

Rahn Services Offered by Contemporary Islamic Financial Institutions: Challenges and Prospects

*Tahira Ifraq

Abstract

The Islamic Financial Institutions are introducing Riba free Shariah compliant mortgage schemes. They are relying on Ijārah, Mushārahah, Murābahah and Mudārahah mortgage models to provide services to the Muslims, especially in the western countries. These models are providing Muslims not only opportunities for Riba- free mortgages but it also satisfied their desires of compliance with Shariah rulings in business transactions.

The present research is aimed to deals with major prospects and challenges of Shariah compliance mortgages schemes. The study will begin with a brief look at rulings of Shariah on rehan. These rulings are related to redemption, sale, destruction, loss, accession to the Property and use of Pledge Property. Then an overview of the conventional and Shariah compliance Mortgages models have been presented. The third part of the study highlighted the rehan services that are presently offered by Islamic Financial Institutions. It is followed by a detailed discussion related to the challenges that are faced by Islamic financial institutions. Finally, in the light of prevailing ambivalent scholarship on Islamic Finance, reconditions related to effeteness of Riba free rehan schemes are presented in the conclusion.

Keywords: Rahn Services, Islamic Financial System, Islamic Institutions.

Introduction:

Islamic Financial Institutions have started developing during last few decades. They have introduced many *Shariah* compliant products in the financial market and *Rahn* is also one of them. Financial institutions are using *rahn* as a guarantee for other products and services, but some of them are offering it as an independent product also. Both moveable and immovable property is subject-matter of *rahn*. It is very important to mention that *rahn* or security is voluntary charitable contract; it is not a profitable business for creditor. All the rules governing *rahn* will be applicable on *rahn* provided by Islamic Financial Institutions.

Security or collateral plays an important role in any financial transaction because it guarantees and insures performance of contract and secures it from possible breach or default. Secure creditor is having priority over other unsecured creditors at the event of bankruptcy or insolvency. Therefore, he enjoys secured position, his rights or interests are protected under law.

*PhD scholar at Faculty of Shariah & Law, International Islamic University, Islamabad.

1. Rulings of *rahn* in Islamic law

The institution of *rahan* has importance in Islamic Financial Laws from early days of Islam. During the period of compilation of Islamic law this institution was of the prime importance for the development of detailed Islamic financial laws. Muslim jurists have given rulings for regulating procedure of *rahn*.

They have derived their rulings regarding matters such as redemption, sale, destruction, loss, accession and use of pledged property. Some details of the rulings of Muslims Jurists are discussed in this section.

Islamic Law on Redemption and Sale:

The pledger is the owner of pledge property and through the contract of pledge; he has transferred possession, not the title of the property. It is lawful for the pledger to redeem back his property upon giving full payment of debt to the pledgee.

Allah says in *Qur'an*:

فَإِنْ أَمِنَ بَعْضُكُم بَعْضًا فَلْيُؤَدِّ الَّذِي أُؤْتِمِنَ أَمَانَتَهُ وَلْيَتَّقِ اللَّهَ رَبَّهُ

[And if one of you deposits a thing on trust with another, let the trustee discharge his trust, and let him fear his lord.]¹

Holy Prophet (P.B.U.H) also said:

(Security cannot be foreclosed, it is for the owner and its *ghunm* and *ghurm* belong to the pledger).²

This *Hadith* shows that the pledger is the real owner of pledged property. It also means that pledge asset should be kept safe and would not be used wrongly by the pledgee so that, it may be able to redeem back to the owner.³ Imam *Abū Hanifah* says that it is a charge or lien on the pledge to extend of loan.⁴ The pledgee creditor cannot stipulate in the contract that in case of non-payment of debt the property will be forfeited by the pledgee as a substitute of debt amount.⁵

The pledge property is kept as security and used only at the time of default on the part of debtor, when the stipulated time of debt payment expires and debt is not paid back by the debtor. The pledgee creditor may go to the court of law for the sale of the pledge asset and recover his debt from the sale proceeds and all the extra amount will be given back to the pledger.⁶ In case the sale proceeds fail to recover the full amount of debt the remaining amount will be treated as an ordinary unsecured debt.⁷ The pledge asset may be sold by the pledgee, without recourse to the court of law, if previously stipulated by the parties in the pledge contract.⁸ The pledger is not entitled to sale the pledge property without the consent of the pledgee creditor.⁹ If debt is paid then sale is valid and if the debt is not paid then sale proceeds of the pledge property will be declared as “pledge property”.¹⁰ The pledgee having the possession of pledge asset has a prior right of claim, in case of bankruptcy or insolvency etc, over all the other creditors.¹¹ The priority is given on the basis of possession and date of registration of pledge.

Islamic Law on Destruction, Loss and Accession to the Property:

According to the law, the pledger is the owner of the pledge asset and all the loss or destruction occurred to the property and any increase or benefit arise out of it belongs to the pledger. As mentioned in this *Aadith*: (Accession and loss belong to the pledger.)¹² The creditor pledgee holds the pledge asset as a trust and he is not responsible for any loss or decrease in pledge asset, if it is not occurred due to his

fault.¹³ If the destruction caused due to the fault or negligence of the pledgee or any third person, having the possession of the asset, he shall be responsible for it.¹⁴ He will have to pay the compensation to the owner because pledge asset is a trust in his hands. Holy Prophet (P.B.U.H) said: (The security is a trust in the hands of a pledgee.)¹⁵ Any increase to the pledge asset belongs to the owner like fruits, off springs, wool etc, not to the pledgee. As mentioned in *Hadith*: (Pledge is for the debt.)¹⁶

Purpose of pledge is to recover the amount of debt in case of default and right of the pledgee creditor is limited to extent of debt not more than that. According to Imām Mālik, the fruits of a pledged garden are not subject of pledge or security, if the property is pledged only, and it was not stipulated earlier by the parties that it will be included in pledge.¹⁷ Any increase or growth may be used by the pledgee to recover the cost of expenses incurred upon the maintenance of the pledged property. This increase may also be used to recover the amount of debt, in case of default, when the sale proceeds of pledge asset are unable to satisfy the full amount of debt. Any extra amount over and above the debt belongs to the owner/pledger.

Islamic Law on use of Pledge Property

The pledge property is security for the amount of debt and any benefit taken from such property by the pledgee is without any compensation and it is over and above the amount of debt. Anything over the amount of debt is “*Ribā*” and hence, forbidden as per saying of the Holy Prophet (P.B.U.H):(Any benefit taking out of debt is *ribā*).¹⁸ The pledger, being the owner of the pledged property, may use the property or get benefit from it with the consent of the pledgee. Consent of pledgee is important due to the fact that, some rights of creditor pledgee associated with the property, might not be infringed by the act of pledger. But the pledgee creditor is not permitted to take benefit from it. Pledged property must be kept intact by the pledgee creditor so that it would be able to redeem back by the owner/debtor.

According to some of *Hanafi* jurists pledgee may get benefit from the pledge asset but with the permission of the owner/pledger and must not be stipulated at the time of contract.¹⁹ But some of them opined that benefit from pledged property is unlawful for the pledgee because it is *ribā* and a mere consent cannot make an unlawful thing lawful.²⁰ If the pledge property is an animal then benefit may be taken out in the form of riding and milking the animal.²¹ It is lawful for the pledgee to milk or ride the animal, at extent of its expenditure incurred, for food and maintenance.²² Any thing over and above the amount of expenditure will be considered *ribā* because up keeping, maintenance, food, safety etc, is the responsibility of pledger and all the expenses, regarding these things, are upon the owner. If pledgee is an institution like Islamic bank then bank charges a rate for maintenance, up keeping and safety of the pledge asset. In case of Islamic banks, they take service charges from the customers for their services. As far as pledge contract is concern, these services include maintenance and safety of pledge asset by the bank. Bank can derive benefits at extent of its service charges only.²³ Anything over the amount of service charges must be returned back to the debtor, by the bank because it amounts to *ribā*.

2-Distinction between Islamic Mortgages and Conventional Mortgages:

Ribā is strictly forbidden in Islam and every transaction based on *ribā* is also forbidden, as Allah says in this *Qur'ānic* verse:

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا الرِّبَا أَضْعَافًا مُضَاعَفَةً

[Devour not usury, doubled and re-doubled.]²⁴

There are many mortgage markets in the world, providing interest-based conventional mortgages to satisfy the need of home finance. A conventional mortgage is a loan of money given by a bank or mortgage broker (agency) generally, for the purchase of a property, an interest is charged over such advance.²⁵ There are many kinds of conventional mortgages available in the market. People generally, go for such mortgages to purchase home and these homebuyers/debtors pay back the amount of loan, advanced by the bank plus an amount of interest charged over such loan money. In case of default on the part of homebuyer, the bank is entitled to hold the title of the house or property. 'Some money today for more money tomorrow.'²⁶ There is no risk sharing on the part of lender. He is earning money through money without providing any services etc., and people are forced to get these mortgages to fulfill their housing needs. Islamic financial institutions started developing their own *Shariah* compliant mortgages, to provide services to the Muslims, especially in western countries.²⁷ *Ijārah*, *Mushārahah*, *Murābahah* and *Mudārahah* mortgage models are currently available in Islamic financial institutions.²⁸

3. *Rahn* services provided by Islamic financial Institutions and its analysis:

Money making is not contrary to Islamic principles but it must be according to prescribed framework. Islam is a great religion indeed, providing rules and principles for every field of life and field of economics and finance is not an exception. Conventional interest-based financial institutions are providing a variety of products and services and earning money out of money.

Besides that, Islamic financial institutions like Islamic banks are also providing many products. *Rahn* is one of its services and it is used as complementary product like guarantee or security to secure other products and used as an independent product as well.²⁹ All the Islamic banks are not offering this kind of product, only few Muslim countries like Malaysia, Indonesia etc., are using *rahn* as an alternative for conventional pawnshops.³⁰ Products of Islamic banks are interest-free and *Shariah* compliant.

Ribā is prohibited by *Qur'ān* and *Sunnah* of the Prophet (P.B.U.H). Holy prophet said:

“Every loan that attracts a benefit is *ribā*”.³¹

This *Hadith* is very important as far as economic is concerned because it is related to loan transaction. According to the *Hadith* any benefit or reward on loan is *ribā* and hence, prohibited. Ruling of this *Hadith* is universally accepted and it is one of *Shariah* maxims although its authenticity is doubtful.³² According to the definition of *Mufti Muhammad Taqi Usmani*; any excess amount over the principal amount of debt in a loan transaction, which is made conditional to the advance of such a debt is called *ribā*.³³ This definition of *ribā* is given particularly in the context of conventional house mortgages although various kinds of *ribā* are prevailing.

Rahn is a legal term used in *fiqh al-mu'āmlat*. *Fiqh al-mu'āmlat al-māliyyah* consists of laws related to financial and economic matters.³⁴ Islam has laid down certain objectives that must be fulfilled while implementing these laws. The primary objective of *Shariah* in monetary matter is protection and preservation of wealth and property.³⁵ No one is allowed to waste or damage it; even he cannot do so with his own property. Islam has also laid down many rules and principles to achieve these objectives of *Shariah*. In fact, all the rules related to property and finance, are means or tools to protect and preserve the wealth and property of people. Another important objective is circulation of wealth among people.³⁶ Wealth must not be limited to certain class or group etc., whole society should get benefits out of it. Islam encourages investing money in business or trade. Prohibition of *ribā* is one of the tools to achieve this objective of wealth circulation because *ribā* may benefit one person or group but damages the society at large. It makes rich more rich and poor more poor. Another important objective of Islam is justice and equality among people. No one is above the law, so everybody is allowed to enter in monetary transaction, own, sell, invest his property etc, but according to the rules and procedures laid down by the lawgiver in this regard.

Specificity or certainty regarding terms of contract, identity of commodity, date and mode of price payment etc, is required in financial transactions because ambiguity or *gharar* leads to disputes and litigation. In case of property acquisition it must be specific and free from encumbrances.³⁷ Therefore, it is required by the parties to the contract to reduce the agreement into writing or have witnesses. These things will work as a proof of transaction between the parties and give them feeling of trust and security and avoid future disputes as well. They may also pledge a property as a security for debt or financial obligation.³⁸ Reducing the terms of contract into writing, having witnesses and pledge with possession are means to achieve the objectives of *Shariah* in *mu'āmlat al-māliyyah*. As Allah says in this verse:

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِنْكُمْ
[O you who believe! Eat not up your property among yourselves in vanities: but let there be amongst you traffic and trade by mutual good-will.]³⁹

The concept of *rahn* in fact, is a way to protect and preserve the wealth of creditor from being defaulted. Contract of *Rahn* secures or guarantee the performance of contract and parties to the contract are permitted to request for a pledge of security, no matter if they are on journey or stay. *Al-rahn* has its specific rules and principles that not only protect the wealth of creditor but also protect and preserve the property of debtor at the same time. All the rules and principles must be followed by the parties in *rahn* contract. Debt is an effective means to fulfill the urgent need of people. On the other hand debt creates dependency. Interest-based conventional system of finance provides debt or finance with high rates of interest. Impact of this kind of finance is negative because it makes the debtor more helpless than before.

Islamic banking and financial industry has now become a huge industry but still Muslims whether living in Muslim or non-Muslim country, have doubts regarding its working and products etc. The most common question among all is

about the permissibility of products offered by Islamic banks. Another important issue is that Muslims do believe that *Shariah* compliant products must be cheaper than conventional products.

Islamic financial institutions are facing many challenges in financial market not only in implementation of *Shariah* compliant products but also to answer heavy criticism of conventional bankers and to maintain their identity and individuality to be *Shariah* based. It is a need of time that every Muslim should know the basic Islamic principles regarding business and economics. They should also seek help of relied upon Islamic scholars in financial matters. People must need to be aware of destructive character of conventional interest-based system of finance. In case of debt financing, Islamic financial industry is also facing many challenges regarding implementation of *fiqhi rahn* or security. Many Islamic mortgages, home financing and pawn broking schemes are introduced as an alternative for interest-based products. A review of these services is given below in the light of principles of Islamic jurisprudence.

Possession of sold commodity by the seller:

There is another thing which is in practice among people⁴⁰ in financial transactions; sellers instead of demanding pledge of security to secure payment of price retain the possession of sold commodity as a *rahn* or security until price is paid by the buyer. In credit sale transaction it is not permitted for the seller to possess the sold commodity without first giving possession to the buyer. As mentioned in *Fatāwā-Hindiyyah* that the buyer in credit sale transaction is not permitted to retain possession of sold commodity neither before nor after the price payment.⁴¹

There may be another case in which seller gives possession of sold good to buyer then buyer gives back commodity as a security for the price to the seller. Most of the scholars considered it valid.⁴² Possession of sold commodity by the buyer is the key point that determines whether it is fit to be a *rahn* or not and without giving possession to the buyer, seller is not entitled to retain possession of good as a *rahn* or security for its price. It may be considered possession of sold good for its price or anything else but not *rahn*. A valid *rahn* has legal consequences different from others and liability in *rahn* is different from simple repossession of sold commodity like for example, a good is sold by the seller and buyer says without acquiring possession that good will remain in your possession until price is paid. In this case if good is destroyed in the possession of seller then sale contract will be extinguished automatically, because it is not *rahn* but its only possession of sold good for its price by the seller and hence, not permitted in credit sale contract. It is allowed only in cash sale contract.

In a credit sale transaction after giving possession of sold object to the buyer and when possession of buyer has been established, now the sold good may become a subject of *rahn* for its price. Buyer after establishing possession may pledge the commodity as a security for its price. The ownership of buyer is now established and recognized under law. If the commodity destroys, sale transaction itself would not be effected by this.⁴³ All the rules governing *rahn* will be applicable on such transaction. Thus, it may be concluded that such kind of *rahn* is valid provided that it must not be a pre-condition in actual contract of sale etc, to *rahn* the

commodity for its price⁴⁴. Therefore, *Ibn Qudāmah* opined in *Al-Mughni* that if buyer and seller enter into the contract of sale with a condition that sale object will become a subject of *rahn* against its price, such kind of *rahn* is not valid⁴⁵. Here it is important to test whether buyer may lawfully utilize sale object or not. If buyer is at legal position of utilizing sale commodity its mean that he may *rahn* the commodity as well. Legal position of buyer is very important in such situation that will surely determine the validity of *rahn*. These aforesaid things are very popular among the practices of Islamic banks and financial institutions. They need to be more careful while entering in such transactions because “*rahn*” is a complete law, having proper rules and principles different from others. Rights and liabilities of both; creditor and debtor are established, recognized and protected under Islamic law.

Bank Mortgages and Home Financing

Home or shelter is basic need of man and due to the large number of people and limited resources; it has now become a great problem in almost every country of the world. Financial institutions and commercial banks have introduced many house financing schemes to provide people their own homes. Besides, conventional mortgages and home financing, Islamic Financial Institutions have also introduced Islamic home financing models in the financial market to provide Muslims with *Shariah* compliant products. The term ‘Islamic mortgages’ has become very popular now especially in the west. In the countries like United Kingdom, United States, Australia etc, where large number of Muslims live and do not want to get interest-based conventional mortgages but want to have their own houses, they may choose Islamic mortgages or *Shariah* compliant home financing schemes now.

Conventional mortgages and home financing schemes are not only interest-based but very costly as well. It is very important to see whether Islamic Financial Institutions are really providing *Shariah* compliant products or only using name of Islam. Islamic system of finance is based on risk and reward sharing and conventional system is based on usury. The key difference between them must be maintained in all the circumstances. Some Islamic financial institutions are not following principles of Islamic jurisprudence and only trying to compete with conventional banks in profit earning. Islamic banks are providing products and services that are not cent percent *Shariah* based because of its initial stage of working. They are improving day by day and one can expect very good results in next few years. There is a huge potential for Islamic products in the financial market because large number of Muslim population wants to indulge in Islamic modes of financing and business.

Islamic mortgages and home financing products are getting very popular among people due to the heavy demand of house finance in the market. Many Islamic house financing products have been launched to provide Muslim customers permissible modes of finance. At the same time these products have been heavily criticized by different classes of people. This criticism is not limited to the contractual validity of particular products but also upon overall working of banking sector. Islamic home financing and mortgage models that have been adopted by Islamic banks and financial institutions are usually based on *al-bay’bithaman ajil*, *murābahah*, *ijārah wa iqtinah* and *mushārakah mutanāqisah* contracts.

Murābahah:

Murābahah is a sale contract and it must fulfill all requirements of a valid sale. In *morābahah* mortgage or home financing structure, property is purchased by the bank from vendor and then bank sells the property immediately to the client at an agreed price plus profit margin. After entering into the contract property becomes the subject of mortgage itself to secure the payment of installments to the bank. It is the practice of mortgage providers that they borrow money from open market at a certain low interest rates and then lend that money at high rates of interest.⁴⁶ Some Islamic mortgage providers are also borrowing money from the open market on interest for lending or financing purposes although these Islamic financial institutions are providing *Shariah* compliant products⁴⁷ but source of finance that is given to Muslim customers probably, is unlawful or coming out of an interest-based financial market. Mortgage provider or bank settles the installments of the client in such a way that the bank or mortgage provider will not only be able to pay off his installment to money market but to earn a rate of profit from his client as well.

Price of contract must be specified and uncertainty or lack of knowledge regarding price, declares the contract invalid under Islamic Commercial Law. *Gharar* or uncertainty regarding material facts of contract creates risk, hazard, gambling, uncertain outcome⁴⁸ etc, and finally may result into the loss of property, money and time. Therefore, installments payable by client to bank must be specified and fixed in total. Banks normally use interest rate swap market to fix their rate of interest while borrowing money from the open financial market and then they can easily fix the installment of clients accordingly. Islamic Financial Institutions must realize and accept this reality that providing finance is not a business under Islamic law. Money can be lent on the basis of interest-free (benevolent) loan that is called *Qardi Hasan*⁴⁹. It is permissible to advance money and charge reasonable fee for providing managerial or account maintenance services and such fee must be according to the services provided and not based on prevailing interest-rates in the market.

Mr. Justice Khalil-Ur-Rehman said in his judgment⁵⁰ that banks must perform their functions without any involvement of *ribā*, *qimār*, *gharar* and all the other prohibited practices. If an institution is working for providing finance in the form of lending or borrowing, it may create back-door or *hiyal* (trick) for *ribā*.⁵¹ Transactions of Islamic banks should be in exchange of commodities, goods and services. The permissible modes of financing have been mentioned by the State Bank of Pakistan under BCD circular 13 of 1984. Under Islamic system of finance, banks shall perform function of financial intermediaries to finance through equity.⁵²

Murābahah is purely a sale contract and it is not an instrument of finance originally. According to *Shariah mudārabah* and *mushārahah* are the best modes⁵³ of financing. It is very important to note that *murabahah* is permitted as an instrument of finance by contemporary Islamic Scholars due to certain economic hurdles.⁵⁴ It must be implemented by observing all its conditions fully so that, it can be identified clearly from an interest-based loan. Therefore, *murābahah* may be used as an instrument of finance, where other modes of finance are not available. *Murābahah* must contain all the features of a valid sale. In case of bank product, the property or commodity must be first purchased by the bank or financial institution.

All the risk and liabilities related to property must be borne by bank or financial institution, as long as it remains in the ownership of bank or financial institution.

It is very hard reality that all the banks and financial institutions do not follow these rules while implementing Islamic instruments. Some of them only change the name of their product and substance remains the same. Another practice is also seen that property or commodity purchased by the bank is not actually purchased by it or even sold to the buyer. They make use of buy-back arrangement and commodity or property that is already ownership of client, repurchased by the bank and immediately sold to the client by the bank at higher price. Some Islamic financial institutions and banks are only working on papers nothing doing actually.⁵⁵ *Ribā* is prohibited and Islam closes all the possible gates from where *ribā* can be entered. Any back-door or *hiyal* that can produce *ribā* is not permitted and sometimes permissible contracts are combined in a way that it becomes usurious transaction although apparently, it remains *Shariah* compliant. A famous *Shariah* Maxim states: “A *hilah* affected on debt is a *hilah* on *ribā*”⁵⁶ Contract-combination is a well known practice among Islamic financial institutions and banks. Most of the time, they use it as a *hiyal* for usurious transactions. It is the duty of jurists or *Shariah* board, of particular bank or financial institution, to look into the contract not only separately but check the scheme as a whole before giving any opinion for its permissibility.

Al-Bay’bithaman ajil:

Some home financing schemes have been adopted based on *Al-Bay’bithaman Ajil* contracts by the banks and financial institutions. *Al-Bay’bithaman ajil* is a credit or deferred payment sale contract. Under this concept of sale, commodities are sold on the basis of deferred⁵⁷ price payment.

It is a well known concept of finance, recognized in Islamic world.⁵⁸ In the practice of banks they purchase a property and sell it to the client under an agreement, on an agreed price plus a profit margin. Customer is contractually bound to make payment on deferred basis. Banks and clients mutually decide the terms and manner of price payment.⁵⁹ *Al-Bay’bithaman Ajil* is widely practiced in Malaysia, Indonesia, Brunei etc, but could not gain popularity in Middle East, United States, Canada etc, because it was rejected by *Shariah* scholars of respective countries⁶⁰ on the basis of its similarity with conventional interest-based loan.

Banks generally, use LIBOR⁶¹ (London inter banks offered rate), KIBOR (Karachi inter banks offered rate) and other economic indicators to determine the price of their products⁶² and do not mention this fact on documents or papers so that it can be used as a back-door for usurious transaction. *Bay’bithaman Ajil* contract⁶³ is not advised to be used widely by the *Shariah* councils due to the nature of contract because it can be used as a backdoor or *hiyal* for *ribā*.

Islamic bank and financial institution being seller of the property required to have ownership of the property. Under *Shariah* principles owner is responsible for the risk and reward arising out of the property. But banking practice of *al-bay’bithaman ajil* contracts show that bank or financial institution plays role of a financier and not of a seller or buyer. No liability or risk is borne by the bank or

financial institution and it is against the Islamic principles of risk and reward sharing and similar to conventional interest-based transactions.

Risk, work and liability are key elements required to be present in any transaction for making its profit or benefit permissible. In business transactions a person is getting profit but at the same time he is bearing risk of loss as well, but in usury, there is no risk involved and profit is fixed. Current, *al-bayibithaman ajil* financing schemes are not following the concept of Daman⁶⁴ (liability), that is required for a valid sale and lack of this important feature not only rendered the transaction invalid but also compels the client to face all the liabilities and risks attached to the property.

Mushārahah Mutanāqisah or Diminishing Mushārahah Home Financing:

The *Mushārahah Mutanāqisah* or Diminishing *Mushārahah* is also one of the famous forms of home financing in many countries. Diminishing partnership model of home and equipment financing is widely accepted in financial market because it is not limited to home financing only but vehicles and other equipments can also be financed by using this model. Diminishing *mushārahah* is a partnership contract where one partner gradually purchases the equity share of the other partner and finally purchases the whole share of other partner.⁶⁵ It is a partnership contract where partners contribute capital and share profit according to agreement and loss according to share in capital. Buying and selling agreement of shares is not part of diminishing partnership contract. In principle it must be separate and independent of the Diminishing *mushārahah* contract.

In practice, bank leases its share of ownership in house and charge an amount of rent to the client for using its share of property. Rental amount is also shared between partners according to their respective share in capital. By the time, client redeems the share of bank it would definitely affect the amount of rental payable to the bank. Finally, client redeems the whole share of bank in property and becomes the sole owner of property. Islamic scholars are considering *mushārahah mutanāqisah* partnership much better⁶⁶ than *al-bayibithaman ajil* and *murābahah* financing because it could be used not only in house financing but other assets and machinery can also be financed and leased out by using this method. *Mushārahah* (partnership) is sharing of risk and reward between partners. There is no concept of partnership in *Shariah* without sharing of risk and reward by the partners. Here property is involved and value of property does not remain same over the time. Any increase or decrease in the value of property belongs to the partners because they are co-owners. In most of the cases large share of property belongs to the bank or financial institution and therefore, bank is entitled to share increase as well as decrease, if any occurred to the property. But financier (bank) does not share any increase or decrease occurred to the property in banking practices, all belongs to the client (partner). It is against the Islamic principles of partnership.⁶⁷ The bank in case of *mushārahah* (partnership) is not sole owner of capital provided. The share capital of bank is provided by other depositors and they are also co-owners in the property. As a principle Islamic Financial Institution is not permitted to surrender⁶⁸ their share of capital without their permission, in shape of any increase or decrease in the value of property. Islamic Financial Institution or bank is surrendering its share in

increasing or decreasing value of property due to the fear of probable loss that might happen and financier wants to avoid it. All these arrangements are made to facilitate the clients and used as a business technique to capture more customers but at the same time it is against⁶⁹ the principles of *Shariah*. Risk and reward sharing is the back-bone of *Mushārah* and it must be taken into account with its full zest and zeal.

There are many operational issues in the implementation of *Mushārah Mutanāqisah* partnership for Islamic Financial Institutions. One of the main problems is determination of rental value payable by the client. In principles, rental value should be determined in the light of market rates. Market rental rates keep on changing due to the price of property. Linkage of rental to market interest rate is totally wrong and unjustifiable but almost all the Islamic Financial Institutions are using LIBOR (London inter banks offered rate), KIBOR (Karachi inter banks offered rate) and other economic indicators to determine the rental value. These bench marks are used in conventional system of finance and do not have any link with Islamic transactions.

Rent of any property must be determined on the basis of its market value not on the basis of market interest rates.

Ijārah wa iqtinah Lease and Financing:

Ijārah wa iqtinah is also a form of leasing and financing. Under Islamic financial institutions it is a lease of an asset that is followed by sale at the end of the term, to the customer. At the end of the lease-term title of the property is transferred to the customer. The customer is entitled to get complete ownership at any time before the completion of term of lease, by paying off remaining balance to the bank.⁷⁰ Bank or financial institution being the owner of property is required to take the best care of property and responsible for any damage, if occurred due to the force of nature,⁷¹ to the property and not due to the negligence of client (lessee). But practically banks do not want to take such liabilities and banks settle conditions of agreement in a way that protects them from probable loss. In the event of default on the part of client, bank is entitled to sell the property and recover his amount from the sale proceeds and payment made by client towards capital⁷² borrowed. Banks or financial institutions will not bear any loss in any case.

As far as the sale price of the house or equipment is concerned, it is fixed and agreed upon by the parties at the time when they entered into the contract. During term of lease if any decrease or loss occurred to the value of property, client will bear it because sale price is already determined and fixed although, client is not owner of the property, he is lessee that is why he is paying rent to the bank. *Ijārah* or lease is a contract where client or lessee uses or possesses the property for certain period of time at an agreed amount of rent.⁷³ It is transfer of usufruct of property to the lessee and lessor remains the owner of the property, and title belongs to him. Any loss or damage occurs to the property without the misconduct or negligence of lessee, belongs to owner/lessor not to the lessee.

Therefore, if capital of bank or financial institution is protected from loss by adding any condition or contractual arrangement it is unlawful and against the basic principles of *Shariah*. It is not permitted to combine two transactions into one in

Shaiyah so; it is required for the bank to do selling and leasing transaction separately. Many *Shariah* compliant schemes working in the financial market to finance not only housing but all the other assets, vehicles, machineries etc, are financed through these schemes. There is a huge criticism not only on the contractual validity of these products but also on the operational and implementation matters.

At the event of rental value determination, Islamic financial system requires that it must be determined according to market value of the property. Locality and condition of property must be taken into account while charging rent. In partnership, Islamic financial institution shares risk and reward of property. Islamic bank or financial institution being co-owner of the property will bear loss or damage occurred to the property and any increase will also be shared by it. *Ijārah* and *Mushārahah Mutanāqisah* structure is adopted by many financial institutions of the world like Lariba Finance House, Guidance Financial Group, Meezan Bank's "Easy home", Bank *al-Islami*, *Al-Burāq Shariah* Compliant Home Financing etc.

This model of finance is best due to its interest-free nature; it can 100% avoid interest and facilitate lower income groups by decreasing the price of houses and term of the financing. Diminishing *Mushārahah* contract must not consist of any terms that guarantee the capital of other partner because partnership is based on the principle of profit and loss sharing in Islam. According to the rules given by AAOFI⁷⁴ (Accounting and Auditing Organization for Islamic Financial Institutions) partners are not permitted to purchase or sell the equity shares of other partners at its face value because selling on face value means guarantee of capital that is unlawful in *Shariah*. Partners are permitted to purchase the equity shares of other partners at its market value or price agreed upon at the time of purchase, not at pre-determined price. Fixing of share's price is actually a protective measure that is being taken by conventional and some Islamic Financial Institutions to protect themselves from probable loss of capital and it transfers otherwise permissible contract into *harām* and usurious transaction.

Another, important issue is determination of price or rental value of property or commodity. LIBOR (London inter banks offered rate), KIBOR (Karachi inter banks offered rate) and other economic indicators are used by the conventional financial institutions for interest rate determination. Unfortunately, Islamic Financial Institutions are also using these indicators for determining cost and rental value of property. Market prevailing interest rates are not equivalent to market price or rental value of property and these interest-rates are always keep on changing. These market interest-rates are floating and hence, creating uncertainty so it should be avoided in order to implement real Islamic economic activity. Rental value of property should be based on the market value of property and not at the market prevailing interest-rates. Islamic Financial Institutions should develop a rental index⁷⁵ or house price index, for determination of rental value of property based on prevailing market value of property. *Shariah* principles of profit and loss sharing should be applied with its true essence and spirit. In case of property, any increase or decrease in the value of property must be shared by all the partners in partnership. If Islamic bank or financial institution is having ownership title in any property, then it must bear all liabilities related to property. Rental value should be based on real market value of property and not on any artificial mode.

There is a need to make amendments in laws related to land so, that the bank becomes principal co-owner of property⁷⁶ and many other practical issues are need to be settled in the light of principles of Islamic jurisprudence. At this present stage of Islamic banking they have to face the pressure of money market because they could not develop their own money market. Islamic financial institutions have needed to be more focused on maintaining the individuality and uniqueness of Islamic economic and financial system.

4-Islamic Pawn Broking System:

Most of the financial institutions are using *rahn* as a guarantee for other products and services.⁷⁷ But very few of them are using *rahn* not only as a complementary product but as an independent product as well. Concept of pawn broking is one of oldest concepts of money lending by depositing collateral or security to the creditor or pawn broker. Many people of the world are fulfilling their need of cash or advance by using this mechanism. In some countries Islamic Financial Institutions are providing *rahn* or Islamic pawn broking services as an alternative for conventional pawnshops.⁷⁸

Conventional pawnshops are interest-based, charge an amount of interest on debt. On the other hand, no one can deny the importance of cash or advance for immediate need fulfillments like education, health problems; festivals etc. Loans provided by banks are happened to be very costly and followed by a lengthy procedure while Pawnshops provide cash on immediate basis with low cost⁷⁹. *Rahn* or collateral is used to secure or guarantee the amount of debt from being default by the debtor. It has motivational factor because it motivates and encourages people to lend more money without fear of default that is normally committed by debtors. Islamic Financial Institutions have introduced pawn broking schemes to provide short-term advances and they receive collateral or *rahn* in the form of gold⁸⁰ or silver. Collateral or security is redeemable at the event of repayment of debt-money and in case of default, lender is entitled to sell the collateral and satisfy his amount of debt from sale proceeds. All the rules and principles governing *rahn* are applicable here because these pawnshops are working under the classic concept of *rahn*. Ownership rights in respect of collateral remains with debtor, only possession is transferred. Allah says in *Qur'an*:

فَرَهَانٌ مَّقْبُوضَةٌ

[Pledge with possession]⁸¹

كُلُّ نَفْسٍ بِمَا كَسَبَتْ رَهِينَةٌ

[Every soul is in pledge for its deeds]⁸²

Concept of debt in Islam is benevolent. Money lending is not a business recognized in *Shariah* because any profit or benefit coming out of debt is considered *ribā*. Producing profit is not the only motive in economic and financial activities in Islam. Fairness, justice and equity must be practiced by the Muslims in money matters. In current Islamic banking and financial scenario, financial assistance is being provided to poor or low-income groups⁸³, in some countries. These institutions are taking *rahn* or collateral in the form of gold or gold ornaments from the borrowers to secure the amount of debt from default. Security or collateral is backbone of these institutions due to the fact most of them are taking collateral only in

the form of gold or gold ornaments because value of gold remains stable over a reasonable period of time. Conventional pawnshops on the other hand, accept collateral not only in the form of gold but diamond, vehicles, watches and electronics as well.

Islamic pawn broking is based on four legal concepts.⁸⁴ The first and most important is *Qardi Hasan* (benevolent loan). Loan or debt will be interest-free without any compensation. The purpose of benevolent loan in Islam is to strengthen the feeling of brother-hood and kindness among people. Second *Shariah* principle of *Wadi'ah Yadul Amānah*⁸⁵ is applied to protect the collateral assets in the possession of lender. Lender or creditor is obliged to keep the collateral in safe place and make sure its safety by taking necessary measures for this purpose. In case of negligence or misconduct on part of lender that results into the loss or damage of asset, liability will be on the lender to replace the collateral items or compensate the debtor. If any loss or damage is occurred to the asset without the negligence or misconduct of lender then he is not obliged to compensate the debtor. *Al-Ujrah* is third *Shariah* concept upon which *Al-rahn* is based. Under this concept a reasonable fee is charged, for the services of preserving, protecting and maintaining the collateral items by the Islamic pawn broking service provider. Islamic Financial Institutions receive collaterals under the concept of trustworthiness (*wadi'ah*) and take all such measures necessary for its safety.

Conventional pawnshops and pawn broking services are getting popular in the world although this concept of lending is not new. Conventional pawnshops are interest-based and cost of loan is based on amount of interest, which is calculated on the basis of monthly interest charges⁸⁶. Interest rate is always fluctuating and it affects the cost of loan.

Islamic pawnshops or pawn broking services have ability to prove themselves, a best alternative for interest-based conventional pawnshops. People need cash or advance, to fulfill their immediate needs of medical, education, marriages etc, and in broader perspective, for small business or trade activities. Islam emphasizes on helping the needy and poor and secured loan is a mechanism that encourages wealthy people to give loan with trust and confidence and help the society in defeating poverty. These services are being provided by Islamic Financial Institutions that are *Shariah* based not interest-based. The debtor is obliged to pay safe-keeping fee, conservancy fee, appraisal fee etc.⁸⁷ They accept only gold, gold ornaments and silver as collateral or *rahn*. Collateral or pledge asset plays an important role in pawn broking and if it is restricted to gold then it would become difficult for poor or low-income group to get benefit from these services. Then it will definitely, contaminate the true purpose of benevolent loan; which is helping the needy or poor without reward. Therefore, it is required that other valuables like vehicles, livestock, watches, electronics etc, should also be accepted by them as collateral⁸⁸. Service charges levied on collateral are heavily criticized by the Islamic Jurists because that may be used as a back-door or *hilah* for usury.⁸⁹ Financial institutions or pawn brokers charge fee for its services and it must be according to the service actually provided, not based on prevailing market interest rates.

First purpose of using this mechanism of lending must be economic welfare of needy or low-income group. Profit earning is permissible but it is not the only

purpose of all the economical activities because approach of *Shari'ah* is much wider than this. Islamic pawnshops or pawn brokers should charge service fee according to the services provided by them because it has possibility to be used as a back-door for *ribā*. Islamic Financial Institutions are facing challenges of fund deficiency in respect of pawn services because heavy funds are required to build place for storing collateral and maintaining its good condition. Governments should take measures in this regard and provide funds or buildings etc. Islamic banks and financial institutions should also help each others in these matters.

Pawn broking is at infant stage and yet to be developed, so there is a need to conduct more and more research on it to make it according to the principles of Islamic jurisprudence and no doubt, it has the ability to provide cheap cost loans and help the lower-income group.

5-Conclusion and Recommendations:

Islamic financial system is restricted by certain rules and principles. Risk and reward sharing is the method of trading. *Ribā* is not only limited to lending borrowing transaction, it can happen in trade as well and it is not the only thing that makes the transaction invalid or *harām*, there are other things like ignorance, coercion, *gharar*, misrepresentation, invalid condition etc, which make the whole transaction invalid from *Shariah* point of view. Islamic mortgages and home financing structures are providing finance or capital to the customers to fulfill their needs of housing.

Our study confirms that *Ijārah* and *Mushārahah Mutanāqisah* structures of home financing are better than other models due to the current financial markets scenario. It can avoid interest cent percent and facilitate lower income-group by decreasing the price of houses and terms of financing. These home financing schemes are heavily criticized due to its similarities with conventional mortgages. Linking price or rental value of property with KIBOR, LIBOR, fixing price of shares in partnership, borrowing money from open market on interest for investment purposes, fake buying selling arrangements between financial institutions and customers etc, are some examples of similarities with conventional mortgages.

Our study also confirms that Islamic financial models are unique and there is no comparison between Islamic and conventional mortgages in any way because Islamic products are *Shariah* compliant and conventional products are interest-based. Islamic mortgages are not fully *Shariah* based but we cannot say that these house financing models are interest-based. Islamic Financial Institutions are forced to adopt some arrangements due to the financial market realities but still these products are better than conventional products. Islamic financial industry is at developing stage and its future is bright but very challenging. Pure monetary transactions where goods are not exchanged may result into opening the door of usury. Therefore, in all business transactions it should be avoided as far as possible.

People need cash to fulfill their immediate needs and also for small business or trade activities. Secured loan is a mechanism that encourages wealthy to lend money with confidence and help the society in defeating poverty. Islamic pawn broking services are also provided by Islamic Financial Institutions. These services provided by Islamic Financial Institutions are *Shariah* based and they accept only

gold and silver as collateral or *rahn* for debts and charge service fee for their managerial services. Ground economic realities cannot be denied. Islam has provided ways and methods for just economy. If some products are adopted by the financial institutions other products like pawn broking should also be adopted. Profit earning is not the only purpose of all economic and financial activities; approach of *Shariah* is to create a welfare Islamic society. Purpose of money lending through pawn broking should be the economic welfare of society.

Islamic Financial Institutions are under obligation to provide *Shariah* based products; they should maintain their identity and individuality and should not mix with conventional system. The primary focus of Islamic Financial Institutions is to provide Islamic products to the Muslims and their competition with conventional financial institutions in profit production may lead them to unfair practices because conventional capitalist system is based on interest and their focus is wealth production only. We believe that Islamic financial and economic system is having all the qualities that are required for a just economy and the need is only to implement this system according to its true spirit, then it will definitely change the condition of present world and will bring prosperity and stability in the world economy.

Recommendations:

Many reforms are required to be made by the financial institutions and by the state as well, in order to implement true Islamic financial instruments. Some of the recommendations, which are developed in the light of our current study, are given below.

1-Islamic Financial Institutions should develop their own benchmark for profit or price determination because they are working in open market, where they have to face market forces and conventional economic indicators are prevailing in the market for interest-rate determination.

2-Rental value of property should be based on actual market value of property, not at market prevailing interest-rates. Islamic Financial Institutions should develop a rental index⁹⁰ or house price index based on prevailing market value of property, for determining the rentals or price value of property.

3-*Shariah* principles of profit and loss sharing should be applied with its true essence and spirit, any increase or decrease in the value of property should be shared by all partners. There should be an actual sale and purchase of property by the institutions. *Ribā*, *gharar*, *qimār* and other unfair practices should be avoided.

4-Our study also confirms that *Al-Rahn* or Islamic pawn broking services has the ability to provide an alternative for interest-based conventional pawnshops. Many reforms are required to be made by the financial institutions and by the state as well, in order to implement true Islamic financial instruments.

Collateral or *al-marhūn* plays an important role and if it is restricted to gold then poor or lower-income group may not get benefit from it, so it is required that other valuables like vehicles, livestock, watches, electronics etc should also be accepted as collateral.

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