THE MAJOR MODES OF ISLAMIC FINANCE
AND
ISLAMIC CAPITAL ADEQUACY

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ABSTRACT

The word “Modes” literally means “methods”, or in other words, it refers to systematic and detailed rules, stipulations and steps to be followed for accomplishing a specific thing. The thing that needs to be accomplished in this context is, however, the subject matter of each of the said modes, i.e. any of the different types of investment activities (trade, leasing, real estate, manufacturing, agriculture, agriculture production etc., or, using Shariah expressions Murabaha, Mudaraba, Musharaka, Ijarah, Istisna, etc.). The word “Finance” in one of its different meanings refers to the supply of money capital or credit, provided by either a person (household), or an organization (private or public – financial or non financial). The word “Islamic” is inserted in the above expression to restrict the type of rules that can govern different modes of finance to the Shariah rules.
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Islamic Modes of Financing

The prohibition of interest in Islam raises the question of how financial intermediation will take place in an Islamic economy in which also there will be, as in interest-oriented economies, sectors having a surplus or deficit of savings and liquidity. The ease, promptness and economy with which the transfer of funds takes place between these sectors will determine to a great extent the efficiency of the financial system as well as the contribution that it can make to the growth of the economy. While Islam has encouraged a greater reliance on equity and profit-and-loss sharing by prohibiting interest and emphasizing the primary modes of mudarabah (passive partnership), shirkah or musharakah (active partnership), and shares of joint stock companies (which are a combination of both the mudarabah and shirkah forms of financing), it has also allowed certain secondary modes like murabahah (cost plus service charge), ijarah (leasing), ijarah wa iqtina’ (hire-purchase), salam (forward delivery contract), and istisna’ (contractual production), to take care of financial needs that are not amenable to the primary modes.

The primary and the secondary modes should together be able to intermediate efficiently and promptly between the surplus and the deficit sectors and thereby help satisfy all the different types of financial needs of a Muslim economy. The difference between these two sets of financing modes is that in the primary modes, the financier’s rate of return does not get determined in advance and depends rather on the ultimate outcome of the businesss or venture. The financier thereby participates fully in the risks of business. In contrast with this, the rate of return in the case of secondary modes gets stipulated in advance. This may make the secondary modes look similar to interest-bearing instruments. What makes a difference is the conditions that the Shari’ah has imposed for the permissibility of these modes to ensure that, even though the return is fixed in advance, the financier does not get this return without sharing the risk at least to some extent. The well-recognized principal of the Shari’ah is that: “No risk, no gain”, (الغنم بالغرم). The financier has to bear some risk if he wishes to derive an income. If the
conditions imposed by the Shari‘ah are not fulfilled earnestly, the secondary modes may easily degenerate into interest-bearing instruments. There can be no doubt about permissibility in the case of modes where the financier bears the entire risk, and about non-permissibility in the case of modes where the financier transfers the entire risk to the entrepreneur. The secondary modes lie in between the two. One may have to be very careful when pronouncing a judgement about them. Their permissibility would depend on the risk that the financier bears and the extent to which the debtor’s interest is also safeguarded. Therefore, people would be treading on a thin edge while undertaking secondary modes. Although the legal system should try to create safeguards by specifying clearly the conditions that must be satisfied for the permissibility of these modes, the ultimate safeguard would be the financiers’ own conscience. Given below is a brief description of both the primary and the secondary modes.

**THE PRIMARY MODES**

All forms of business organization where two or more persons pool together their financial resources, entrepreneurship, skills and goodwill to do business have been discussed by the fuqaha’ under the general terms of mudarabah and shirkah. Most of the principles indicated below have been derived by the fuqaha’ directly or indirectly from the Qur’an, the Sunnah of the Prophet, and the practice of the sahabah (the Prophet’s companions). It is generally agreed that the essential difference between mudarabah and shirkah lies in whether or not all the partners make a contribution towards management as well as finance or only one of these. The legal discussion of mudarabah is nearly uniform among the different schools of Muslim jurisprudence, with differences mainly on minor details. However, in the case of shirkah, there are some fundamental differences. Hence only the broad principles of shirkah have been outlined below. The major differences have been indicated in footnotes.

*Mudarabah* and *shirkah* are both treated as fiduciary contracts (*‘uqud al-amanah*) in the fiqh literature, and unblemished honesty and fairness are considered absolutely imperative. The partners must act in good faith for the
benefit of the partnership and any effort by partners (or directors of joint stock companies) to cheat and derive an unfair share of income would be in utter violation of Islamic teachings. The Qur’an requires the honest fulfilment of all contracts (al-Qur’an, 5: 1) irrespective of whether these are written or oral, and explicit or implied. It prohibits all betrayal of trusts (al-Qur’an, 8: 27) and considers it immoral to derive any income by cheating, dishonesty or fraud.¹

**Mudarabah**

*Mudarabah* is a form of partnership where one of the contracting parties, called the *sahib al-mal* or the *rabb al-mal* (the financier), provides a specified amount of capital and acts like a sleeping or dormant partner, while the other party, called the *mudarib* (entrepreneur), provides the entrepreneurship and management for carrying on any venture, trade, industry or service with the objective of earning profits. The *mudarib* is in the nature of a trustee as well as an agent of the business. As a trustee he is required to act with prudence and in good faith, and is responsible for losses incurred due to his wilful negligence. As an agent he is expected to employ and manage the capital in such a manner as to generate optimum profits for the *mudarabah* business without violating the values of Islam. The *mudarabah* agreement could also be consummated between several financiers and entrepreneurs.

*Mudarabah* is also synonymously termed *qirad* in which case the financier is called *muqarid*. In general, the *Hanafiyyah, Hanbaliyyah* and *Zaydiyyah* schools of Muslim jurisprudence have used the term *mudarabah* while the *Malikiyyah* and *Shafi‘iyyah* have preferred the term *qirad*.

The *mudarabah* agreement could be formal or informal, and written or oral. However, in view of the Qur’anic emphasis on the writing and formalizing of loan agreements (al-Quran, 2: 282-3), it would be preferable for all *mudarabah* agreements to be in writing, with proper witnesses, to avoid any misunderstanding.

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¹There are innumerable Qur’anic verses and Prophetic *ahadith* which emphasize the characteristics of a Muslim. It is not possible to provide a complete coverage. The interested reader may wish to refer to Chapter 3 of Chapra, 1970 (pp. 25-37), for a brief summary.
Mudarabah contracts could also be unrestricted or restricted. In the unrestricted case, the mudarabah agreement does not specify the period, the place of business, the specific line of trade, industry or service, and the suppliers or customers to be dealt with. A restriction in terms of any one of these renders the mudarabah into a restricted one. In the case of restricted mudarabah, the mudarib must respect the restrictions imposed by the sahib al-mail. If the mudarib acts contrary to these restrictions, he is alone responsible for the consequences. In the case of mudarabah restricted by time, the mudarabah is dissolved with the expiry of the specified time period. In the case of unrestricted mudarabah, the mudarib has an open mandate and is authorised to do everything necessitated by the mudarabah in the ordinary course of business. If he is guilty of wilful negligence, fraud or misrepresentation, he is himself responsible for the consequences, and the resulting loss, if any, cannot be charged to the mudarabah account.

All normal expenses related to the mudarabah business, but not the personal expenses of the mudarib, can be charged to the mudarabah account. The mudarib is not entitled to a fixed remuneration or to an absolute amount of profit specified in advance. His only entitlement beyond the normal expenses of business is to a proportionate share in the profit as a reward for his management services.

The net profit is to be divided between the sahib al-mal and the mudarib in accordance with a just proportion agreed in advance and explicitly specified in the mudarabah agreement. There cannot be a distribution of profits until the losses have been written off and the equity of the sahib al-mal has been fully restored. Any distribution of profits before the conclusion of the mudarabah agreement will be considered as an advance. In the case of a continuing mudarabah, it may be permissible to specify a mutually agreed accounting period for the distribution of profits, treating each period independently. However, it seems that even in such an arrangement, the net loss in any given accounting period would need to be written off by charges against profits in future periods unless the mudarabah agreement has come to
a final conclusion. Hence in the case of a continuing mudarabah, it may be
advisable to build reserves from profits to offset losses.

All losses incurred in the ordinary course of business must be charged
gen losses must however be borne by the sahib al-mal and any
stipulation that it will also be shared by the mudarib would be void and
enforceable. The general principle is that the sahib al-mal risks only his
capital while the mudarib risks only his time and effort. This is probably the
reason why mudarabah is sometimes referred to as ‘partnership in profit’

If it has been agreed that the entire profit will be taken by the mudarib,
then the sahib al-mal would be considered as having given a loan without
interest (qard hasan) and the mudarib would be required to bear all losses and
be responsible for returning the principal to the lender (sahib al-mal) in
accordance with the agreement. The sahib al-mal would in this case bear no
risk and any excess beyond the principal claimed by him as a right would be
equivalent to interest (riba).

If it has been agreed that the entire profit will be taken by the sahib al-
mal, the mudarib will be entitled to the customary remuneration (ajr al-mithl)
for his services. If he decides to forego even the remuneration, the transaction
becomes an ibda‘ or bida‘ah. This has often been the case in history,
particularly when the capital of widows, orphans and charitable institutions
was involved or when services were rendered by businessmen to each other by
way of mutual cooperation.

The liability of the sahib al-mal in a mudarabah contract is limited to
the extent of his contribution to the capital and no more. This is an important
point because it may not be appropriate for the sahib al-mal to be a sleeping
partner if his liability is unlimited. The mudarib is not allowed to commit the
mudarabah business for any sum greater than the capital contributed by the
sahib al-mal. If he does so he is on his own, himself eligible for the profits
from his extra commitments and responsible for the losses, if any. Goods
purchased on credit in the course of normal business operations within the
framework of the general consent of the sahib al-mal in the mudarabah
agreement would be on the responsibility of both the *sahib al-mal* and the *mudarib* in accordance with the principles of *shirkah al-wujuh* (discussed under *shirkah*).

In case the *mudarib* also contributes a specified amount to the capital of the *mudarabah*, he takes the entire profit related to his portion of the total capital, the balance of the profit being divided as agreed. The loss, if any, would be divided among them in proportion to their share in the total capital, for losses, according to the *fuqaha’s*, are an erosion in equity and must be charged to the capital.

The *mudarabah* would become dissolved with the completion of the venture for which it was undertaken, or the expiry of the specified time period, or the death of either the *sahib al-mal* or the *mudarib*, or the serving of notice by either of the two partners of his intention to dissolve the *mudarabah*.

The *mudarib* is required to work with honesty and sincerity and to exercise maximum possible care and precaution in the exercise of his functions. In the words of al-Jaziri, the *mudarib* should discharge his duties like “A Muslim who does not commit a breach of trust, does not lie and does not act insincerely; such is the main with whom the *sahib al-mal* will be at ease and in whom he will have confidence for the safety of his investments. ... The *sahib al-mal* should not give his funds to someone who is unwary, spendthrift or untrustworthy, because the care and safety of wealth are imperatives and its waste and dissipation are prohibited.”

\(^2\)
Shirkah

*Shirkah* (or *sharikah*) refers to partnership between two or more persons. It may be of two kinds: *shirkah al-milk* (non-contractual) and *shirkah al-‘uqud* (contractual).

*Shirkah al-milk* (non-contractual partnership) implies co-ownership and comes into existence when two or more persons happen to get joint-ownership of some asset without having entered into a formal partnership agreement; for example, two persons receiving an inheritance or gift of land or property which may or may not be divisible. The partners have to share the gift, or inherited property or its income, in accordance with their share in it until they decide to divide it (if it is divisible, e.g., land) or sell it (if it is indivisible, e.g., a house or a ship). If the property is divisible and the partners still decide to stick together, the *Shirkah al-milk* is characterised as *(ikhtiyariyyah)*. However, if it is indivisible and they are constrained to stay together, the *shirkah al-milk* is characterized as *(jabriyyah)* (involuntary). *Shirkah al-milk* the essence of which is common ownership of property, cannot be considered a partnership in a strict sense because it has not come into existence by mutual agreement to share profits and risk. Accordingly, it appears in *fiqh* discussions as a peripheral notion.

**Shirkah**

*Shirkah al-milk*  
*Shirkah al-‘uqud*

*khtiyariyyah*  
*Jabriyyah*

*al-Mufawadah*  
*al-‘Inan*  
*al-Abdan*  
*al-Wujuh*

*Shirkah al-‘uqud* (contractual partnership) can, however, be considered a proper partnership because the parties concerned have willingly entered into a contractual agreement for joint investment and sharing of profits and risks. The agreement need not necessarily be formal and written. It could also be informal and oral. However, as indicated under *mudarabah*, it would

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3 According to al-Jaziri, 1938, *shirkah* is classical and preferable, (vol. 3, p. 63).
be preferable if the shirkah al-‘uqud is also formalized by a written agreement with proper witnesses, specifically stating the agreed terms and conditions in conformity with the Qur’anic teachings about loans and important business transactions (al-Qur’an, 2: 282-3). Just as in mudarabah, the profits can be shared in any equitably agreed proportion. Losses must, however, be shared in proportion to capital contributions.4

Shirkah al-‘uqud has been divided in the fiqh books into four kinds: al-Mufawadah (full authority and obligation); al-‘Inan (restricted authority and obligation); al-Abdan (labour, skill and management); and al-Wujuh (goodwill, credit-worthiness and contacts).

In the case of al-mufawadah, the partners are adults, equal in their capital contribution, their ability to undertake responsibility and their share of profits and losses, have full authority to act on behalf of the others and are jointly and severally responsible for the liabilities of their partnership business, provided that such liabilities have been incurred in the ordinary course of business. Thus each partner can act as an agent (wakil) for the partnership business and stand as surety or guarantor (kafil) for the other partners.5

Al-‘Inan on the other hand does not require all partners to be adults or have an equal share in the capital. They need not be equally responsible for the management of the business. Accordingly their share in profits may be unequal, but this must be clearly specified in the partnership contract. Their share in losses would of course be in accordance with their capital contributions. Thus in shirkah al-‘inan the partners act as agents but not as

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4 According to the Shaf‘i school, even profits should be divided in proportion to capital contributions. This is because the contribution of labour (or skill and management) is difficult to measure and it is assumed that labour will be contributed equally. Profits, like losses, should also be in proportion to the risk shared. However, if two partners contribute to the capital and only one of them works, then even according to the Shaf‘i school, the working partner’s share in the profit should be higher. (Ibn Rushd, 1960, vol. 2, pp. 253-45; Al-Marghinani, al-Hidayah, n.d., vol. 3, p. 7.

5 The Hanafi, the Maliki and the Hanbali schools, all recognize mufawadah partnership, with some differences. The Hanafis require that there be equality of the partners in net wealth and that the entire net wealth should enter the partnership business. The Malikis do not consider this to be necessary. They require only the equality of capital contributions (see Ibn Rushd, 1960, vol. 2, pp. 252-5; and al-Sarakhsi, Al-Mabsut, 1978, vol. 11, p. 177).
sureties for their colleagues.\(^6\) Hence their liability towards third parties is several but not joint.

Shirkah al-\textit{abdan}\(^7\) is where the partners contribute their skills and effort to the management of the business without contributing to the capital. In shirkah al-\textit{wujuh} the partners use their goodwill, their credit-worthiness and their contacts for promoting their business without contributing to the capital.\(^8\) Both these forms of partnership, where the partners do not contribute any capital, would tend to remain confined primarily to small-scale businesses.

These are of course models. In practice, however, the partners may contribute not only finance but also labour, management and skills, and credit worthiness and goodwill, and may not necessarily provide these equally. The ‘\textit{inan} form, which implies unequal shares and is recognized by all schools, is more practical and has, therefore, become the most popular and widely used form of partnership. In this case, the profits may be divided in accordance with a contractually agreed proportion, since the \textit{Shari‘ah} admits an entitlement to profit arising from a partner’s contribution to any one of these three business assets.\(^9\) However, the \textit{Shari‘ah} makes it absolutely imperative that losses should be shared in proportion to the contribution made to capital. This is because losses, as already indicated, constitute an erosion in equity according to the \textit{ijma‘} (consensus) of the jurists and must be charged to the capital. If a loss has been incurred in one period, it must be offset against profits in the subsequent periods until the entire loss has been written off and the capital

\(^6\)\textit{Al-Hidayah}, vol. 3, p. 4; see also \textit{Majallah}, Article 1335; and Udovitch 1970, pp. 134-5. ‘\textit{Inan} is the only partnership recognized by the Shafi‘i’s and the partners must share the profits and losses in accordance with their capital contributions (see footnote 4; see also Ibn Rushd, 1960, vol. 2, p. 251; and al-Jaziri, 1938, vol. 3, p. 76).

\(^7\)This is also called \textit{Shirkah al-\textit{a’mal}} (partnership in labour or management), \textit{shirkah al-sana‘ah} (partnership in crafts or art) and \textit{shirkah al-taqabbul} (partnership in contracting).

\textit{Abdan} is the plural of \textit{badan}, which means body, and refers technically to the effort and skills made available by the partners. \textit{Shirkah al-\textit{abdan}} is not recognized by al-Shaf‘i, according to whom \textit{shirkah} arises from the pooling of only financial resources because, as indicated above in footnote 4, the contribution of work and skills cannot be measured precisely and it is assumed that all partners will contribute these equally to the partnership (see Ibn Rushd, 1960, vol. 2, p. 255).

\(^8\)\textit{Wujuh} is the plural of \textit{wajh}, which means face, and refers here to the strengths associated with a person’s own reputation, goodwill and credit-worthiness. \textit{Shirkah al-\textit{wujuh}} or credit partnership is not recognized by the Maliki and Shafi‘i schools (Ibn Rushd, 1960, p. 255).
sum has been restored to its original level. This may be done in one stroke or in instalments depending upon circumstances and the understanding of the partners. However, until the total loss has been written off, any distribution of ‘profits’ will be considered as an advance to the partners. Accordingly, it would be desirable to build reserves from profits to offset automatically any losses that may be incurred in future.

Just as shirkah or partnership may not fall into any one of the specific models indicated above and may be a combination of all three forms, mudarabah may also not fall into the classical category. The real world situation may be a combination of mudarabah and shirkah where all partners contribute to the capital but not to the entrepreneurship and management. In this case profits need not be shared in accordance with capital contributions. They may be shared in any proportion agreed to by the partners, depending on the contribution to the success and profitability of the business. The only requirement of the Shari’ah would be justice, which would imply that the proportional shares of partners in profit must reflect the contribution made to the business by their capital, skill, time, management ability, goodwill and contacts. Anything otherwise would not only shatter one of the most important pillars of the Islamic value system, but also lead to dissatisfaction and conflict among the partners and destabilize the partnership. The losses must, however, be shared in proportion to capital contribution and the stipulation of any other proportion would be ultra vires and unenforceable.

It is important to indicate here that there is no specific direct discussion in the fiqh literature on the nature of the partners’ liability, limited or unlimited, with respect to third parties. This is however, understandable because the nature of liability gains prominence under interest-based loan-financing which makes it possible to raise a large superstructure on a small equity base. In such a situation it is important to know the extent of the equity-holder’s liability. Limited liability helps confine the degree of the equity-holder’s risk to the extent of his share in total equity. However, in an

9 See al-Sarakhsi, 1978, vol. 11, p. 157, and Majallah, Articles 1347 and 1348, and also Article 1371. See also footnotes 4 and 7.
Islamic economy, since all financial participation in business would be essentially in the form of equity, the only exceptions being suppliers’ credits acquired through the secondary modes and *qurud hasanah*, the liability of the partners would in reality be limited to their capital contributions. Prudence would induce the ‘suppliers’ to keep an eye on total equity, movement of sales and cash flows of the business concerned, while *qurud hasanah*, being a charitable extension of credit without interest or share in profit or loss, would tend to be limited. All other participants in the business (whether by way of loan or equity) would be treated as equity holders and would share in the risks of business. Since interest-bearing loans are not allowed, the total obligations of the business could not be out-of-step with the total assets, and any erosion in their value may not exceed the total equity. Hence, in the ultimate analysis liability would essentially be limited to the extent of the total capital (including ploughed-back profits), invested in the partnership business. However, it may be desirable to make this point clear in the legal reform being undertaken in Muslim countries in conformity with their Islamization programme.

**The Corporation**

The corporate form of business organization, with a separate legal entity, does not appear directly in the classical *fiqh* discussions. The closest approximation to the corporate legal entity have been the bayt al-mal (public treasury), mosque property, *awqaf* (trusts), and *mufawadah* partnership. However the fuqaha’ have now in general approved the corporate form on the basis of the *fiqh* principles of *qiyaṣ* (analogy) and *istiḥsān* or *al-maslahah al-mursalah* (public interest). There are of course differences on details, but these need not concern us here.

The corporation should be an important form of business organization in the Islamic system. It provides certain conveniences and advantages not available in other forms of business organization. Some of these are: (i) limited liability of the stockholders, (ii) divisibility and easy transferability of

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11 For a valuable discussion on the subject, see al-Khafif, 1962, pp. 22-7 and 96-7; and al-Khayyat, 1971, vol. 2, pp. 127-256.
ownership, (iii) the absence of *delectus personae* among stockholders (the personal right of partners to choose other partners) such that stock certificates can change hands without the prior approval of other stockholders, (iv) separate legal entity of the corporation apart from its stockholders, enabling the corporation to sign contracts in its own name, to sue and be sued, and to continue its separate existence perpetually irrespective of the turnover of its stockholders.

The concepts of limited liability of stockholders, easy transferability of shares and separate legal entity of the corporation should be perfectly acceptable in an Islamic economy as these do not appear to violate any principles of the *Shari'ah*. These advantages of the corporation would not only provide easily available, and yet ‘liquid’, assets to savers but also make substantially large sums of equity financing accessible to entrepreneurs, which may not be possible if reliance was placed only on *mudarabah* and *shirkah*.

The corporate form of business organization could be made to play a significant role in an Islamic economy after the abolition of interest. However, unlike its counterpart in the capitalist economy, the Muslim corporation should be required to raise most of its financing needs through capital subscription. Nevertheless, the scope for raising short- and medium-term financing through *mudarabah*, *shirkah* and the secondary modes, to be discussed later, should not be ruled out to avoid the over-capitalization of the corporation, to tide over periods of liquidity shortages, and to provide respite until under-capitalization has been removed by the issue of new shares.

The modern corporation constitutes essentially a combination of *mudarabah* and *shirkah al-‘inan*. All shareholders are partners, not necessarily equal, by virtue of their having contributed in varying amounts to the capital of the corporation. In this sense the shareholders wear the hat of the *sahib al-mal*. However, shareholders who act also as directors are like *mudaribs* by virtue of their responsibility for the management of the company. They are agents through whom the company acts. They also occupy a fiduciary position, and

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must act with loyalty and good faith and exercise maximum possible care and skill in the discharge of their responsibilities in the same way as a mudarib is expected to do in his capacity as a trustee. The directors, therefore, wear the hats of both the sahib al-mal and the mudarib.

It would, however, be necessary to regulate the corporations in the light of Islamic teachings to ensure that justice is done to shareholders as well as consumers and to remove the malpractices of corporations. The divorce of ownership from control, particularly in large corporations, leads to malpractices and it would be important to introduce reforms, especially in proxy rules, to safeguard the interests of shareholders. It may be preferable to treat the directors (who are not employees but shareholders) as mudaribs, in which case they would not be entitled to a fixed management fee or remuneration as they are in modern corporations. They can get an agreed extra percentage share in the profit, if any, for their management services, in addition to their normal share in the profit like other shareholders on the basis of their shareholdings. This extra percentage share should be clearly specified in the Articles of Agreement so that it is well known by the shareholders. If the corporation makes a loss, they should get no ‘fee’ for their management services, and should share in the losses in proportion to their stock-holdings. The adoption of this principle may prove to be healthy because the ‘management’ (directors and not employees) should get a reward only if it has contributed to profits.

The directors should also be prevented from making ‘secret’ profits for themselves. They should not be allowed to manipulate share prices or to get an advantage from their insiders’ knowledge of company affairs. The ‘expense account’ of directors should also be controlled in the light of mudarabah principles, allowing them only genuine business expenses and nothing more. These and other necessary reforms should help do away with some of the malpractices that have crept into the corporate form of business. It would also be desirable to prevent the formation of holding companies to avoid the centralization of business and industry in a few corporations leading to concentration of wealth and power.
The reform of stock exchanges would be an indispensable element of the Islamization programme to fit the corporate form of business organization in the Islamic setting.\textsuperscript{13} The objective should be to ensure that share prices reflect underlying business conditions and do not fluctuate as erratically as they do in conventional stock markets. A well-organized and properly regulated stock market would help provide the ‘sane’ secondary market that is necessary to raise the confidence of savers and investors and to enable them to buy or sell shares in response to their circumstances or their perceptions of future market developments. Such ease and convenience in investing and disinvesting should constitute one of the important pillars for supporting the edifice of an interest-free and equity-based economy.

**THE SECONDARY MODES**

Although the primary modes of financing may enable businesses to have access to a substantial amount of capital, particularly if the shares are securitized, they may not necessarily be suitable for all financial needs like the purchase of houses and durable goods for personal use, suppliers’ credits, and leasing of premises and equipment. In most of these, profit-and-loss sharing may either not be feasible or may not be desired by the buyer or the seller. The *Shari’ah* has, therefore, been realistic and allowed a number of secondary modes, all of which are intended to facilitate the sale (or purchase) of goods and services and have, therefore, the word *bay‘* (sale) usually affixed before them. Some of the most prominent of these modes are: *murabahah* and *bay‘ al-mu‘ajjal*, *ijarah*, *ijarah wa iqtina*, *bay‘ al-salam*, and *bay‘ al-istisna‘*. In their classical forms they did not necessarily involve credit except in the case of *bay‘ mu‘ajjal* and *bay‘ al-salam*. However, in their modern formulations they almost invariably involve credit along with an agreed rate of return over the cost. There is a difference of opinion among the *fuqaha‘* on the permissibility of this rate of return, a minority of them being against it and a majority being in favour. The argument of those in favour is that the *Shari’ah* has prohibited interest but allowed trade (al-Qur’an, 2: 275). When the

\textsuperscript{13} For a brief discussion of these reforms, see the section on “A Sane Stock Market” in Chapra, 1985, pp. 95-100; and also Chapra, Summer 1985, pp. 75-81.
financing becomes associated with sale of goods and services, as it does in the case of secondary modes, the return becomes a part of the price and is indistinguishable from profit, which is permitted.14

This raises the question of what makes the rate of return involved in these modes different from interest. As indicated earlier in the introduction, the Shari’ah has imposed certain conditions for their permissibility. If these conditions are not fulfilled honestly, the secondary modes would degenerate into legal devices (hiyal, singular hilah) for dealing in interest. Hence, it is important to fulfil earnestly the conditions that the Shari’ah has imposed with the objective of ensuring that the seller of the good or service on credit also bears a certain amount of risk to be entitled to profit and that the interest of the purchaser is also safeguarded. One of these conditions is that the seller or lessor cannot sell or lease what he or she does not own and possess to be able to give delivery. He must acquire ownership and possession of the good or asset before he can sell or lease it. Once the seller or lessor acquires ownership and possession, he becomes subject to risk. Any agreement to sell or lease before ownership as well as possession have been actually acquired has to be in the nature of an option on the part of both the seller and the buyer. This automatically prevents the sale or lease transaction from becoming a pure financing device. The implications of this may become clear when the secondary modes are discussed in greater detail.

Bay‘ al-Mu‘ajjal and Bay‘ al-Murabahah

In the classical fiqh literature, bay‘ al-mu‘ajjal refers to a sale of goods or property against deferred payment (either in lumpsum or instalments). 15 Bay‘ al-mu‘ajjal need not have any reference to the profit margin that the supplier may earn. Its essential element which distinguishes it from a normal sale is the deferred payment. Bay‘ al-murabahah is one of three different possibilities in a sale. One of these possibilities is murabahah, which stands

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14 See the whole treatise on this issue by al-Misri, 1986, and also 1990. Kahf has also argued that the “prohibition of interest is not a sine qua non to denial of recognition of time value of money” (Kahf, 1994).

15 The Majallah refers to bay‘ al-mu‘ajjal as bay‘ bi al-nasi‘ah or bi al-ta’jil wa al-taqsit. (See Articles 245-51).
for the supply of goods or property by the seller to the buyer at cost plus a
specified profit margin mutually agreed between them. The terms of payment
in the classical *murabahah* did not necessarily involve credit; they could be
either cash or credit. The other two possibilities are sale at cost price without
any profit for the seller (*tawliyah*), and sale at a specified loss (*wadi’ah*). All
three possibilities are perfectly legal from the point of view of the *Shari‘ah*. Since all the three forms require an honest declaration of the cost, they are
referred to in the *fiqh* literature as *buyu‘ al-amanah* (fiduciary sales).

However, in their modern usage, both the terms (*Bay‘ al-mu‘ajjal* and
*bay‘ al-murabahah*) are an extension over their classical sense. They involve
an agreed rate of return as well as credit and are used synonymously (the
former in Pakistan and the latter in other countries, particularly the Arab
world). They are used to refer to an agreement where the bank purchases the
goods or property desired by its customer, who is seeking financing for their
purchase, and then sells them to the customer at an agreed price which yields a
specified margin of profit to the bank, the payment being settled by the
customer within an agreed time frame either in instalments or lumpsum.16
Sami Hamoud has referred to it as *bay‘ al-murabahah li al-amir bi al-shira’*
(sale of goods at an agreed margin of profit to one who has ordered their
purchase).17 It is however popularly referred to as *al-murabahah* and is being
widely used by the Islamic Development Bank for its foreign trade financing
operations and also by almost all Islamic banks established so far.

*Bay‘ al-mu‘ajjal* and *bay‘ al-murabahah* are perfectly legitimate
transactions according to the *Shari‘ah*, provided that the risk of the transaction
is borne by the financier until the possession has been passed to the customer.
For such a transaction to be legal, the bank must sign two separate contracts,
one with the supplier and the other with the customer. It would not be lawful
for the bank to have only one contract with the purchaser, the only service
rendered by it being the remittance of the amount to the supplier on behalf of

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17 Homoud, 1976, pp. 476-83. For valuable information on *murabahah*, particularly with
respect to the differences among the various schools of *fiqh*, see al-Ba‘li.
the purchaser. In this case the transaction would not be different from an interest-based financial arrangement. In addition to the dual contract, the bank must continue to be responsible until the goods have been actually delivered to the customer, not necessarily by the bank, in accordance with specifications and other terms of the contract. Some of the fuqaha’ (Shari‘ah scholars) insist that the customer should enjoy the ‘option’ (khiyar) until the goods have been actually delivered to him.¹⁸ Most other scholars do not consider this to be necessary. However, if the option is also available to the customer, murabahah would be unanimously acceptable.

Is it possible for the banks to provide the option? Perhaps. Exception may be where the customer is the only or the predominant user of the commodity, because in this case the bank may not be able to sell the goods in case the customer decides not to buy the goods obtained by the bank for him. In case of option, however, the bank would be carrying a much larger risk and may have to carry out, before agreeing to the financing, a more intensive market survey than may be possible for most Islamic banks in their present state of infancy and small size. To avoid the risks involved in a non-binding option, what the banks are doing in practice is to make the customer as their agent for the purchase of the goods as well as for taking delivery from the supplier.

It may not be desirable to make the task of Islamic banks extremely difficult from the very beginning, provided that there is a clear understanding that they would move more and more in the classical direction and do not get grounded, as feared by Siddiqi, in the ‘status quo’.¹⁹ The danger will, however, always remain that bay‘ al-mu‘ajjal and bay‘ al-murabahah forms of financing may deteriorate into purely financing arrangements with the agreed profit margin being no better than a camouflage for interest. Accordingly the

¹⁸ Al-Misri, 1402, AH., pp. 179-89; see also al-Ba‘ili, pp. 58-63. Some Islamic banks, particularly the Faisal Islamic Bank of Sudan, allow the option to their customers
Pakistan Council of Islamic Ideology has rightly stressed that it would not be advisable to use it widely or indiscriminately.\(^{20}\)

One of the most difficult problems faced by Islamic banks is the delay by their customers in settling their financial obligations under the *bayʿ al-murabahah* and *bayʿ al-muʿajjal* modes. In the conventional banking system, a delinquent customer has to reschedule his debt, usually at a higher rate. The additional interest cost to the customer may motivate him to pay on time. The question, therefore, is how to take care of the problem of deliberate delays in payments in the Islamic financial system. A number of opinions have been expressed on this subject, but so far there is no consensus.\(^{21}\)

The extreme view allows only imprisonment to serve as a deterrent, if the delay is unjustified, but prohibits any monetary penalty on the defaulter, or compensation to the aggrieved party, for fear that this may become equivalent to interest. Although the imprisonment may serve as a deterrent to unjustified delay in payments, it would not provide any relief to the aggrieved party which has suffered damage and loss of income. The liberal view, however, allows the imposition of a financial penalty on the debtor who delays payment without any justification, to serve as a deterrent, but allows it to be made available to the aggrieved party as compensation only if the penalty is imposed by a court. However, even in the case of a court decision, there are two different views. If the penalty is imposed by a court, it can be made available to the aggrieved party as compensation. One view permits the court to determine compensation for the damage caused by late payment as well as the loss of income suffered by the aggrieved party. The other view allows the court to determine compensation for only the actual damage but not for the loss of income. If the penalty is not determined by a court, then the proceeds must be utilized for charitable objectives only and cannot be made available as compensation to the aggrieved party. Given the present-day judicial structure

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\(^{20}\) The Council's Report, 1980, p. 15

\(^{21}\) For a range of opinions expressed on the subject, see M. A. Zarqa and M. A. El-Gari, 1991, pp. 25-57 as well as the comments by M. Zaki ʿAbd al-Barr, and Habib al-Kaf, on pp. 61-64 of this same issue, and by Rabiʿ al-Rubi on pp. 67-69 of the 1992 issue of the same Journal.
of Muslim countries, the requirement of a court decision for the sake of compensation to the aggrieved party may not be practical because court decisions usually take several years and involve a substantial litigation cost. Therefore, some mechanism needs to be devised to promptly penalize the party guilty of unjustifiable delay in payment and to compensate the aggrieved financier. Specialized banking tribunals that Pakistan has introduced may be a way out of this problem.

**Leasing (Ijarah, Kira')**

There are different types of leasing, and the permissibility of any one of them would depend essentially on whether the terms and conditions of the lease are in conformity with the Shari'ah. Discussed below are the operating lease, the financial lease and the security lease.

**Operating Lease**

The kind of leasing which the fuqaha' have generally discussed in the classical fiqh literature, and about the permissibility of which there is no doubt, is what is now called the operating lease. In this case the owner of an asset, the lessor (mu'jjir, or mukari, مؤجر, مکاری) allows another party, the lessee (musta'jir, مستأجر), to have the use (manfa'ah, منفعة) of the leased asset (ma'jur, مأجر) in return for compensation (ajr or 'iwad, أجر, عوض). The operating lease distinguishes itself from other forms of leasing in a number of ways. Firstly, the lessor is himself the real owner of the leased asset and, therefore, bears all the risks and costs of ownership. All defects which prevent the use of the equipment by the lessee are his responsibility, even though it is possible to make the lessee responsible for the day-to-day maintenance and normal repairs of the leased asset. Secondly, the lease is not for the entire useful life of the leased asset but rather for a specified short-term period (a month, a quarter, or a year) and ends at the end of the agreed period unless renewed by the mutual consent of both the lessor and the lessee. The entire risk is thus born by the lessor.

Financial Lease or Hire Purchase *(Ijarah wa Iqtina’)*

Since the entire risk is borne by the lessor in the operating lease, there is a danger of misuse of the leased asset by the lessee. The financial lease helps take care of this problem by making the lease period long enough (usually the entire useful life of the leased asset), to enable the lessor to amortize the cost of the asset with profit. At the end of the lease period the lessee has the option to purchase *(iqtina’)* the asset from the lessor at a price specified in advance or at its market value at that time. The lease is not cancellable before the expiry of the lease period without the consent of both the parties. There is, therefore, little danger of misuse of the asset.

A financial lease has other advantages too. The leased asset serves as security and, in case of default on the part of the lessee, the lessor can take possession of the equipment without court order. It also helps reduce the lessor’s tax liability due to the high depreciation allowances generally allowed by tax laws in many countries. The lessor can also sell the equipment during the lease period such that the lease payments accrue to the new buyer. This enables the lessor to get cash when he needs liquidity. This is not possible in the case of a debt because, while the Shari’ah allows the sale of physical assets, it does not allow the sale of monetary debts except at their nominal value.

Some of the fiqhah have expressed doubts about the permissibility of financial lease. The rationale they give is that the long-term and non-cancellable nature of the lease contract shifts the entire risk to the lessee, particularly if the ‘residual’ value of the asset is also fixed in advance. The end result for the lessee may turn out to be worse than the outright purchase of the asset through an interest-bearing loan. A financial lease has thus the potential of becoming more exploitative than outright purchase. Suppose the lease contract is for five years. The lessee would have to continue making lease payments even if he does not need the asset, say, after two years. In the case of a purchase through an interest-bearing loan, the purchaser can sell the asset in the market and repay the loan, thus reducing his loss. This he cannot do in a financial lease. If he is unable to make lease payments, he may lose his
stake in the asset even through he has paid a part of the asset price beyond the rental charge he would normally pay in an operating lease.

However, there are *fuqaha*’ who consider financial lease to be permissible if certain conditions are satisfied. Firstly, the lessor must bear the risks of leasing by being the real owner of the leased asset. He cannot lease what he does not own and possess, and should be responsible for all the risks and expenses related to ownership. Therefore, a leasing contract where the lessor acts only as an intermediary between the supplier and the lessee and plays the role of only a financier, with ownership of the asset being nothing more than a legal device to provide security for repayment of the loan and legal protection in case of default, is not allowed. In this case the lessor leases an asset before buying it and taking possession of it, and gets a reward without bearing any risk. Secondly, lease payments cannot start until the lessee has actually received possession of the leased asset and can continue only as long as it remains usable by him. Thirdly, all manufacturing defects and other problems which are beyond the control of the lessee, should be the lessor’s responsibility. The lessee can, however, be made responsible for the proper upkeep and maintenance of the leased asset. Fourthly, the lease contract should be separate from, and independent of, the contract for the purchase of the residual asset. The residual value has to be market-related and cannot be fixed in advance. The purchase contract has, therefore, to be optional and cannot be binding because the quality of the asset at the end of the lease period as well as its market-related price, two of the essential requirements for a valid contract, are unknown when the lease contract is signed.

All Islamic banks as well the Islamic Development Bank use the financial lease by fulfilling, or at least making an effort to fulfil, the *Shari’ah* conditions. The residual value remains a problem but the banks have tried to overcome it by setting a small nominal value for the residual asset or transferring it as a gift from the lessor to the lessee. This does not, according to some *fuqaha*’, fulfil the *Shari’ah* requirement because the residual value gets automatically predetermined and becomes built into the lease payments.
Security Lease

The security lease (also referred to as ‘financing’ lease) is not acceptable from the point of view of the Shari‘ah because it is not a lease in the traditional sense; it is just a financing transaction, and nothing more than a disguised security agreement. It involves the effective transfer to the lessee of all the risks and rewards associated with ownership. The security lease has, therefore, to be ruled out from Islamic finance.

Bay‘ al-Salam

In contrast with the murabahah sale, where the delivery of goods is made by the supplier in advance and the payment is deferred, the salam sale involves advance payment by the purchaser and deferral of the delivery of goods. This is an exception to the general Shari‘ah rule that you cannot sell what you do not own and possess. Its permissibility is, however, based on the Qur’an, Sunnah and Ijma ‘(consensus) and is applicable to all fungible agricultural, industrial and other goods provided that the price of the commodity and the time and venue of delivery are clearly specified at the time of agreement to remove any possibility of uncertainty and dispute. It serves a useful purpose by enabling producers to acquire financing for different working capital needs.

Bay‘ al-Istisna‘

This is also an exception to the general prohibition against selling what one does not own and possess. It refers to a contract whereby a manufacturer agrees to produce and deliver a certain agreed good in specified quantity on a given date in the future. The price gets fixed in advance but need not be paid at the time of the agreement as is necessary in a salam transaction. The price may be paid in instalments in step with the progress of the work (a house, a building, or a factory) or partly at the front end and the rest at the time of delivery.
CAPITAL ADEQUACY

IFSB sets out the requirements for calculating the minimum regulatory capital requirements for credit, market and operational risks.

The Standard covers minimum capital adequacy requirements based predominantly on the standardised approach in respect of credit risk and the basic indicator approach for operational risks of the IIFS, with respect to Pillar 1 of Basel II, and the various applicable measurement methods for market risk set out in the 1996 Market Risk Amendment. The IFSB is aware of the fact that some IIFS are progressively improving their risk management practices to the extent that they will be in a position to meet the requirement for applying the internal models approach for measuring their risk exposures. While this Standard stops short of explaining approaches other than the standardised approach, supervisory authorities are welcome to use other approaches for regulatory capital purposes if they have the ability to address the infrastructure issues adequately. The IFSB will monitor these developments and plans to consult the industry in the future and eventually to make any necessary revisions.

The Standard does not address the requirements covered by Pillar 2 (Supervisory Review Process) and Pillar 3 (Market Discipline) of Basel II as these two issues will be covered by separate standards.

Some IIFS may use different product names or contract titles as part of their market differentiation or a commercial expression. While it is not the intention of the IFSB to require IIFS to change the way they manage the business and risks, IIFS are required to use the substance of the Shari’ah rules and principles governing the contracts of these instruments to form the basis for an appropriate treatment in deriving their minimum capital adequacy requirements.

The minimum capital adequacy requirements for IIFS shall be a CAR of not lower than 8% for total capital. Tier 2 capital is limited to 100% of Tier 1 capital.

In calculating the CAR, the regulatory capital as the numerator shall be calculated in relation to the total risk-weighted assets as the denominator. The total of RWA is determined by multiplying the capital requirements for market risk and operational risk by 12.5 (which is the reciprocal of the minimum CAR of 8%) to
convert into risk-weighted equivalent assets, and adding that resulting figures to the sum of RWA computed for credit risk.

The Shariah rules and principles whereby IAH provide funds to the IIFS on the basis of profit-sharing and loss-bearing Mudarabah contracts, or on the basis of agency for an agreed upon fee, instead of debt-based deposits, i.e. lending money to the IIFS, would mean that the IAH would share in the profits of a successful operation, but could also lose all or part of their investments. The liability of the IAH is exclusively limited to the provided capital and the potential loss of the IIFS is restricted solely to the value of its work. However, if negligence, mismanagement, fraud or breach of contract conditions can be proven, the IIFS will be financially liable for the capital of the IAH. Therefore, credit and market risks of the investment made by the IAH shall normally be borne by themselves, while the operational risk is borne solely by the IIFS.

IFSB minimum regulatory capital calculation is primarily focused on

- Credit Risk (Standarised Approach)
- Market Risk (Standarised Approach Basel I)
- Operational Risk (Basic Indicator Approach)

**CAPITAL RATIO FORMULA**

Standard formula

\[
\text{Eligible Capital} = \left\{ \frac{\text{Total Risk-weighted Assets (Credit+ Market Risks) Plus Operational Risks}}{\text{Less}} \right\} - \text{Risk-weighted Assets funded by PSIA (Credit + Market Risks)}
\]
CREDIT RISK

Credit risk exposures in Islamic financing arise in connection with accounts receivable in Murabahah contracts, counterparty risk in Salam contracts, accounts receivable and counterparty risk in Istisna contracts and lease payments receivable in Ijarah contracts, and sukuk held to maturity in the banking book. In the standard, credit risk is measured according to the Standardised Approach of Basel II, as will be discussed below, except for certain exposures arising from investments by means of Musharakah or Mudarabah contracts in assets in the banking book. The latter are to be treated as giving rise to credit risk (in the form of capital impairment risk), and risk-weighted using the methods proposed in Basel II either for “equity exposures in the banking book” or, at the supervisor’s discretion, the supervisory slotting criteria for specialised financing.

The assignment of RW shall take into consideration the followings:

- The credit risk rating of a debtor, counterparty or other obligor, or a security, based on external credit assessments. The IIFS are to refer to their supervisory authorities for eligible external credit assessment institutions (ECAI) that are to be used in assigning credit ratings for the purpose of calculating credit risk weights;

- credit risk mitigation techniques adopted by the IIFS;

- types of the underlying assets that are sold and collateralised or leased by the IIFS; and

- Amount of specific provisions made for the overdue portion of accounts receivable or lease payments receivable.

The IIFS shall disclose the names of the ECAI that it has used for the purpose of assigning RW to its assets. If there are two assessments by ECAI chosen by an IIFS which map into different risk weights, the higher risk weight will be applied. If there are three or more assessments with different risk weights, the assessments corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights will be applied.
Banks already authorised by the supervisory authority to use IRB for credit risk in their conventional banking business may, at the supervisor’s discretion, be allowed to do so for their Islamic banking business.

**Market risk**

Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices. The risks in IIFSs that are subject to the market risk capital requirement are:

- Equity position risk in the trading book, and market risk on trading positions in *Sukuk*;
- Foreign exchange risk; and
- Commodities and inventory risk.

**Equity Position Risk (including *Sukuk* held for trading)**

The capital charge for securities in IIFSs’ trading book comprises two charges that are separately calculated for the following types of risk:

(a) **Specific Risk**

The capital charge for specific risk is 8% on all long equity positions and must be calculated on a market by market basis (for each national market). The capital charge can be reduced to 4% for a portfolio that is both liquid and well diversified, subject to criteria determined by the supervisory authorities.

(b) **General Market Risk**

The capital charge for general market risk is 8% on all long equity positions. These positions must be calculated on a market by market basis (for each national market).

(c) In the case of *Sukuk* in the trading book, the provision for **specific risk** charge will depend on the RW of the issue and the term to maturity of the *Sukuk*, as follows:
* Supervisory authority has the discretion to apply a different specific risk weight to sukuk issued by certain foreign government.

**Capital Adequacy**

The risk weighted assets to capital ratio, calculated in accordance with the State Bank of Pakistan guidelines on Capital Adequacy was as follows:

<table>
<thead>
<tr>
<th>Regulatory Capital Base</th>
<th>Rupees in 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tier I Capital</strong></td>
<td></td>
</tr>
<tr>
<td>Shareholders Capital</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Reserves</td>
<td>-</td>
</tr>
<tr>
<td>Accumulated loss</td>
<td>(8,354)</td>
</tr>
<tr>
<td><strong>Total Tier I Capital</strong></td>
<td>1,991,646</td>
</tr>
<tr>
<td><strong>Tier II Capital</strong></td>
<td></td>
</tr>
<tr>
<td>Subordinated Debt (upto 50% of total tier I Capital)</td>
<td>-</td>
</tr>
<tr>
<td>General Provisions Subject to 1.25% of total risk weights asset</td>
<td>1,001</td>
</tr>
<tr>
<td>Revaluation Reserve (upto 50%)</td>
<td>5,621</td>
</tr>
<tr>
<td><strong>Total Tier II Capital</strong></td>
<td>6622</td>
</tr>
<tr>
<td><strong>Total Regulatory Capital</strong></td>
<td>1,998,268</td>
</tr>
</tbody>
</table>
## Risk-Weighted Exposures

<table>
<thead>
<tr>
<th>Credit Risk</th>
<th>Exposure PKR'000</th>
<th>RWA PKR'000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>On Balance Sheet Items:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and Other liquid Assets</td>
<td>1,128,931</td>
<td>158,142</td>
</tr>
<tr>
<td>Due From Financial Institution</td>
<td>412,131</td>
<td>412,131</td>
</tr>
<tr>
<td>Investments</td>
<td>493,008</td>
<td>231,132</td>
</tr>
<tr>
<td>Financings</td>
<td>959,133</td>
<td>927,872</td>
</tr>
<tr>
<td>Fixed Assets</td>
<td>441,428</td>
<td>441,428</td>
</tr>
<tr>
<td>Other Assets</td>
<td>590,043</td>
<td>542,366</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,024,674</strong></td>
<td><strong>2,713,071</strong></td>
</tr>
<tr>
<td><strong>Off Balance Sheet Items:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan Repayment Guarantees</td>
<td>113,018</td>
<td>113,018</td>
</tr>
<tr>
<td>Purchase and Resale Agreements</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Performance Bond etc</td>
<td>109,880</td>
<td>54,940</td>
</tr>
<tr>
<td>Revolving Underwriting Commitments</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Stand By Letter of Credit</td>
<td>185,809</td>
<td>92,905</td>
</tr>
<tr>
<td>Outstanding Foreign Exchange Contracts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Purchase</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>- Sale</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>408,707</strong></td>
<td><strong>260,863</strong></td>
</tr>
</tbody>
</table>

**Credit Risk-Weighted Exposures** | **2,973,934**

## Market Risk

<table>
<thead>
<tr>
<th></th>
<th>Exposure PKR'000</th>
<th>RWA PKR'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Market Risk</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Specific Market Risk</td>
<td>19,896</td>
<td>248,700</td>
</tr>
</tbody>
</table>

**Market Risk-Weighted Exposures** | **248,700**

**Total Risk-Weighted Exposures** | **3,222,634**

**Capital Adequacy Ratio “CAR”%** | **62.00729**
CONCLUSION

Financing through a Musharaka partnership is investment-based. The capital provider has full control in the management of the business. In addition, he shares proportionately in both the profits and losses of the business. Therefore, the rate of return is uncertain and can be either positive or negative. The cost of capital is also uncertain and there exists perfect correlation between the relationship of cost of capital and rate of return on capital.

It is an investment-based form of financing. The provider of capital in Mudaraba has no role in the management of the capital. However, he has to bear the risk of capital loss as well as the opportunity cost of capital for the entire period of the contract. The rate of return is quite uncertain and the cost of capital is also uncertain. Hence, there is a perfect correlation between cost of capital and rate of return on capital.

The Bai Salam agreement is a combination of debt and trading. The capital provider has no control over the management of capital provided. However the capital provider takes all of the risk as profits cannot be determined until the commodity is delivered and the final sale price is determined. In addition the capital provider incurs the opportunity cost associated with the capital outlay. Like the other three previously discussed modes of finance there is no certain rate of return. In addition the cost of capital is uncertain ex-ante. Also, there is no correlation in the relationship of cost of capital and rate of return on capital.

Minimum capital standards are thus a vital tool to reducing systemic risk. They also play a central role in how regulators supervise financial institutions. But capital requirements have so far tended to be simple mechanical rules rather than applications of sophisticated risk-adjusted models.
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