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HANDOUT

BNK612

Financial Jurisprudence in Islam

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Financial Jurisprudence in Islam

Lecture Handouts

Prepared for the students of Virtual University of Pakistan

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1. Introduction to Fiqh al-Mu'amalat

LEARNING OBJECTIVES

- Define fiqh al-mu'amalat and its place in Islamic jurisprudence
- Explain the sources of Islamic commercial law
- Distinguish between 'ibadat and mu'amalat

The word **fiqh** literally means deep understanding. In Islamic legal terminology it is the science of deriving practical rulings (ahkam 'amaliyyah) from their detailed evidences. **Fiqh al-mu'amalat** is the branch of fiqh that governs dealings and transactions between people - buying and selling, partnerships, leasing, guarantees, agency and all financial contracts. While 'ibadat (acts of worship) are fixed and devotional, mu'amalat are flexible and purposive: their rulings aim at justice, mutual consent and the prevention of exploitation.

The primary sources of Islamic commercial law are the **Qur'an**, the **Sunnah** (the Prophet's sayings, actions and tacit approvals), **ijma'** (consensus of qualified scholars) and **qiyas** (analogical reasoning). Secondary tools include istihsan (juristic preference), maslahah (public interest) and 'urf (recognized custom). A famous hadith states: 'The truthful, trustworthy merchant will be with the prophets, the truthful and the martyrs' (Tirmidhi), which sets the ethical tone of all Islamic finance.

Mu'amalat

All interpersonal dealings - commercial, financial and civil - as distinct from 'ibadat (worship). The default rule in mu'amalat is permissibility (ibahah) unless a clear prohibition exists.

Maqasid al-Shari'ah

The higher objectives of Islamic law: protection of religion, life, intellect, progeny and wealth (mal). Islamic financial jurisprudence exists to protect wealth through lawful earning and just exchange.

SECTION SUMMARY

Fiqh al-mu'amalat governs all financial dealings in Islam. Its sources are Qur'an, Sunnah, ijma' and qiyas; its guiding objectives are justice, consent and the protection of wealth from unlawful means.

2. The Concept of 'Aqd (Contract)

LEARNING OBJECTIVES

- Define 'aqd and its pillars (arkan)
- Explain the conditions of a valid contract
- Identify causes of invalidity (fasad, butlan)

An **'aqd** (contract) is the lawful connection between the offer (ijab) and acceptance (qabul) that creates legal effects - transfer of ownership, usufruct or obligations. The classical Hanafi jurists identify the **pillars (arkan)** of a contract as: (1) the two contracting parties ('aqidan) who must have legal capacity (ahliyyah); (2) the offer and acceptance (sighah) expressed clearly; (3) the subject matter (ma'qud 'alayh) which must exist, be lawful, deliverable and precisely known; and (4) in some formulations, the consideration or price.

For a contract to be **sahih (valid)** it must satisfy conditions of formation (shurut al-in'iqad): parties must be sane and of age of discernment, the offer and acceptance must correspond in one session (majlis al-'aqd), and the subject matter must be free of excessive uncertainty (gharar). If a pillar is missing the contract is **batil (void)**; if a condition is defective it is **fasid (defective)** - for example a sale with an unknown price is fasid and must be corrected or cancelled.

- **Majlis al-'aqd**: the session of contracting - offer and acceptance should occur in the same sitting.
- **Khiyar (options)**: e.g. khiyar al-majlis (option during the session) and khiyar al-shart (stipulated option period) protect parties from hasty bargains.
- **Ahliyyah**: full legal capacity requires puberty, sanity and prudence; a minor of discernment may contract with guardian approval.

■ VERY IMPORTANT

The distinction between batil (void - missing a pillar) and fasid (defective - missing a condition) is a favorite exam question. Memorize: batil = no legal effect at all; fasid = effect exists but must be rectified, otherwise the contract is dissolved.

SECTION SUMMARY

A valid 'aqd needs capable parties, matching offer and acceptance, and a lawful, known, deliverable subject matter. Missing pillars make it batil; missing conditions make it fasid.

3. Riba: The Prohibition of Interest

LEARNING OBJECTIVES

- Define riba and its two classical types
- Cite Qur'anic and hadith evidence for prohibition
- Explain the rationale (hikmah) behind the prohibition

The Qur'an condemns riba in the strongest terms: 'Allah has permitted trade and forbidden riba' (2:275), and those who persist are warned of 'war from Allah and His Messenger' (2:279). The classical jurists divide riba into **riba al-nasi'ah** (increase charged for deferment - the pre-Islamic practice of doubling a debt on default and the essence of modern interest) and **riba al-fadl**

(excess in spot exchange of the six ribawi commodities - gold, silver, wheat, barley, dates, salt - hand to hand in unequal amounts, per the hadith of 'Ubadah ibn al-Samit).

The wisdom behind the prohibition includes: preventing unjust enrichment without effort or risk; keeping wealth circulating productively rather than hoarded in debt; protecting borrowers from exploitation; and directing finance toward profit-and-loss sharing (mudarabah, musharakah) where risk is shared fairly. Modern Islamic banking replaces interest with trade-based (murabaha), lease-based (ijara) and partnership-based modes.

- **Riba al-nasi'ah:** any contractual increase on a loan for time - e.g. charging 10% per annum on a loan.
- **Riba al-fadl:** exchanging 1 kg of dates for 2 kg of dates on the spot - unequal exchange of the same ribawi genus.
- The 'illah (effective cause) debated by schools: Hanafis - same genus + measurability; Shafi'is - being currency or food.

SECTION SUMMARY

Riba (interest/usury) is strictly prohibited. Riba al-nasi'ah = increase for deferment; riba al-fadl = unequal spot exchange of ribawi goods. Islamic finance substitutes risk-sharing contracts.

4. Gharar, Maysir and Prohibited Elements

LEARNING OBJECTIVES

- Define gharar and its degrees
- Define maysir (gambling) and its modern forms
- List other prohibited elements in contracts

Gharar is excessive uncertainty or deception in a contract that may lead to dispute - for example selling fish still in the sea, or a sale where the price or object is unknown. The Prophet (peace be upon him) forbade 'the sale of gharar' (Muslim). Minor, unavoidable uncertainty (like the exact ripening date of fruit on a tree sold as a whole) is tolerated; major uncertainty affecting the essence of the bargain voids it. Modern applications: conventional insurance is debated because of gharar (uncertain payout), which is why **takaful** (mutual guarantee) was developed.

Maysir is gambling - acquiring wealth by chance without productive effort. The Qur'an groups it with intoxicants as 'great sin' (2:219) and 'an abomination of Satan's handiwork' (5:90). Modern forms include lotteries, casino games and speculative derivatives that are pure bets on price movements. Contracts must also avoid **jahalah** (ignorance of essential terms), **ikrah** (coercion), **najsh** (false bidding to inflate prices) and **ihtikar** (hoarding to manipulate prices).

Gharar yasir vs. gharar fahish

Minor uncertainty (yasir) that is unavoidable or customary is excused; major uncertainty (fahish) that touches the pillars of the contract invalidates it.

SECTION SUMMARY

Gharar (excessive uncertainty), maysir (gambling), coercion, deception and hoarding are all prohibited elements that can void or corrupt a financial contract.

5. Bay': The Contract of Sale

LEARNING OBJECTIVES

- Define bay' and its conditions
- Classify types of sale in Islamic law
- Explain salam and istisna' as exceptional sales

Bay' (sale) is the exchange of property for property with mutual consent. Its conditions: the object must be pure (tahir) and lawful, owned by the seller, deliverable, known in quantity and quality, and the price must be fixed and known. The Prophet said: 'Do not sell what you do not possess' - so short-selling of non-owned assets is prohibited.

Types of sale

- **Bay' al-musawamah**: ordinary bargaining sale at an agreed price.
- **Bay' al-murabaha**: sale at cost plus a disclosed profit margin - the backbone of Islamic bank financing.
- **Bay' al-tawliyah**: sale at cost without profit; **bay' al-wadi'ah**: sale at a disclosed loss.
- **Bay' al-sarf**: currency exchange - must be spot and equal when same currency.
- **Bay' al-salam**: advance payment for future delivery of fungible goods with full specification - an exception to 'do not sell what you do not own', permitted by hadith for agricultural finance.
- **Istisna'**: manufacturing contract - order goods to be manufactured to specification; payment may be in stages. Used for construction and industrial finance.

■ VERY IMPORTANT

Salam vs. istisna' is a classic comparison question. Salam: full advance payment, fungible goods, fixed delivery date, cannot be cancelled unilaterally. Istisna': payment can be deferred/installed, manufactured items, more flexible, binding on Hanafi view once work begins.

SECTION SUMMARY

Bay' requires lawful, owned, known, deliverable goods and a known price. Salam (advance-paid future delivery) and istisna' (manufacture-to-order) are Shari'ah-compliant exceptions enabling agricultural and industrial finance.

6. Murabaha: Cost-Plus Financing

LEARNING OBJECTIVES

- Explain the murabaha mechanism step by step
- Distinguish murabaha from interest-based lending
- State the Shari'ah conditions for bank murabaha

Murabaha is a sale at cost plus an agreed, disclosed profit. In banking practice (**murabaha to the purchase orderer**): (1) the customer requests the bank to buy a specific asset; (2) the bank purchases and takes ownership (even briefly - constructive possession suffices); (3) the bank sells it to the customer at cost + profit, usually payable in installments. Because the bank owns the asset between the two sales, this is genuine trade, not a loan with interest.

Shari'ah conditions: the first purchase must be real (the bank bears ownership risk, however briefly); the cost and profit must be disclosed; the second sale price, once fixed, cannot be increased on default (no compounding - a charity clause may instead direct late-payment penalties to charity); the asset must be lawful and exist. AAOIFI standards require the bank's purchase and sale to be two separate contracts.

- Why not riba? The profit is a trading margin on a real sale with ownership risk, not an increase on a loan.
- Default rule: price is frozen at contract; rescheduling cannot increase the debt.
- Common uses: vehicle finance, equipment finance, trade finance, home finance (diminishing musharaka is often preferred for homes).

SECTION SUMMARY

Murabaha = bank buys asset, then sells to client at disclosed cost-plus, often on installments. Two genuine sales with real ownership in between distinguish it from interest.

7. Salam and Istisna' in Detail

LEARNING OBJECTIVES

- List the conditions of a valid salam contract
- Explain istisna' and its modern applications
- Compare parallel salam structures

The Prophet permitted salam saying: 'Whoever makes a salam contract, let him do so for a known measure, known weight and known term' (Bukhari, Muslim). Conditions: **full advance payment** at contract; goods must be fungible and precisely described (quality, quantity, date and place of delivery); delivery date fixed; goods normally available in the market at delivery. In **parallel salam**, the bank does back-to-back salam contracts - one as buyer from a farmer, one as seller to a miller - earning a margin without taking delivery itself.

Istisna' (commissioned manufacture) needs no advance payment; price may be paid in installments and the item is manufactured to agreed specifications. It cannot be revoked unilaterally after manufacture begins (Hanafi view). Banks use istisna' for project and construction finance, often combined with ijara (lease) after completion. Unlike salam, istisna' is not restricted to fungibles and delivery time may be flexible.

SECTION SUMMARY

Salam finances agriculture with full advance payment for described future goods. Istisna' finances manufacturing/construction with flexible payment. Both are exceptions to the 'possession' rule, carefully conditioned.

8. Ijara: Leasing

LEARNING OBJECTIVES

- Define ijara and its pillars
- Distinguish ijara from conventional lease and from sale
- Explain ijara muntahia bittamlik

Ijara is the transfer of usufruct (manfa'ah) for a consideration (ujrah) over a known period. The lessor retains ownership and bears ownership risks (major maintenance, insurance of the corpus); the lessee bears ordinary maintenance and pays rent for actual usufruct. Rent may be fixed or benchmarked, but once fixed for a period it cannot be unilaterally changed.

Ijara muntahia bittamlik (lease ending in ownership) is the Islamic home/car finance workhorse: the bank leases the asset to the customer and ownership transfers at the end - via gift, token sale, or gradual transfer (diminishing musharaka + ijara is the common Pakistani structure). Crucially, the lease and the transfer promise must be separate documents to avoid 'two transactions in one'. If the asset is destroyed without lessee negligence, the lease terminates - unlike conventional leases where payments continue.

- Lessor: major maintenance, ownership taxes, takaful of asset.
- Lessee: minor/operational maintenance, careful use.
- Rent for a period already elapsed is due even if the lessee did not use the asset; no rent accrues after total destruction.

SECTION SUMMARY

Ijara sells usufruct, not the asset. Ownership risks stay with the lessor. Ijara ending in ownership - kept as two separate undertakings - powers Islamic home and auto finance.

9. Mudarabah and Musharakah: Partnerships

LEARNING OBJECTIVES

- Define mudarabah and its profit/loss rules
- Define musharakah and its types
- Explain diminishing musharakah

Mudarabah is a trustee partnership: one party (rabb al-mal) provides capital, the other (mudarib) provides work. Profit is shared by agreed ratio; **loss is borne by capital alone** (the mudarib loses his effort), unless caused by the mudarib's negligence or breach. The mudarib is a trustee (amin), not a guarantor - capital cannot be guaranteed. This mode underlies Islamic deposits: depositors are rabb al-mal, the bank is mudarib.

Musharakah is a joint partnership where all partners contribute capital (and usually work) and share profit by agreement but **loss strictly in proportion to capital**. Types include shirkat al-'inan (limited investment partnership) and shirkat al-mufawada (full partnership). **Diminishing musharakah** (musharaka mutanaqisa): the bank's share is gradually bought out by the client - the standard structure for Islamic home financing in Pakistan, combined with ijara of the bank's share.

■ VERY IMPORTANT

The loss rule is the key distinction examiners love: in mudarabah the financier bears financial loss; in musharakah loss follows capital ratios. In NEITHER may profit be guaranteed as a fixed return - that would be riba.

SECTION SUMMARY

Mudarabah: capital + work; loss on capital. Musharakah: joint capital; loss pro-rata. Profit ratios are agreed; guaranteed returns are prohibited. Diminishing musharakah enables home finance.

10. Wakalah, Kafalah, Hawalah and Rahn

LEARNING OBJECTIVES

- Define the four accessory contracts
- Explain their roles in Islamic banking
- State key conditions for each

Wakalah (agency): one person authorizes another to act on his behalf - used for investment accounts (bank as wakil for a fixed fee plus performance incentive) and for letters of credit.

Kafalah (guarantee/suretyship): a third party guarantees another's obligation - the basis of Islamic bank guarantees and of takaful's mutual guarantee concept. The guarantor may charge a fee for the service (ujr) but not for the guarantee amount itself.

Hawalah (transfer of debt): a debtor's obligation is transferred to another - used in bills of exchange and debt transfers; the transfer must be of an established debt. **Rahn** (pledge/mortgage): property is held as security for a debt; the pledgee may not benefit from the pledged asset (that would be riba) and must return it on repayment. Islamic banks take rahn as collateral for financing.

SECTION SUMMARY

Wakalah (agency), kafalah (guarantee), hawalah (debt transfer) and rahn (pledge) are the supporting contracts that let Islamic banks offer guarantees, LCs, investment agency and secured finance.

11. Takaful: Islamic Insurance

LEARNING OBJECTIVES

- Explain why conventional insurance is problematic
- Describe the takaful model and its types
- Explain surplus distribution

Classical scholars object to conventional insurance on grounds of **gharar** (uncertainty of payout), **maysir** (chance-based gain) and **riba** (investment of premiums at interest). **Takaful** (from kafala - mutual guarantee) replaces the sale of risk with **mutual contribution**: participants donate (tabarru') to a common pool; claims are paid from the pool; any surplus belongs to participants, not shareholders.

Models: **wakalah model** - operator manages the pool as agent for a fee; **mudarabah model** - operator shares in investment profit of the pool (less favored by AAOIFI now); **hybrid** - wakalah for underwriting + mudarabah for investments. Types: **family takaful** (life/education plans) and **general takaful** (motor, property, marine). In Pakistan, takaful is regulated by the SECP under Takaful Rules 2012, with window operations allowed for conventional insurers.

SECTION SUMMARY

Takaful = participants mutually guarantee each other through a donated pool managed by an operator; surplus returns to participants. It removes the gharar/maysir/riba objections to conventional insurance.

12. Sukuk: Islamic Capital Market Instruments

LEARNING OBJECTIVES

- Define sukuk and distinguish from bonds
- Describe major sukuk structures
- Note Pakistan's sukuk market

Sukuk are certificates of equal value representing undivided ownership in tangible assets, usufruct, or a business venture - not a debt claim. Unlike bonds (which are loans earning interest), sukuk holders own a share of an underlying asset/venture and earn returns from its performance. AAOIFI lists 14 eligible structures.

- **Sukuk al-ijara**: most common - SPV buys assets, leases them back; rentals fund periodic payments; e.g. Pakistan's sovereign ijara sukuk.
- **Sukuk al-mudarabah/musharakah**: investors share venture profits.
- **Sukuk al-salam/istisna'**: for commodity and project finance.
- Tradability: sukuk representing real assets/usufruct are tradable; pure debt (murabaha/salam receivables) generally is not, at face value rules.

Pakistan is an active sukuk issuer - the government issues Ijarah Sukuk regularly (including on the Pakistan Stock Exchange), and corporates issue sukuk for project finance. The Shari'ah Advisory Board of SBP and SECP Shari'ah boards approve structures.

SECTION SUMMARY

Sukuk = asset/venture ownership certificates, not interest-bearing debt. Ijara sukuk dominate; returns come from real economic activity, and most asset-backed sukuk are tradable.

13. Shari'ah Governance and Islamic Banking in Pakistan

LEARNING OBJECTIVES

- Describe the Shari'ah governance framework
- Outline the role of SBP's Shari'ah Board
- List key AAOIFI/IFSB standards

Every Islamic bank must have a **Shari'ah Board** of qualified scholars that approves products, audits compliance and issues rulings. In Pakistan the **State Bank's Shari'ah Board** sets national policy, supported by the 'Essentials and Model Agreements' for each financing mode. Internally, Shari'ah compliance departments and annual Shari'ah audits enforce adherence; non-compliant income must be purified (given to charity).

International standard-setters: **AAOIFI** (Bahrain) issues Shari'ah, accounting and governance standards; **IFSB** (Malaysia) issues prudential standards for Islamic financial institutions. Pakistan's framework aligns with both. The industry's growth - full-fledged Islamic banks (e.g. Meezan) plus Islamic windows - shows customer demand, but scholars continue to debate whether some products (e.g. organized tawarruq) truly embody risk-sharing.

SECTION SUMMARY

Shari'ah Boards, SBP's national Shari'ah Board, AAOIFI and IFSB standards together govern Islamic finance. Compliance is audited and impure income is purified - the industry's credibility rests on this governance.

14. Contemporary Issues and Exam Pointers

LEARNING OBJECTIVES

- Identify current debates in Islamic finance
- Consolidate high-yield exam topics

Live debates: **tawarruq** (commodity murabaha for cash - permitted by some, seen as legal trick/hilah by others); benchmarking rents/profits to KIBOR (permitted as a pricing reference, not as interest); penalty for late payment (must go to charity, not income); and whether Islamic banks sufficiently use profit-sharing (mudarabah/musharakah) versus debt-like murabaha/ijara.

High-yield exam pointers

- Definitions: fiqh, mu'amalat, 'aqd, arkan, riba (two types), gharar, maysir, batil vs fasid.
- Comparisons: salam vs istisna'; murabaha vs riba loan; ijara vs conventional lease; mudarabah vs musharakah (loss rules); takaful vs insurance; sukuk vs bonds.
- Mechanisms: step-by-step murabaha; diminishing musharakah home finance; parallel salam; wakalah deposit model.
- Evidence: Qur'an 2:275, 2:279 (riba); hadith on gharar; 'do not sell what you do not possess'; hadith permitting salam.
- Pakistan specifics: SBP Shari'ah Board, SECP Takaful Rules 2012, sovereign ijara sukuk.

SECTION SUMMARY

Master the definitions, the pairwise comparisons, the step-by-step mechanisms and the scriptural evidences - these four angles cover nearly every BNK612 exam question.