Frequently Asked Questions – Personal Finance

Question 1: What is Murabaha?

Murabaha is a sale transaction. Technically, it is a deferred payment sale. The following example shows how it works in Islamic banking.

Islamic bank and the client sign a Master Murabaha Finance Agreement and an agency agreement. The customer undertakes to purchase the asset from the bank. It is a one-sided promise and undertaking. According to the agency agreement, the customer purchases goods from the supplier on bank's behalf. The bank pays the supplier and obtains the title and physical/constructive possession of the asset. The customer signs a declaration that he has purchased the goods on bank's behalf and now he is willing to purchase the asset. After offer and acceptance, the sale is executed and the customer pays the agreed price to the bank.

Question 2: What is Musharakah?

Mufti Taqi Usmani in his book "Introduction to Islamic Finance" defines it as follows:

"Musharakah is a word of Arabic origin which literally means sharing. In the context of business and trade, it means a joint enterprise in which all the partners share the profit or loss of the joint venture. It is an ideal alternative for the interest-based financing with far-reaching effects on both production and distribution."

Question 3: What is Mudarabah?

Mufti Taqi Usmani in his book "Introduction to Islamic Finance" defines it as follows:

"Mudarabah is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "Rabb-ul-maal", while the management and work is an exclusive responsibility of the other, who is called 'Mudarib'."

Question 4: How does home financing work in Diminishing Musharakah?

In Diminishing Musharakah, the customer approaches the bank for the joint purchase of an asset/property. Designated valuation agencies are consulted for the valuation of the asset/property. The seller of the property is paid by the bank and the bank and the customer enter into a Musharakah Agreement.

It is referred to as 'Diminishing Musharakah' because of the arrangement. The ownership stake of the tenant increases and that of the bank decreases or diminishes with the periodic installments. The rent decreases as the ownership stake of the tenant increases.

The share of the bank in asset/property is divided into units. These units are purchased by the customer periodically. When the customer has purchased all the units, he becomes the sole owner of the asset/property. Rent is not charged immediately and is charged at the end of the month for the use of asset/property for the respective month. Rent for at least one period is fixed. Unit price fixed for a period does not change during that period.

The rent is calculated based on 1-year KIBOR (Karachi Interbank Offered Rate). KIBOR is used as there is no other benchmark rate available. The logical argument is that in a society if there is only one merchant who sells prohibited products, and then he starts to sell one legitimate product, he can use the profit rates on prohibited products for pricing and calculating profit margin on the legitimate product.

In the Musharakah Agreement, the floor rate (minimum rate) and the ceiling rate (maximum rate) is stated based on which the rent amount can vary. In Musharakah agreement, it is stated that if payment is made on time, the transfer of ownership will take place accordingly.

The risk of damage to the property is borne by the bank and the customer, according to the stake in the property at the time of disaster. Just like in conventional mortgage, a penalty is charged if a customer withdraws from the contract and that is paid to charity. The logical argument presented for such a penalty is that the contract involves a promise/undertaking to pay rent and purchase units of the asset/property and if a customer withdraws from the promise/undertaking, he can be asked to pay a penalty for maintaining financial discipline.

Question 5: How does car finance work in Ijarah?

Ijarah means to give something on rent. In Ijarah, the right of use of a vehicle is transferred to another person for a consideration. The lease period starts when the vehicle has been delivered by the lessor in a usable condition. The bank (lessor) bears the ownership related costs and the customer (lessee) bears the usage related costs. If the vehicle is destroyed or becomes unusable, the bank stops taking rent and does not charge rent for that period. The vehicle remains in the ownership of the bank until the bank sells the vehicle to the customer via a separate agreement.

The process flow is as follows:

The customer approaches the bank for obtaining a vehicle on lease. The customer undertakes to make periodic lease payments for the lease period. Bank receives the title of the vehicle and pays the vendor. The lease agreement is signed whereby the bank leases the vehicle and the customer starts using the vehicle and pays rent for each period. In the end, the customer can purchase the vehicle from the bank by way of a separate purchase agreement.

Question 6: How does Umrah finance work in Islamic Banking?

Umrah financing is provided by some financial institutions using the concept of Qard-e-Hasan which can be paid in installments too. Some banks also have special deposit schemes which assign a higher profit sharing ratio to customers who want to perform holy pilgrimage and want to save money quickly for financing the necessary funds. By way of better returns on deposits, people can save the required funds quickly to perform the holy pilgrimage.

Question 7: Can one perform hajj with obtaining finance?

Performing Hajj is obligatory for all Muslims. It is obligatory on people who can afford the cost of travel and have the necessary physical capability to perform it. Hence, it is not necessary to perform it while one does not have the necessary funds. Islamic scholars are largely of the opinion that taking on debt for such a journey is not recommendable.

Question 8: Can other consumer durables be financed in Islamic banking?

Consumer durables could be financed using the concept of Ijarah. Ijarah means to give something on rent. In Ijarah, the right of use of an asset is transferred to another person for a consideration. The lease period starts when the consumer durable has been delivered by the lessee in a usable condition. The bank (lessor) bears the ownership related costs and the customer (lessee) bears the usage-related costs. If the asset is destroyed or becomes unusable, the bank stops taking rent and does not charge rent for that period. The asset remains in the ownership of the bank until the bank sells the asset to the customer via a separate agreement.

The process flow is as follows:

The customer approaches the bank for obtaining an asset on lease. The customer undertakes to make periodic lease payments for the lease period. Bank receives the title of the asset and pays the vendor. The lease agreement is signed whereby the bank provides the asset on lease and the customer starts using the asset and pays rent for each period. In the end, the customer can purchase the asset from the bank by way of a separate purchase agreement.