Chapter 2 – Islamic Finance: A Conceptual Framework
2.1 Introduction

The Islamic economic system differs substantially from the Western conventional, capitalistic one as it goes beyond the pure financial and economic sphere. Its most important foundations are the Islamic religion and the Shari’ah – the Islamic law- providing a religious framework as well as social and ethical boundaries for Islamic finance and banking activities. The foundation of Islamic Banking is based on the ‘Islamic faith’, explicitly stating that the operations of Islamic Banking must stay within the limits of Islamic Law (Shari’ah) in action as well as in deeds. ‘Shari’ah’ – an Arabic word meaning ‘way to the source of life’ is used to refer to legal system of keeping with the code of conduct and behaviour called by the Holy Qur’an. Islamic Banks use four governing principles: No interest based transaction (Riba or interest is prohibited); Risk Sharing (profit Loss Sharing – PLS); Asset/Service Backing (as against Debt-backed); and Contractual Certainty (no use of Gharar).

Shari’ah can be translated as “the way to the source of life” (Algaoud and Lewis 2007, 38) and is used to denominate a legal system which promotes a certain code of behaviour described by the Holy Qur’an and the Hadith (the authentic tradition). It includes a set of duties and practices such as prayer, manners and morals, marriage etc. (Algaoud and Lewis 2007, 38) The Holy Qur’an is the “Divine Books revealed to Prophet Muhammadﷺ” and is referred to as “guidance for mankind” (Iqbal and Mirakhor 2007, 10 and 14). “As such it does not rely on the authority of any earthly lawmaker.” (Algaoud and Lewis 2007, 38) Additionally to the Holy Qur’an, the Shari’ah is based on “judgements given by
the Prophet ﷺ himself, reflecting the application of rules, principles and injunctions already enunciated in the Holy Qur’an” called the Hadith (Algaoud and Lewis 2007, 38). In practice, however there is “no universality of Islamic law [Shari’ah]” (Lewis and Algaoud 2001, 39) as it is applied adhering to the principles of “analogical reasoning” and “independent human reasoning of those specialized in law”. The former is based on analogies existing between new problems and those existing in primary sources, such as the Holy Qur’an and the Hadith (Iqbal and Mirakhor 2007, 15). The latter refers to Shari’ah scholars, being experts in Islamic law, who can interpret the Shari’ah themselves. Both principles result in a “great flexibility” (Iqbal and Mirakhor 2007, 15) in law making.

Therefore, ‘Islamic Banking’ deals in Shari’ah Compliant Products and Services only. It means no gain or reward is permissible without taking any commensurable risk equally applied to capital and labour, money is essentially a medium of exchange and not a store of or commodity. Its exchange makes wheels of business to move.

2.2 Islamic Banking Governing Principles

It has been already mentioned that there are certain key assumptions that distinguish Islamic Finance essentially from conventional financing activities. The four most important principles are described as follows:

2.2.1 Prohibition of Riba (Interest)

The issue of Riba is the most fundamental and most far reaching aspect in the Islamic financial system. Its interpretation is subject to many debates
around the world. It can be translated into English as “increase”, “access”, “growth”, “addition”, “usury” (Algaoud and Lewis 2007, 42) or simply “prohibited gain” (Ayub 2007, 47). Most Islamic scholars agree that the Holy Qur’an prohibits the payment and taking of any interest.

2.2.1.1 References from Qur’an

Chapter 002. Verse 275 Those who swallow usury cannot rise up save as he ariseth whom the devil hath prostrated by (his) touch. That is because they say: Trade is just like usury; whereas Allah permitteth trading and forbiddeth usury. He unto whom an admonition from his Lord cometh, and (he) refraineth (in obedience thereto), he shall keep (the profits of) that which is past, and his affair (henceforth) is with Allah. As for him who returneth (to usury) - Such are rightful owners of the Fire. They will abide therein.

Chapter 002. Verse 276 Allah hath blighted usury and made almsgiving fruitful. Allah loveth not the impious and guilty.

Chapter 002. Verse 278 O ye who believe! Observe your duty to Allah, and give up what remaineth (due to you) from usury, if ye are (in truth) believers.
Chapter 003. Verse 130 O ye who believe! Devour not usury, doubling and quadrupling (the sum lent). Observe your duty to Allah, that ye may be successful.

Chapter 004. Verse 161 And of their taking usury when they were forbidden it, and of their devouring people's wealth by false pretences, We have prepared for those of them who disbelieve a painful doom.

Chapter 030. Verse 039 That which ye give in usury in order that it may increase on (other) people's property hath no increase with Allah; but that which ye give in charity, seeking Allah's Countenance, hath increase manifold.

Some more liberal experts argue that only “usury” in the sense of exorbitant, excessive interest should be banned (Algaoud and Lewis 2007, 42f.). The latter opinion was followed by believers of Hinduism, Judaism and Christianity, too. (Lewis and Algaoud 2001, 64). Over the years the prohibition lost its importance in the other world religions. In the Muslim world, there is a substantial difference between profits resulting from entrepreneurial activities and profits generated by granting loans. The
latter is defined as “receiving a monetary advantage without giving a counter value” (Algaoud and Lewis 2007, 42) and is therefore forbidden according to the Holy Qur’an. It declares that those who take Riba are at war with God and his Prophet Muhammad because Riba deprives the wealth of God’s blessing and encourages the wrongful appropriation of property belonging to others and harms Muslims’ welfare. In transactions only the principal should be paid and in case the counterparty is unable to pay it should be forgone. (Lewis and Algaoud 2001, 28 and 29)

2.2.2 Maysir and Gharar–The prohibition of gambling and transactions involving speculation

The “unjustified enrichment through games of pure chance” (Algaoud and Lewis 2007, 40) in order to “amass wealth without effort” (Lewis and Algaoud 2001, 30) is called Maysir or Qimar (the Arabic terms are used identically) and forbidden according to the Holy Qur’an. Maysir is involved in contracts where the ownership of a good depends on the occurrence of a predetermined, uncertain event in the future. In other words there will be a definitive gain for one party and a definitive loss for the other party, but when the contract is signed it is not sure who will be the winner or the looser. (Gassner and Wackerbeck 2007, 31) The Qur’an tells about this principle among others in chapter 2 verse 219 which states:

\[
\text{Chapter 002. Verse 219 They question thee about strong drink and games of chance. Say: In both is great sin, and (some) utility for men; but the sin}
\]
of them is greater than their usefulness. And they ask thee what they ought to spend. Say: that which is superfluous. Thus Allah maketh plain to you (His) revelations that haply ye may reflect.

Chapter 005. Verse 090 O ye who believe! Strong drink and games of chance and idols and divining arrows are only an infamy of Satan's handiwork. Leave it aside in order that ye may succeed.

2.2.3 Risk Sharing (Profit Loss Sharing – PLS)

Each Islamic financing technique is based upon either of two basic principles. These are “profit and loss sharing” and “mark-up” (also referred to as “cost-plus financing”). The profit and loss sharing technique is used for equity-based financing modes as the bank invests directly in business ventures and participates in generated profits or losses. In contrast the mark-up technique is applied in debt-financing techniques as the customer appears as debtor to the bank, paying the original purchase price of a commodity plus a predetermined mark-up.

2.2.4 Asset / Service Backed Financing

Islamic asset-based finance has certain characteristics due to which debt crises are less likely to arise. In particular, the total value of debt, which includes the spot value of commodities purchased on credit as well as an implicit mark-up, is set from the very beginning. The total value of debt can be paid in instalments, without increasing its total value, as there is no
compounded interest to pay on the outstanding balance. When debtors face unavoidable circumstances that would make them insolvent, they are often granted grace periods to assist them to bring their finances back into order. No penalty interest can be levied in this case. In other words, debt rescheduling is granted at no extra cost to borrowers. Islamic asset-based finance is created through the finance of acquiring goods and services on credit, and the loan is thus used from the very beginning for its prescribed and asset-based purpose. Default resulting from improper use of borrowed funds is therefore most unlikely. Asset-based finance directly contributes to the ability of the economy to meet its internal and external financial obligations.

2.3 Islamic Financing Methods and Products

Islamic banking and finance has been developed in the first place to finance trade and commerce (in compliance with the Shari’ah) and consequently to foster the economic development in the countries where it operates. Nowadays the financing of private investments has also become a huge market, however originally it was forbidden to take loans for private persons as it would encourage them to “live beyond their means”. The best example in this case is a huge housing loan for which a person put debts on himself for a lifetime.

Theoretically, there are different types of Islamic methods of finance that link agricultural activities, industrial activities, trade activities etc., however, this study focuses on the common Islamic methods of business transactions that are known and practiced by Islamic Banking and other Islamic institutions and which (research shows) comply with Shari’ah. These Islamic instruments take the form of
Mudarabah, Musharakah, Murabaha, Bai Muajjall, Bai Salam, Istsna, Ijarah and Qardh Hassan.

### 2.3.1 Mudarabah

Mudarabah, in jurisprudence, is a mode of financing through which the bank (the owner of the capital or rabb-al-mal) provides capital finance for a specific venture indicated by the customer (entrepreneur or mudarib) (Obaidullah 2005, p. 57). Mudarabah is a contract between two parties: an investor (businessman or bank) who provides a second party, the entrepreneur, with financial resources to finance a particular enterprise. Profits are shared between the two parties (rabb-al-mal and mudarib) according to a pre-agreed ratio, but if there are losses the investor bears all financial losses and the entrepreneur only loses his/her effort and his/her time as

![Figure 2.1: Bank Finances Mudarabah for Client](Image)
shown in Figure 2.1. This distribution of profits and losses is an equitable approach that conforms to Islamic principles.

Although Mudarabah may be applied in various economic activities, the majority of Islamic jurists and scholars hold the view that Mudarabah contracts are more suitable for commercial activities. However, other activities such as agricultural activities are generally complex and need further research and thorough analysis.

2.3.2 Musharakah

Musharakah, full partnership, is the second way of the profit/loss sharing method found in an Islamic finance. Musharakah as a financial contract is defined as an arrangement where two or more parties establish a joint commercial enterprise and all contribute capital as well as labour and management as a general rule (Iqbal and Molyneux 2005, p. 20). Profits and losses that proceed from Musharakah are shared...
among its parties as per a pre-agreed ratio. Musharakah financing is again an equitable partnership contract that is applied and well known worldwide by individuals and firms. Musharakah is well suited for financing private or public companies and in project financing for short, medium and long term periods. In the context of Islamic banking, Musharakah is described as a joint venture between an Islamic bank and a customer or business firm for certain operations. Lewis and Algaoud (2001) claim that Musharakah contracts may be established in two ways. The first way is a permanent contract which ensures for its parties (investor, bank and entrepreneur) an equitable sharing in profit/loss annually as per a pre-agreed ratio. This kind of contract (permanent contract) is constant for unlimited period according to their agreement as shown in Figure 2.2.

The second type of Musharakah is a diminishing contract that is more preferred by bankers, because it allows the bank to reduce its equity share each year and receives periodic profits based on its reduced equity. The share of the customer in the capital of enterprise increases over time by virtue of which he becomes the complete owner to this enterprise. Musharakah have many advantages that provide equal benefits for all parties and there is a consensus among Islamic scholars about many of these characteristics. However, El-Gamal (2000) has observed that most of the parties in the Musharakah contracts usually require the help of the legal experts and their services to avoid any Riba or Gharar.

2.3.3 Murabaha

Murabaha, mark up on sale, is an Islamic instrument for buying and reselling purchases or imports of capital goods and other commodities by institutions,
including banks and firms. Under the Murabaha contract, a customer provides the bank with the specifications and prices of the goods that would be purchased or imported. An Islamic bank studies the application and collects information about the specifications and prices of the goods focusing on the price and conditions for payment. When the bank and its client agree on the terms of the deal (purchase or import), the bank purchases the goods or commodities and resells them to the customer. The profit that accrues to the bank is mutually agreed upon as a profit margin (mark-up) on the cost of purchase (Mettwally 2006). In many cases, the bank is able to obtain the same terms from a different vendor and would gain a discount which is a profitable for customers using this method. According to many scholars (Obaidullah 2005; Iqbal and Molyneux 2005; Lewis and Algaoud 2001; El-Gamal 2000; Kahf 1997), there are certain fundamental principles attached to Murabaha like: Goods must be classified and clearly identified according to commonly accepted standards and must exist at the time of sale; Goods for the sale must be in the ownership of the bank at the time of sale; the purchase cost price must be known at the time of sale and it should be declared to the client, especially when the bank succeeds in obtaining a discount, thus, the profit margin is calculated on the net purchase price, which means the discount represents a benefit for the client; and the time of delivery of goods and the time of the payment must be specified.

In this context, the Murabaha contract is just a two-party buying and selling contract between a bank and a customer with no financial intermediation or financing. In other words, the bank offers this service to the clients who should pay the goods’ price plus the profit margin to the bank immediately after receiving the purchases
or imports. In addition, the client could pay the value of goods and the bank’s profit by deferred instalments or deferred lump sum without increase over the original value and this contract is named as Bai Muajjall-Murabah or Bai Bithaman Ajjal which is used by Islamic banking worldwide (Obaidullah 2005).

Musharakah and hybrid modified Mudharabah and Ijara are the main thrust of Islamic financial contracts on profit and loss sharing, which can be deemed as equity (Musharakah) and hybrid (modified Mudharabah and Ijara) facilities (Ahmad, 1994). However, the risks of these vehicles are inherently higher than conventional ones as espoused by Ebrahim (1999). One definition of an Islamic Bank is a bank that, by its own choice, opts to comply with two sets of law: the law of the Land (Jurisdiction); and the Islamic Law (Shari'ah). This is why Islamic bankers have two types of legal counsel: traditional "lawyers" and "Shari'ah Councils" (Al-Bahar, 1996).

Rayner (1991) lays down four elements of a contract on a property (mal): they are lawfulness, existence, deliverability and precise determination. Ebrahim (1999) explains that profits on Murabahah facilities are generally higher than conventional loans because Islamic instruments are structured to share the risk of the asset or venture. Hence, the "profits" and "interest-charge" implied are similar in outcome, although not by design (Iqbal and Mirakhor, 1999; Rosly, 1999).

Thomas (1995) is of the view that Riba, Gharar and Maysir manifested in the conventional system can wreak havoc in an economy as advanced as the USA, as depicted by the massive failures of US savings and loans institutions of the 1980s. Islamic banking aims to promote economic growth through risk-sharing
instruments whose payoffs fluctuate with economic output and do not structurally impair the economy in the manner of excessive fixed-interest debt does in a poor economic environment such as a recession (Asquith et al., 1994; Andrade and Kaplan, 1998).

### 2.3.4 Bai Muajjall

Bai Muajjall means the sale on a deferred payment basis that allows business or individuals to receive products now and pay for their value in the future. Lewis and Algaoud (2001) consider that credit for a sale could include Bai Muajjall-Murabaha, since all deferred payments are in instalments or in a lump sum. However, there is a significant difference between Bai Muajjall and Bai Muajjall-Murabaha in that if any kind of Murabaha, a buyer must know the price of the commodity as a requirement to acceptable contract (Obaidullah 2005). There is a consensus among Islamic jurists and scholars about permissibility of a credit sale (Bai Muajjall) as a form of finance that has no Riba. El-Gamal (2000) points out Islamic jurists over many centuries have permitted sales where the price increased for deferment, but have forbidden sales where the amount of a debt increased for deferment.

### 2.3.5 Bai Salam

Bai Salam, prepaid purchase, is a form of advance payment or forward buying defined by Iqbal and Molyneux (2005, 25) as follows: “Salam is a sale contract in which the price is paid in advance at the time of contracting against delivery of the purchased goods/services at a specified future date”. Even though the sale and purchase of nonexistent goods are prohibited according to Gharar, the Bai Salam is
a permissible activity that is adopted by the Sunna to facilitate certain activities in agriculture and industry. As an example, *El-Gamal (2000, 17)* cites the following Hadith that was narrated on the authority of Ibn Abbas: The Messenger of Allah came to Madinah and found its inhabitants entering Salam contracts (with the price paid in advance) in fruits for one, two, and three years. He said: whoever enters into a Salam contract let him specify a known volume or weight, and a known term of deferment. In addition, the Messenger of Allah said: “whoever enters into Salaf, should stipulate a determined weight and measurement, and a determined date of delivery”, the word (Salaf) of the Hadith has meaning of Salam (*cited in Al-Masri (2003, p. 29)*). Clearly, as it has been seen above there are some legal requirements for Bai Salam contract to be permissible that are adopted by most scholars and could be summed up as follows: The commodities sold should not be available at the time of contracting; the quality and quantity of goods must be known; the date and place of delivery for these commodities should be defined; and the purchase cost price should be paid completely at the time of the contract.

### 2.3.6 Istisna

Istisna, manufacturing, is a new method in modern Islamic banking that is defined as a contract in the manufacturing industry which allows flexibility to one party to obtain industrial goods by an upfront cash payment and deferred delivery or a deferred payment and deferred delivery. It has been translated by *El-Gamal (2000)* as “commission to manufacture” which is used as the work progress in manufacturing and building. This method has a significant advantage that is the cost price is prepaid or is deferred as instalments to create a product which is at a lower
price than the cost of buying the complete product or building. In the context of Islamic banking, individuals or firms could request their bank to facilitate a contract of producing something, and thus the bank concludes Istisna contract with third party who is the manufacturer that produces and delivers specific items under particular requirements (Lewis and Algaoud 2001). The permissibility of Istisna is adopted by the use of analogy (Qiyas) among most of Muslim jurists with the permissibility of Bai Salam (El-Gamal 2000). However, Istisna differs in many ways from Bai Salam, Istisna’s subject is a commodity or item which needs manufacturing, the payment in Istisna could be a lump sum or installments and could be deferred as well and; the time of delivery in an Istisna contract could be unknown (Iqbal and Molyneux 2005).

2.3.7 Ijarah (Lease Financing)

Ijarah in Arabic means exactly reward or recompense that proceeds from the rental contract between two parties in English, the lessor (owner of the asset) leases capital asset to the lessee (in need of the asset). Ijarah literally means “to give something on rent” (Lewis and Algaoud 2001). The use of Ijarah was known before Islam and is adopted in Islam as evidenced by the Holy Quran and the Sunna. For example, (28: 26-27 cited in El-Gamal 2000, p. 13) …Said one of them: O father, hire him on wages, for truly the best to employ is a strong and trust worthy 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. It is also adopted by the following Hadith narrated by Ahmad Abu Dawud and Al-Nasai: The farmers during the time of the Prophet used to pay rent for the land
in water and seeds. He forbade them from doing that, and ordered them to use gold and silver (money) to pay the rent (cited in El-Gamal 2000, p. 13).

In Islamic finance, there are two forms of leasing: (1) direct leasing finance (Ijarah), whereby a lessor (individuals or firms) allows a lessee to use capital assets owned by the lessor for a specified period of time ranging between a few days, months and years depending on the type of asset. In return the lessee pays a rental fee monthly or annually according to a pre-agreed amount. However, the ownership of the capital assets cannot transfer to the lessee in this type of leasing and the insurance on the capital assets is the responsibility of the lessor (Zaher and Hassan 2001). In Islamic banking, Ijarah has been adapted to the modern needs to be as Hire- purchase (Ijarah wa-Iqtina), whereby an institution or individual customer could request the bank to purchase equipment with the intention of leasing it to the customer. In turn, the Islamic bank rents the asset to the client who pays a certain fixed rent and promises to purchase the asset within a specified period to transfer its ownership from the bank to the customer (Al-Jarhi and Iqbal 2001). Furthermore, this mode of leasing could be transformed as a decreased leasing method that allows the client to pay every specific period an installment of the value of the asset plus its rent to reduce this value until he/she become completely the owner of this asset (Metwally 2006).

2.3.8 Qardh Hassan (Benevolent Loans)

The act of lending money is not forbidden in Islamic Sharia only, Riba is prohibited on all the processes of lending. Qardh Hassan is a benevolent loan without any interest that was adopted in Islam to assist the needy and to attempt to alleviate
hardships. Consequently, individuals and firms may lend money on an interest free basis to a number of beneficiaries and in many cases such as education, marriage and other social purposes. The amount paid by the lender is considered an interest free loan from the time of payment until the date of the settlement. Metwally (2006) and Lewis and Algaoud (2001) add the borrower’s payment of any amount over and above the loan to the lender is permissible according to his discretion. Furthermore, asking for an asset as collateral and charging administrative expenses by the lender is a permissible matter that ensures the lender taking or receiving his money (Obaidullah 2005). Although, Islamic banks worldwide have offered these loans in recent decades, benevolent loans are known for many decades ago among Muslims and non-Muslim alike.

The discussion on various methods of Islamic Finance presented in this chapter leads us to deduce that these products are by and large less exposed to serious business and financial risks, which otherwise is the problem in conventional banking. Therefore, it is expected that stakeholders in India like their counterparts in other countries will have positive attitude towards the use of these products. The attitudes, perceptions and awareness of market participants towards Islamic methods of finance are an important consideration in its establishment and development. These have been widely studied in Muslim and non-Muslim countries such as Egypt, Jordan, Singapore and the United Kingdom. Still many countries, where Islamic methods of finance need to be studied and a number of challenges remain to be faced. India, being one among the many countries that have not yet adopted Islamic banking and finance, even though being second-largest Muslim
population in the world. The country is also home to the biggest number of Muslim inhabitants for a non-Muslim majority nation.

Further, there are several factors that shape the perceptions and attitudes of stakeholders towards adoption of Islamic banking. However, present study is based to analyse perception and attitudes towards Islamic methods of banking and finance with a main focus to examine the perceptions and attitudes towards the potential use of Islamic methods of banking and finance by retail consumers, business firms, bank employes, self-employed and others in India, particularly in the state of Jammu and Kashmir.

Accordingly, there is a strong possibility that Islamic banks and Islamic methods of finance will ultimately be established in India. Therefore, empirical study of this type was badly required to investigate attitudes towards Islamic methods of banking and finance and their awareness of these new methods of finance. The main aim of the study is to analyse their attitudes towards Islamic methods of finance. In next chapter, detailed analysis of review of literature will enable us to understand the basic framework of interest-free banking and finance and will help to develop basic premises for this study.