



MAIN TYPES OF CONTRACTS IN ISLAMIC FINANCE AND THEIR SHARE IN THE FINANCIAL MARKETS

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Article history:	Abstract:
Received: 14 th June 2022 Accepted: 14 th July 2022 Published: 24 th August 2022	In this paper, I will try to put a light on the main types of contracts in Islamic Finance. The main differences of these Islamic Financial equities have been explained. Moreover, there has been provided a comparison analysis of conventional financial instruments and Islamic Financial instruments.

Keywords: Islamic Finance, Musharakah, Mudarabah, Murabahah, Ijarah, Salam

INTRODUCTION. Recently, Islamic finance has been gaining more attention by not only the Muslims but also non-Muslim investors as well around the globe. The share of Islamic financial assets has been on constant increase in the UK, Germany, France and the US in the last decade. In this descriptive paper, the main contract types and their fundamental principles in Islamic Finance will be illustrated.

MUSHARAKAH

According to Usmani (2008), the word "Musharakah" comes from Arabic which means sharing. In the financial course it refers to a joint enterprise where the partners will share the profit or loss of the joint venture. So, it is a mutual or multilateral contract between two or more partners to complete a business project. All of the conditions should be clarified beforehand eliminating any uncertainty. Also, the parties should enter the contract with their free consent without any misinterpretation or fraud.

Distribution of profit in a Musharakah contract should be agreed upon the time of the contract's effective date. If profit shares are not predetermined in the contract, this kind of partnership is not valid based on Shariah principles. Also, it is not allowed to fix a lump sum amount of profit beforehand, it should derive from the performance of the business and be a share of the profit. The ratio of the profit sharing does not necessarily be proportionate to the ratio of investment. It can be more or less based on the agreement upon the time of making contract. However, it is agreed among the scholars that if one partner is a sleeping partner, meaning he or she does not take part in the procedure of the business and contributes only in financial terms, his or her profit share cannot be more than the proportion of his or her investment.

Sharing loss – when it comes to sharing loss, it is strictly predetermined that losses are shared among the partners solely based on the proportion of the investment they make. Thus, if the loss is more or less

than the proportion of the investment, this contract will not be valid based on Shariah regulations.

Management of the Musharakah project is generally carried out by all the partners, but it can be pre-agreed that one of them will manage the project. The termination is basically done at the end of the project, but any of the partners may leave the Musharakah contract after giving proper notice to the rest of the partners.

MUDARABAH

Usmani (2008), describes Mudarabah as a different kind of partnership from Musharakah where one partner invests all the required amount while the second partner is exclusively responsible for the management and work of the project.

The investor is called "rabb-ul-mal" which means the owner of the asset, while the borrower is called 'mudarib'.

Main differences of the Mudarabah from the Musharakah mode of financing are:

1. Investment comes only from one side, while the other side is only responsible for professional expertise and management.
2. Unlike Musharakah, in Mudarabah project investor ('rabb-ul-mal') cannot participate in decision making procedures. It is carried out only by the borrower ('mudarib'). However, the investor may choose the business, and determine the type of it before investing.
3. In Musharakah, all the sides share the loss, if any, depending on the proportion of their investments, while in Mudarabah, the loss will be incurred only by the investor, because the borrower has not invested anything but his time and labour. So, the borrower will lose his time and will not be paid for that particular time. However, it should be clear that the borrower has performed diligently, without any fraud. If any negligence, or fraud is detected by the borrower, then he shall be responsible for the loss caused by his negligence.



4. In Mudarabah, all the assets will only belong to the investor, the borrower can get his share only from the incurred proceeds when he could sell the product with excess profit.

Regarding the distribution of profits, it can be agreed beforehand to any proportion based on the type and difficulties in a particular business. No particular proportion is specified by Shariah, thus, it is left completely upon the mutual consent of the parties. However, similar to Musharakah, it is not allowed to fix a lump sum amount of profit beforehand. Also, the shares should only be tied up to the profit not to the capital itself.

MURABAHAH

In its original term Murabahah contract is used in the sale of products. Most of the time it is deferred payment. Usmani (2008), criticizes some Islamic banks that most of the time they use it incorrectly. He explains Murabahah is actually a sale contract in which the borrower may have the opportunity to pay it at a time in the future. The seller can set the price at his own will, and it is allowed to ask a higher price for deferred payment than the current market price. However, one strict condition here, that makes Murabahah to be compliant with the Shariah regulation, is that the seller should inform the buyer about the real cost of the product and its mark-up. If the buyer agrees to the proposed price, then the contract will be considered valid. Additionally, there are some other important requirements as well for the contract to be valid:

1. The product should be ready to use, and the seller should own the product before selling it.
2. The deal must be done at a time, without being contingent on any future events.
3. All the specifications and the details of the product must be informed to the buyer before the sale of it.
4. The price must be certain and fixed
5. The sale must be unconditional, which means the results should not be dependent on any condition.
6. The time of the payment should be exact and should not change.
7. After the agreement of the price, it cannot be changed because of early payment.
8. To charge extra for late payment will be considered as interest and thus this type of contract is not valid. To punish the buyer for late payment, some extra penalty may be used in terms of extra payment, but the seller cannot use it as income, it should be given to

charity. This measure is only to punish the late payment, and make the buyer feel the responsibility, and should not be intended to earn profit from it.

9. The nature of the product should be such that the direct cost of that particular product must be identified and the buyer must be informed

IJARAH

Basically, there are two types of Ijarah in Shariah, the first one is referred to employment of services of some experts.

While, the second is used for renting out the property or usufruct¹. Although, in principal usage of Ijarah method in Shariah is not meant for as a mode of financing, many contemporary Islamic Financial Institutions use it as mode of financing which is very similar to the lease of a property or equipment. However, there are some basic requirements for Ijarah to be valid based on Shariah regulations.

1. The owner of the usufruct must transfer the subject of a contract to another person to make use of it for a pre-agreed period.
2. The leased property must have a certain value to be used. Thus, things without usufruct cannot be leased.
3. The ownership of the property must remain under the seller during the rent period. So, only usufruct or the right to use the property will be transferred to the lessee while, the lessor will still own the property.
4. All the expenses and liabilities like: land tax, arising from ownership of the property will be covered by the owner, while expenses and liabilities arising from the usage will need to be covered by the lessee like: water usage, electricity etc.
5. The beginning and the end of the rent period must be clearly specified in the contract.
6. The property cannot be used by the lessee for any purpose but exactly specified in the contract. If there is not any indication of such purpose in the contract, then the lessee may use it in any purpose withing the Shariah regulations.
7. Any harm caused by the lessee should be borne by the lessee

¹ *Usufruct is the combination of two property rights to itself. Usus and fructus. Usus refers to the right to use some property without altering or damaging it. While, fructus means to enjoy the benefits of it. Namely, receive the profit from it for example it can be used as building for the plant or market. (Investopedia)*



- The rental payments must be determined at the time of contract for the whole period of the lease. If it is for a long period, it is allowed to have different prices, but it should exactly be specified in the contract. The exact period and amount must be specified, like in the second year of the rent the price will be 10% more than in the first year.

SALAM

Salam is also a sale contract similar to Murabahah, the main difference is that it is deferred delivery while, in Murabahah the payment was deferred. So, in Salam, the payment will be paid beforehand for the product to be delivered in time in future. There are also some requirements of Shariah for a Salam contract to be valid:

- The buyers need to pay the full price of the product at a time with the deal.
- The exact quality and the quantity must be specified and agreed by both parties.
- The exact place and date of the commodity must also be specified in the contract.
- There are certain products which are exactly specified by Prophet Muhammad (PBUH) that the delivery of them must be on the spot hand to hand. Thus, Salam contract cannot be used for these products. These are Gold, Silver, Dates, Wheat, Salt and Barley.

To conclude, the main contract types of Islamic Finance have been explained briefly. These are Musharakah, Mudarabah, Murabahah, Ijarah and Salam. Only basic concepts are provided, there are many specifications and deep explanations if one explores them fully, but it will take much time and is beyond the scope of this research. Moreover, the above-mentioned contract types are the main ones and commonly used, there are many other types of contracts and all of them will be based on the principles of Shariah.

Furthermore, contracts in a hybrid mode of one another are also more common, like until certain phase it will be Mudarabah, and then it will turn into a Musharakah form. But every detail must be specified at pre-agreed terms in the contract. Hybrid modes give more flexibility and increase the attractiveness of contracts. Securitization of these modes of finance basically formulates the Sukuk market.

Figure 4



Source: Islamic Finance Development Report 2020 (REFINITIV)

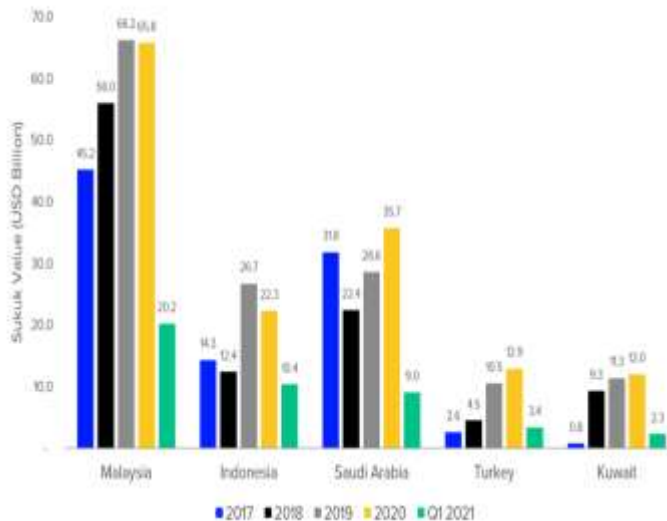
It can be observed from the graph above that most of the Sukuk were issued based on Murabahah and Ijarah contracts in 2019, while Salam constituted the smallest portion. One can see that the hybrid form of Sukuk is also popular among the investors.

According to Refinitiv Quarterly Sukuk Monitor report 2021, despite being ongoing pandemic crisis, the total Sukuk issuances have increased in the first quarter of 2021, comparing with corresponding period in 2020. Thus, in 2020 the global issuances were \$ 41 billion for the end of first quarter, while this number reached \$ 47 billion in 2021 for the same period. A massive increase observed in Southeast Asian region and some parts of GCC (Gulf Cooperation Council) region. However, because of being highly dependent on oil and gas exports, during the pandemic crisis there has been a sharp decline in the amount of Sukuk issuances in most of the GCC countries. The amount of total issuances was \$ 10.2 billion in first three months of 2020, and this amount decreased to \$ 6.5 billion in the first quarter of 2021. However, this decline was offset by rapid increase in Indonesian Sukuk market. With \$ 10.2 billion worth of issuances of Sukuk, Indonesia achieved the top Sukuk issuer title for the first quarter of 2021. Additionally, Malaysia also achieved 28% increase in Sukuk issuances in comparison with the amount from the corresponding period for the last year.



Figure 5

Sukuk Issuance by the Leading Five Countries 2017 – Q1 2021



Source: Quarterly Sukuk Monitor Report 2021 (REFINITIV)

Regarding the type of the Sukuk issuances, the Refinitiv Quarterly Sukuk Monitor 2021, states that Murabahah types of Sukuks were leading while, in terms of amount issued Wakala issuances dropped to thirds place being after Murabahah and Ijarah. Murabahah issuances reached \$15 billion, while Ijarah and Wakala showed relatively similar results, \$ 10.74 billion and \$ 10.09 billion respectively. In terms of Sukuk issuance by tenor, one can observe that short term Sukuk issuances (\$ 16 billion) with less than one year maturity were the most popular among investors. While, Sukuk with 1-to-3-year maturity (\$ 3.2 billion) were the least preferred length of tenor for the first quarter of 2021.

CONCLUSION

To conclude, these are most common modes of financing in Islamic Finance and their fundamental principles. Additionally, descriptive analysis of current Sukuk market has been introduced briefly.

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