

# **ISLAMIC LAW OF CONTRACT: APPLICATIONS IN ISLAMIC FINANCE**

**Dr. Muhammad Tahir Mansoori**



IPS Press is the publishing arm of Institute of Policy Studies, Islamabad – an independent think tank dedicated to promoting policy-oriented research. Pakistan Affairs, International Relations and Faith and Society are some of the major study areas at IPS.

## **Islamic Law of Contract: Applications in Islamic Finance**

© IPS Press 2020

All rights reserved. No part of this publication may be reproduced, translated, stored in a retrieval system, or transmitted, in any form or by any means, without the prior permission in writing of Institute of Policy Studies, Islamabad.

Enquiries concerning reproduction should be sent to IPS Press at the contact details given below:

IPS Press  
Institute of Policy Studies  
Nasr Chambers, 1, MPCHS Commercial Centre, E-11/3,  
Islamabad, Pakistan  
Tel: +92 51 8438391-3 Fax: +92 51 8438390  
Email: publications@ips.net.pk URL: www.ips.org.pk

ISBN: 978-969-448-788-5

Title Designing: Asif Taimuri  
Layout Formatting: Abid Hussain

Printed in Pakistan by  
Premier Printers, Rawalpindi

# Table of Contents

Foreword.....	xvii
Preface .....	xxi

## Part-I

### General Theory of Contract

<b>Chapter 1: General Principles of Contracts in the Qur'ān and the Sunnah .....</b>	<b>3</b>
1. Free Mutual Consent .....	4
2. Prohibition of <i>Gharar</i> .....	5
3. Prohibition of <i>Ribā</i> .....	6
4. Prohibition of <i>Qimār</i> (Gambling) and <i>Maysir</i> (Games of Chance) .....	8
5. Prohibition of <i>Khilābah</i> and <i>Ghishsh</i> (Fraud and Deception) .....	9
6. Prohibition of Two Mutually Inconsistent Contracts or Contingent Contracts.....	11
7. Conformity of Contract with the <i>Maqāsid al-Shari'ah</i> (Objectives of the <i>Shari'ah</i> ).....	12
8. Principle of Liability for Loss and Entitlement to Profit .....	14
9. Permissibility as a General Rule.....	15
Conclusion.....	17

<b>Chapter 2: Meaning of ‘Aqd (Contract) and Other Similar Terms.....</b>	<b>19</b>
Meaning of the Terms: <i>Mithāq</i> , <i>Ahd</i> and <i>‘Aqd</i> .....	19
Definition of ‘Aqd.....	21
Preferred definition.....	24
Analysis of the Definition.....	24
Conclusion.....	25
<b>Chapter 3: Elements of Contract: Form (<i>Sīghah</i>) .....</b>	<b>27</b>
Form of Contract .....	28
Meaning of <i>Ijāb</i> and <i>Qabūl</i> .....	28
Different Kinds of Form ( <i>Sīghah</i> ).....	28
Condition Necessary for <i>Sīghah</i> (Form) .....	31
Lapse of Offer in Modern Law .....	34
Causes of Cancellation of Offer ( <i>Ijāb</i> ).....	35
Conclusion.....	36
<b>Chapter 4: Elements of the Contract: Subject-Matter .....</b>	<b>39</b>
Condition Relating to Subject-Matter.....	39
Conclusion.....	51
<b>Chapter 5: Contractual Capacity of Contracting Parties.....</b>	<b>53</b>
Capacity for Execution or <i>Aḥliyyah al-Adā</i> .....	53
The Condition of <i>Aḥliyyah-al-adā</i> .....	54
Complete and Deficient Capacities of Execution .....	54
Complete Capacity .....	56
Circumstances Affecting the Legal Capacity of a Person... ..	56
Conclusion.....	63

<b>Chapter 6: Delegated Authority .....</b>	<b>65</b>
1. Contract of Agency ( <i>Wakālah</i> ).....	65
Conditions of Agency.....	66
Subject-Matter of an Agency.....	68
Termination of Agency .....	71
2. Guardianship ( <i>wilāyah</i> ) .....	78
Conclusion.....	82
<b>Chapter 7: <i>Sahīh</i>, <i>Fāsid</i> and <i>Bāṭil</i> Contracts .....</b>	<b>85</b>
Valid or <i>Sahīh</i> Contract.....	86
Kinds of Valid Contract.....	87
The <i>Lāzim</i> (Binding) and <i>Jā’iz</i> (Non-binding) Contract ....	91
<i>Fāsid</i> (Irregular contract).....	92
Causes of Irregularity in <i>Fāsid</i> Contracts.....	92
Difference Between Valid and Irregular Contracts .....	98
Forms of Irregular Contract .....	99
The <i>Bāṭil</i> Contract.....	100
Causes of Invalidity .....	101
Conclusion.....	105
<b>Chapter 8: Extrinsic Causes of Invalidity <i>Gharar</i> (Uncertainty)</b>	<b>107</b>
Definitions of <i>Gharar</i> .....	107
Effect of <i>Gharar</i> on Contracts .....	115
Insurance: A Modern Contract of <i>Gharar</i> .....	116
Types of Insurance.....	117
Types of <i>Gharar</i> in Insurance .....	119

View Point of Proponents of Insurance regarding <i>Gharar</i> .....	120
Conclusion.....	122
<b>Chapter 9: Extrinsic Causes of Invalidity.....</b>	<b>125</b>
Literal Meaning of <i>Ribā</i> .....	125
Technical Meaning of <i>Ribā</i> .....	125
Other Meanings and Definitions of <i>Ribā</i> .....	127
<i>Ribā</i> in the Qur'ān .....	128
Forms of <i>Ribā</i> al-Qur'ān, i.e. <i>Ribā</i> al-Jahiliyyah .....	131
<i>Ribā</i> in Sunnah .....	132
Kinds of <i>Ribā</i> .....	134
<i>Ribā</i> al-Fadl, <i>Sarf</i> and <i>Qard</i> (Loan) .....	140
Other Forms of <i>Ribā</i> .....	146
Indexation of Loans and <i>Ribā</i> .....	150
Arguments of Proponents.....	152
Arguments of the Opponents of Indexation .....	153
The Element of <i>Ribā</i> al-Fadl.....	155
Conclusion.....	157
<b>Chapter 10: Defect of Consent and its Effect on Contract ..</b>	<b>159</b>
I. Mistake ( <i>Khaṭā'</i> ).....	159
II. Fraud ( <i>Tadlīs</i> , <i>Taghrīr</i> , <i>Khilābah</i> ).....	162
Traditional Forms of Fraud in Islamic Juristic Literature	163
Coercion ( <i>Ikrāh</i> ).....	167
Conditions of Effective Coercion .....	168
Kinds of Coercion.....	168

Effects .....	169
Conclusion.....	170
<b>Chapter 11: Extrinsic Conditions and their Effect on the Contract.....</b>	<b>171</b>
Viewpoint of Zāhirī Jurists.....	172
Hanbalī viewpoint .....	172
Viewpoint of Hanafī, Shāfi‘ī and Mālikī Jurists.....	174
Conclusion.....	177
<b>Chapter 12: Islamic Law of Options (<i>Khayārāt</i>).....</b>	<b>179</b>
Kinds of Options .....	179
Conclusion.....	191
<b>Chapter 13: Classification of Contracts .....</b>	<b>193</b>
A. Classification According to Function of Contract.....	193
B. Classification of Contracts with Regard to Time of Completion.....	198
Conclusion.....	202

## Part-II

### Specific Contracts

<b>Chapter 14: Contract of Sale .....</b>	<b>207</b>
Definition of <i>Māl</i> (Subject-matter) .....	207
Classification of <i>Māl</i> .....	208
Conditions for Validity of Sale .....	210
Expressly Prohibited Sale Contracts of Islamic law .....	212

Kinds of Sale Transactions .....	217
I. <i>Muqāyadah</i> .....	217
II. <i>Bay‘ Muṭlaq</i> .....	218
III. <i>Sarf</i> .....	218
Definition of Money .....	220
IV. <i>Salam</i> Contract .....	223
Difference Between <i>Salam</i> Sale and Ordinary Sale .....	224
The Conditions of a Valid <i>Salam</i> .....	225
Modern Applications of the <i>Salam</i> Contract.....	229
V. <i>Istisnā‘</i> .....	231
Difference Between <i>Istisnā‘</i> and Other Allied Contracts .	232
Modern Applications of <i>Istiṣnā‘</i> .....	235
VI. <i>Murābahah</i> .....	236
Conditions of <i>Murābahah</i> .....	239
Modern Applications of <i>Murābahah</i> .....	241
Conclusion.....	243
<b>Chapter 15: Contract of <i>Ijārah</i> (Leasing) .....</b>	<b>245</b>
Definition .....	245
Features of <i>Ijārah</i> .....	246
Legitimacy of <i>Ijārah</i> .....	247
Kinds of <i>Ijārah</i> .....	248
Modern Applications of <i>Ijārah</i> .....	254
<i>Ijārah</i> in Islamic Banks.....	255
Conclusion.....	257

<b>Chapter 16: Contract of <i>Mushārakah</i> (Partnership).....</b>	<b>259</b>
Definition .....	259
Definition of Partnership in Law.....	260
Concept of Company in Modern Law.....	262
Legitimacy of <i>Sharikah</i> .....	264
Kinds of <i>Sharikah</i> .....	265
Kinds of <i>Sharikat al-'aqd</i> .....	267
<i>Sharikat al-amwāl</i> (Investment partnership) .....	269
Kinds of <i>Sharikat al-Amwāl</i> .....	273
<i>Inān sharikat al-amwāl</i> .....	273
<i>Mufāwadhbah sharikat al-amwāl</i> .....	280
<i>Sharikat al-a'māl</i> : Work partnership .....	281
Definition .....	281
<i>Inān</i> work partnership.....	282
<i>Mufāwadah</i> work partnership.....	284
<i>Sharikat al-wujūh</i> (Credit partnership) .....	286
Modern Forms of Partnership .....	289
Diminishing Partnership in Islamic Banks.....	291
Conclusion.....	293
<b>Chapter 17: Contract of <i>Mudārabah</i>.....</b>	<b>295</b>
Various Definitions of <i>Mudārabah</i> .....	295
Legitimacy of <i>Mudārabah</i> .....	297
Elements of <i>Mudarabah</i> .....	299
Conditions of <i>Mudārabah</i> .....	300
Types of <i>Mudārabah</i> .....	304

Dissolution of <i>mudarabah</i> .....	307
Conclusion.....	309
<b>Chapter 18: Contract of <i>Kafālah</i> (<i>Suretyship or Guarantee</i>) ..</b>	<b>311</b>
Definition .....	311
Elements of <i>Kafālah</i> .....	311
Legitimacy of <i>Kafālah</i> .....	311
Kinds of Suretyship.....	312
Contract of Guarantee in English Law .....	314
Rules of <i>Kafālah</i> .....	314
Contract of Guarantee in Islamic Banks .....	322
Conclusion.....	324
<b>Chapter 19: Contract of <i>Hawālah</i> (<i>Assignment of Debt</i>).....</b>	<b>327</b>
Validity of <i>Hawālah</i> .....	<b>Error! Bookmark not defined.</b>
Effects of <i>Hawālah</i> .....	330
Kinds of <i>Hawālah</i> .....	331
Comparison between <i>Hawālah</i> and Negotiable Instruments .....	335
Modern Forms of <i>Hawālah</i> .....	340
Conclusion.....	340
<b>Chapter 20: Contract of <i>Rahn</i> (Pledge/Mortgage) .....</b>	<b>343</b>
Definition .....	343
Legal Status of the Pledged/Mortgaged Property .....	344
Benefiting from Pledged/Mortgaged Property .....	349
Rahn in Pakistani Law .....	353
Rahn in Islamic Banks.....	354

Conclusion.....	356
-----------------	-----

## Part-III

### Issues in Islamic Finance

<b>Chapter 21: Concept of <i>Hiyal</i> and its Applications in Modern Islamic Finance .....</b>	<b>359</b>
Treatment of <i>Hiyal</i> in Islamic Law Schools .....	362
Use of <i>hiyal</i> in Islamic Banks .....	370
Unlawful <i>hiyal</i> in Islamic Finance.....	370
<i>Hiyal</i> as <i>Makhārij</i> in Islamic Finance.....	389
Conclusion.....	391
<b>Chapter 22: Investment in Equities: <i>Shari'ah</i> Appraisal of Screening Norms.....</b>	<b>393</b>
Introduction.....	393
1. Screening Norms for <i>Shari'ah</i> Compliance .....	395
2. Viewpoint of Opponents .....	396
3. Viewpoint of Proponents.....	399
4. Rules for Investment in Mixed Business.....	399
5. Arguments of the Proponents of Mixed Activity....	403
6. Screens for Acceptable Financial Ratios.....	404
7. Analysis of Screens.....	409
Conclusion.....	411
<b>Chapter 23: Islamic Microfinance: Fundamental Concepts and Principles.....</b>	<b>415</b>
Introduction.....	415

Concept of Islamic Microfinance .....	415
Fundamental Beliefs and Values.....	416
Islamic Social Values in Islamic Microfinance.....	420
General Principles of Islamic Microfinance .....	423
Modes of Islamic Microfinance .....	427
Conclusion.....	430
<b>Chapter-24: Promise and Bilateral Promise in Islamic Finance .....</b>	<b>433</b>
Viewpoint of Classical Jurists .....	433
Viewpoint of Modern Muslim Scholars.....	435
Promise in Banking Transactions .....	437
Promise in Currency Exchanges .....	438
Conclusion.....	443
<b>Chapter 25: <i>Takāful</i>: Concept and Application .....</b>	<b>445</b>
Different Models of Takāful .....	447
Takāful Practice in Islamic Financial Markets .....	450
Working of the <i>takāful</i> business .....	452
General <i>Takāful</i> Business .....	456
Conclusion.....	459
<b>Chapter 26: Concept of <i>Maqāsid al- Shari‘ah</i> Applications in Islamic Finance .....</b>	<b>461</b>
Concept of <i>Maqāsid</i> .....	461
Definition of <i>Maqāsid</i> .....	462
Analysis of Definitions .....	462
Shari‘ah Evidence of <i>Maqāsid</i> .....	464

Textual Evidence for <i>Maqāṣid</i> .....	465
Classification of <i>Maqāṣid / Maṣālih</i> in Order of Priority .	468
Revival of the Theory of <i>Maqāṣid</i> .....	473
Applications in Islamic Finance.....	475
Ideal <i>Maqāṣid</i> in Islamic Finance .....	476
Conclusion.....	493