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بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

A THEORETICAL COMPARISON
BETWEEN *AL-BAY' BITHAMAN ĀJIL*,
MUSHĀRAKAH MUTANĀQISAH
PARTNERSHIP AND *IJĀRAH SUKŪK*

BY

EDIB SMOLO

INTERNATIONAL ISLAMIC UNIVERSITY
MALAYSIA

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BAY^C BITHAMAN ĀJIL, MUSHĀRAKAH
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BY

EDIB SMOLO

A dissertation submitted in partial fulfilment of the
requirements for the degree of Master of Economics

Kulliyyah of Economics and Management Sciences
International Islamic University
Malaysia

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*Let's live Islam and for Islam
And not live at the expense of Islam*

ABSTRACT

Asset acquisition, such as home financing and car financing, takes a large bulk of peoples' income. The *murābahah*, which is also known as BBA in Malaysia, is predominantly used in Islamic banks. Deeper analysis shows that the BBA, as practiced in Malaysia, is actually based on *bay' al-'inah*. On the other hand, MMP consists of a *mushārahah* (partnership) and an *ijārah* (leasing) contracts where the equity of the financier follows a diminishing balance method. This paper tries to explore the alternative modes of financing and investment such as *mushārahah mutanāqisah partnership* (MMP), *ijārah* and *ijārah sukūk* and their implementation in the current Islamic banking and finance industry. Throughout the paper we will compare these three modes with predominant one, BBA, from Islamic and economic perspective. The paper concludes that MMP, *ijārah* and *ijārah sukūk* have several advantages over BBA. Apart from being *Sharī'ah* compliant, by implementing MMP model we can avoid interest (*ribā*) totally by using some rental or house index. It is also shown that the balance of financing under MMP, at any point of time, will never exceed the original price of the asset, unlike the BBA where it can go beyond its original price. All these modes of financing are in line with the *maqāsid al-Sharī'ah* since they are not contributing to the macroeconomic problems. Finally, as the Islamic capital market is evolving rapidly, the due attention is given to the *ijārah sukūk* or Islamic certificates. This investment instrument can be used widely for financing almost every project especially long-term projects. However, for *ijārah sukūk* to be effective tool of Islamic capital market we need a well developed secondary market to trade these certificates.

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BBA

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BBA

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BBA

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:

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APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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**A THEORETICAL COMPARISON BETWEEN *AL-BAY^C BITHAMAN ĀJIL*,
*MUSHĀRAKAH MUTANĀQISAH PARTNERSHIP AND IJĀRAH SUKŪK***

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To my parents, Esad and Nadžija

and

To those who inspired my endeavours

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Edib Smolo
Kuala Lumpur
June 2007

TABLE OF CONTENTS

Abstract	ii
Abstract in Arabic	iii
Approval Page	iv
Declaration Page	v
Copyright Page	vi
Dedication	vii
Acknowledgements	viii
List of Tables	xii
List of Cases	xiii
List of Abbreviations	xiv
CHAPTER 1: INTRODUCTION	1
1.0 Background of the Study	1
1.1 Problem Statement	6
1.2 Justification of Problem	7
1.2.1 General Point of View	8
1.2.2 Religious Point of View	9
1.2.3 Economic Point of View	13
1.3 Infrastructure of Islamic Banks	16
1.4 Objectives of the Study	17
1.5 Methods of the Study.....	18
1.6 Outline of the Study	19
CHAPTER 2: <i>BAY' BITHAMAN 'AJIL</i>	20
2.0 Introduction.....	20
2.1 Definition	20
2.2 Basic Features of BBA	23
2.3 Determination of the Price	25
2.4 Overdependence of Islamic Banks on BBA Financing	27
2.5 Sharī'ah Rulings on BBA	30
2.6 How Does It Work? – Mechanism of BBA	33
2.7 Risks Related to BBA	36
2.8 Maqāsid Al-Sharī'ah, Qawā'id Al-Fiqh and BBA	38
2.9 Objections Related to the BBA	43
2.10 Vulnerability of the BBA Contract	45
2.10.1 Rising Interest Rate.	46
2.10.2 Falling Interest Rate.	49
2.10.3 Inflation	51
2.11 Conclusion	52
CHAPTER 3: <i>MUSHĀRAKAH MUTANĀQISAH PARTNERSHIP</i>	56
3.0 Introduction.....	56
3.1 Literature Review	58
3.2 Overview of Mushārahkah	62
3.2.1 Definition.	63

3.2.2	Legality of Mushārah Mutanāqisah	63
3.2.3	Profit and Loss Sharing under MMP	64
3.2.4	Termination of Mushārah Mutanāqisah	64
3.3	Mechanism of Mushārah Mutanāqisah Partnership	65
3.4	Basic Conditions for Valid Mushārah Mutanāqisah Partnership	69
3.5	Salient Features of the Mushārah Mutanāqisah Partnership	72
3.6	Advantages and Disadvantages of MMP	72
3.6.1	Advantages of the MMP	72
3.6.2	Disadvantages of the MMP	75
3.7	Examples of MMP Being Practiced	76
3.8	Comparison Between Conventional Loan, BBA and MMP	80
3.9	Necessary Legal Amendments	82
3.9.1	Income Tax Act 1967	84
3.10	Conclusion	85
CHAPTER 4: <i>IJĀRAH SUKŪK</i>		88
4.0	Introduction	88
4.1	Literature Review	89
4.2	Nature of Ijārah Sukūk	92
4.2.1	Definition of Ijārah Sukūk	92
4.2.2	Conditions for Issuance of Sukūk	93
4.2.3	Structure and Mechanism of Ijārah Sukūk	94
4.2.4	Sale of the Leased Asset	96
4.2.5	Characteristics of Ijārah Sukūk	97
4.2.6	Application of Ijārah Sukūk	101
4.3	Evolution of Ijārah Sukūk: A Historical Overview	102
i)	Bahrain	103
ii)	Malaysia	104
iii)	Qatar	106
iv)	Saudi Arabia	107
v)	United Arabic Emirates (UAE)	108
vi)	The Rest of the World	108
4.4	Securitization	111
4.5	Advantages and Disadvantages of Ijārah Sukūk	115
4.5.1	Advantages of Ijārah Sukūk	115
4.5.2	Disadvantages of Ijārah Sukūk	116
4.6	Challenges Related to Ijārah Sukūk	117
4.7	Practical Issues	119
4.8	Comparison Between BBA, MMP and Ijārah Sukūk	121
4.9	Conclusion	124
CHAPTER 5: RESEARCH FINDINGS AND ANALYSIS		126
5.0	Introduction	126
5.1	Research Methodology	126
5.2	Data Collection	128
5.3	Findings and Analysis	129
5.3.1	Profile Analysis	129
5.3.2	BBA Analysis	131
5.3.3	MMP Analysis	137

5.3.4	Comparative Analysis between BBA and MMP	141
5.3.5	Ijārah Sukūk Analysis	144
5.3.6	General Comments by the Participants	147
5.4	Conclusion	149
CHAPTER 6: CONCLUSION		151
6.0	Introduction.....	151
6.1	Findings and Contributions	152
6.2	Limitation and Further Research	158
BIBLIOGRAPHY		160
APPENDIX A: A Mathematical Derivation Model		171
APPENDIX B: Survey		176
APPENDIX C: Frequency Tables		181

LIST OF TABLES

<u>Table No.</u>		<u>Page No.</u>
1.1	Islamic Banking System: Financing concepts as at end of 2005	8
2.1	Modes of Islamic Finance in Malaysia	29
3.1	Comparison between conventional loan, BBA and MMP	81
4.1	Features of <i>Ijārah Sukūk</i>	101
4.2	<i>Ijārah Sukūk</i> Ratings History	111
4.3	Comparison between BBA, MMP and <i>Ijārah Sukūk</i> contract arrangements	122
5.1	Distribution of Questionnaires and Response Rate	129
5.2	Distribution of Respondents by Gender, Age, and Marital Status	130
5.3	Distribution of Respondents by Education, Occupation and Knowledge about Islamic Products	131
5.4	Respondents' Perception of BBA	132
5.5	Familiarity with MMP	137
5.6	Respondents' Perception of MMP	138
5.7	Preference: BBA, MMP and Conventional Loan	142
5.8	True Representative of IFS	143
5.9	Development of IFS	143
5.10	Familiarity with <i>Ijārah Sukūk</i>	144
5.11	Participants' perception on <i>Ijārah Sukūk</i>	145
5.12	Occupation vs. Familiar with MMP	148
5.13	Occupation vs. <i>Ijārah Sukūk</i>	148

LIST OF FIGURES

<u>Figure No.</u>		<u>Page No.</u>
2.1	Real <i>al-bay^ʿ bithaman ājil</i>	34
2.2	Actual <i>al- bay^ʿ bithaman ājil</i>	36
3.1	<i>Mushārah mutanāqisah</i> structure in home financing	66
3.2	<i>Mushārah mutanāqisah</i> structure in corporate financing	69
4.1	Malaysian Global <i>Sukūk</i>	96

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ACHC	Ansar Co-operative Housing Corporation
AFHL	American Finance House LARIBA
AHL	Ansar House Limited
AIBs	Assets Ijārah Bonds
APR	Annual Profit Rate
BAFIA	Banking and Financial Institutions Act 1989
<i>BBA</i>	<i>Bay' Bithaman Ājil</i>
DJCSI	Dow Jones Citigroup Sukuk Index
GNP	Gross National Product
IDB	Islamic Development Bank
IBA	Islamic Banking Act 1983
IBF	Islamic Banking and Finance
ICHC	Islamic Co-operative Housing Corporation
IIUM	International Islamic University Malaysia
IRTI	Islamic Research and Training Institute
KFH	Kuwait Finance House (M) Berhad
LIBOR	London Inter-Bank Offer Rate
LTP	Lease-To-Purchase
MCCA	Muslim Community Cooperative Australia
MMP	<i>Mushāraka Mutanāqisah</i> Partnership
M-M	<i>Mudhārabah</i> and <i>Mushārah</i>
PBUH	Peace Be Upon Him
PLS	Profit and Loss Sharing
PPA	Property Purchase Agreement
PSA	Property Sale Agreement
RA	<i>Radiyallāhu 'Anhu</i>
S.O.S	Shared Ownership Scheme
SPV	Special Purpose Vehicle
swt	<i>Subhānahū wa ta'ālā</i>
S&P	Sales and Purchase Agreement

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND OF THE STUDY

Islamic economics, banking and finance started breathing some forty years ago. The emergence of the Islamic banks is considered as “the most remarkable and revolutionary development”¹ within the banking system today, it has engraved itself into the world of economic and financial systems. Many scholars have written on Islamic economics in general and Islamic banking and finance in particular. Many workshops, seminars and conferences are being held all over the world discussing the issues pertaining to Islamic economics and finance. Nevertheless, this discipline is very young one and it is in the process of development.

Since the Islamic economics follows the teachings of Islam, it is governed by the Laws of Allah (swt) (i.e. *Sharī'ah*). This implies that the interest (*ribā*) and other illegal acts (e.g. *gharar* and exploitation) are strictly prohibited, and trade with mutual consent is encouraged. Allah (swt) says in this regard:

الَّذِينَ يَأْكُلُونَ الرِّبَا لَا يَقُومُونَ إِلَّا كَمَا يَقُومُ الَّذِي يَخْبِطُهُ الشَّيْطَانُ مِنَ الْمَسِّ ذَلِكَ
بِأَنَّهُمْ قَالُوا إِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا وَأَحَلَّ اللَّهُ الْبَيْعَ وَحَرَّمَ الرِّبَا فَمَنْ جَاءَهُ مَوْعِظَةٌ مِّنْ
رَّبِّهِ فَانْتَهَىٰ فَلَهُ مَا سَلَفَ وَأَمْرُهُ إِلَى اللَّهِ وَمَنْ عَادَ فَأُولَٰئِكَ أَصْحَابُ النَّارِ هُمْ فِيهَا
خَالِدُونَ (البقرة, 275)

“Those who devour usury will not stand except as stands one whom the Evil One by his touch hath driven to madness. That is because they say: "Trade is like usury but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord desist shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the fire: they will abide therein (for ever)”, (Al-Qur'an, al-Baqarah: 275)

¹ M. Azizul Hoque, “Islamic Banking and Some of Its Possible Impacts” in *Islamic Banking: How Far Have We Gone?*, edited by A.H. Pramanik (IIUM: Research Centre, 2006), 107.

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ إِلَّا أَنْ تَكُونَ تِجَارَةً عَنْ تَرَاضٍ مِّنْكُمْ
وَلَا تَقْتُلُوا أَنْفُسَكُمْ إِنَّ اللَّهَ كَانَ بِكُمْ رَحِيمًا (النساء, 29)

“O ye who believe! eat not up your property among yourselves in vanities: but let there be amongst you traffic and trade by mutual goodwill: nor kill (or destroy) yourselves: for verily Allah hath been to you Most Merciful”² (Al-Qur'an, an-Nisa': 29).

Having these verses in mind, many Muslim scholars have tried, and are still trying, to come up with modes of financing³ that are *Shari'ah based*⁴ and in line with *maqāsid al- Shari'ah*. Usually Islamic scholars refer to Islamic modes of finance as *Shari'ah compliant* products while here we would like to promote *Shari'ah based* and not *Shari'ah compliant* modes of financing. This thesis focuses on some of the financial instruments, namely *mushārah mutanāqisah* partnership, *ijārah* and *ijārah sukūk*, which are used to finance acquisition of assets and which, if implemented properly would be *Shari'ah-based*.⁵

This is not an easy job when we are trying to combine two things that are mutually exclusive; Islamic banking and finance based on *Shari'ah* which prohibited *ribā* and other illegal acts and conventional banking and finance that is solely based on *ribā*. Ziauddin Sardar raises the question of whether or not we need banks in an

² Translation by A.Yusuf Ali.

³ Note: Mode, product and instrument of financing will be used interchangeably throughout this paper.

⁴ What do we mean here by *Shari'ah-based* is that Islamic financial products should be in line with *maqāsid al- Shari'ah* and *al-qawā'id al-fiqhiyyah*. In other words, it should incorporate *Shari'ah* as whole. Here, the author acknowledges indebtedness to Prof. Dr. Mahmood Sanusi for the introduction of *Shari'ah-based* term during the consultation with the author. Mahmood Sanusi (personal communication, December 29, 2006), International Islamic University Malaysia, Malaysia.

⁵ According to Muhammad Anwar, there are 21 operational modes which are interest free and can be used by Islamic banks. They are: *mudarabah*, *musharakah*, *musharakah mutnaqisah*, *ijārah*, *ijārah wa iqtina*, *murābahah*, *bai' al-salam*, *bai' al-mu'ajjal* (*bai' bi al-thaman al-ajil*), *bai' istisna*, *bai' eena*, *muzara'ah*, *musaqah*, *qard al-hasan*, *wakalah*, service charge, sale on installments, development charges, equity participation, sale and purchase of shares, purchase of trade bills, and financing through *awqaf*. See Muhammad Anwar, “Islamicity of Islamic Banking Practices” in *Islamic Banking: How Far Have We Gone?*, edited by A.H. Pramanik (IIUM: Research Centre, 2006), 355.

Islamic economic system.⁶ He further goes on saying that by inheriting western-made banks we are inheriting the western culture and values. By accepting the banks we accept “the entire exploitative and theoretical framework that comes with it.”⁷ It is that system itself that is bad – according to him - and therefore should be addressed with caution. Another scholar, Muhammad Anwar, also questions banking system as well as the operations of Islamic banks. He opines that both are of doubtful validity due to the problem of seigniorage.⁸ However, we believe that without banks it would be very difficult to meet the needs of all economic agents in today’s world. It is necessary for us to have banks and financial institutions, but these banks and institutions should be fully in line with the *Shari’ah* teachings. These banks and institutions may not necessarily be like ordinary banks and financial institutions but rather investment banks and institutions (i.e. PLS-based banks and institutions).

Today’s Islamic banking and finance, though still young, have not reached its horizons yet. The main reason, I would say, is that Islamic economics is a subordinate to the conventional economic system. It is functioning under some kind of supervision of the latter. More and more time is spent for justification of Islamic economics and promoting it to Western world. This led Islamic economics to become “variation of Western economic thought.”⁹ Its scope of products or derivatives is very limited and *ribā* of conventional banks is, more or less, a benchmark for the rate of return in Islamic banks. Due to these reasons many Muslims are reluctant to use facilities

⁶ Ziauddin Sardar, *Islamic Futures: The Shape of Ideas to Come*, (Kuala Lumpur: Pelanduk Publications, 1988), 203-206.

⁷ *Ibid.*, 204.

⁸ This is due to the fact that Islamic banks are operating under fractional reserve system. It means that even Islamic banks create fiat money using Islamic modes of finance. See Muhammad Anwar (2000, 2006). Regarding the socio-economic effects of the creation of fiat money and seigniorage see also Ahamed Kameel Mydin Meera (2002, 2004) as well as Meera and Larbani (2005).

⁹ See Seyyed Vali Reza Nasr, *Islamization of Knowledge: A Critical Overview*, (Islamabad: International Institute of Islamic Thought, 1992), 3.

offered by Islamic banks.¹⁰ Furthermore, standards and requirements with regard to operating and running of Islamic banking and finance (IBF) differ from a country to a country.

How much “Islamic” is an Islamic bank? Can they survive in this increasingly volatile market and tough competition? Did they fulfil the necessary criteria and accomplish the mission bestowed upon them? – are only some of the questions that can be raised in this regard. Islamic banks are rotating around one or two products with which they are trying to meet all needs of the people. In Malaysia, they are mostly using *bay' bithaman ājil (BBA)* or instalment sale mode of finance. Their practice is very similar to their conventional counterparts. It seems that they are only carrying Islamic name,¹¹ while everything else is more or less the same as in conventional banks. According to *New Horizon*,¹² Islamic banks are operating using modes of Capitalist system. This overdependence on few instruments and mainly short-term financing is worrisome since it cannot address all needs of the Muslim society. Long term projects are rarely financed due to the mismatch between the short-term deposits and long-term financing of those projects. There are two reasons why we should be concerned about this situation of Islamic banks. Firstly, overemphasis of Islamic banks on short-term financing will marginalize them since there are serving only a part of public needs and this will push them into shadows of the financial system. Secondly, this practice does not create new capital, thus it does not contribute to Gross National Product (GNP) growth.¹³ In most cases these funds from Islamic banks are

¹⁰ For example, *bay' bithaman ājil* or *BBA* mode of financing is widely used in countries such as Malaysia, Indonesia, Brunei, etc. while this mode of finance is disapproved by Middle Eastern scholars.

¹¹ See Muazzam Ali, “Islamic Banking: The Challenge From Within,” *New Horizon*, no. 101, August 2000, 3.

¹² “Islamic Banking: A Long Journey Ahead,” *New Horizon*, no. 104, November 2000, 2.

¹³ Ismail Bacha Obiyathullah, “Conventional versus Mudaraba Financing: An Agency Cost Perspective” in *Islamic Banking: How Far Have We Gone?*, edited by A.H. Pramanik (IIUM: Research Centre, 2006), 177-178.

used for customer goods which are not adding to the economic growth and development. Very little is used to meet investment needs and finance development and growth projects. It is therefore believed that *mudārabah* and *mushārah* financing instruments should be used by Islamic banks and financial institutions. Obiyathullah is of opinion that these two modes of financing are “the *raison d’être* of Islamic banks.”¹⁴ Muhammad Taqi Usmani stated that the *mushārah* is “the ideal instrument of financing according to *Sharī‘ah*”¹⁵ since it allows the share of the profit and loss by both parties according to their invested capital.

It is in a human nature to strive for a better life and to live more comfortably. One of the basic goals, that every individual is trying to get throughout his lifetime, is the comfort of a home and the necessity of a car. However, meeting these ends requires one to have funds. In most cases personal income and saving are not enough to buy a house or a car on cash terms. Therefore, these individuals, wishing to meet their life dreams, have no other option but to apply for a loan from a bank or financial institution. If they do not have Islamic scheme of finance available for them they will be trapped into the web of *ribā* (interest). Because of all of this, Muslim *Ummah* in general and Islamic economists in particular are responsible for protecting these individuals from harm of *ribā* by providing them with Islamic modes of finance. Implementing *MMP* and *ijārah* financing will enable them to get what they want while at the same time avoiding *ribā* payment.

¹⁴ Ibid., 178.

¹⁵ Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, (The Hague: Kluwer Law International, 2002), 113.

1.1 PROBLEM STATEMENT

Islamic banks have passed the test of the time. Throughout the years of its existence, the activities and services have improved leading to great results. Besides all of this, current status and development of Islamic banks and financial institutions are far from being bright. Stella Cox is reported saying:

Whilst we can begin this new millennium on a very positive note, there are ongoing inefficiencies that need to be addressed. We must nurture all that has been achieved to date whilst avoiding complacency and finding solutions to existing problems that will continue to strengthen Islamic economic and financial practice and maintain its growth curve. This can be achieved, In sha Allah, through sharing of ideas and experiences so that the levels of education and depth of knowledge are broadened throughout the industry.¹⁶

This paper is of the view that Islamic banks and financial institutions, due to the limited modes of finance and services, and primarily short-term financing, are not at their optimum performance. In other words, there is a lot more to be done. This paper attempts to offer more *Shari'ah* compliant ways for these institutions to reach their optimum goals.

The purpose of this study is to analyze the characteristics and operational procedures used by Islamic banks and financial institutions with special focus on *MMP*, *ijārah* and *ijārah sukūk*. This paper will try to answer following questions:

1. What is the current *status quo* of Islamic banks and financial institutions?
2. Which modes of finance are used the most by Islamic banks?
3. How can *MMP*, *ijārah* and *ijārah sukūk* modes of finance be implemented into Islamic banking and finance?
4. Why these products?

¹⁶ Cited in "Islamic Banking: A Long Journey Ahead," *New Horizon*, no. 104, November 2000, 2.

5. How can these modes of finance promote profit-sharing financing and help both, Islamic banks as well as customers?
6. What are the problems and challenges faced by Islamic banks in today's world?
7. What are possible obstacles for implementing these modes of finance and how can these problems be avoided?

1.2 JUSTIFICATION OF PROBLEM

So far, Islamic banks and financial institutions have been overwhelmed by few products/services, among which one is more predominant than the others. This one is known as *Bay' Bithaman Ājil* (BBA) or differed payment (on instalment). The minimum and maximum percentage of banking finance under each mode, shown as average for ten leading Islamic banks – according to Muhammad Anwar – are as follows: “*murābahah-cum-bai' al-mu'ajjil* 45%-93%, *mushārahah* 1%-20%, *mudarabah* 1%-17%, *ijārah* (leasing) 0%-14% and other modes 0%-30%”.¹⁷ He also cites the mode of financing of Bank Islam Malaysia Berhad for the year ended on 30 June 1999. In this case the proportions are: *murābahah-cum-bai' bi al-thaman al-ājil* 91.55%, *ijārah* 3.41%, *mushārahah* 0.52%, *mudārahah* 0.47%, and *qard al-hasan* 2.63%.¹⁸ Another set of data showing proportions of each mode of financing is presented in Table 1 below. It is due to this reason, among others, that Islamic banks failed to reach their zenith. They failed on these levels: Firstly, they were not able to capture bigger share of the market size and to attract new customers due to the limited modes of financing. Secondly, they were not able to meet unlimited needs and wants of the clients with limited modes of financing (using mainly BBA). Thirdly, they were

¹⁷ Anwar, “Islamicity of Islamic Banking Practices”, 356.

¹⁸ Ibid.

not able to fulfil the role of the Islamic banks, i.e. to promote just, profit sharing approach and to set the path for Islamic economic order.

Table 1.1
Islamic Banking System: Financing concepts as at end of 2005

<i>Mode of Finance</i>	<i>2005</i>
Al-Bay ^c Bithaman Ajil	40.70%
Al-Ijāra	31.60%
Al-Istisna'	0.90%
Mudharaba & Mushāraka	0.30%
Murābahah	6.90%
Other Islamic Contracts	19.60%

Source: Bank Negara Malaysia, *Annual Report 05*.

This proposal will be justified from three points of view, namely from general point of view, religious point of view and economic point of view.

1.2.1 General Point of View

The solutions, offered by this paper to the under-developed Islamic banks and financial institutions, will be beneficial for both, Islamic banks as supplier of the funds and clients as the customers of Islamic banks and users of these funds. From the perspective of the clients, these services will result in following: