

Islamic Modes of Financing

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The fundamental objective of Islamic finance is to fulfill the teachings of the Holy Quran, as opposed to capitalist approach to get maximum return from financial assets.

The operations of markets based on Riba or unfair contracts, the risk of speculation (Gharar) are inapplicable as the basic principle of the Shariah.

The Holy Quran does not contain any condemnation regarding the investments which are morally acceptable and have the benefits of fair and legitimate profit.

Islamic law reflects the general spirit of Allah's commands that control all the aspects of Muslim life. Islamic finance is directly related to spiritual values and social justice. In Islam there is no separation between religion and the state of business.

Receiving and paying interest is prohibited for Muslims as per the injunctions of Shariah law which prevents vigilant Muslims from involving in prohibited economic transactions.

Some conditions governing Islamic investment can be described as follows:

- Money does not make money in itself, but it is effective only if it involves in a task, activity, or job.
- All the investment must be made on the basis of profit and loss sharing; investment is lawful only in those business activities which are not prohibited.
- There will be no gharar in business contracts, it means that uncertainty, and ignorance and the conditions which lead to disputes are strictly prohibited.

Islamic Modes of Financing:

In pursuant to the judgment of the supreme court on Riba dated December 23, 1999 the commission for Transformation of Financial System was set up in the State Bank of Pakistan. The commission gave approval for the Islamic modes of financing on the basis of Musharaka, Mudaraba, Murabaha, Musawama, Leasing, Salam and Istisna. The Shariah board also gave approval of these financial modes in order to circulate the business of Banks conducting Islamic banking in Pakistan. Details of these essentials are given below.

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- 20 Jean J. Du Plessis, 'Corporate Law and Corporate Governance Lesson from the Past: ebbs and flows, but far from "the end of history...": Part 2' Comp. Law.2009, 30(2) 43-51
- 18 The Act 1856 was repealed by the Companies Act 1862, after that, different committees were established and the new companies' law enactments (Companies Acts: 1890, 1908, 1929, 1948, 1967, 1976, 1980, 1981, 1983, 1985 and 1989) were introduced to overcome the corporate crisis and the issues of corporate governance which rose with the passage of time.
- 19 J.H. Farrar & B.M. Hannigan, (n. 14) 15-25

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- 2 Abu Daud, Sulaiman b. Ash'ath, Kitab-al-Buyu', Bab al-Shirkah, Hadith No. 3477, Dar al-Salam, Riyadh, 1999/ 1420
- 3 The *Hadith* of the Prophet (PBUH) is not only fundamental source of the Islamic Law after the Qur'an but also a source of interpretation of holy *Quran* in a practicable way.
- 4 Abu Daud, Sulaiman b. Ash'ath, Kitab-al-Buyu', Bab al-Shirkah, Hadith No. 3383, Dar al-Salam, Riyadh, 1999/ 1420
- 5 Ibn Qudamah, Abu'Abd Allah, Ahmad b. Muhammad Al-Mughni, Vol: 5, Page 3, Maktabah' Al-Riadh. 1981/1401.
- 6 Companies in Islam (26 Sept. 2007) available on <http://www.khilafah.com/index.php/the-khilafah/economy/1029-companies-in-islam>
- 7 Timur Kuran, 'the Absence of the Corporation in Islamic Law: Origin and Persistence' (2008) Department of Economics, University of Southern California. Los Angeles, USA available on http://dukespace.lib.duke.edu/dspace/bitstream/handle/10161/2546/Kuran_The_Absence_of.pdf?sequence=1
- 8 Timur Kuran, (n. 6) at pp. 8-9
- 9 Timur Kuran, (n. 6) at pp. 9; Joseph Patrich, *Sabas, leader of Palestinian monasticism; a comparative study in eastern monasticism, fourth to seventh centuries*, (Washington, D.C. 1995) 32-33
- 10 Timur Kuran, (n. 6) at pp. 9; S. M. Stern, 'the Constitution of the Islamic City' in A. H. Hourani and S.M. Stern (eds.), *The Islamic City*, (Oxford 1970) at pp. 47-48
- 11 Tirmidhi, Saleh b. 'Abd al-Aziz, Jami' al-Tirmidhi, Bab fi Fazl al-Fiqh 'ala al-'ibadah, page 610, Dar al-Salam linnashr wa-al-taudhi', al-Riadh, 1999/1420.
- 12 Abdulssalam Mahmoud Abu-Tapanjeh, 'Corporate governance from the Islamic perspective: A comparative analysis with OECD principles, Critical Perspective on Accounting 20 (2009) 556-567 at pp. 561
- 13 Al-Jazivi, 'Abd al-Rahman kitab al-Fiqh'ala Madhahib al-arba'ah Vol: 3 Page 63 Dar al-Ihya al-turath al-'arabi, Baivul, p 1369.
- 14 Companies in Islam (26 Sept. 2007) available on <http://www.khilafah.com/index.php/the-khilafah/economy/1029-companies-in-islam>
- 15 Sarakhsi-shams al-Din, Al-Mabsoot, Vol:11 Page 151 Dar al-mu'arif, Bairut,1987/1398
- 16 J.H. Farrar& B.M. Hannigan, Farrar's Company Law, 3rd Ed (Butterworths 1991) 16-18
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1946 and these were based upon changes in the law of England.⁽²¹⁾ However, the new Companies Act 1935 was introduced on the basis of previous statutory developments. The Directors' Liability Act of 1890 created the directors' liability to compensate all shareholders for damages suffered due to their untrue statements.²² The Insolvency Acts (1986, 1994 and 2000), the Company Directors Disqualification Act 1986, and the Enterprise Act 2002 also enacted to govern the insolvency, winding up and directors disqualification proceedings. Now the Companies Act 2006 is enacted that repealed the Companies Act 1985. New Companies Act 2006 is comprehensive in which already legal principle of common law through court decisions also incorporated and codified to bring clarity for business and corporate communities.

Conclusion:

The companies and corporate activities are as old as societies. The corporate and trade activities have direct concern on state economy. That is why; these activities were regulated under the supervision of state authorities rather than individuals themselves. The corporate norms of earlier societies and empires prevailed in the later societies with some modifications that were required with the passage of time. The Roman legal culture is influential in the development of western corporate system but the principles of Islamic law of contract are regarded as comprehensive business arrangements among the business communities and they laid down the basic principle of Islamic and western corporate law through partnership business in which companies are regarded as modern form of partnership or joint-stock companies.

certain privileges by Royal Charter. During 17th century most of these companies started joint stock trade on their members' behalf and these companies also established fixed capital represented by shares which was freely saleable and transferable. At that time, company was incorporated only by Royal Charter or act of Parliament. The first two decades of 18th century witnessed the flood of fraudulent schemes of company flotation and the best example is South Sea Company and an associated company, the Sword Blade Company.(17)

In 1720, the Parliament came down to remedy the deception of investors through Bubble Act. The Act prohibited the use of corporation unless the corporation was authorized by Royal Charter or Act of Parliament but the Act exempted from its application to: 1) all the undertaking established before 24 June, 1718 and, 2) two companies founded by Act; South Sea Company and the East India Company. This particular Act provided the benefits of the South Sea Company in competition with the Bank of England but this company failed and its shares decreased ridiculously.(18) In this crisis, the estates of the directors were confiscated for the benefit of the company. The similarity is found between the recent corporate crises i.e. Enron and HIH Ltd, where several of the directors and officers were prosecuted and jailed. Although the Bubble Act 1720 made impossible for companies to raise further capital by invitations to the public for the next hundred years to 1825 (repeal of the Bubble Act) but it does not destroy the unincorporated companies which continuously formed and freely issued their transferable shares.(19)

In 19th century, two new developments occurred in British corporate law: first, the Joint Stock Companies Act 1844 was enacted- under which any company comprising more than twenty five members with transferable shares might obtain incorporation by registering a deed of settlement executed by its members. Secondly, the Limited liability Act 1855 was passed which provided limited liability of the members of a company.(20) The act was repealed by the Joint Stock Companies Act 1856 that allowed incorporation of the companies with limited liability and introduced the memorandum and articles of association by omitting the provisional registration and deed of settlement. During 1862 to 1907, a number of laws were passed that permitted the alteration of capital, the amendment of the memorandum and articles, as well as registration of private Companies. The Companies Consolidation Act 1908 gathered all the previous laws into single Act. The amendment of the law continued till the Act of 1907. In India, the company laws were introduced in 1850. This was followed by changes in 1857, 1866, 1887 till the law of 1913 which based upon the English Law of 1908. Changes made in this law in

- i. Shirkat al-Amwal by way of mufawadah in which two or more partners invests a sum of money equally in a business with equal footing in their capabilities and share its profit and loss according to agreement and will be responsible for each other transactional acts.
- ii. Shirkat al-Amwal by way of 'Inan in which two partners invest their capital not necessarily with equal proportion of shares and run their business representing each other with no responsibility of loss.

B. *Shirkat al-A'mal or Shirkat al-Abdan* (The Company of Bodies or Labours):

- i. *Shirkat al-A'mal or Shirkat al-Abdan* by way of *mufawadah* in which two or more people come together with their skills such as consultants, doctors, engineers, craftsmen, lawyers and constitute the company with equal proportion of profit and loss and equal responsibility in business transactions.
- ii. *Shirkat al-A'mal or Shirkat al-Abdan* by way of 'Inan in which two or more people come together with their skills such as consultants, doctors, engineers, craftsmen, lawyers and constitute the company with different proportions of shares in profit and loss e.g., $1/3$ and $2/3$ or $1/4$ and $3/4$ or any negotiated settlement.

C. *Shirkat al-Wujooh* (The Company of reputation)

- i. *Shirkat al-Wujooh* by way of *mufawadah* (The Company of reputation) In this type of company, the capital is provided by silent partner and the reputation is used by the active partner both of them will be responsible/liable and having equal proportion of the profit and loss. The partners could be rich merchant having guarantee for payment of debts and the company is backed by the wealthy partners.
- ii. *Shirkat al-Wujooh* by way of 'Inan. In this type of business the capital is provided by the silent partners and reputation, standing and respect is used by the active partner having no responsibility/liability for each other and both of the partners having different proportions shares, profit and loss.(15)

2.2 Evolution of British system of Companies:

The Company or corporate governance is as old as the company or corporate form itself. During the 11th to 13th century associations of merchants called 'Merchant Guilds'. Guild means an association of merchants or crafts people in medieval Europe which was formed to provide counseling to its members and to formulate rules and regulation for trade. They obtained Charter from Crown to secure their members from practices of monopoly. Later on, this trading was known as 'Commenda' or 'Societas'.(16) These Guilds with the passage of time matured into family partnership and then partnership with outsiders. In 14th century, the word 'company' was adopted by certain merchants for trading overseas with

territories. At the time of the Islamic conquests, corporate life was mostly limited to the Roman Middle East territories than Eastern Empires.(10) The Muslims jurists focused on organisational efficiency when classic Islamic legal system took place between 7th to 10th centuries with the possibility that they might have influenced by Roman traditional system under the approval of the Prophet (SAWS) as Islamic law demands that each and every positive/good thing is treasurer of the *mo'min*/muslim, where from he found has the right to use it.(11)

However, the start of Islamic era with the command of Prophet Muhammad (SAWS) led to the formation of Islamic legal system by modifying the existing customary laws of tribes that were immoral and against the Islamic principles rather abolition of previous system and practices as a whole. The Prophet (SAWS) established the norms of state and its political systems of governance. He had given an Islamic legal system to regulate the all sphere of life. Although the Islamic law is presumed comprehensive but it also provides elasticity for legislation to meet-out the needs of society rather than stick on divine law. However, the new legislation should be based on basic principle of Islamic law provided in the *Qur'an* and *Sunnah* of the Prophet (SAWS). Islamic law not only covers the personal affairs of the people but also many aspects of politics, economics, banking, business or contract law and other social issues.(12)

A Company (*Shirkah*) is regarded as an arrangement between two or more people to do some type of work in order to make profit and such profit is distributed among the contractual parties as dividend rather than salary. Islamic law defines *shirkat* or partnership in general as an underlying idea of mixing shares in such a way that one of them cannot be distinguished from the other. *Shirkah* has also been defined as a contract between two or more people for participation in a capital and its profit.”(13) The Islamic Law provides comprehensive frame work for contractual matters which are applied on companies. In Islamic system, the kinds of companies in contractual framework might be defined and classified in following manners:(14)

Shirkat al-'Uqood means two of more people come together making a contract for the investment of their capital and labour or reputation.

It is of three kinds:

- a) *Shirkat al-Amwal*(The Company of Capitals)
- b) *Shirkat al-A'mal* (The Company of Bodies)
- c) *Shirkat al-wujooh* (The Company of Reputations)

Each of the above is sub-divided into two categories i.e., 'Inan (limited) and *mufawadah* (unlimited).

A. *Shirkat al-Amwal*: