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Turkey: Basics Of Islamic Finance And Islamic Contracts

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There is a general misunderstanding in the Western (Christian) world about Islamic Finance Contracts and Islamic Finance that is based on assumptions that have no foundation whatsoever.

Most are wary of the topic and only vaguely familiar with the issue. Any evaluation is often limited to the discussion to the making of interest in the context of Islamic Finance.

Since the Islamic world always refers to the QUR'AN as containing the very words of God (whereas the BIBLE is considered to be comprised of the words of God as narrated by human beings), and by consequence uses those words as the true basis of behavior in daily life, the Western world perceives the Islamic World to be a massive, non- evolving structure and not adapted to the needs of the modern world. This is clearly not the case.

Islamic Contracting and Finance are based on "asset based finance", "partnership" and "shared risk and reward" in order to avoid the pure and simple lending of money. It also has a basic ethical understanding which is actually quite universal (for example: no investment in gambling, prostitution, arms factories...). However, generally, doing business and making profits are allowed and even encouraged. The surplus thus created should be used to support the family and to distribute equitably amongst the destitute.

The combination of those rules gives raise to special types of contracts, special clauses and restrictions. Contracts should be clear and transparent, free of uncertainties and gambling and the rights and obligations of the parties should be equitably divided.

In Islamic Finance, (1) contracts for partnerships and (2) specific sales contracts are the "basic daily tools" of which a lawyer should have knowledge and that can often be easily introduced one's own legal framework, respecting the specific restrictions of the Islamic way of thinking. Most problems are related to the fact that some areas of the Western legal framework (such as lending contracts) are not yet adapted to the use of Islamic contracts (ex. tax incentives are mostly rewarded to "lending structures" and less to partnerships).

As set forth above, Islamic thinking is not static, but on the contrary, is always evolving. Interpretations of rules therefore can be different, both in time and place, in different parts of the world. As a result, the information contained herein is a very basic introduction.

First we explain some interesting points of "asset finance".

***Murabahah* (sale with or without deferred payment)**

The *MURABAHAH*-contract basically is a simple sales contract where the transaction is concluded at one point in time, but the payment can be deferred to a later time ("*Bai'mu'ajjal*" variation).

The *MURABAHAH*-contract then is NOT a loan (and certainly not in violation to the prohibition interest), but a pure sale. The sale is concluded against a fixed price (early or late payment is acceptable) that may give rise to a "mark up" as any other conditions to the sale can be (delivery at another place, packaging, etc.) and whereas installments can be agreed upon.

When there is the involvement of an Islamic Finance Institution, the latter one will acquire the commodity first and then sell it to the client with (or without) deferred payment.

***Ijarah* (lease agreement)**

The *IJARA* can best be described as the Islamic version of the western style lease: Transfer of the usufruct only: The risk and liabilities associated with the use of the asset will be borne by the Client.

All the risks and liabilities connected with the ownership (loss, destruction ...) of the assets rest with the Owner / Financial Institution.

The *IJARA* can become a "*Ijarah wa Iqtina*" (financial lease) when the User/Client has the right to acquire the commodity at the end of the lease period.

***Salam* (sale of future goods or forward)**

Another contract that is used for financing is the "*BAI AL SALAM*" (in short *SALAM*).

One of the basic rules for Islamic Contracting is that nothing can be sold that does not already exist.

This contract form was basically intended to finance agricultural exploitations and is used in this manner to allow farmers to receive financing to assist in the development of crops.

Therefore, contracting over future goods is allowed, but quantity, quality and time of delivery have to be specified. The

commodity must be composed of units with homogenous characteristics and which are traded by counting, measuring or weighing according to usage and customs of trade (excluding precious stones of which quality can differ). Payment must be immediate and instant buy-back in general is not allowed.

***Istisna* (sale of future goods – to be manufactured or forward)**

ISTISNA' in many regards appears the same as a *SALAM*, with the difference that *ISTISNA'* always relates to commodities that are to be manufactured.

The Manufacturer sells the yet-to-be-made commodity to the Buyer/Financial Institution.

The difference between *SALAM* and *ISTISNA'* is that:

- the payment of the price is not necessarily immediate (deferred payment possible)
- and individualized goods can be envisaged.

If the Manufacturer is acquiring the goods that he will use to make the commodity from the Buyer / Financial Institution - and therefore his only contribution really is his labor, then an *ISTISNA'*-contract in general is not permissible (the *IJARAH* or rent of labor contract is then used).

***Musharakah* (ordinary partnership)**

This partnership refers to a joint business enterprise in which the partners (two or more persons) undertake to share all the profit/losses of the venture. The way profit will be shared must be agreed at the outset and any periodical advance for one or more partners will be off-set at the settlement of the accounts.

The profit sharing has to be in relationship to the input of capital, but it can be agreed that one partner gets a bigger share (ex. Provides more labor) provided that a non-working partner to the *MUSHARAKAH* (the "silent partner" or capital provider) is always granted a maximum of the ratio linked to his input in capital.

It is impermissible to establish a fixed and guaranteed return to be allocated to a partner; since it would suggest the loan of money and/or would mean that a partner does not take his share in possible losses.

Buy-out clauses (unit per unit) can be built into a contract, preferably at market price or at historic value. Consequently, one partner will slowly buy out the other partner. This technique sometimes is used for investment purposes, where the Financial Institution partners up with a Client, leases the good to the Client (through *IJARA*) and slowly exits the project.

***Mudarabah* (trust financing – limited partnership)**

In this type of partnership, a silent partner "*rabb al-mal*" only invests money and a working partner (or working partners) "*mudarib*" only invests his labor. This arrangement is most commonly used when the Client needs capital input from the Financial Institution.

The "*mudarib*" will manage the partnership for all matters that concern the normal course of business. Besides his labor, he suffers no loss (excluded responsibility for fraud, negligence, misconduct or willful wrongdoing or contravention of his mandate). He can be rewarded an agreed upon portion of the profit, wherein advances are allowed, which are likely subject to ultimate pay back would the project fail. The "*rabb-al-mal*" risk is limited to capital he invests.

Though it will take some time to get used to the different contract combinations within Islamic Finance, the attentive reader will sense that this is nothing new. After all ... a sale is a sale. Provided that the lawyer is aware of the "does and don'ts" and the rationale behind those rules, Islamic Contracting can easily be adapted to most finance, corporate and construction needs. The ethical conditions moreover make it more "clean" contracting than conventional ones and the need for basic rules of this kind is felt worldwide.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Specific Questions relating to this article should be addressed directly to the author.



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