

Islamic financial transaction terminology

Bai' al-inah (sale and buy-back agreement)

The financier sells an asset to the customer on a deferred-payment basis, and then the asset is immediately repurchased by the financier for cash at a discount. The buying back agreement allows the bank to assume ownership over the asset in order to protect against default without explicitly charging interest in the event of late payments or insolvency. Some scholars believe that this is not compliant with Shariah principles.

Bai' bithaman ajil (deferred payment sale)

This concept refers to the sale of goods on a deferred payment basis at a price, which includes a profit margin agreed to by both parties. This is similar to Murabahah, except that the debtor makes only a single installment on the maturity date of the loan. By the application of a [discount rate](#), an Islamic bank can collect the market rate of interest.

Bai muajjal (credit sale)

Literally *bai muajjal* means a credit sale. Technically, it is a financing technique adopted by Islamic banks that takes the form of murabaha muajjal. It is a contract in which the bank earns a profit margin on the purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in installments. It has to expressly mention cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price. (Deferred-payment sale)

Mudarabah (profit sharing)

Mudarabah is an arrangement or agreement between the bank, or a capital provider, and an entrepreneur, whereby the entrepreneur can mobilize the funds of the former for its business activity. The entrepreneur provides expertise, labor and management. Profits made are shared between the bank and the entrepreneur according to predetermined ratio. In case of loss, the bank loses the capital, while the entrepreneur loses his provision of labor. It is this financial risk, according to the Shariah, that justifies the bank's claim to part of the profit. The profit-sharing continues until the loan is repaid. The bank is compensated for the time value of its money in the form of a floating rate that is pegged to the debtor's profits.

Murabahah (cost plus)

"Murabahah" is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "rabb-ul-mal", while the management and work is an exclusive responsibility of the other, who is called "mudarib". This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the Murabaha is paid in full.

This type of transaction is similar to [rent-to-own](#) arrangements for furniture or appliances that are very common in [North American](#) stores.

Musawamah

Musawamah is the negotiation of a selling price between two parties without reference by the seller to either costs or asking price. While the seller may or may not have full knowledge of the cost of the item being negotiated, they are under no obligation to reveal these costs as part of the negotiation process. This difference in obligation by the seller is the key distinction between Murabaha and Musawamah with all other rules as described in Murabaha remaining the same. Musawamah is the most common type of trading negotiation seen in Islamic commerce.

Bai salam

Bai salam means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver, or currencies based on these metals. Barring this, Bai Salam covers almost everything that is capable of being definitely described as to quantity, quality, and workmanship.

Basic features and conditions of Salam

1. The transaction is considered Salam if the buyer has paid the purchase price to the seller in full at the time of sale. This is necessary so that the buyer can show that they are not entering into debt with a second party in order to eliminate the debt with the first party, an act prohibited under Sharia. The idea of Salam is to provide a mechanism that ensures that the seller has the liquidity they expected from entering into the transaction in the first place. If the price were not paid in full, the basic purpose of the transaction would have been defeated. Muslim jurists are unanimous in their opinion that full payment of the purchase price is key for Salam to exist. Imam Malik is also of the opinion that the seller may defer accepting the funds from the buyer for two or three days, but this delay should not form part of the agreement.
2. Salam can be effected in those commodities only the quality and quantity of which can be specified exactly. The things whose quality or quantity is not determined by specification cannot be sold through the contract of salam. For example, precious stones cannot be sold on the basis of salam, because every piece of precious stones is normally different from the other either in its quality or in its size or weight and their exact specification is not generally possible.
3. Salam cannot be effected on a particular commodity or on a product of a particular field or farm. For example, if the seller undertakes to supply the wheat of a particular field, or the fruit of a particular tree, the salam will not be valid, because there is a possibility that the crop of that particular field or the fruit of that tree is destroyed before delivery, and, given such possibility, the delivery remains uncertain. The same rule is applicable to every commodity the supply of which is not certain.
4. It is necessary that the quality of the commodity (intended to be purchased through salam) is fully specified leaving no ambiguity which may lead to a dispute. All the possible details in this respect must be expressly mentioned.
5. It is also necessary that the quantity of the commodity is agreed upon in unequivocal terms. If the commodity is quantified in weights according to the usage of its traders, its weight must be determined, and if it is quantified through measures, its exact

measure should be known. What is normally weighed cannot be quantified in measures and vice versa.

6. The exact date and place of delivery must be specified in the contract.
7. Salam cannot be effected in respect of things which must be delivered at spot. For example, if gold is purchased in exchange of silver, it is necessary, according to Shari'ah, that the delivery of both be simultaneous. Here, salam cannot work. Similarly, if wheat is bartered for barley, the simultaneous delivery of both is necessary for the validity of sale. Therefore the contract of salam in this case is not allowed.

Hibah (gift)

This is a token given voluntarily by a debtor to a creditor in return for a loan. Hibah usually arises in practice when Islamic banks voluntarily pay their customers a 'gift' on savings account balances, representing a portion of the profit made by using those savings account balances in other activities.

It is important to note that while it appears similar to interest, and may, in effect, have the same outcome, Hibah is a voluntary payment made (or not made) at the bank's discretion, and cannot be 'guaranteed.' However, the opportunity of receiving high Hibah will draw in customers' savings, providing the bank with capital necessary to create its profits; if the ventures are profitable, then some of those profits may be gifted back to its customers as Hibah.^[23]

Ijarah

Ijarah means lease, rent or wage. Generally, Ijarah concept means selling benefit or use or service for a fixed price or wage. Under this concept, the Bank makes available to the customer the use of service of assets / equipments such as plant, office automation, motor vehicle for a fixed period and price.

Advantages of Ijarah

Ijarah provides the following advantages to the Lessee:

Ijarah conserves the Lessee' capital since it allows up to 100% financing.

Ijarah gives the Lessee the right to access the equipment on payment of the first installment. This is important as it is the access and use (and not ownership) of equipment that generates income.

Ijarah arrangements aid corporate planning and budgeting by allowing the negotiation of flexible terms

Ijarah is not considered Debt Financing so it does not appear on the Lessee' Balance Sheet as a Liability. This method of "[off-balance-sheet](#)" financing means that it is not included in the Debt Ratios used by bankers to determine financing limits. This allows the Lessee to enter into other lease financing arrangements without impacting his overall debt rating.

All payments towards Ijarah contracts are treated as operating expenses and are therefore fully tax-deductible. Leasing thus offers tax-advantages to for-profit operations.

Many types of equipment (i.e computers) become obsolete before the end of their actual economic life. *Ijarah* contracts allow the transfer of risk from the Lessee to the Lessor in exchange for a higher lease rate. This higher rate can be viewed as insurance against obsolescence.

If the equipment is used for a relatively short period of time, it may be more profitable to lease than to buy.

If the equipment is used for a short period but has a very poor resale value, leasing avoids having to account for and depreciate the equipment under normal accounting principles.

Ijarah thumma al bai' (hire purchase)

Parties enter into contracts that come into effect serially, to form a complete lease/ buyback transaction. The first contract is an *Ijarah* that outlines the terms for leasing or renting over a fixed period, and the second contract is a *Bai* that triggers a sale or purchase once the term of the *Ijarah* is complete. For example, in a car financing facility, a customer enters into the first contract and leases the car from the owner (bank) at an agreed amount over a specific period. When the lease period expires, the second contract comes into effect, which enables the customer to purchase the car at an agreed to price.

The bank generates a profit by determining in advance the cost of the item, its residual value at the end of the term and the time value or profit margin for the money being invested in purchasing the product to be leased for the intended term. The combining of these three figures becomes the basis for the contract between the Bank and the client for the initial lease contract.

This type of transaction is similar to the [contractum trinius](#), a legal maneuver used by European bankers and merchants during the Middle Ages to sidestep the Church's prohibition on interest bearing loans. In a *contractum*, two parties would enter into three concurrent and interrelated legal contracts, the net effect being the paying of a fee for the use of money for the term of the loan. The use of concurrent interrelated contracts is also prohibited under Shariah Law.

Ijarah-wal-iqtina

A contract under which an **Islamic bank** provides equipment, building, or other assets to the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the promise does not become an integral part of the lease contract to make it conditional. The rentals as well as the purchase price are fixed in such manner that the bank gets back its principal sum along with profit over the period of lease.

Musharakah (joint venture)

Musharakah is a relationship between two parties or more, of whom contribute capital to a business, and divide the net profit and loss pro rata. This is often used in investment projects, letters of credit, and the purchase of real estate or property. In the case of real estate or property, the bank assess an imputed rent and will share it as agreed in advance. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions. This concept is distinct from fixed-income investing (i.e. issuance of loans).

Qard hassan/ Qardul hassan (good loan/benevolent loan)

This is a loan extended on a goodwill basis, and the debtor is only required to repay the amount borrowed. However, the debtor may, at his or her discretion, pay an extra amount beyond the principal amount of the loan (without promising it) as a token of appreciation to the creditor. In the case that the debtor does not pay an extra amount to the creditor, this transaction is a true interest-free loan. Some Muslims consider this to be the only type of loan that does not violate the prohibition on *riba*, since it is the one type of loan that truly does not compensate the creditor for the time value of money.

Sukuk (Islamic bonds)

[Sukuk](#) is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed-income, interest-bearing bonds are not permissible in Islam. Hence, Sukuk are securities that comply with the Islamic law ([Sharia](#)) and its investment principles, which prohibit the charging or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.

Takaful (Islamic insurance)

Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals. Insurance by combining the risks of many people enables each individual to enjoy the advantage provided by the [law of large numbers](#). See Takaful for details.

Wadiah (safekeeping)

In **Wadiah**, a bank is deemed as a keeper and trustee of funds. A person deposits funds in the bank and the bank guarantees refund of the entire amount of the deposit, or any part of the outstanding amount, when the depositor demands it. The depositor, at the bank's discretion, may be rewarded with *Hibah* (see above) as a form of appreciation for the use of funds by the bank.

Wakalah (power of attorney)

This occurs when a person appoints a representative to undertake transactions on his/her behalf, similar to a [power of attorney](#).

Islamic equity funds

Islamic investment equity funds market is one of the fastest-growing sectors within the Islamic financial system. Currently, there are approximately 100 Islamic equity funds worldwide. The total assets managed through these funds currently exceed US\$5 billion and is growing by 12. 15% per annum. With the continuous interest in the Islamic financial system, there are positive signs that more funds will be launched. Some Western majors have just joined the fray or are thinking of launching similar Islamic equity products.

Despite these successes, this market has seen a record of poor marketing as emphasis is on products and not on addressing the needs of investors. Over the last few years, quite a number of funds have closed down. Most of the funds tend to target high net worth individuals and corporate institutions, with minimum investments ranging from US\$50,000 to

as high as US\$1 million. Target markets for Islamic funds vary, some cater for their local markets, e.g., Malaysia and Gulf-based investment funds. Others clearly target the Middle East and Gulf regions, neglecting local markets and have been accused of failing to serve Muslim communities.

Since the launch of Islamic equity funds in the early 1990s, there has been the establishment of credible equity benchmarks by Dow Jones Islamic market index ([Dow Jones Indexes](#) pioneered Islamic investment indexing in 1999) and the FTSE Global Islamic Index Series. The Web site failaka.com monitors the performance of Islamic equity funds and provide a comprehensive list of the Islamic funds worldwide.

Islamic laws on trading

The [Qur'an](#) prohibits [gambling](#) (games of chance involving money) and insuring ones' health or property (also a game of chance). The [hadith](#), in addition to prohibiting gambling (games of chance), also prohibits [bayu al-gharar](#) (trading in risk, where the [Arabic](#) word *gharar* is taken to mean "risk" or excessive uncertainty).

The [Hanafi madhab](#) (legal school) in Islam defines [gharar](#) as "that whose consequences are hidden." The [Shafi](#) legal school defined *gharar* as "that whose nature and consequences are hidden" or "that which admits two possibilities, with the less desirable one being more likely." The [Hanbali](#) school defined it as "that whose consequences are unknown" or "that which is undeliverable, whether it exists or not." [Ibn Hazm](#) of the [Zahiri](#) school wrote "*Gharar* is where the buyer does not know what he bought, or the seller does not know what he sold." The modern scholar of Islam, Professor Mustafa Al-Zarqa, wrote that "Gharar is the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes the trade similar to gambling." There are a number of [hadith](#) that forbid trading in *gharar*, often giving specific examples of *gharhar* transactions (e.g., selling the birds in the sky or the fish in the water, the catch of the diver, an unborn calf in its mother's womb etc.). Jurists have sought many complete definitions of the term. They also came up with the concept of *yasir* (minor risk); a financial transaction with a minor risk is deemed to be [halal](#) (permissible) while trading in non-minor risk (*bayu al-ghasar*) is deemed to be [haram](#).^[25]

What *gharar* is, exactly, was never fully decided upon by the Muslim jurists. This was mainly due to the complication of having to decide what is and is not a minor risk. Derivatives instruments (such as stock options) have only become common relatively recently. Some Islamic banks do provide [brokerage](#) services for stock trading.