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The Role of Islamic Financial Instruments in the Business of Islamic Financial Institutions

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Abstract
Financial markets play an important role in stimulating an economy and mobilizing saving for investment operations. Development of these markets would be helpful in introducing Islamic banking and solving a number of contemporary economic problems. Islamic financial system can have both Money and Capital Market as also Primary and Secondary Markets with a different procedure of creation and trading of their instruments. Development of secondary markets and effective supervisory/regulatory system is equally important. This research deals with the markets that can function in Islamic financial structure and the instruments that have been developed for their functioning. It would also discuss why some kinds of markets and instruments have not been developed so far in Islamic finance discipline. Financial markets should be given due importance in order to discharge the obligation of preserving capital and ensuring its growth because they lead to fulfil the general human needs and discharge functions relating to capital. Islamic capital market will work on different set of principles. The Islamic Fiqh Academy of the OIC has observed, "Although the original concept of financial markets is sound and its application is very much needed in the present-day context, yet their existing structure does not present an example to carry out the objective of investment and growth of capital within the Islamic framework. This situation requires serious academic efforts to be undertaken in collaboration between the Fuqaha and the economists, so that it may be possible to review the existing system with its procedure and instruments and to amend what needs amendment in the light of the recognized principles of Shariah".
Keywords: Instruments, Institutions, Islamic Finance, Business, Debt, Risk sharing

Inrtoduction

The primary markets will operate on the basis of equity instruments like share, redeemable equity capital, *Mudarabah* / *Musharakah* certificates (MCs) or *Sukuk* representing ownership in leased assets or debt instruments resulting from trading modes issued directly to investors or fund providers. According to mainstream Islamic finance theory, debt securities do not have secondary market in principle. However, there is possibility of securitization of debt resulting from real trading transactions when they are pooled with other assets or instruments

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representing ownership in real assets. All equity or participatory instruments have secondary market because they represent ownership in real assets.

Pure debt or bonds market is not an active part of Islamic financial markets because debt liabilities have to be paid at the nominal value. A debt security would result from a real transaction based on any trading mode that can implicitly include time value of money at the stage of pricing of the underlying commodities. The instruments on the basis of which Islamic market has to function would need to be backed by or represent real asset transactions. These instruments could be of both variable and quasi fixed/fixed return nature. Equity Instruments having a claim to share in the net income and the assets of a business give variable return while the second type of instruments can be issued in respect of trade or leading based transactions subject to observation of principles of underlying Islamic modes. Backing by real assets according to rules of the relevant modes is must and mere replacement of one paper transaction with another kind of similar paper transaction will not serve the real purpose.

Debt Avoidance

Islam allows debt. But it recommends debt only as a closing motel and now not as a method to finance one's developing lifestyle needs. Muslims are warned in opposition to extravagance. The holy Quran says:

وَّكُلُواْ وَاشْرَبُواْ وَلاَ تُسْرِفُواْ إِنَّهُ لاَ يُحِبُّ الْمُسْرِفِينَ.[1]

" Eat and drink, but waste not by excess, for God loveth not the prodigals "

وَآتِ ذَا الْقُرْبَى حَقَّهُ وَالْمِسْكِينَ وَابْنَ السَّبِيلِ وَلاَ تُبَذِّرْ تَبْذِيرًا. إِنَّ الْمُبَذِّرِينَ كَانُواْ إِخْوَانَ الشَّيَاطِينِ وَكَانَ الشَّيْطَانُ لِرَبِّهِ كَفُورًا.[2]

"Squander no longer wastefully, sincerely the squanderers are the Satan's brethren."

Clothing

Ibn Abbas related that the Prophet said: Any Muslim who gives a Muslim a garment to wear will be in Allah's safekeeping as long as a shred of it remains on him.[3]

Debt: Relieving the person in debtv Abu Qatadah related that the Prophet said: If anyone would like Allah to save him from the hardships of the Day of Resurrection, he should give more time to his debtor who is short of money, or remit his debt altogether.[4]

Food and the Needy

Safwan ibn Salim related that the Prophet said: Anyone who looks after and works for a widow and a poor person is like a warrior fighting for Allah's cause, or like a person who fasts during the day and prays all night.[5]

Anas related that the Prophet said: If any Muslim plants something or sows seed from which a man, a bird or an animal eats, it counts as a charity for him.[6]

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[1] al-Aeraf: 7:31

[2] Bani Israel: 17:26-27

[3] Al-Tirmidhī, Muhammad ibn Isa, *Sunan al-Tirmidhi* (Beirut: Dar al-Gharb al-Islami, 1998), 236/2

[4] Muslim bin Ḥajjāj al-Qashīri, *Al-Jami'al-Saḥiḥ* (Bairūt: Dār Aḥya al-Turath al-'arbi, 1990), 156/1

[5] Bukhārī, Muḥammad bin Ismā'īl, *al-Jāmi' al-Ṣaḥīḥ* (ar-Riyāḍ: Maktabah Dār al-Salām, 1986, wa al-Ṭab'ah al-Thāniyah 1419H/1999), 369/2

[6] Bukhārī, *al-Jāmi'al-Ṣaḥīḥ*, 369/2

Relatives who are needy

Abu Huraira narrated that the Prophet said: The best charity is that which is practiced by a wealthy person. And start giving first to your dependents.[7]

Salman ibn Amer reported that the Prophet said: To give something to a poor man brings one reward, while giving the same to a needy relation brings two: one for charity and the other for respecting the family ties.[8]

Stinginess

Jabir reported that the Prophet said: Avoid doing injustice to others, for on the Day of Judgment, it will turn into manifold darkness, and safeguard yourself against miserliness, for it ruined those who were before you. It incited them to murder and treating the unlawful as lawful.[9]

Shariah Position of Debt Certificates or Bonds

Although Islamic banks will be having a large portfolio of receivables based on their trade operations, yet they cannot participate in trading of such instruments in secondary market. Islamic *Fiqh* Academy of the OIC in its sixth session (14-20 March, 1990) resolved the following in respect of debt certificates, receivables or bonds (sic);

a) The bond, which represents an undertaking to pay its amount along with interest related to its face value or to a pre-determined profit, is prohibited in *Shariah*. Their issuance, purchase and their negotiation, is all prohibited because they are interest-bearing loans, no matter whether their issuing authority belongs to the private sector or is a public entity related to the State. The change in the nomenclature, such as calling the bonds "certificate" or investment securities" or saving certificates" or calling the interest "profit" or "income or service charge" or commission" has no effect on the aforesaid ruling.

b) The "zero coupon bonds" are also prohibited because they are loans sold at a price lower than their face value, and the owners of such bonds benefit from the difference in their prices, which is considered a discount on the bonds.

c) Similarly, the "prize bonds" are also prohibited because they are loans in which a liability to pay a pre-determined profit or an additional amount is undertaken in favour of their bearers as a whole, or in favour of an undetermined number of persons out of them. Moreover, these bonds have a resemblance with gambling ("*Qimar*")

d) The interest-bearing bonds can be substituted by the instruments issued on the basis of the contract of "*Mudarabah*" meant for a particular project or a particular enterprise, wherein no pre-determined profit or interest shall be paid to the bearers. The investors will be entitled to get a proportionate share in the profit of the project in relation to the proportion of their respective investments. This profit cannot be given to unless it has been actually yielded.

Shariah Compliant Markets and Instruments

Islamic investment vehicles that are traded in Islamic financial markets include *Shariah* compliant stocks wherein income is derived from dividends and capital gains keeping in view the screening criteria recommended by *Shariah* scholars to ensure *Shariah* compliance. Other instruments are *Mudarabah*/*Musharakah* certificates, Units of open or close-ended mutual funds and investment *Sukuk* wherein income is derived from buying, selling as also getting return from the underlying businesses and assets.

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[7] Bukhārī, *al-Jāmiʿ al-Ṣaḥīḥ*, 369/2

[8] Al-Tirmidhī, Muhammad ibn Isa, *Sunan al-Tirmidhi*, 321/1

[9] Muslim bin Ḥajjāj, *Al-Jamiʿal-Saḥiḥ*:369/2

Islamic financial institutions can place their funds on *Mudarabah* basis in inter-bank money market to share profits or bear loss, if any. They can also issue negotiable Certificates of Deposits (CODs) or Certificate of Investments (COIs). They will establish specific *Musharakah* funds and the proceeds of these Funds can yield quasi fixed return on the basis of income earned on trade-financing operations of the banks. Beings a shareholder in the income of a fund, these certificates will be negotiable in the secondary market. Legal and regulatory framework, however, will need to be developed to support such operations.

Sukuk can be issued by the Governments, Corporations, banking and non-banking financial institutions and by business/industrial concerns. As forward sale/purchase of goods through Salam rules is permissible; there is also possibility of commodity futures market that, of course, will be different from the conventional commodity futures market. As such, following types of markets governed by principles of relevant contracts or modes are available in Islamic financial structure.

1. Equity or stocks markets.
2. Securities markets like non-government securities (banks, non-banks, corporate, and housing Securities.)
3. Government and municipal securities market.
4. Commodity futures market.
5. Interbank money market for placement of funds on *Mudarabah* basis.
6. Foreign exchange market (limited).

Besides equity instruments in the form of shares of any company, Islamic financial system has other redeemable participating instruments representing ownership in the assets and hence entitled to participate in the profit/loss resulting from the operations on the assets. Various types of participatory instruments can be based on:

a. Profit/Loss sharing (*Mudarabah*/*Musharakah*) like Participation Term Certificates (PTCs).
b. Rent sharing in the form of Diminishing *Musharakah* or otherwise.

In addition to shares, redeemable equity-based instruments. There could be investment certificates normally termed as *Sukuk* in Islamic finance terminology. Investment *Sukuk* are different in nature from common shares of the joint stock companies there are certificates of equal value representing undivided share in ownership of tangible assets of particular projects or specific investment activity, usufruct and services. These are issued on the basis of *Shariah*-nominated contracts in accordance with relevant rules of the concerned contracts.

Debt securities in a conventional framework can be issued with or without any real transactions. The debt security in Islamic framework would normally result from a real transaction based on *Bai-Muajjal*, *Bai Salam* or *Istisna* transactions or from *Ijarah* contracts. If a debt security is not a result of a real transaction, it will not carry any time value of money. However, if a debt security is a result of a real transaction, time value can be implicitly included as an integral part of the transaction.

Equity Markets

Equity market is the most strategic part of Islamic capital markets where shares of Joint Stock Companies, redeemable participation certificates and other instruments representing ownership of their holders in the assets backing them are traded among individuals, corporate bodies and business and financial entities. IFIs can take part in equity market business for raising funds through equity and mutual fund offerings and trade in stocks, Units of open and close ended Mutual Funds and instruments of redeemable capital.

Shareholders of a company can be physical persons, or legal persons or both. As per rules in most of the countries, a Company is deemed to have a separate entity distinct from its members. Therefore, the company has legal rights and bears liabilities. It can sure for its rights and can be sued for failing to discharge its commitments. The relevant law provides for two sets of liabilities in the case of a Joint Stock Limited Company: - (1) The liability of the shareholders, who subscribe their share capital for establishing the business but virtually detach themselves from the affairs of the business thereafter, is limited to the extent to their share capital. (2) The liability of the Company relating to its business affairs is unlimited meaning that in the case of winding up of a company the earnings of the company along with the recovered loans will first of all be utilized to pay all debts, taxes, wages, salaries and rents. In case the liabilities are still not fully discharged, this legal person will be disposed of to settle the debts and other liabilities. If certain payments are still outstanding, this legal person will be declared to be insolvent like an ordinary physical person who is declared insolvent under such a situation.

Raising equity capital through shares, MCs, *Shirkah* based TFCs offerings, underwriting of shares issues and their trading are subject to a number of conditions and criteria. Prospectus of the Company issuing shares must provide all information required by *Shariah* for the *Shirkah* based contacts. *Shariah* experts are of the view that shares of joint stock companies cannot be traded when all assets are still in liquid form (cash or receivables) except at face value or break-up value. However, fresh share issues (IPOs) can be made on premium. The companies with better rating and good will offer the shares in premium e.g. a share with nominal value of Rs. 10 is offered at Rs. 20. *Shariah* expert allow such offering with the recommendation that amount of premium may be kept as Reserves of the Company. It implies that the purchase of the shares pay Rs. 10 as nominal value and additional Rs. 10 that are kept as Reserves are part of the Company's capital and owned by holders of shares on pro-rata basis.

It is permissible that a company or group of companies underwrites issuance of shares. It means an undertaking to subscribe to the shares that are not subscribed without any consideration. However, underwriter can ask for consideration for services provided other than the take-up services, such as conducting feasibility studies or marketing the shares.

Besides shares companies can issue *Mudarabah* / *Musharakah* certificates (discussed in this article) and also raise redeemable capital by issuing Term Finance Certificates as alternative of debentures in conventional capital structure. Similarly, they can issue mutual funds of a number of the categories like Equity Fund, *Ijarah* Funds, *Murabahah* Funds and Mixed Funds.

The *Shariah* scholars have observed that there is no objection in the *Shariah* to the secondary market trading of equity based financial instruments, particularly shares of joint stock companies. These certificates should, however, represent real assets. A part of their assets can be in the form of debts created by Islamic modes, but the debt element should not be predominant.

Investment *Sukuk* as Islamic Market Instruments

Sukuk were used by the Muslim societies of the Middle Ages as Papers representing financial obligations originating from trade and other commercial activities. However, the *Sukuk* structures presently found in Islamic finance are different from the *Sukuk* originally used and are akin to the conventional concept of securitization, a process in which ownership of the underlying assets is transferred to a large number of investors through papers commonly known as *Sanadat*, Certificates, *Sukuk* or other instruments representing proportionate value of the relevant assets.

Investment *Sukuk* are different in nature from common shares of the joint stock companies. These are certificates of equal value representing undivided share in ownership of tangible assets of particular projects or specific investment activity, usufruct and services. These are issued on the basis of *Shariah*-nominated contracts in accordance with relevant rules of the

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concerned contracts. *Sukuk* can be of a number of types based on the *Shariah* modes as the underlying contract or sub-contract, most important of which are *Shirkah*, *Ijarah*, Salam and *Istisna*. As per the basic rules of *Shariah*, investments *Sukuk* have to be structured, on one side, on the principle of *Mudarabah* principle. On the other side, business could be conducted through participatory or fixed return modes/ instruments. Thus, the rates of return on *Sukuk* will be either variable (in case the modes on Second leg are participatory) or quasi-fixed (in case of modes with fixed return). *Sukuk* of the second category can be made fixed return *Sukuk* through the provision of any third-party guarantee.

Developing *Shariah* Compliant Securities

Strictly speaking, there is no counterpart in Islamic finance of fixed-income bonds and securities which are quite popular in the conventional market. However, Islamic capital markets can have a variety of instruments on the basis of partnership and debt creating modes. These instruments are negotiable in secondary market subject to some conditions.

In terms of the use of funds mobilized by financial institutions, following may be the categories of *Sukuk*: *Mudarabah Sukuk*, *Musharakah Sukuk*, *Sukuk* of ownership in leased assets, *Sukuk* of ownership of usufructs, Salam *Sukuk*, *Istisna Sukuk* and *Murabahah Sukuk*. *Shirkah* based certificates could be issued to risk-prone investors while *Sukuk* created on *Ijarah* and trade-based modes would suit those investors who are not in position to bear the risk of loss. It is also possible to design *Mudarabah* and *Musharakah* (*Shirkah* based) certificates with low risk return package by scrutinizing a combination of *Murabahah* and leasing based financing operations. During last few years, a number of instruments have been introduced for medium- and long-term investment on *Shariah* compliant basis.

These are of two types in terms of their nature and flow of return:

Fixed/Quasi Fixed (Stable) Income Securities: Banks can securitize or sell a pool of assets or offers Certificates of Deposits (CDs) against a fund composed of pooled *Ijarah* and some *Murabahah*, Instalments sale and *Istisna* contracts. It will offer the investors/depositors a defined stream of cash flow constituting the return on the pooled assets. Such securities would accommodate risk-averse investors like widows, retired persons, etc. and generate new resources for additional intermediation and income flow to the banks.

Variable Income (*Shirkah* Based) Securities: For such securities banks can securitize a pool of *Musharakah* and *Mudarabah* contracts that are part of their assets portfolio. Such securities will offer the investors a stream of variable income with potential for growth; based on the strength of the underlying projects- Profit and risk both would be higher than in case of stable income securities. These would accommodate risk taking investors with commensurate possibility of higher income. IFIs can manage a variety of mutual funds which would be just like *Mudarabah* Company that would finance the government needs through *Ijarah* or *Murabahah-Ijarah* mixed. Its securities/certificates would be tradable just like shares of *Mudarabah* Company and income earned by the Mutual Fund would be distributed among the certificate holders after deduction of expenses.

Since *Murabahah* operations are least risky and leasing operations can also be selective to choose only low risk transactions, the securitization of such transactions will give low risk capital instruments for the Islamic capital market. It is possible to develop Islamic fixed/quasi fixed-income securities. The basic idea is to form a Fund/Trust that would mobilize funds to invest in fixed income operations based on leasing and *Murabahah*. Banks can establish different leasing funds on the basis of which they can invite deposits, issue deposit certificates of different maturity and offer different risk-return packages, to meet the risk-return preferences of their clients.

While it is relatively easy for banks/financial institutions to securitize their assets booked through *Ijarah*, Salam, *Istisna*, *Murabahah* or on the basis of mixed assets portfolio, development of *Shariah* compliant instruments for financing government budget deficits is a difficult task mainly because the governments needing finance do not have sufficient real unencumbered assets for conversion of debt stock into securities.

After developing appropriate institutions, it is also possible to engineer Islamic financial instruments to replace the interest-based instruments in the money market. Financing for commodity operations of governments through trade-base modes can became a basis of developing short-term securities carrying quasi-fixed return to replace T-Bills. Banks can establish *Musharakah*/*Mudarabah* funds to be managed by them on the basis of leasing and trade. These securities/certificates would be tradable and income earned by the Mutual Fund would be distributed among the certificate holders after deduction of expenses. These funds can also securities and the securities so developed can serve as money/capital market instruments.[10]

It would also require appropriate enabling laws to protect the interests of investors and issuers, appropriate accounting standards, study of the targeted marked and standardized contracts, historical financial statistics, appropriate flow of financial date to investors, grading of assets liquidity and risks and standardized services quality. In all this process, regulators have to play a crucial role.

Scrutinizing the *Ijarah* contracts is a key factor in solving liquidity management problem and for financing the public sector needs in any economy. It is possible due to flexibility in juristic rules of *Ijarah* contract. Payment of *Ijarah* rentals can be unrelated to the period of taking usufruct by the lessee, i.e. it can be made before the beginning of the lease period, during the period or after the period, as the parties may mutually decide. This flexibility can be used to evolve different forms of contracts and *Sukuk* that may suit different purpose of issues and the holders.

Further, the lesser can sell the leased asset provided it does not hinder the lessee to take benefit from the asset. The new owner(s) would be entitled to receive the rentals of remaining period. *Ijarah* certificates or *Sukuk* issued to them represent the pro rate ownership of their holders in the tangible assets, and not only the liquid amounts or debts; they can be traded in the secondary market on the basis of market forces. Similarly, owners of shares of any leased asset can dispose of their share in the asset to the new owners individually or collectively. Anyone who purchase these *Sukuk* replaces the sellers in the pro rate ownership of the relevant assets and all the rights and obligations of the original subscribed are passed on to him. [11]

Another important benefit of *Ijarah*, as compared with other modes, is that Governments can use this concept as alternative tool to interest based borrowing provided it has durable assets useable in the process of performing government functions. *Ijarah Sukuk* offer flexibility from the point of view of their issuance, management and marketability also. All private and public entities can issue these instruments. Further, *Sukuk* can be issued by financial intermediaries or directly by users of the leased assets.

The simplest structures of *Ijarah Sukuk* is that an Islamic bank or a Fund Manager Securities the assets already booked under *Ijarah*. In this case, ownership of the leased assets would transfer to the purchasers of *Ijarah* securities who would be entitled to prorate rentals and also bear the ownership related risks. Banks can also have established different leasing funds

[10] Khan, M. H. (2004), A Handbook for Practitioners in Rural Support Programme.p.45

[11] Khandker, Shahidur R, K. Baqui and K. Zahed (1995), *German Bank:* Performance and Sustainability. World Bank Discussion Paper 306. Washington D.C.

on the basis of which they can invite deposits for funding their leasing operations and offer different risk-return packages to meet the preferences of their clients. They would distribute the return in the form of rentals net of any defaults or ownership related expenses charging some management fee.
There could be more sophisticated and innovative structures of *Ijarah Sukuk*. For the purpose of funding public sector needs and liquidity management by Islamic banks, the best structure of *Ijarah Sukuk*, as an alternative to interest-based sovereign and corporate bonds, is that the government (or any entity) in need of funds may sell unencumbered specific fixed assets to the SPV for forming a pool of assets for leasing to the Government. The SPV will lease the assets to the Government against which it will issue *Ijarah Sukuk* in local or international markets to those interested in investment. The rentals stipulated between the SPV and the government and calculated per certificate would represent the possible earning to the *Sukuk* holders. As such, on one side this structure of *Sukuk* is based on partnership, while on the other side it is based on *Ijarah* or leasing principle.
The sovereigns will have to ensure that the pool of assets that is the underlying basis of the transaction comprises the assets that are unencumbered property of the Government and that are in its use by one way or the other. Separate pool of assets would have to be sold to the SPV for every issue. Once the government has sold any asset, the same asset cannot become basis for further securitization unless the government repurchases it in any normal *Shariah*.

Asset Based Financing

Islamic banks lend funds based on trade (i.e., real economic activities) rather than pure finance. In other words, they act as genuine traders who help consumers and investors acquire desired goods/commodities/assets. This trade-based financing involves real goods and services whether through sale (Ba'i such as *Murabahah* or cost-plus sale) or agency (*Wakalah*). That means Islamic financing is backed by real goods or assets. Transactions that have no such real or physical assets are considered by *Shariah* null and void ab initio (originally and essentially *Batil*). Islamic banking effectively helps ensure stability in the value of money and also helps prevent speculation and manipulation. The fund flows through Islamic financial modes of financing are linked directly to the flow of goods and services in the economy. Hence, the movement of funds in an Islamic economy is based on real fundamentals and takes place in a slow but sure manner contrary to the case with conventional economies where interest-based short-term funds swing in sudden fits and large proportions that usually wreak havoc in the financial sector and the broader economy.[12]
The prohibition of *Riba* and the permissibility of trade (and real economic activities) necessitate linking profit and risk (*al-Kharaj bid-Dhaman and al-Ghunmbilghurm*) to circumvent transactions in which money creates money. To avoid any involvement in such transactions (*Ribawi* transactions), Islamic banking uses modes of lease (*Ijarah*), and fee-based contracts (commissions) as well as investment modes). As such, the relationship between an Islamic bank and its clients may be in the form of buyer (*Istithmarr* and seller, principal and agent, lesser and lessee, transferor and transferee, guarantor and guarantee, depositor and custodian/deposited, and partnership (partner to partner).

Risk Sharing

Any Islamic banking transaction, the Islamic financial institution and/or its deposit holder take(s) the risk of ownership of the tangible asset, real services or capital before earning any profit there from

[12]Khan, M. H. (2001), Community Organization a Rural Development: Experience in Pakistan. Vanguard.p.112

Sanctity of Contracts

Before executing any Islamic banking transaction, the counter parties have to satisfy whether the transaction is halal (valid) in the eyes of Islamic *Shariah*. This means that Islamic bank transaction must not be invalid or voidable. If there are any invalid components in the contract and unless these invalid components are eliminated, the contract will remain voidable.

Financing in Halal/ *Shariah* Complaints Activities

Every Islamic banking transaction has certain economic purpose/activity. Further, Islamic banking transactions are backed by tangible asset or real service. Islamic banks cannot involve in *Riba*/interest related transactions.

They cannot lend money to earn additional amount on it. However, as stated above, it earns profit by taking risk of tangible assets, real services or capital and passes on this profit/loss to its deposit holders who also take the risk of their capital.

Prohibition of Speculative Behaviour (*Gharar*)

The concept of *Gharar* has been broadly defined via the Islamic scholars in two methods. First, *Gharar* implies uncertainty. Second, it implies deceit. The Quran has honestly forbidden all enterprise transactions, which cause injustice in any form to any of the parties. It is able to be within the form of hazard or peril main to uncertainty in any commercial enterprise, or deceit or fraud or undue advantage. *Gharar* is taken into consideration to be of lesser significance than Riba. At the same time as the prohibition of *Riba* is absolute, some degree of *Gharar* or uncertainty may be desirable insure kinds of contracts. The presence of excessive *Gharar* makes a settlement forbidden.[13]

Ibn Juzay, the well-known Maliki jurist offers a list of ten instances, which represent, in his view, instances of forbidden *Gharar*. Those cases are defined as follows:[14]

1. Trouble in putting the customer in possession of the challenge-depend; along with the sale of stray animal or the younger nonetheless unborn when the mother isn't always a part of the sale.
2. Need of knowledge (*Jahl*) with regard to the charge or the problem depend, such as the vendor saying to the capacity purchaser: “I promote you what is in my sleeve?”
3. Want of know-how (*Jahl*) in regards to the characteristics of the charge or of the challenge-count, which includes the vendor announcing to the capacity consumer: “I promote you a chunk of cloth which is in my domestic.” or the sale of an article without the purchaser examining or the seller describing it.
4. Want of information (*Jahl*) with regard to the quantum of the price or the amount of the problem-remember, such as a suggestion to sell “at these days’ fee” or “at the market price.”
5. Need of understanding (*Jahl*) in regards to the date of destiny overall performance consisting of a proposal to promote when a stated man or woman enters the room or whilst a said man or woman dies.
6. two sales in one transaction, which includes promoting one article at extraordinary expenses, one for cash and one for credit, or promoting two unique articles at one fee, one for immediate remittance and one for a deferred one.
7. The sale of what is not predicted to restore, consisting of the sale of a sick animal.

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[13] Abdul Ghafoor, A. L. M. *Interest free Commercial Banking*. Groningen, Netherlands: Apptec, 2002, 16
[14] Al-Zuhaylı, W. *Al-Fiqh Al-'Islamıwa 'Adillatuh*. Damascus: Dar Al-Fikr, Fourth revised edition, 1997, 12

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8. *Bai al-Hasah*, which is a sort of sale whose outcome is determined via the throwing of stones. (i) *Bai Munabadha*, that's a sale executed by using the seller throwing a cloth on the client and accomplishing the sale transaction without giving the customer the opportunity of well examining the item of the sale.
9. *Bai Mulamasa*, in which the bargain is struck by way of touching the item of the sale without inspecting.

From the above, it's far clean that *Gharar* does no longer have a single definition and is a reasonably large idea. In modern-day parlance, *Gharar* can also definitely consult with settlement hazard. it may talk to inadequacy of records shared among parties to a transaction, together with, when the price, characteristics of object of transaction and so forth aren't recognized to each the events on the time of transaction. It could refer to misspecification and inaccuracy of information shared between parties to a transaction attributable to fraud or deceit. it could also confer with undue complexity in transactions or virtually games of threat.

It could be mentioned that *Gharar* subjects in the context of commercial transactions most effective. Similar situations of *Gharar* triumphing in the context of non-commercial transactions without a consideration, including, offers, presents, ensures do now not make the agreement illegal. For this reason, at the same time as industrial coverage is deemed illegal because it includes *Gharar*, mutual cooperative insurance is an acceptable product for Islamic microfinance.

It could additionally be noted that the prevalence of *Gharar* poses a great task to an Islamic prison professional in the context of the casual putting of rural and micro economies with their non-standardized contracts of numerous kinds.[15]

Instruments of Microfinance

Most important forms of MFI[16] can be understood from the institutional innovation perspective. With microfinance, institutional innovation does no longer continually imply growing a brand-new institutional kind, but may be the edition of a present institutional kind to the restrictions and potentials of a sure purchaser group, in particular nearby surroundings.[17]

Essential kinds of MFI are:

The Cooperative Version

Stimulated with the aid of the fulfilment in Europe and North America on the stop of the nineteenth century, this becomes the primary model to introduce microfinance in growing international locations. The cooperative individuals are the owners, contributing to the fairness capital through stocks. Loans are only granted to the members. Cooperative MFIs are solely consciousness at the provision of economic services.

The Grameen Solidarity Group Model

This model is based on group peer pressure whereby loans are made to individuals in groups of four to seven (Berenbach and Guzman, 1994). Group members collectively guarantee loan repayment, and access to subsequent loans is dependent on successful repayment by all group members. Payments are usually made weekly (Ledgerwood, 1999). According to Berenbach and Guzman (1994), solidarity groups have proved effective in deterring defaults as

[15] M A El-Gamal, 2001 "*An Economic Explication of the Prohibition of Gharar in Classical Islamic Jurisprudence*"p.256
[16] Microfinance Institutions
[17]Kyereboah-Coleman, A. *The impact of capital structure on the performance of microfinance institutions.* 2007, The Journal of Risk Finance Incorporating Balance Sheet, 8(1), 56-71.

evidenced by loan repayment rates attained by organisations such as the Grameen Bank, who use this type of microfinance model7. They also highlight the fact that this model has contributed to broader social benefits because of the mutual trust arrangement at the heart of the group guarantee system. The group itself often becomes the building block to a broader social network (1994, p.121).

Solidarity Credit Organizations

Here, 3 to ten clients be part of a group to get hold of get entry to monetary offerings (usually credit), previous to them saving earlier than receiving a mortgage. Further, non-financial offerings are offered to institution individuals, consisting of education or get entry to marketplace statistics. Group members collectively assure loan repayment, and get right of entry to next loans is given handiest once previous loans are paid in complete.

Rotating Savings and Credit Associations

These are formed when a group of people come together to make regular cyclical contributions to a common fund, which is then given as a lump sum to one member of the group in each cycle (Grameen Bank, 2000a). According to Harper (2002), this model is a very common form of savings and credit. He states that the members of the group are usually neighbours and friends, and the group provides an opportunity for social interaction and are very popular with women. They are also called merry-go rounds or Self-Help Groups (Fisher and Sriram, 2002).

Village Banks

The village financial institution is efficaciously a mixture between the cooperative and solidarity group fashions, searching for to capitalise at the benefits of every. The village financial institution typically has fewer participants than a cooperative, and is less formalised and complex in structure. Some worldwide NGOs sell the status quo of village banks. Their primary form of credit assures is predicated on peer stress amongst contributors, as is the case in team spirit credit groups.

Village banks are community-managed credit and savings associations established by NGOs to provide access to financial services, build community self-help groups, and help members accumulate savings (Holt, 1994). They have been in existence since the mid-1980s. They usually have 25 to 50 members who are low-income individuals seeking to improve their lives through self-employment activities. These members run the bank, elect their own officers, establish their own by-laws, distribute loans to individuals and collect payments and services (Grameen Bank, 2000a). The loans are backed by moral collateral; the promise that the group stands behind each loan (Global Development Research Centre, 2005).

The sponsoring MFI lends loan capital to the village bank, who in turn lend to the members. All members sign a loan agreement with the village bank to offer a collective guarantee. Members are usually requested to save twenty percent of the loan amount per cycle (Ledgerwood, 1999). Members' savings are tied to loan amounts and are used to finance new loans or collective income generating activities and so they stay within the village bank. No interest is paid on savings but members receive a share of profits from the village bank's re-lending activities. Many village banks target women predominantly, as according to Holt (1994, p.158) "the model anticipates that female participation in village banks will enhance social status and intra household bargaining power".

The Linkage Version

This version builds on existing casual self-help organizations, which includes rotating credit score and financial savings associations ([18]). It seeks to combine the strengths of current

[18] Sika, J.M. &B. Strasser, Tontines in Kamerun: *Verknüp fung traditioneller*, 2000, 45

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casual systems (patron proximity, flexibility, social capital and attaining poorer clients) with the strengths of the formal system (e.g. threat pooling, term transformation, provision of lengthy-time period investment loans and monetary intermediation throughout regions and sectors).

Micro Banks with Individual Economic Contracts

Other MFIs are member-based (i.e. individuals contribute within the management, possession and manipulate of the MFI). Micro banks (e.g. BancoSol in Bolivia), depend on person contracts among the organization and its patron. Despite the fact that this sort of MFI is closest to the conventional banks, the mortgage collateral approaches are generally non-traditional.[19]

Capital Shap

Maximum MFIs appoint high leverage, and finance their operations with long-term (in preference to short-term) debt. Enormously leveraged microfinance institutions carry out higher with the aid of accomplishing out too much broader customers, enjoying economies of scale, and accordingly being better capable of cope with moral danger and adverse choice, enhancing their potential to cope with threat ([20]).

Various factors, other than level within the existence cycle, seem to be related to the performance of MFIs. Recent studies via Bogan ([21]), for example, show that the dimensions of belongings and capital structure of MFIs are related to overall performance. In phrases of sustainability and outreach, asset length is vital: a measure of presents received by way of MFIs (from donors inclusive of charities, governments and worldwide companies) as a percentage of belongings is extensively and negatively associated with sustainability and is undoubtedly associated with MFI fee according to borrower. Bogan also finds proof to aid the announcement that the usage of offers drives down MFI's operational self-sufficiency. She shows that long term use of presents can be associated with inefficient operations because of lack of the aggressive pressures that could be related to attracting marketplace investment. Significantly, the outcomes do no longer imply that offers are related to more or extra highly-priced outreach. Consequently, offers should avoid the development of MFIs into aggressive, efficient, sustainable operations ([22]).

Gist

In short, in this article, it has been endeavoured to discuss all aspects of microfinance which are necessary to understand, the nature, functions and possible results of Microfinance in Pakistani context.

Conclusion

In conclusion, Islamic financial instruments play a pivotal role in shaping the operations and success of Islamic financial institutions (IFIs). These instruments, guided by Shariah principles, offer ethical alternatives to conventional finance by prohibiting interest-based

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und semi-formeller Finanzierungssysteme. E+Z Entwicklung und Zusamenarbeit, 41(11), 316-318

[19]Ledgerwood, J., Microfinance Handbook: *An Institutional and Financial Perspective,* Washington DC: The World Bank, 2000, 19

[20]Kyereboah-Coleman, A. (2007) *The impact of capital structure on the performance of microfinance institutions*. The Journal of Risk Finance Incorporating Balance Sheet, 8(1), 56-71.

[21]Bogan, V. (2008) *Microfinance Institutions*: Does Capital Structure Matter?
Available at SSRN: http://ssrn.com/abstract=1144762.

[22]Bogan, V. (2008) *Microfinance Institutions*: Does Capital Structure Matter?
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transactions and promoting risk-sharing, transparency, and social responsibility. Instruments like Debt Certificates or Bonds, Investment *Sukuk* as Islamic Market Instruments serve as key financing tools, enabling IFIs to offer a range of products that cater to the diverse needs of individuals, businesses, and governments while adhering to Islamic values. The strategic use of these instruments not only fuels business growth for IFIs but also strengthens trust among stakeholders who seek ethical financial solutions. Additionally, these instruments contribute to financial inclusion by providing accessible financing options for sectors underserved by conventional banking. As Islamic finance continues to grow globally, the role of these instruments will likely expand, enhancing economic stability, fostering ethical investments, and aligning financial practices with the values of a growing number of Muslim and non-Muslim investors alike.

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