

## Overview of Islamic Modes of Financing

### 1. Mudarabah (Passive Partnership)

This is a contract between two parties: a capital owner (rabb-al-māl) and an investment manager (mudārib). Profit is distributed between the two parties in accordance with the ratio that they agree upon at the time of the contract. Financial loss is borne by the capital owner; the loss to the manager being the opportunity cost of his own labor, which failed to generate any income for him.

### 2. Musharakah (Active Partnership)

A musharakah contract is similar to that of the mudarabah, with the difference that in the case of musharakah both partners participate in the management and provision of capital and also share in the profit and loss. Profits are distributed between partners in accordance with agreed ratios, but the loss must be distributed in proportion to the share of each in the total capital.

### 3. Diminishing Partnership

This is a contract between a financier (the bank) and a beneficiary in which the two agree to enter into a partnership to own an asset, as described above, but on the condition that the financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule.

### 4. Murabahah (Sales Contract at a Profit Markup)

Under this contract, the client orders an Islamic bank to purchase for him a certain commodity at a specific cash price, promising to purchase such commodity from the bank once it has been bought, but at a deferred price, which includes an agreed upon profit margin called markup in favor of the bank.

## **5. Ijarah (Leasing)**

The subject matter in a leasing contract is the usufruct generated over time by an asset, such as machinery, airplanes, ships or trains. This usufruct is sold to the lessee at a predetermined price. The lessor retains the ownership of the asset with all the rights as well as the responsibilities that go with ownership.

## **6. A Lease Ending in the Purchase of the Leased Asset**

Leasing that ends in the purchase of the leased asset is a financing contract which is intended to transfer ownership of the leased asset to the lessee at the end of the lease agreement. This transfer of ownership is made through a new contract, in which the leased asset is either given to the lessee as a gift or is sold to him at a nominal price at the end of the lease agreement. According to a decision of the OIC Fiqh Academy, this second transfer-of-ownership contract should be signed only after termination of the lease term, on the basis of an advance promise to affect such a transfer of ownership to the lessee. Rent installments are calculated in such a manner as to include, in reality, recovery of the cost of the asset plus the desired profit margin.

## **7. Istisna**

Al-Istisnā is a contract in which a party orders another to manufacture and provide a commodity, the description of which, delivery date, price and payment date are all set in the contract. According to a decision of the OIC Fiqh Academy, this type of contract is of a binding nature, and the payment of price could be deferred

## **8. Salam**

Salam is a sales contract in which the price is paid in advance at the time of contracting, against delivery of the purchased goods/services at a specified future date. Not every commodity is suitable for a salam contract. It is usually applied only to fungible commodities

## **Classification and Utilization of Islamic Modes of Financing:**

Islamic banks utilize Islamic modes of financing on two sides:

1. The side of liabilities or resource mobilization
2. The side of assets or resource utilization.

On the resource mobilization side, the mudārabah mode, either general or restricted to a certain business line, is the mode most frequently used. The bank and the investment deposit holders share the realized profit in accordance with the ratios agreed upon between the parties at the time of contracting. The deposits in the current account are treated as if they are loans from the clients to the bank and therefore, bear no yield to the account holders. However, being loans to the bank, their principal is guaranteed by the bank. Islamic banks have achieved significant success in attracting resources on the basis of the mudārabah contract.

When utilizing these resources for income generation, Islamic banks use both fixed return modes such as murābahah and leasing and variable return modes such as mudārabah and mushārahah.

While, on the liabilities side, Islamic banks have made significant progress in using profit sharing, this is not the case on the assets side. The share of profit-sharing modes in the total financing provided by Islamic banks is very small. Most of the financing is provided on a murābahah basis.