

# Islamic Funding Structures And Financing Vehicles

[This article was published in the 10th issue of [Nida'ul Islam](#) magazine, November-December 1995]

---

Islamic banks around the world have devised many creative financial products based on the risk-sharing, profit-sharing principles of Islamic banking. For day to day banking activities, a number of financial instruments have been developed that satisfy the Islamic doctrine and provide acceptable financial returns for investors. Broadly speaking, the areas in which Islamic banks are most active are in trade and commodity finance property and leasing. Some of the basic financial techniques of Islamic banking are the following:

**Murabaha:** This is the sale of a commodity at a price which includes a stated profit known to both the vendor and the purchaser. This can be called a cost plus profit contract. The price is usually paid back by the buyer in deferred payments. Under Murabaha, the Islamic bank purchases, in its own name, goods that an importer or a buyer wants, and then sells them to him at an agreed mark-up. This technique is usually used for financing trade, but because the bank takes title to the goods, and is therefore engaged in buying and selling, its profit derives from a real service that entails a certain risk, and is thus seen as legitimate. Simply advancing the money to the client at a fixed interest rate would not be legitimate. It is important to note that only a legitimate profit in addition to the actual price is considered lawful under Islamic law. Any excessive addition on account of deferred payments will be disallowed as it would amount to a payment based on the value of money over time i.e. interest.

**Mudaraba:** This implies a contract between two parties whereby one party, the *rabb al-mal* (beneficial owner or the sleeping partner), entrusts money to the other party called the *mudarib* (managing trustee or the labour partner). The *mudarib* is to utilise it in an agreed manner and then returns to the *rabb al-mal* the principal and the pre-agreed share of the profit. He keeps for himself what remains of such profits. The following characteristics of *mudaraba* are of significance:

- The division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump-sum or guaranteed return.
- The investor is not liable for losses beyond the capital he has contributed.
- The *mudarib* does not share in the losses except for the loss of his time and efforts.

Briefly, an Islamic bank lends money to a client - to finance a factory, for example - in return for which the bank will get a specified percentage of the factory's net profits every year for a designated period. This share of the profits provides for repayment of the principal and a profit for the bank to pass on to its depositors. Should the factory lose money, the bank, its depositors and the borrower all jointly absorb the losses, thereby putting into practice the pivotal Islamic principle that the providers and users of capital should share risks and rewards.

**Musharaka:** This is a partnership, normally of limited duration, formed to carry out a specific

project. It is therefore similar to a western-style joint venture, and is also regarded by some as the purest form of Islamic financial instrument, since it conforms to the underlying partnership principles of sharing in, and benefiting from, risk. Participation in a musharaka can either be in a new project, or by providing additional funds for an existing one. Profits are divided on a pre-determined basis, and any losses shared in proportion to the capital contribution.

In this case, the bank enters into a partnership with a client in which both share the equity capital- and perhaps even the management - of a project or deal, and both share in the profits or losses according to their equity shareholding.

**Ijara Wa Iktina:** Equivalent to the leasing and installment-loan, hire-purchase, practices that put millions of drivers on the road each year. These techniques as applied by Islamic banks include the requirement that the leased items be used productively and in ways permitted by Islamic law.

**Muqarada:** This technique allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy muqaradah bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders.

**Salam:** A buyer pays in advance for a specified quantity and quality of a commodity, deliverable on a specific date, at an agreed price. This financing technique, similar to a futures or forward-purchase contract, is particularly applicable to seasonal agricultural purchases, but it can also be used to buy other goods in cases where the seller needs working capital before he can deliver.

Besides their range of equity, trade financing and lending operations, Islamic banks world-wide also offer a full spectrum of fee-paid retail services that do not involve interest payments, including checking accounts, spot foreign exchange transactions, fund transfers, letters of credit, travellers' cheques, safe-deposit boxes, securities safekeeping investment management and advice, and other normal services of modern banking.

Almost every Islamic bank has a committee of religious advisers whose opinion is sought on the acceptability of new instruments and who have to provide a religious audit of the bank's end of year accounts.

The concepts of equity and morality are at the root of Islamic banking. In Islam moral and equitable values form an integral part of the rules of law governing contractual and financial relations to such an extent that the relationship which exists between equity, law and religion is an organic rather than supplementary relationship. The importance of Islamic banking has increased dramatically over the past 10 years. The main difference between Western and Islamic-style banking is the concentration on people and their businesses rather than on accounts- it is a much more 'grass roots' banking according to one expert.

---

[\[Islamic Server Home\]](#) / [\[Reference Materials\]](#) / [\[Glossary\]](#) / [\[Other Islamic Sites\]](#) / [\[Email MSA-USC\]](#)