* were declared by the Prophet (pbuh) to be brothers. Subsequently, they joined as partners in trades, in different forms of *Musharakah*. The Prophet (pbuh) said: "Allah says: I am the third [partner] of the two partners as long as they do not betray each other. When one of them betrays the other, I depart from them" (Sulayman, n.d.: 3383). "Profit return is shared according to conditions determined freely by partners. And the loss is dealt with according to ratio of their capitals" (Ibn-Majah, 1999: 2273). Abu al-Minhal narrated that Zayd Ibn Arqam and al-Barra' Ibn 'Azib were partners, and they bought silver in cash and credit. Their practices were brought to the Prophet (pbuh) and the Prophet (pbuh) pronounced that what was bought on cash then they could benefit from it and what was bought on credit then they should reject it" (Al-Bukhari, 1999: 2060). It is learned that Prophet (pbuh) approved the partnership.

Musharakah has been practiced throughout the history of Muslims without any objection from the jurists. Imam Ibn al-Munzir states in his book 'al-Ijma': "And they (Muslim jurists) agree on the validity of partnership where each of the two partners contributes capital in dinar or dirham, and co-mingles the two capitals to form a single property which is indistinguishable, and they would sell and buy what they see as (beneficial) for the business, and the surplus will be distributed between them whilst the deficit will be borne together by them, and when they really carry out as prescribed, the partnership is valid" (Ismayi, 2012: 17). Thus, there is a consensus of opinion among the jurists of all schools- of thought that *Musharakah* is a valid and legitimate contract in Islam. There is criticism that *Musharakah* is a very old form and unfit for modern banking. But, *Musharakah* doesn't need to be implemented

only in its traditional forms. Every new form or partnership, suitable for modern banking, is acceptable as long as it conforms to the principles of *Shari'ah*. (Usmani, 2002b: 19). Therefore, *Musharakah* is completely based on *Shari'ah* principles having no forbidden element. Muslim scholars have opined that more *Musharakah* instruments should be developed and used for the future development of Islamic banking.

7.3 *Murabaha* and its *Shari'ah* Foundation: It refers to the sale of a commodity at a price that includes a pre-determined mark-up profit known to both parties. In *Murabaha* contract, the seller expressly mentions the cost of the sold commodity and sells it to the buyer at the cost plus profit upon the consent of both parties. The payment in a *Murabaha* may be on cash or deferred price. In Islamic banking, *Murabaha* involves purchase of a commodity by a bank on behalf of a client and its resale to the latter on cost-plus-profit basis. The bank discloses its cost and profit margin to the client. Rather than advancing money to a borrower, which is used in conventional banking, an Islamic bank buys the goods from the market and sells these to the customer for a pre-agreed price (Abd Jabbar, 2009: 5). This is the most popular contract in Islamic banking, about 59% of all the value of Islamic banking products (Lee, Kun-Ho & Ullah, 2007: 245). Three parties get involved in a *Murabaha* contract: the seller or receiving party (the Islamic bank) who buys a commodity; the buyer or ordering party (the client) who wishes to buy the commodity from the seller; and the provider or facilitator, between the seller and the buyer (Siddiqui, 2008: 682). The following conditions should be maintained to form a valid *Murabaha* contract: a) The commodity must exist at the time of sale and be in the ownership of the seller in physical or constructive possession. Constructive possession means a situation where the possessor has not taken physical delivery of the commodity, but it has come into his control and all rights and liabilities of the commodity are passed on to him. B) The sale must be instant and absolute. A sale attributed to a future date or event is void. C) The subject of sale must be *Shari'ah*-approved, specified and identified to the buyer. The seller must explain all the flaws and benefits of the commodity clearly. D) The delivery of the commodity must be certain. E) The price of the commodity and profit of the seller should be certain, known and agreed by both the parties (Kettell, 2010: 27; Ayub, 2007: 217-218).

The *Shari'ah* foundation of *Murabahah* is found in the Qur'an, *Sunnah*, *Ijma* and *Qiyas*. Several verses of the Holy Qur'an such as "Allah permitted trade and prohibited usury" (2: 282) allow the sale contract generally. There is no direct juristic authority from the *Sunnah* on the legitimacy of *Murabahah*. It is deemed permissible based on the general permissibility of sale in Islamic law. The Muslim people have inherited the *Murabahah* transactions for ages without any objection and that would constitute *Ijma* on the permissibility of *Murabahah*. The *Qiyas* in this regard is that since the Prophet (pbuh) approved the *Tawliyah* sale (sale based on cost price), the sale on mark-up will be equally permissible on the basis of analogy on the *Tawliyah* sale. The determination of cost and making it known to the buyer are common in both the *Tawliyah* and *Murabahah*. The *Shari'ah* principle for *Mua'malat*, 'everything is permitted except those explicitly forbidden by the *Shari'ah*' also supports the validity of *Murabahah* contract. Thus, *Murabahah* is a *Shari'ah*-compliant contract and widely practiced in modern Islamic banking.

7.4 *Ijarah* and its *Shari'ah* Foundation: *Ijarah* is a contract between the two parties: the lessor or owner of the asset (the bank) and the lessee (the client) who is in need of the asset (Kettell, 2010: 55). With this contract, an Islamic bank buys the asset from the seller and then rents it to the contracting party at an agreed price plus profit for a certain period at a fixed rental charge (Chong & Liu, 2009: 129). *Ijarah* is used in two different forms: to employ the services of a person on wages or to transfer the usufruct of a property in exchange for a rent (Kettell, 2010: 55). In this case, *Ijarah* is analogous to the term 'leasing' of conventional banking. The rules of *Ijarah* are similar to the rules of sale as both contracts involve transfer of some assets to another (Ayub, 2007: 380).

Ijarah thumma al-Bai' (hire purchase), a kind of *Ijarah*, has now been used in Islamic banking modes. In this practice, the parties enter into two contracts that come into effect serially. The first is an *Ijarah* contract that outlines the terms for leasing over a fixed period, and the second contract is a *Bai'* that triggers a sale once the term of *Ijarah* is complete. For example, a customer leases a car from the owner (bank) at an agreed amount over a specific period with first contract. At its end, the second contract comes into effect that enables the customer to purchase the car at an agreed price. The bank generates a profit by determining in advance the cost of the item, its residual value and the profit margin. In order to be valid, an *Ijarah* contract should maintain the following conditions: a) The contract must be capable of being fulfilled and performed. B) The usufruct of the goods should have value and be lawful according to *Shari'ah*. C) The lessor should have full possession of the property. D) The lessor should hand over the property to the lessee as per the agreed conditions. E) The property and its rent should be specified, known and identified (Ayub, 2007: 380).

The legality of *Ijarah* is deduced from the Qur'an, *Sunnah* and *Ijma*. Describing the story of the Prophet Musa (pbuh) of being hired to undertake a specific task, the Holy Qur'an said: "And said one of them (the two women): 'O my father! Hire him! Verily, the best of men for you to hire is the strong, the trustworthy'. He said: 'I intend to wed one of these two daughters of mine to you, on condition that you serve me for eight years, but if you complete ten years, it will be (a favor) from you..." (28: 267). This verse acknowledges the legality of *Ijarah*. The Prophet (pbuh) said: "Pay the hired worker his wages before his sweat dries off" (Ibn-Majah, 1999: 2443). "He, who hires a person, should inform him of his fee" (Al-Nasai, n.d.: 3857). Abdullah ibn Umar narrated: "Allah's Apostle gave the land of Khaibar to the Jews to work on and cultivate and take half of its yield. The land was used to be rented for a certain portion" (Al-Bukhari, 1999: 678). So, the prophetic traditions approved the permissibility of *Ijarah* contract. *Ijarah* has unanimously been approved by the companions of the Prophet (pbuh) and prominent jurists of the recognized schools of Islamic law. They view that the need to utilize the usufruct of different articles (properties and services) is similar to the need to utilize the articles. When the contract of sale of such properties and services is permitted, the lease of its usufruct shall also be permitted on the ground of *Istislah* and needs.

7.4 *Bai' al-Salam* and its *Shari'ah* Foundation: It refers to an agreement between the seller (Islamic bank) and the buyer (client), whereby the seller undertakes to supply specific goods to the buyer at a future date in exchange for an advanced price fully paid at the time of the contract (Abd Jabbar, 2009: 9). In this contract, the price is paid in advance and the supply of goods is deferred (Rosly, 2005: 139). The objects of this contract are commodities but cannot be gold, silver or currencies. It is mainly applied to agricultural products and to fungible manufactured goods (Visser, 2009: 61). The following conditions should be maintained: a) The buyer should pay the full price in advance at the time of contract. B) The object must be fungible, of quality and clearly defined physically and quantitatively. D) The date and place of delivery must be specified in the contract. E) The buyer cannot enjoy ownership rights of the commodity before possessing it (Ayub, 2007: 255; Abd Jabbar, 2009: 9; Rosly, 2005: 139).

7.5 *Istisna'* and its *Shari'ah* Foundation: It is a contract of sale where the seller is the manufacturer and the customer is the purchaser of future manufactured goods (Chong & Liu, 2009: 129). With this contract, the seller commits to manufacture the goods as specified in the contract for the buyer. To be more precise, a customer gives clearly described specifications to a manufacturer for non-existing goods that are to be manufactured and then delivered on an agreed future date (Khan & Porzio, 2010: 53). In this contract, an Islamic bank can play both the roles either as a financier and intermediary between two parties and orders the goods on behalf of the customer or the role of manufacturer. In *Istisna'*, the following conditions should be maintained: 1) The delivery time should be fixed. The purchaser may fix a maximum time for delivery. 2) The specification of the good and its price should be known and fixed. 3) The price can be paid at once or in installments

according to the agreement. 4) The delivery of the goods may take place through constructive possession. 5) The risk to the goods remains with the seller before delivery and with the purchaser after delivery (Iqbal, 2009: 92; Ayub, 2007: 263,269; Abd Jabbar, 2009: 10).

In *Istisna'*, the object is always something that needs to be manufactured or processed, while the object of *Bai' Salam* involves agricultural products. It is not necessary in *Istisna'* contract, the price is to be paid in full in advance unlike in *Bai' Salam*. The time of delivery must be fixed in *Salam*, but a maximum time can be fixed in *Istisna'* (Iqbal, 2009: 92; Rosly, 2005: 139).

7.7 Bai' Muajjal and its Shari'ah Foundation: It is the sale of goods based on a deferred payment in a pre-agreed period, whereby the delivery of goods is immediate and the payment is deferred (Abd Jabbar, 2009: 7). The deferred payment becomes a loan payable by the buyer at a time or installment. Islamic bank, purchasing the asset from the owner on cash, sells it to the customer at the original price plus profit for the specified period. Nature of repayment and period are being determined by agreement of the bank and client (Rosly, 2005: 90). It involves three separate agreements. The first details the asset to be acquired and are identified by the customer. The second applies to when the bank sells the asset to the customer. The third applies to when the bank sells the property in the event of failure to pay by the customer (Venardos, 2005: 78). The deferred price must be fixed at the time of sale. Once the price is fixed, it can neither be decreased nor increased in any case. In *Bai' Muajjal*, the bank does not need to disclose its profit margin to the customer unlike in *Murabaha* (Rosly, 2005: 90).

Bai' al-Salam, *Istisna'* and *Muajjal* are very similar in nature with minor differences in deferred payment or delivery. The *Shari'ah* basis of these modes is derived from the Holy Qur'an, *Sunnah* and *Ijma*. The Holy Qur'an says (2: 282): "O Believers! When you contract a debt for a fixed term, you should put it in writing." In *Sunnah*, the Prophet (pbuh) prohibited the sale of commodity which is not in the possession of seller presently, but he made an exception in the case of *Salam*. He said: "When a man involves in *Salam* and pays for goods to be delivered later, the parties should settle the weight and measure and date of delivery of goods" (Al-Bukhari, 1999: 2240). The Prophet (pbuh) saw the people in Medina paying in advance the price of fruit or dates to be delivered over one, two or three years without specifying the quality, measure or quantity of the commodity or the time of delivery. Then, the prophet (pbuh) ordered: "whoever pays money in advance for fruit to be delivered should pay it for a known quality, specified measure and weight of course along with the price and time of delivery" (Al-Bukhari, 1999: 2241). "The Prophet (pbuh) bought some foodstuff on credit from a Jew and mortgaged an iron armor to him" (Al-Bukhari, 1999: 571). The Prophet (pbuh) bought a camel for him from outside Medina whereby the payment was settled later on in Medina (Ibn al-Hajjaj, n.d.: 3886).

These *Qur'anic* verses and Prophetic traditions theoretically acknowledged the contract on deferred payment or delivery upon the fulfillment of basic conditions. These financing modes i.e. *Bai' al-Salam*, *Istisna'* and *Muajjal* are unanimously declared legitimate by all schools of Islamic law, with mere differences in duration issues. Thus, the Muslim jurists constituted *Ijma* for the legality of these contracts as these have not involved in any forbidden element. The *Shari'ah* principal 'for *Mua'malat*, everything is permitted except those explicitly forbidden by the *Shari'ah* also supports the legitimacy of these contracts as the main objective of these contracts is the benefit and welfare of the society by easing the everyday dealings within the *Shari'ah* framework. Legitimacy of these contracts also

recognized by the established *Shari'ah* bodies such as the International Islamic Academy of *Fiqh* (IIFA) of OIC²⁸ and Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI).²⁹

7.8 Qardh al-Hasan and its Shari'ah Foundation: It is a form of *Sadaqah*.³⁰ It is a benevolent loan provided free from all kinds of interest or profit. It is extended on the basis of welfare and the debtor is only required to repay the principal amount. In Islamic banking, *Qardh al-Hasan* is a loan contract between the lender (bank) and the borrower (client), which is applied as a social service to help the poor, needy, or small farmers (Siddiqui, 2008: 684). It is returned at the end of agreed period without any interest, compensation, or share in the profit or loss of the business (Venardos, 2005: 83).

Qardh al-Hasan has not only been permitted, but also highly encouraged with due reward in the hereafter in Islam. Almost in all the verses in which it is mentioned, it is stipulated that it is made directly to the Almighty Allah instead to the recipient. The Holy Qur'an says: "He who will give Allah Qardh al-Hasan, which Allah will double into his credit and multiply many times" (2: 245).³¹ The *Sunnah* of the Prophet (pbuh) is also very clear in this regard. The Prophet (pbuh) said: "At night during which I was made to perform journey, I saw at the door of the Paradise written, "A sadaqa is equivalent to ten like that (in reward) while lending has eighteen times reward." I said, "O Gabriel, what is the reason that lending is more excellent than Sadaqa?" He said, "The beggar asks while he possesses it (money) while the one who demands loan does not demand it but because of his need" (Ibn-Majah, 1999: 2431). *Qardh al-Hasan*, being an interest free loan, may ensure the movement of wealth amongst all classes of people in the society.

7.9 Tawarruq and its Shari'ah Foundation: It is a contract to obtain money, whereby someone buys a commodity on deferred payment, in order to sell it to a third party at a lower price to obtain cash (Abd Jabbar, 2009: 11). It involves three parties i.e. an Islamic bank, who plays an intermediary role, the client who wishes to obtain money and the supplier. For example, the client buys a car from the bank on deferred payment and resells it immediately to a third party to obtain cash money. For a valid *Tawarruq* contract, the goods should be sold to a third party, other than the original seller (Ayub, 2007: 349). This contract is becoming increasingly popular in Islamic banking as it is very easy to obtain cash (Visser, 2009: 70). In the financing process based on *Tawarruq* contract, the bank buys the product and sells it to the client on deferred payment. The client asks the bank to sell it in the market. The role of the bank here is as an agent of the client. The bank sells the product to a third party and gives the cash from the sale to the client (El-Gamal, 2006: 72; Abd Jabbar, 2009: 11; Ayub, 2007: 350). The following conditions should be maintained: 1) The seller must own the product before he offers it to the buyer. 2) The seller should explain the details of the product to the buyer. 3) The seller should be able to deliver the product at the agreed time. 4) The modes of payment should be clearly mentioned (El-Gamal, 2006: 62-63; Ayub, 2007: 350).

²⁸ International Islamic Fiqh Academy (IIFA) is an Academy for advanced study of Islam based in Jeddah, founded by OIC with its resolution No.8/3-C, (I.S.). Besides traditional Islamic sciences, the IFA seeks to advance knowledge in the realms of culture, science, and economics. For details, see: <http://www.iifa-aifi.org>.

²⁹ The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-profit corporate body that prepares accounting, auditing, governance, ethics and *Shari'ah* standards for Islamic financial institutions. It founded in 1991 based in Bahrain. Its standards are currently followed by all the leading Islamic financial institutions across the world. For details, see: <http://aaoifi.com>

³⁰ A comparison of the contents of Qur'an, 2:261 with any of *Qardh al-Hasan* represents nothing but spending (infaq) in the way of Allah.

³¹ "If you give Allah Qardh al-Hasan. He will double it to your credit and he will grant you forgiveness (64: 17). "And give Allah Qardh al-Hasan, it will be increased manifold to their credit" (Al-Qur'an, 57: 18). "Who is he that will give Allah Qardh al-Hasan? For Allah will increase it manifold to his credit" (Al-Qur'an, 57: 11). "Establish regular prayer and give regular charity and give Allah Qardh al-Hasan---" (Al-Qur'an, 73: 20).

The *Shari'ah* legality of *Tawarruq* contract is based on *Maslahah Mursalah* (public interest). The use of *Tawarruq* seems as *Hajiyyat*, the absence of which may lead to hardship in the life of the community. A *Hadith* indirectly supports the implications of *Tawarruq*. It says: When the governor of Khaibar brought to the Prophet (pbuh) *Janib* (a high quality of dates), He asked "Are all the dates of Khaibar like this?" He responded "No, by Allah, But we take one Sa' of these (dates of good quality) for two or three Sa's of other dates (of inferior quality)". The Prophet (pbuh) replied, "Do not do so, but first sell the inferior quality dates for money and then buy *Janib* with that money" (Al-Bukhari, 1999: 1936). Here, the Prophet (pbuh) approved two separate sales which is also in the case of *Tawarruq*. Ali ibn Abu Taleb said: 'I would not abandon the *haji* even if I had to do it through *Tawarruq*' (Ibn al-Athir, n.d.: 301-302). This statement implies that he would not use *Tawarruq* except if that was the last option. It indicates the permissibility of *Tawarruq*. The explicit usage of the term *Tawarruq* in the post-Prophetic period and the edicts on it by Muslim jurists suggest that it was practiced in the periods after the Prophet (pbuh), the companions and their followers (Ahmed & Aleshaikh, 2014: 285). Major well-known fatwa issuing bodies including AAOIFI and IIAF held that *Tawarruq* is permissible (AAOIFI, 2010: 525; IIFA, 2009). Due to the nature of this contract, it has become the most controversial contract in Islamic banking. Some scholars are worried about the *Shari'ah* compliance of *Tawarruq* practice, while other scholars permit it noting that the majority jurists of different schools of Islamic law considered *Tawarruq* as legally permissible (Lasasna, 2015). The *Tawarruq* contract should be used where necessary to avoid interest, especially when the client's intention is not to purchase goods, but merely to obtain money (Ayub, 2007: 349).

3. CONCLUSION

The *Shari'ah*, as an all comprehensive and all embracing system of life, presents a framework to govern economic practices. It includes the prohibition of *Riba*, uncertainty, gambling, and forbidden items, while it promotes trade-based activities and profit-loss sharing. The best application of economic transaction within the *Shari'ah* framework has been resulted in the emergence of Islamic banking system. The industry has been expanding rapidly not only in the Muslim country but also in many western countries. The single most important characteristic of Islamic banking is its *Sharia'h* compliance. All the products, operations and services of Islamic banks should abide by the principles of *Shari'ah* strictly. Without incorporating the instructions of *Shari'ah*, a bank could not be an Islamic bank. But, several recent studies revealed that many Islamic banks are not maintaining their commitment to *Shari'ah* compliance properly. It has been criticized that some products are almost similar to the conventional banking except the change of the names of products. In this regard, to understand the *Shari'ah* compliance of Islamic banking modes, this article examined their *Shari'ah* foundation and identified that all the major products used by Islamic banking system, are theoretically compliant by *Shari'ah*. These have either been directly deduced from the text of the Holy *Qura'n* and *Sunnah* or by the *Ijtihad* of contemporary Muslim jurists. The basic principal in this connection is that 'everything is permitted except which is explicitly prohibited by the *Shari'ah*'. A banking product could not be declared as prohibited until it is explicitly found contradict to a *Shari'ah* instruction. However, there are some contracts currently used by some Islamic banks like *Bay' al-Inah*, *Tawarruq*, where there is disagreements exist among the *Shari'ah* Scholars about the permissibility. Several *Shari'ah* ruling bodies also established such as AAOIFI, IIFA, which are doing research and providing *Shari'ah* instructions to make the products and services of Islamic banks strictly *Shari'ah*-compliant. Moreover, *Shari'ah*

board of an Islamic bank has direct responsibility to ascertain that the products comply with the principles of Shari'ah before they are launched. Therefore, it can be summed up that all the products, operations and services of Islamic banking system are theoretically Shari'ah compliant and deduced from the sources of Shari'ah.

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