

# Shari'ah Contracts for Islamic Financial Institutions

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Chapter 2 Overview

# Chapter Content Outline

Elements of **Shariah Contracts**

Classification of **Shariah Contracts**

Exchange Based Contracts

Partnership Contracts

Charitable Contracts

Agency Contracts

Security Contracts

Supporting Contracts



# Historical Context



## Prophet's Financial Practices

Islamic methods of finance drew upon examples from **Prophet Muhammad's experiences** during his lifetime



## Financial Transactions

The Prophet (pbuh) reportedly **bought on credit**, took financing, and gave personal property as security or lien



## Mudharabah Contract

Prophet Muhammad (pbuh) used the **Mudharabah contract** to trade with Khadijah's capital, involving travel to Syria



## Partnership Practices

Muslims in Arabia widely practiced **Shirkah or Musharakah** (full partnership) for commercial enterprises based on profit-and-loss-sharing



## Trade Partnership

Sayfi bin A'idth was the Prophet's **partner in trade** to Yemen before his prophethood

# Elements of Shariah Contracts

## Essential Elements (Rukun)

- Contracting parties (Buyer/Seller/Lessor/Lessee/Partners)
- Form of contract (Offer & Acceptance)
- Subject matter (Item Sold/Underlying Asset, Price, Benefit/Usufruct, Deposit, Debt, Pledge, Work)

## Conditions of Essential Elements

- Parties: Capable of responsibility, not prohibited from dealing with property, free from coercion
- Item Sold: Must exist, be halal, have use, be owned by seller, be deliverable, be known and specific
- Price: Must be known currency and absolute amount
- Offer/Acceptance: Must be absolute, acceptance must agree with offer, made at same meeting

## General Principles



### Al-Aqad

Contract as the basis of transaction



### Al-Taradi

Mutual Consent



### Lawful Objectives

Contractual objectives must be permissible

# Classification of Shariah Contracts

Contracts of Exchange/Transfer of Property Uqudul Muawadat - Transfer ownership of goods/merchandise

Contracts of Security Uqudul Tawthiqat - Provision of securities to protect parties' interests

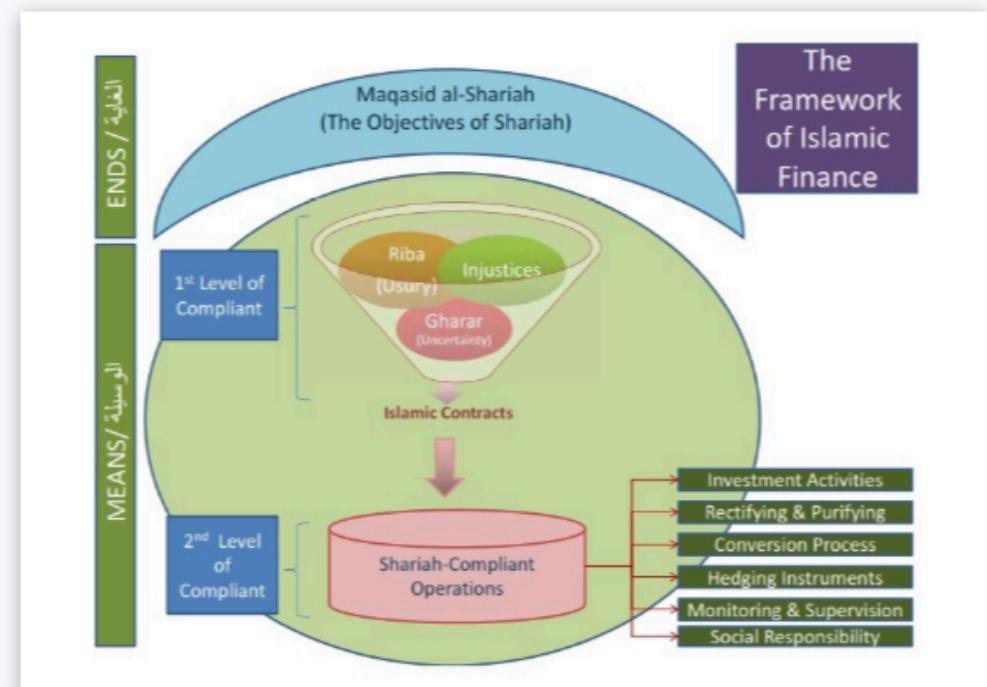
Contracts of Partnership Shirkah - Joint venture with shared capital, management, profits, liabilities

Contract of Safe Custody Wadiyah - Property deposited for safekeeping

Contracts Pertaining to Utilization of Usufruct Uqudul Manfaah - Transfer right to use property

Contracts Pertaining to Work/Services One party requested to do work, with or without consideration

Gratuitous Contracts Uqudul Tabarruat - Unilateral contracts favoring recipient



# Exchange Based Contracts



## Murabahah

Cost Plus

Sale based on **cost price plus profit** Cost and profit disclosed to buyer



## Istisna'

Manufacturing Sale

Order for **manufacture of item** according to specifications Item does not exist at contract time



## Bai Salam

Forward Contract

**Full advance payment** for future delivery of an item Commonly used in agriculture



## Bai Dayn

Sale of Debt

**Debt trading** for Islamic Capital Market instruments Trading of debt must be on cash terms



## Ijarah

Lease

Sale of the **use of another's property** Property belongs to lessor



## Ijarah Thumma Bai

Hire Purchase

**Leasing followed by purchase** – two separate contracts Used for consumer goods like vehicles



## Bai Bithaman Ajil

Deferred Payment Sale

Normal sale with **payment deferred** to agreed later date Item must exist at contract time

# Partnership Contracts



## Musyarakah

Joint Venture

Partnership or joint business venture to make profit

- ↗ **Profit sharing** based on agreed ratio (may differ from investment ratio)
- ↘ **Loss sharing** strictly based on ratio of funds invested



## Mudharabah

Profit Sharing

Arrangement between investor (capital provider) and entrepreneur (runs business)

- █ Bank can act as **entrepreneur** (for customer deposits) or as **capital provider** (for customer ventures)
- ⚠ **Losses** suffered shall be borne solely by the capital provider



# Security Contracts



## Kafalah

Guarantee

### Essential Elements

Dhamin (guarantor)

Madmun lah (creditor)

Madmun anh (debtor)

Madmun bih (debt)

Contract

### Rules

**Multiple guarantors** permissible

**Duration/ceiling amount** can be fixed

**Remuneration** for providing guarantee is not permissible

Only **actual expenses** can be claimed



## Rahn

Pledge

### Essential Elements

Pledgor

Pledgee (Islamic Bank)

Obligation or right to a claim (debt)

Pledge (property pledged)

Contract

### Features

Pledge may be **exchanged**

Debt secured can be **increased**

Bank has **right to possession** until debt is paid in full

Pledgor/pledgee cannot sell/pledge without other's consent

Court may compel sale if debtor defaults

# Charitable Contracts



## Hibah

Gift

Payment made **willingly** in return for a benefit received

### Pillars



#### Donor

Eligible, legal owner,  
mature



#### Donee

Living human



#### Hibah Object

In existence, valuable,  
separate



#### Sighah

Offer and Acceptance



## Wadiyah

Safekeeping

Custody of safekeeping; bank **guarantees safety** and  
repayment

### Types



#### Wadiyah Yad Amanah

Custodian must **not mix/pool/use** deposits, nor charge fees



#### Wadiyah Yad Dhamanah

If custodian breaches Amanah rules, converts to Dhamanah,  
requiring **guarantee of return/replacement**. Typically used in  
deposit-taking; bank may pay Hibah (gift)

# Agency Contracts



## Wakalah

Agency

Contract where a **person (principal)** asks another **(agent)** to act on his behalf for a specific task; agent is paid a fee

### Agent Role

Agent is a **safe custodian** of entrusted items

Must mention acting on behalf of principal when concluding contracts

Applies to: **Hibah**, Lending, Debt, **Wadiyah**, **Rahn**, **Musharakah**, and **Mudharabah** contracts

### Key Features

Agent acts within **specified authority** granted by principal

Agent entitled to **pre-agreed fee** for services rendered

Agent **liable** for negligence or misconduct

# Supporting Contracts



## Hiwalah

Transfer

Transfer of the **right to demand debt** from debtor to another liable person



**Hiwalah al-haqq** (transfer of right)



**Hiwalah al-dayn** (transfer of debt)

⚙️ Can be **Restricted** or **Unrestricted**

⬅️ Transfers both the **debt** and the **right to collect**



## Muqasah

Set-off

Settlement of debt by **contra-transaction** where creditor is also indebted to debtor for same amount

➡️ Allows **mutual debts** to be offset against each other

➡️ Only the **balance** (if any) remains payable

✅ Requires **mutual agreement** between parties

⬆️ Commonly used in **banking operations** to simplify transactions



## Ibra'a'

Rebate

Arises from **deferred payment sale** when buyer makes early redemption

🏛️ Creditor (seller)

👤 Debtor (buyer)



## Wa'd

Promise

Expression of **willingness** of a person or group on particular subject matter

👤 **Unilateral promise** not binding upon silent party

⚠️ Person making promise must be **competent** and **of sound mind**

# Summary



## Foundation of Islamic Finance

Shari'ah contracts form the **foundation** of Islamic financial institutions



## Prohibitions

All contracts must avoid **Riba, Gharar**, and other prohibitions



## Essential Elements

Elements of contracts include **contracting parties, form of contract**, and **subject matter**



## Classification

Contracts are classified into **exchange, partnership, security, charitable, agency**, and **supporting** types



## Specific Requirements

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