

Islamic Banking and Microfinance Product Mechanism

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Abstract

Islamic banking and microfinance provide financial services that align with Shariah principles, emphasizing ethical and socially responsible financial transactions. Islamic banking prohibits interest (riba) and speculative transactions (gharar), instead focusing on profit-sharing models, asset-backed financing, and risk-sharing structures. Key Islamic banking mechanisms include Murabaha (cost-plus financing), Mudarabah (profit-sharing), Musharakah (joint venture), and Ijara (leasing). These models enable banks to earn returns while adhering to ethical and risk-averse principles. Microfinance in Islamic finance aims to support financially excluded individuals, especially in underdeveloped regions, by offering small-scale, interest-free financing and Shariah-compliant services. Islamic microfinance products often employ Qard Hasan (benevolent loans) and partnerships like Mudarabah and Musharakah, enabling low-income clients to engage in small business activities, improve livelihoods, and achieve financial independence. Overall, Islamic banking and microfinance mechanisms are distinctively designed to promote economic growth and financial inclusion within ethical frameworks, creating a sustainable alternative to conventional banking systems for underserved communities.

Keywords: Islamic Microfinance, Products, Musharkah, Murabaha, Ijara, Salam, Istisna

Introduction

Islamic banking and microfinance represent financial systems that adhere to Shariah principles, promoting ethical and socially responsible financial transactions. These systems prohibit interest (riba) and speculative activities (gharar), instead focusing on profit-sharing models, asset-backed financing, and risk-sharing structures. Islamic banking provides alternative mechanisms such as Murabaha (cost-plus financing), Mudarabah (profit-sharing), Musharakah (joint venture), and Ijara (leasing) to ensure compliance with ethical and risk-averse practices. On the other hand, Islamic microfinance caters to financially marginalized individuals by offering small-scale, interest-free financing and Shariah-compliant services. By employing models like Qard Hasan (benevolent loans) and partnerships such as Mudarabah and Musharakah, Islamic microfinance enables low-income clients to engage in entrepreneurial activities, improve their livelihoods, and achieve financial stability. This unique system not only promotes economic growth but also ensures financial inclusion and sustainability within an ethical framework.

Microfinance can be broadly defined as: "The provision of small-scale financial services such as savings, credit and other basic financial services to poor and low-income people".¹

All ideas or laws in Islam owe their origin to its holy book – the Quran and the sayings and deeds of its Prophet (peace be upon him) encapsulated in books of Hadith. A saying of the Prophet (peace be upon him) forcefully drives domestic the important message of Islam regarding poverty: "Poverty is almost like disbelief in God." On any other occasion the Prophet (peace be upon him) is reported to have stated "there is no asceticism in Islam". Islam perspectives poverty to be a curse to be eradicated thru effective efforts unlike a few global religions and philosophies that commemorate asceticism. Poverty is in conflict with "enrichment of self (*Nafs*)", that's one of the number one goals (*Maqasid*) of *Shariah*. Islamic jurists have unanimously held the view that it's far the collective duty (*Fard Kifayah*) of a Muslim society to take care of the simple desires of the bad. In truth, in keeping with al-Shatibi, the mentioned Islamic pupil, this is the raison deter of society itself.²

Partnership Based

Musharakah

The literal meaning of *Musharakah* is sharing. The root of the word "*Musharakah*" in Arabic is *Shirkah*, which means being a partner. It is used in the same context as the term "shirk" meaning partner to Allah. Under Islamic jurisprudence, *Musharakah* means a joint enterprise formed for conducting some business in which all partners share the profit according to a specific ratio while the loss is shared according to the ratio of the contribution. It is an ideal alternative for the interest-based financing with far reaching effects on both production and distribution. The connotation of this term is little limited than the

term "*Shirkah*" more commonly used in the Islamic jurisprudence. For the purpose of clarity in the basic concepts, it will be pertinent at the outset to explain the meaning of each term, as distinguished from the other. "*Shirkah*" means "Sharing" and in the terminology of Islamic *Fiqh*, it has been divided into two kinds³:

(1) **Shirkat-ul-milk (Partnership by joint ownership)**: It means joint ownership of two or more persons in a particular property. This kind of "*Shirkah*" may come into existence in two different ways:

- i. Optional (*Ikhtiari*): At the option of the parties e.g., if two or more persons purchase equipment, it will be owned jointly by both of them and the relationship between them with regard to that property is called "*Shirkat-ul-Milk Ikhtiari*" Here this relationship has come into existence at their own option, as they themselves elected to purchase the equipment jointly.
- ii. Compulsory (*Ghair Ikhtiari*): This comes into operation automatically without any effort/action taken by the parties. For example, after the death of a person, all his heirs inherit his property, which comes into their joint ownership as a natural consequence of the death of that person.

There are two more types of Joint ownerships (*Shirkat-ul-Milk*):

- *Shirkat-ul-Ain*
- *Shirkat-ul-Dain*

A property in *Shirkat-ul-Milk* is jointly owned but not divided yet, is called *Musha*. In *Shirkat-ul-Milk* undivided shares or other assets can be used in the following manner:

a) ***Mushtarik Intifa'***: Mutually or jointly using an asset by taking turns under circumstances where the partners or joint owners are on good terms.

b) ***Muhaya***: Under this arrangement the owners will set turns in days for example one may use the product for 15 days and then the other may use it for the rest of the month.

c) ***Taqseem***: Referring to division of the jointly owned asset. This may be applied for property where the asset that is owned can be divided permanently for example jointly taking a 1,000 sq. yards plot and making a house on 500 yards by each of the 2 owners.

d) Under a situation where the partners are not satisfied with *Muhaya* arrangement, the property or asset jointly held can be sold off and proceeds divided between the partners.

(2) ***Shirkat-ul-Aqd* (Partnership by contract)**: This is the second type of *Shirkah*, which means, "a partnership effected by a mutual contract". For the purpose of brevity, it may also be translated as "joint commercial enterprise." *Shirkat-ul-Aqd* is further divided into three kinds:

(i) ***Shirkat-ul-Amwal* (Partnership in capital)** where all the partners invest some capital into a commercial enterprise.

(ii) *Shirkat-ul-Aamal* (Partnership in services) where all the partners jointly undertake to render some services for their customers, and the fee charged from them is distributed among them according to an agreed ratio. For example, if two people agree to undertake tailoring services for their customers on the condition that the wages so earned will go to a joint pool which shall be distributed between them irrespective of the size of work each partner has actually done, this partnership will be a *Shirkat-ul-Aamal* which is also called *Shirkat-ut-Taqabbul* or *Shirkat-us-Sanai* or *Shirkat-ul-Abdan*.

(iii) *Shirkat-ul-Wujooh* (Partnership in goodwill). The word has its root in the Arabic word *Wajahat* meaning goodwill. Here the partners have no investment at all. They purchase commodities on deferred price, by getting capital on loan because of their goodwill and sell them at spot. The profit so earned is distributed between them at an agreed ratio.

Each of the above three types of *Shirkat-ul-Aqd* are further divided into two types:

1. a) ***Shirkat-Al-Mufawada: (Capital & labour at par):*** All partners share capital, management, profit, and risk in absolute equals. It is a necessary condition for all four categories to be shared amongst the partners; if any one category is not shared, and then the partnership becomes *Shirkat-ul-Ainan*. Every partner who shares equally is a Trustee, Guarantor and Agent on behalf of the other partners.
2. b) ***Shirkat-ul-Ainan:*** A more common type of *Shirkat-ul-Aqd* 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.

All these modes of "Sharing" or partnership are termed as "*Shirkah*" in the terminology of Islamic Fiqh, while the term "*Musharakah*" is not found in the books of Fiqh. This term (i.e. *Musharakah*) has been introduced recently by those who have written on the subject of Islamic modes of financing and it is normally restricted to a particular type of "*Shirkah*", that is, the *Shirkat-ul-Amwal*, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes *Shirkat-ul-Aamal* also where partnership takes place in the business of services.

It is evident from this discussion that the term "*Shirkah*" has a much wider sense than the term "*Musharakah*" as is being used today. The latter is limited to "*Shirkat-ul-Amwal*" only i.e. all the partners invest some capital into a commercial enterprise, while the former includes all types of joint ownership and those of partnership.

Mudarabah

This is a kind of partnership where one partner gives money to another for investing in a commercial enterprise. The investment comes from the first partner who is called "*Rab-ul-Maal*" while the management and work are an

exclusive responsibility of the other, who is called “*Mudarib*” and the profits generated are shared in a predetermined ratio.

There are two types of *Mudarabah* namely:

1. ***Al Mudarabah Al Muqayyadah***: *Rab-ul-Maal* may specify a particular business or a particular place for the *Mudarib*, in which case he shall invest the money in that particular business or place. This is called *Al Mudarabah Al Muqayyadah* (restricted *Mudarabah*).
2. ***Al Mudarabah Al Mutlaqah***: However, if *Rab-ul-Maal* gives full freedom to *Mudarib* to undertake whatever business he deems fit, this is called *Al Mudarabah Al Mutlaqah* (unrestricted *Mudarabah*). However, *Mudarib* cannot, without the consent of *Rab-ul-Maal*, lend money to anyone. *Mudarib* is authorized to do anything, which is normally done in the course of business. However, if they want to have an extraordinary work, which is beyond the normal routine of the traders, he cannot do so without express permission from *Rab-ul-Maal*. He is also not authorized to:
 1. a) keep another *Mudarib* or a partner
 2. b) Mix his own investment in that particular *Mudarabah* without the consent of *Rab-ul-Maal*.

Conditions of Offer & Acceptance are applicable to both. A *Rab-ul-Maal* can contract *Mudarabah* with more than one person through a single transaction. It means that he can offer his money to ‘A’ and ‘B’ both so that each one of them can act for him as *Mudarib* and the capital of the *Mudarabah* shall be utilized by both of them jointly, and the share of the *Mudarib*.

Investment

In *Mudarabah*, *Rab-ul-Maal* provides the investment and *Mudarib* the management therefore the *Rab-ul-Maal* should hand over the agreed investment to *Mudarib* and leaves everything to *Mudarib* with no interference from his side but he has the authority to:

1. a) Oversee the *Mudarib*’s activities and
2. b) Work with *Mudarib* if the *Mudarib* consents.

In what form should the capital be? Should it be liquid or non-liquid assets like equipment, land etc. can these form a capital?

The basic principle is that the capital in *Mudarabah* is valid just the way as it is in *Shirkah* which according to Hanafi Fiqh should be in liquid form but according to other scholars’ equipment, land etc. can also be included as capital. However, all agree on the following:

Assets other than cash can be used as an intermediate step.

However, this is subject to the determination of exact amount of the assets before it is used for *Mudarabah*. If the assets are not correctly evaluated, the *Mudarabah* is not valid.

***Mudarabah* Expenses**

The *Mudarib* shares profit of the *Mudarabah* as per agreed rate with the investor but his expenses like meals, clothing, conveyance and medical are not borne by *Mudarabah*. However, if he is traveling on business and is overstaying the night, then the above expenses shall be covered from capital. If *Mudarib* goes for a journey which constitutes *Safar-e-Sharai* (more than 48 miles) but does not overstay the night, his expenses will not be borne by *Mudarabah*.

All expenses which are incidental to the *Mudarabah*'s function like wages of employees/workers or Commission in buying/selling or stitching, dyeing expenses etc. have to be paid by the *Mudarabah*. However, all expenses will be included in the cost of commodities which *Mudarib* is selling for e.g. if he is selling readymade garments then the stitching, dyeing, washing expenses etc. can be included by the *Mudarib* in the total cost of the garments.

If the *Mudarib* manages the *Mudarabah* within his city, he will not be allowed any expenses, only his profit share. Similarly, if he keeps an employee, this employee will not be allowed any expenses, just his salary.

If the *Mudarabah* agreement becomes *Fasid* due to any reason, the *Mudarib*'s status will be like an employee, meaning:

1. a) Whether he is traveling or doing business in his city, will not be entitled to any expense such as meals, conveyance, clothing, medicine etc.
2. b) He will not be sharing any profit and will just get *Ujrat-e-Misl* (ordinary pay) for his job.

Distribution of Profit & Loss

It is necessary for the validity of *Mudarabah* that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. The *Shariah* has prescribed no particular proportion; rather it has been left to their mutual consent. They can share the profit in equal proportions and they can also allocate different proportions for *Rab-ul-Maal* and *Mudarib*. However, in extreme case where the parties have not predetermined the ratio of profit, the profit will be calculated at 50:50.

The *Mudarib* & *Rab-ul-Maal* cannot allocate a lump sum amount of profit for any party nor can they determine the share of any party at a specific rate tied up with the capital. For example, if the capital is Rs. 100,000/-, they cannot agree on a condition that Rs. 10,000 out of the profit shall be the share of the *Mudarib* nor can they say that 20% of the capital shall be given to *Rab-ul-Maal*. However, they can agree that 40% of the actual profit shall go to the *Mudarib* and 60% to the *Rab-ul-Maal* or vice versa

It is also allowed that different proportions are agreed in different situations. For example, the *Rab-ul-Maal* can say to *Mudarib* "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit". Similarly, he can say "If you do the business in your town, you will be entitled to 30% of the profit and if you do it in another town, your share will be 50% of the profit".

Apart from the agreed proportion of the profit, as determined in the above manner, the *Mudarib* cannot claim any periodical salary or a fee or remuneration for the work done by him for the *Mudarabah*.

All schools of Islamic *Fiqh* are unanimous on this point. However, Imam Ahmad has allowed for the *Mudarib* to draw his daily expenses of food only from the *Mudarabah* Account. The Hanafi jurists restrict this right of the *Mudarib* only to a situation when he is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc. but he is not entitled to get anything as daily allowances when he is in his own city.

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, and then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

The *Mudarabah* becomes void (*Fasid*) if the profit is fixed in any way. In this case, the entire amount (Profit + Capital) will be of the *Rab-ul-Maal*. The *Mudarib* will just be an employee earning *Ujrat-e-Misl*.

The remaining amount will be called (Profit).

This profit will be shared in the agreed (pre-agreed) ratio.

Roles of the *Mudarib*:

Ameen (Trustee): To look after the investment responsibly, except in case of natural calamities

Wakeel (Agent): To purchase from the funds provided by *Rab-ul-Maal*

Shareek (Partner): Sharing in any profit

Zamin (Liable): To provide for the loss suffered by the *Mudarabah* due to any act on his part.

Ajeer (Employee): When the *Mudarabah* gets *Fasid* due to any reason, the *Mudarib* is entitled to only the salary, *Ujrat-e-Misl*.

In case there is a loss, the *Mudarib* will not even get the *Ujrat-e-Misl*.

Termination of *Mudarabah*

The *Mudarabah* will stand terminated when the period specified in the contract expires. It can also be terminated any time by either of the two parties by giving notice. In case *Rab-ul-Maal* has terminated services of *Mudarib*, he will continue to act as *Mudarib* until he is informed of the same and all his acts will form part of *Mudarabah*.

If all assets of the *Mudarabah* are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of *Mudarabah* are not in cash form, it will be sold and liquidated so that the actual profit may be determined. All loans and payables of *Mudarabah* will be recovered. The provisional profit earned by *Mudarib* and *Rab-ul-Maal* will

also be taken into account and when total capital is drawn, the principal amount invested by *Rab-ul-Maal* will be given to him, balance will be called profit which will be distributed between *Mudarib* and *Rab-ul-Maal* at the agreed ratio. If no balance is left, *Mudarib* will not get anything. If the principal amount is not recovered fully, then the profit shared by *Mudarib* and *Rab-ul-Maal* during the term of *Mudarabah* will be withdrawn to pay the principal amount to *Rab-ul-Maal*. The balance will be profit, which will be distributed between *Mudarib* and *Rab-ul-Maal*. In this case too if no balance is left, *Mudarib* will not get anything

Uses of *Musharakah* / *Mudarabah*:

These modes can be used in the following areas (or can replace them according to *Shariah* rules).

Asset Side Financing

- Short/medium/long - term financing
- Project financing
- Small & medium enterprises setup financing
- Large enterprise financing
- Import financing
- Import bills drawn under import letters of credit
- Inland bills drawn under inland letters of credit
- Bridge financing • LC without margin (for *Mudarabah*)
- LC with margin (for *Musharakah*)
- Export financing (Pre-shipment financing)
- Working capital financing
- Running accounts financing / short term advances

Liability Side Financing

- For current /saving/investment accounts (deposit giving Profit based on *Musharakah* / *Mudarabah* – with predetermined ratio)
- Inter- Bank lending / borrowing
- Term Finance Certificates & Certificate of Investment
- T-Bill and Federal Investment Bonds / Debenture.
- Securitization for large projects (based on *Musharakah*)
- Certificate of Investment based on *Murabahah*
- Islamic *Musharakah* bonds (based on projects requiring large amounts – profit based on the return from the project)

Trade Based

Murabahah

Murabahah is essentially a Sale of goods (cost plus profit) where there is a “deferred” element which validates the profit earned arising from the sale transaction. To understand the difference, it is key to analyse the “deferred” elements, and the risks associated to the deferment.

Essentially, there are two types of deferment in a Murabahah i.e.:

1. Deferment arising from future/deferred settlement of Sale Price – This is the most common form of **Murabahah** where risks to the Seller is minimized by the almost immediate transfer of ownership of the goods.

This is generally used for debt creation where the Seller (usually a Bank in the case of financing products) purchase goods into its ownership and quickly sells the goods to the Buyer (usually customer) where the Sale Price (inclusive of profit) is concluded with the future settlement terms agreed. Once the debt creation is completed, the ownership transfers from the Seller to the Buyer and the Buyer will start to make payments on the agreed Sale Price.

All risks on the goods (valuation, pricing, ownership) are transferred quickly from Seller to Buyer; the Seller only holds the credit risk of the debt i.e. the risk that the Buyer may not able to pay the Sale price at the future date as agreed.

This category of *Murabahah* is generally classified as a **Debt-Based Structure** where the Bank only holds the Credit Risks (Valuation Risks is held by the Customer).

2. Deferment arising from future delivery of goods sold – This structure is riskier than the earlier mentioned deferment of Sale Price settlement. Deferment of delivery of goods means the Seller purchases the goods now but do not enter into a Sale transaction with the Buyer until much later.

Instead, the Seller holds the ownership of the goods for a period of time and enters into a contract at an agreed future date. The Seller will carry the ownership risks and valuation risks until the goods are sold at the Sale Price (inclusive of profit). Once the Buyer enters the contract, the ownership of goods is transferred on settlement of the Sale Price at spot (either a *Murabahah* arrangement or *Musawamah* Simple Sale transaction).

Due to the riskier nature of the above, the Buyer is usually required to undertake to enter into the Sale contract (via Letter of Undertaking in favour of the Seller). On then the Seller procure the goods from Supplier, creating a legal obligation on the Buyer to complete the sale at the agreed future delivery date, even if the Buyer decides not to complete the *Murabahah* transaction (default on the arrangement). By this undertaking, the Buyer takes on the pricing risks as at the date of Sale transaction; the price of goods on the open market may be higher or lower than the contracted Sale Price.

Additionally, with the Letter of Undertaking, the risks on the Seller are mitigated, resulting the credit risk of the Buyer to be similar/equivalent to the “debt” structure of *Murabahah* arising from deferment of Sale Price.

This arrangement is commonly referred to in the market as “**Murabahah Purchase Order**” or MPO where the Seller will only proceed to purchase goods to hold it for a period of time with the surety of the Letter of Undertaking as a risk mitigated. This category of *Murabahah* can be classified as either

an **Equity-Based Structure** (if the Bank chooses to hold the ownership until sale i.e. opens to valuation risks without a Letter of Undertaking) or a **Debt-Based Structure** (where the Bank executes the Letter of Undertaking and effectively transferring the valuation risks to the customer).

Musawamah

Musawamah can be defined as a sales contract with deferred delivery of the goods. Thus, unlike *Mudarabah*, the Bank does not intervene as a seller on credit of the goods acquired on command of its relationship, but as a purchaser, with cash payment of a commodity that will be delivered to it by its partner.

The rules of the *Shariah* prohibit in principle any commercial transaction whose object is non-existent at the time of its conclusion. However, some commercial practices, although not meeting this requirement, are tolerated given their necessity in people's lives. This is the case of the sale MUSAWAMAH which was authorized by the Prophet in the Hadith "the one who makes the MUSAWAMAH, that he does it for a known volume, for a known weight and for a known time.

Practical Terms and Conditions for Musawamah

1. The Bank (purchaser) places an order with its customer for a given quantity of goods, a value corresponding to its financing need.
2. The customer (seller) sends to the Bank a proforma invoice indicating the nature, the quantities and the price of the goods ordered.
3. Both parties agree to the terms of the transaction and sign a *Musawamah* contract with agreed terms (nature of goods, quantities, prices, terms and conditions of delivery and / or sale on behalf of the Bank etc.)
4. At the same time, both parties sign a proxy sale agreement whereby the Bank authorizes the seller to deliver or sell (as the case may be) the goods to a third party. The seller undertakes, under his / her full responsibility, to collect and remit the amount of the sale to the Bank.
5. In addition to the ordinary guarantees required by the Bank in its financing activities (bonds, pledges, mortgages, etc.), it may require the seller to take out credit insurance to guard against the risk of non-payment of final purchasers, Insurance for subrogated goods to the benefit of the Bank.
6. Upon maturity, in the event that the Bank elects to mandate the seller to sell the goods on its behalf, the latter shall invoice them on behalf of the Bank and deliver the quantities sold, taking care, if the Bank deems it necessary, to require buyers to have the removal bills targeted at the counter's counters (a measure designed to enable the monitoring and control of the operation).
7. The remuneration of the seller's mandate may be granted in the form of a commission, a drawback or an interest in the margin generated by the sale of the goods. It can also be deducted at the beginning of the

transaction and integrated into the amount of the advance (financing *Musawamah*). In any event, its amount must be calculated by reference to the margin rates applied in the market for similar transactions.

8. The Bank may utilize the warping technique by requiring the storage of goods in a general store in the contractual terms of sale and selling it, either itself or through its customer, by endorsing the warrant and Receipt as a guarantee of payment.
9. The selling price of the goods by the seller on behalf of the Bank shall be at least equal to the minimum annual rate of return as set out in its financing policy, after a deduction of commissions and other charges.

Benefits of Musawamah Method of Financing

While *Musharakah*, *Mudarabah*, Leasing and *Mudarabah* allow Islamic Bank to respond to a large extent to the needs of its clientele in terms of financing the cycles of creation, investment and exploitation of companies, these different techniques are insufficient on their own to cover all these needs.

This applies, for example, to the financing requirements of the Working Capital Fund, certain operating costs such as wages, taxes and duties, customs duties, etc.

These needs, which often require a direct monetary contribution, therefore require a more appropriate form of financing than the *Murabahah*, which must be compulsory for reasons of compliance with Shari a principle, through the purchase of stocks and their resale by the Bank itself.

Musawamah has the advantage of allowing the Bank to advance funds directly to its client, positioning itself as buyer vis-à-vis him and granting him a time limit for the delivery of the purchased goods. Moreover, the mandate formula, as will be discussed below, allows the client to continue to deal with its ordinary clientele on the sole condition that it does on behalf of the Bank, up to the value of Goods acquired by it under the *Musawamah* contract.

Compared to *Musharakah*, which adapts more to the long cycle, *Musawamah* is characterized by its least risk insofar as the debt of the Bank (or its counter value) constitutes, as in *Mudarabah*, a constant commercial debt on the customer (the seller).

It appears, therefore, that this type of financing offers greater opportunities and greater flexibility to the Bank's intervention, while remaining within the framework of the principles of Islamic *Shariah*.

As such, *Musawamah* presents itself as an ideal means of financing certain types of economic activities such as Agriculture, Handicraft, Import-Export, Youth Cooperatives, and PMI – SMEs in addition to the sector of distribution.

In addition, *Musawamah* could be a substitute for the practice of commercial discounting. The effects and / or securities in the client's possession will be taken as a guarantee of the *Musawamah* financing that the Bank may agree to.

Analysed by comparison with traditional banking practices, *Musawamah* can substitute for short-term credits such as cash facilities, overdrafts, campaign credits and commodity advances. Conditions of **Conformity of the Musawamah to the principles of Shariah:**

1. The goods covered by the contract must be known (in kind and quality), quantities (in number, volume or weight) and valued (in currency or other counter party in the case of barter).
2. The period of delivery of the goods by the seller must be fixed in the contract and known by both parties.
3. The price (or consideration) of the goods shall be fixed in the contract known to both parties and paid by the buyer (Bank) in cash.
4. The place of delivery must be determined and known to both parties.
5. The buyer may demand from the seller a bond to guarantee the delivery of the goods at maturity or any other real or personal guarantee.
6. The buyer may mandate the seller to sell and / or deliver the goods at maturity to a third party for a commission or commission. The seller is then personally liable to the buyer for the recovery of the sale price.
7. The buyer cannot sell the merchandise before its delivery by the seller. However, it is allowed to do so through a parallel *Musawamah* contract.

Salam

This contract (also known as ‘advance payment sale’) is an advance payment for deferred delivery. In this case, the bank pays the agreed amount of the financing to the client in advance, and the goods are delivered to the bank at a specified future date and place.’ (Khan 2000: 25) To avoid any misunderstanding, it should also be added that the goods in question have to be based on a client’s demand. Of such contracts, *Shirazi* says the following:

When, during the process of production, the producer feels a financial constraint on part of his or her working capital needs ... forward deals are signed only to help the producer by supplying part of the working capital needs. Banks [can be] authorized to sign such deals only at the request of a producer. (Shirazi 1988: 201)

It must be added, though, that the produced goods could have been used either in another process for further value-adding or, if they are needed in society, the request could have been made by a third party. The Islamic bank does not receive the goods, rather, it acts as a facilitating agent. A producer’s need for working capital does not alone justify payment from the bank. One of the uses of the *Qard-ul-Hassan* contract mentioned earlier is to pay the working capital of those producers, which have already been financed by the Islamic bank and thus enjoy a good reputation. Such an instrument can be used as a trilateral contract involving the bank, the client, and the client’s supplier or producer.

As to the price of the commodity in question, a Salam purchase is usually cheaper than a spot purchase (Khan 2000:25). There is no need for an Islamic bank to enter into any conceivably profitable transaction, and to ensure that it is

entirely *Shariah* compliant, the price of the forward purchase should never exceed the cash price of similar products at the time the goods are delivered. Khan sees Salam as ‘an exception to the general rule that the seller must possess the goods he is selling.’

Istisna

Istisna’ means asking someone to construct, build or manufacture an asset. In Islamic finance, *Istisna*’ is generally a long-term contract whereby a party undertakes to manufacture, build or construct assets, with an obligation from the manufacturer or producer to deliver them to the customer upon completion. In practice, the key advantage of an *Istisna*’ contract is that it can provide flexibility to the customer, where payments can be made in instalments linked to project completion, at delivery or after project completion. In contrast to *Istisna*’, for *Salam* contract the payment has to be made in full, in advance.

Istisna' Application: Examples:

Infrastructure projects are the main examples of *Istisna*’ application. This includes: construction of power plants, factories, roads, schools, hospitals, building and residential developments. The parties to an *Istisna*’ contract are: The Producer or Manufacturer; the Bank (i.e. the financier); and the Customer (i.e. purchaser of goods).

Istisna' Structure

The below diagram shows *Istisna*’ structure:

The above structure is also known as “simple *Istisna*”, where it is assumed that the buyer has the required financing to directly coordinate with the manufacturer on the project. If the buyer does not have the financing, then the below parallel *Istisna*’ structure can be used.

The parallel *Istisna*’ involves: the customer (the buyer); the Islamic bank (the seller); and the manufacturer (in some cases it can also involve sub-contractors), where the buyer can obtain financing from the Islamic bank the following diagram shows parallel *Istisna*’ structure:

Istisna' Validity, Amendments and Cancellations

In order for the *Istisna*’ to be valid, the price must be fixed from the outset. In the event of any unforeseen event that causes a delay in delivery the price of *Istisna*’ can be amended, if it is mutually agreed. After the manufacturer has started the work, the contract cannot be cancelled unilaterally.

Rental Based

Ijarah

Ijarah, (Arabic: الإجارة, *al-Ijarah*, "to give something on rent"⁴ or "providing services and goods temporarily for a wage" (a noun, not a verb), is a term of *Fiqh* (Islamic jurisprudence) and product in Islamic banking and finance. In traditional *Fiqh*, it means a contract for the hiring of persons or renting/leasing of the services or the “usufruct” of a property, generally for a

fixed period and price. In hiring, the employer is called *Musta'jir*, while the employee is called *Ajir*. *Ijarah* need not lead to purchase. In conventional leasing an "operating lease" does not end in a change of ownership, nor does the type of *Ijarah* known as *al-Ijarah (Tashghiliyah)*.⁵

In Islamic finance, *al Ijarah* does lead to purchase (*Ijarah -wa- Iqtina*, or "rent and acquisition") and usually refers to a leasing contract of property (such as land, plant, office automation, a motor vehicle), which is leased to a client for stream of rental and purchase payments, ending with a transfer of ownership to the lessee, and otherwise follows Islamic regulations.⁶

Rules of *Ijarah*

Islamic finance theorist Muhammad Taqi Usmani lists seventeen "Basic Rules of Leasing" (leasing referring to Islamic leasing which Usmani uses interchangeably with *Ijarah*) in his work *Islamic Finance: Principles and Practice* — although "the principles of *Ijarah* are so numerous that a separate volume is required for their full discussion".⁷ Some of the rules include agreeing on the cost of the lease and the period of time for which it will last; clear terms in the contract; agreeing on purpose the lessee will use the property for, which they must stick to; the lessor (owner of the leased property) agreeing to bear all the "liabilities emerging from the ownership", etc.⁸ Usmani lists eleven "basic differences between the contemporary financial leasing" and "leasing allowed by the *Shariah*".⁹

Faleel Jamaldeen lists three features of *Ijarah* that distinguish it from conventional leasing:

- The lessor must own the asset being leased for the entire period of the lease.
- No compound interest may be charged if the lessee delays or defaults on payment.
- Use of the asset being leased must be specified in the contract.

Types of *Ijarah*

In terms of its *modus operandi*, *Ijarah* can be classified as operating *Ijarah* and financial *Ijarah*:

Operating *Ijarah* (*Ijarah Tashghiliyah*):

Conventionally, operating *Ijarah* used to be the one and only type of *Ijarah*. According to operating *Ijarah*, an owner of a property leases it to others for a specified period. The ownership of the leased property remains with the owner at the end of the lease tenor. For example, an Islamic bank could have some properties/assets on its books for lease. These properties/assets will remain on the bank's books at the end of *Ijarah*. Typically, this operating lease is not preceded by a promise by the owner to sell it to the lesser.

Financial *Ijarah* (*Ijarah Muntahia Bit Tamleek*):

This is a modern form of *Ijarah* that has been created following the evolution of Islamic banking and finance. It constitutes a form of *Ijarah* in which ownership

is transferred to the lessee at the end of a specific period. According to the method of ownership transfer, this particular type of *Ijarah* can be classified into four different types:

Ijarah Muntahia-Bit-Tamleek through Hibah (gift): where legal title is transferred to the lessee without any more payments. The financial lease that is associated with *Hibah*-type transfer is widely used by Islamic banks. The *Hibah* (gift) can be either ordinary (unconditional) or conditional. Ordinary *Hibah* is not embedded with a condition of payment of all rental instalments, while conditional *Hibah* contains such a condition, which makes it legally more enforceable (once the lesser pays the last instalment, the lesser is legally bound to automatically transfer the property title).

Ijarah Muntahi-a-Bit-Tamleek through Ba'i (sale): in this type of *Ijarah*, the lease agreement is executed with an understanding that the lesser will sell the property to the lessee at the end of *Ijarah* tenor. This sale-based transfer can take a number of forms:

- a) **Ijarah Muntahi-a-Bit-Tamleek** through transfer of legal title at the end of lease tenor for a token consideration.
- b) **Ijarah Muntahi-a-Bit-Tamleek** through transfer of legal title prior to the end of lease tenor for a price that is equivalent to the remaining *Ijarah* instalments (net of rental).
- c) **Ijarah Muntahi-a-Bit-Tamleek** through gradual transfer of legal title of the leased property.

Diminishing Musharakah

Diminishing *Musharakah* is a type of partnership (*Shirkah*) where one partner purchases the other partner's share gradually. It is also called *Shirkah-al-Mutanaqisah*. According to this concept, a financier and his client participate either in the joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it is understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share until all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.

Fundamentals of Diminishing Musharakah Agreement:

The proposed arrangement is composed of the following transactions:

- To create joint ownership in the property (*Shirkat-ul-Milk*).
- Giving the share of the financier to the client on rent.
- Promise from the client to purchase the units of share of the financier.
- Actual purchase of the units at different stages.

How Diminishing Musharakah Works?

The Diminishing *Musharakah* based on the above concept has taken different shapes in different transactions. Some examples are given below:

- It has been used mostly in-house financing. The client wants to purchase a house for which he does not have adequate funds. It approaches the financier who agrees to participate with him in purchasing the required house 20% of the price is paid by the client and 80% of the price by the financier. Thus, the financier owns 80% of the house while the client owns 20%. After purchasing the property jointly, the client uses the house for his residential requirement and pays rent to the financier for using his share in the property. At the same time, the share of financier is further divided in eight equal units, each unit representing 10% ownership of the house. The client promises to the financier that he will purchase one unit after three months. Accordingly, months, he purchases one unit of the share of the financier by paying 1/10th of the price of the house. It reduces the share of the financier from 80% to 70%. Finance, the rent payable to the financier is also reduced to that extent. At the end of the second term, he purchases another unit increasing his share in the property to 40% and reducing the share of the financier to 60% and consequently reducing the rent to that proportion. This process goes on in the same fashion until after the end of two years, the client purchases the whole share of the financier reducing the share of the financier to 'zero' and increasing his own share to 100%
- This arrangement allows the financier to claim rent according to his proportion of ownership in the property and at the same time allows him periodical return of a part of his principal through purchases of the units of his share.
- 'A' wants to purchase a taxi to use it for offering transport services to passengers and to earn income through fares recovered from them, but he is short of funds. 'B' agrees to participate in the purchase of the taxi, therefore, both of them purchase a taxi jointly. 80% of the price is paid by 'B' and 20% is paid by A. After the taxi is purchased, it is employed to provide transport to the passengers whereby the net income of \$1000/- is earned on daily basis. Since 'B' has 80% share in the taxi, it is agreed that 80% of the fare will be given to him and the rest of 20% will be retained by 'A' who has a 20% share in the taxi. It means that \$800/- is earned by 'B' and \$200/- by 'A' on daily basis. At the same time the share of 'B' is further divided into eight units. After three months 'A' purchases one unit from the share of 'B'. Consequently, the share of 'B' is reduced to 70% and share of 'A' is increased, after the first term of three months increased to 30% meaning thereby that as from that date 'A' will be entitled to \$300/- from the daily income of the taxi and 'B' will earn \$700/-. This process will go on until after the expiry of two years, the whole taxi will be owned by 'A' and 'B' will take back his original investment along with income distributed to him as aforesaid.

- 'A' wishes to start the business of ready-made garments but lacks the required funds for that business. 'B' agrees to participate with him for a specified period, say two years. 40% of the investment is contributed by 'A' and 60% by 'B'. Both start the business on the basis of Diminishing *Musharakah*. The proportion of profit allocated for each one of them is expressly agreed upon. But at the same time 'B's share in the business is divided to six equal units and 'A' keeps purchasing these units on gradual basis until after the end of two years 'B' comes out of the business, leaving its exclusive ownership to A. Apart from periodical profits earned by 'B', he gains the price of the units of his share which, in practical terms, tend to repay to him the original amount invested by him.

Conclusion

The Islamic banking and microfinance product mechanisms prove a matchless, ethical, and socially inclusive approach to financial services, grounded in the principles of Shariah. By prohibiting interest-based transactions and emphasizing risk-sharing, asset-backed financing, and transparency, these mechanisms offer an alternative to conventional finance that aligns closely with the values of economic justice and social welfare. Islamic banking products, such as Murabaha, Mudarabah, and Musharakah, enable institutions to provide profit-generating services while minimizing risks and fostering ethical partnerships with clients. In the realm of microfinance, Islamic models empower low-income individuals through accessible, interest-free, and asset-backed financing that allows them to improve their economic status. Islamic microfinance tools, including Qard Hasan and profit-sharing models, are designed to serve financially excluded populations while promoting financial independence, entrepreneurship, and community development. In sum, Islamic banking and microfinance contribute to sustainable economic growth, financial inclusion, and social equity, offering a meaningful, ethical alternative that appeals to diverse populations globally, especially within Muslim-majority communities.



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