

GLOSSARY

<i>Al-Qur'an</i>	The Holy book revealed by Allah SWT to Prophet Muhammad SAW
<i>Al-Sunnah</i>	The legal way or ways, orders, acts, of worship and statements of the Prophet SAW, that have become models to be followed by the Muslim
<i>Ahliyyah</i>	Capacity or aptitude
<i>Fuqaha'</i>	Jurist (one who is learned in <i>fiqh</i>).
<i>Ijma'</i>	Consensus of Opinion
<i>Qiyas</i>	Analogical deduction.
<i>Shariah</i>	Divinely revealed law, identified by its primary sources, <i>Al-Qur'an</i> , <i>sunnah</i> , <i>ijma'</i> and <i>qiyas</i>
<i>'Uqud</i>	The contract between persons in transaction
<i>'Uqud al-amanah</i>	Fiduciary contracts

'UQUD IN FINANCIAL SERVICES FOR ENTREPRENEURSHIP

**By
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1.0 Introduction

Islam is neither simply a religion nor a mere ideological vision. It is a comprehensive religion and a practical system of life that covers every single aspect of human life. In Islam, the development of *ummah* is the priority in the economic system and therefore Islam strongly encourages people to involve in business or to be an entrepreneur.

An entrepreneur will be dealing with a lot of commercial activities which falls under various types of contract or *'uqud*. *'Uqud* in Islam is the very essence of each human dealings and it covers a variety of transactions to meet the financial needs of the society either in equity or debt or any other modes of financing.

As for evolution of Islamic law of contract, it starts with *al-Quran* which already prescribes several types of nominate contract as well as certain general contractual maxims. Thereafter, the traditions or *al-Sunnah* supplement the Quranic groundwork as a support or additional explanation to its general provision. The Muslim jurists in all Islamic school of law later developed the principles of contract. In *al-Quran*, there are only over forty verses out of 6666

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verses on a dozen types of commercial contract. Apart from one important verse on performing contract which enjoins believers to keep faith to contracts (Al-Quran: *Surah al-Maidah*, verse 1), three verses with a common theme of keeping promise (Al-Quran: *Surah al-Isra*, verse 34) and there are few verses which reveal a relatively advanced stage of commercial contracts, such as sale and hire, charges or personal guarantee as (security) and fiduciary contracts such as deposit.

The whole idea of having a contract is to satisfy the consent of both parties to a contract and it is the best available means to reflect the intention and accordingly the consent of the parties. As the effect, *al-Quran* has already prescribed on the believers 'not to devour your assets among yourselves in vanity, except in trading by your consent' (Al-Quran: *Surah al-Nisa*, verse 29). In addition, the Prophet (PBUH) is reported to have said that 'The Property of a Muslim is not licit for others to enjoy unless by his consent.

In contract of financial services, the central idea of *'uqud* is to reflect the terms, conditions and intention of the parties. As regard to entrepreneurship, there are various types of *'uqud* under Islamic law which can be a basis for financing facility products in Islamic financial institution. Shariah principles offer a wide diversity and very flexible mode of financing in every field of entrepreneurship either for a small and medium enterprise (SME) or a non-small medium enterprise.

Various types of *'uqud* under Islamic law provide flexibility for entrepreneurs to choose the best mode of Islamic financing products that appropriate to the nature of their business. These types of contracts can be classified as unilateral and bilateral and primary and secondary modes. This chapter is intended to provide a general overview on *'uqud* in Islamic commercial transactions and its modern application as practiced by Islamic financial institution. It is hoped that the discussion in this chapter would be beneficial for students, the public as well as practitioners to understand basic concept of contracts under Islamic law in relation with the entrepreneurship.

2.0 *'Uqud* or Contract in Islamic Commercial Transaction

Contract in Arabic term is called *'Aqd*. Plural of *Aqd* is *'uqud*. Literal meaning of *Aqd* is to bind or to strengthen. The word *Aqd* is also used in Arabic in the sense of confirming an oath. As such, any covenant, pact, agreement and treaty will also be referred to as *Aqd* since all of them demonstrate firm resolve for execution.

'Uqud or contract technically means as an expression of the matching between a positive proposal made by one of the contractors and the acceptance of the other contractor in a way which has an impact on the subject of the contract (Ala'Eddin Kharofa, 1997) . The Islamic Civil Law Codification which took place in the 19th century, namely the *Majallah al-Ahkam al-'Adliyyah* and *Murshid al- Hayran* (the

1891 Egyptian version of the Ottoman's Majallah), provides a precise definition to a contract. The Mejlle defined contract as little contracting parties obligating themselves with regards a given matter and binding themselves together with the same as a result of connecting an offer with an acceptance (Trans. by C.Y Tyser n.d. p. 16). A contract is the connection of an offer with an acceptance in a lawful manner which marks its effect on the subject of that connection.

From the above definition, it could be understood that a contract can be summarize to be an engagements and agreement between two persons in a legally accepted, impact, and binding manner whereby it has the connection of an offer with an acceptance in a lawful manner which marks its effect on the subject of that connection and there is an expression of the matching between a positive proposal made by one the parties and the acceptance of the other party in a way which has an impact on the subject matter of the contract.

Basically, there are six elements of *'uqud* from a syariah perspective. First elements of contract are offeror and the offeree (Said Sabiq 1995: 95). As for the parties to a contract, they must be legally competent to enter into a contract. The competence to transact in Islamic law is measured largely by two aspects, namely prudence and puberty as revealed in *surah al-Nisa'* verse 6 "Observe the *orphans through testing their abilities until they reach the age of marriage; then if you find them capable of sound judgment, hand over to them their property*". The most important part of each party is their possess capacity or aptitude (*ahliyyah*). Second elements of contract are offer and acceptance. With reference to an

expression of both offer and acceptance, syariah recognizes both express contracts as well as what has been described as contract by conduct. Third element of contract is subject matter or "*mahall*" (Ala'Eddin Kharofa, 1997). As for the subject matter of contract, Islamic law stresses on the lawfulness, existence, deliverability and precise determination. Lawfulness requires that the object must be lawful, that is something, which is permissible to trade. Fourth element of contract is consideration or price (Ala'Eddin Kharofa, 1997). As for the consideration, Islamic law does not restrict it to a monetary price, but it may be in the form of another commodity. The Islamic prohibition against uncertainty requires that the price must be in existence and determined at the time of the contract and cannot be fixed at a later date with reference to the market price, nor can it be left subject to determination by a third party.

A contract in Islamic approach implies beyond religious implications and totally different from conventional economist point of view. Islam emphasizes on the clarity, fairness of the transaction including the prohibition of interest, the elimination of uncertainty and the promotion of risk. In Islam all economic dealings or contract are meant to promote economically just, socially fair, and ethically correct dealings according to Islamic principles, foster the solidarity and cohesion of the Muslim *ummah* and bring about cooperation in all walks of life.

In modern time, the application of various contracts under Islamic law that has been currently practiced is slightly different from what has been practiced by previous generations as discussed by traditional *fuqaha'*. Modern Islamic

financial instruments which provide financing facility for entrepreneur may fall under any category of *'uqud* in project financing, trade financing and any other facility. Hence, it is important for us to know the current application of *'uqud* in financial services and its relationship with the entrepreneurship in Islam.

2.0 Entrepreneurship in Islam

Entrepreneur can be defined as a person who starts or organizes a commercial enterprise or person who works under contract as an intermediary in the business. According to Graham Beaver (2002), the entrepreneurial characteristics has been identified include innovation, with the entrepreneur being recognize as the agent for change, the willingness to take risks and the ability to make confident and judgmental decisions. In short, the entrepreneur is a person who involve in business activity by setting up a company or enterprise in a certain commercial area such as manufacturing, services sector, food industries and construction sector.

In Islamic entrepreneurship, the entrepreneur must posses a different standard of qualities with other types of entrepreneur. Muslim entrepreneur must first to have faith in the oneness of Allah, that there is nothing worthy of worship except Allah, the Creator and Sustainer of the universe (See Muhamad Nejatullah Siddiqi 1989: 1-20). This tawheedic approach is the ultimate concept of entrepreneur in Islam.

Muslim entrepreneur must also believe that any asset from the business is a God's ultimate ownership (Dr. Wahbah al-Zuhailly, 1989). There is no disagreement among the Muslims scholars in the belief that ownership of property belongs to God as it is explicitly stated in surah al-baqarah verse 255 where Allah says: "*Unto Allah (belongeth) whatsoever is in heavens and whatsoever is in earth*". According to Sohrab Behdad (1992), God's ultimate ownership is the source of the ambiguity in property rights in Islam. It's also implies that His ownership supersedes the right of the individual to property. Thus, a state representing the will of God from Islamic state perspective and may impose limits on individual property rights. The restrictiveness of these limits will depend upon the extent of interference of individual property rights with the realization of God's will in the society of Muslims.

The concept of entrepreneurship in Islam also bases on co-operation, generosity and benevolence. That is why Islam really encourages *'uqud al-tabarruat* or unilateral contract such as loan (*al-Qard*) in order to promote cooperation and inculcate sense of brotherhood amongst Muslims. At the same time Islam extremely prohibited monopoly, exploitation, fraud or usurious transactions. In other word, every entrepreneur should always preserve the good deeds and avoiding the evil such as being honest, fair, and accurate in every transaction.

All the above principles are expected not only to have significant impact on the business ethics of Muslim entrepreneur, but also to be a habit and customary practice of each person that involve in commercial activities. It is strongly urged

that every Muslim entrepreneur to observe all the above principles in doing business in order to promote a good governance of Islamic entrepreneurship.

4.0 'Uqud in Financial Services

Many entrepreneurs need support infrastructures and financial facilities in commencing their business venture. In this modern time, it is undeniably to say that a lot of entrepreneurs adhere much on the existing financial instruments offered by Islamic financial institution. These financial instruments may fall under various categories of 'uqud which is dependent on the nature of business of the respective entrepreneur.

Conceptually, contracts classified under the Islamic law of transaction can be divided into unilateral contract and bilateral contract. The former comprises of transactions which are gratuitous in nature such as *Isqatat* (waiver), *ibra'* (rebate), *muqasah* (off-set of the debt), *will (wasiyyat)*, *endowment (fund)* and *loan (al-Qard)*. The latter refers to a contract which require consent of both parties such as 'uqud *Tamlikat* (contract of ownership) or 'uqud *al-Mua'wadhat* (exchange), 'uqud *Isytirak* (contract of partnership) either *mudharabah* (passive partnership) or *musyarakah* (active partnership), 'uqud *Tawsiqat* (contract of security) either *Kafalah* (suretyship) or *Rahnu* (pledge), 'uqud *Itlaqat* (contract pertaining to do a work) either *wakalah* (agency), or *hiwalah* (debt transfer),

'uqud Taqyiydat (contract of restriction) and *'uqud Hifz* (contract of safe custody) or *wadiah* (safekeeping) (Abdul Nasir Musa Abu AlBasl. 1999).

As regard to the *'uqud* in financial services for entrepreneurship, mostly it involves only a few types of *'uqud* namely *isytirak* and *al-muawadhat*. These modes of financing can be further categorized as the primary modes and the secondary modes (Chapra, M. Umer.1985). The primary modes refer to *mudharabah*, *musyarakah* and shares of joint stock companies (combination of *musharakah* and *mudharabah* term of financing. Secondly, it refers to the secondary modes such as *murabahah* (cost plus service charge), *ijarah* (leasing), *ijarah summa al-bay* or *ijarah wa iqtina* (hire purchase), *hiwalah* (debt transfer), *salam* (forward delivery contract), and *istithna'* (contractual production). Both of these modes are able to provide financial needs to the community especially to the entrepreneur.

The primary modes of *mudharabah*, *musyarakah* and shares of joint stock companies are classified under *'uqud Isytirak*. This is the most encourages mode of financing in Islam as it provides greater reliance on equity and profit loss sharing. Here, the profit or return is not being determined upfront and it depends much on the effort, business risk and viability and also to the ultimate outcome of the venture.

Mudharabah mode of financing means an agreement made between a capital provider and another party (entrepreneur), to enable the entrepreneur to carry out business projects, based on a profit sharing basis, of a pre-agreed ratio. In

the case of losses, the losses are borne by the provider of the funds. On the basis of a contract of *mudharabah*, financial institution may provide financing to entrepreneurs who want to perform certain project in retail or corporate financing.

Musyarakah refers to a partnership or joint venture for a specific business, whereby the distribution of profits will be apportioned according to an agreed ratio. In the event of losses, both parties will share the losses on the basis of their equity participation. The essential difference between *mudharabah* and *musyarakah* is the contribution towards management and finance whereby in the former, the losses are borne by the capital provider and the latter, the losses and profits will be shared based on equity participation. *Mudharabah* provides a proper means to the entrepreneur who has no capital but skills and expertise in certain area to start their business. Under *musyarakah* financing, any financial institution may finance acceptable projects whereby it has the right to participate in the management of the project.

The primary modes are treated as fiduciary contracts (*'uqud al-amanah*) whereby all partners in the business must act bona fide for the benefit of the partnership (See *Al-Quran*, 5:1 and 8:27). Any element of cheating and unfair treatment of sharing of profit is extremely prohibited. In these primary modes, all forms of business organization will be shared and it depends on their financial resources, entrepreneurship, skills and goodwill.

The secondary modes of financing refer to a contract of exchange or *al-Mua'wadhat* such as *murabahah*, *ijarah*, *ijarah wa iqtina*, *salam*, and *istithna'* and

its supporting contract such as *hiwalah* and *wakalah*. *Hiwalah* and *wakalah* are considered as a supporting contract because they exist side by side with another contract. For example *hiwalah* is originated from contract of exchange whereby transfer of debt from one to another can not be done unless there is already a selling transaction which creates debt. The secondary modes are less preferable by some scholars due to its features which are keen to be similar with the existing conventional financing instruments that based on interest bearing. However, these modes are undeniably permissible by majority of Muslim jurist subject that they fulfilled all the conditions and pillars of 'uqud as derived from *al-Quran* and *al-sunnah*. These modes mostly concern on the trading or selling and buying transaction through different mode of payment either cash sale, lump sum, deferred payment, deferred delivery sale and etc.

Murabahah means the sale of goods at a price, which includes a profit margin as agreed to by both parties. Such sales contract is valid on the condition that the price, other costs and the profit margin of the seller are stated at the time of the agreement of sale. Under this mode of financing the entrepreneur may approach any financial institution to provide his financing for working capital. *Murabahah* however normally is a short term financing in which the payment must be made within one to three months.

Ijarah refers to an arrangement under which the lessor leases equipment, building or other facility to a client at an agreed rental against a fixed charge, as agreed by both parties. *Al-Ijarah Thumma al-Bai'* (leasing and subsequently

purchase) refers to a contract to be followed by purchase. Under the first contract, the hirer leases the goods from the owner at an agreed rental over a specified period. Upon expiry of the leasing period, the hirer enters into a second contract to purchase the goods from the owner at an agreed price. *Ijarah* is a mode of financing which conceived as a sale of usufruct.

As practiced *ijarah* is a mode of financing to meet the financing requirements of income generating projects in industry and other important sectors for which the rental payment and lease period are determined in the light of the projected profitability, life span and cash flow of the project. For example *ijarah* is popular in financing various materials such as plant, machinery and equipment for industrial purpose.

Hiwalah means transferring a debt from one debtor to another and *wakalah* refers to agency principle. A combination of *hiwalah* and *wakalah* on certain financing facility is suitable for revolving credit, overdraft or credit line facility. The entrepreneur may utilize this facility in financing their project, infrastructure financing and etc. This credit facility is normally utilized for a long term project that involves various phases to be completed. A contract of *wakalah* may also be applicable when the entrepreneur deals with an import and export transactions. Normally, the entrepreneur will utilize the letter of Credit facility.

Bai' al-Salam or *salam* means an agreement whereby payment is made in advance for delivery of specified goods in the future. *Salam* is valid, subject to the condition that the quality and the nature of the subject matter, time, place of

delivery and the price are clearly stipulated at the time of the contract. Under this mode of financing, the entrepreneur is able to acquire any asset for working capital by advance payment at a discounted price and subsequently sells the asset upon delivery.

Istithna' is a contract whereby a party undertakes to produce specific goods and services, and made according to certain agreed-upon specifications at a determined price and for a fixed date of delivery. The main objective of the *Istithna'* mode of financing is to promote manufacturing and construction. The production of goods includes any process of manufacturing, construction, assembling or packaging. In *Istithna'*, the work is not conditioned to be accomplished by the undertaking party alone, and this work or part of it can be done by others under his control and responsibility. *Istithna'* could be used in pre-shipment financing of the acquisition of capital goods and to finance intangible goods such as gas and electricity. This may relate to manufacturing of complete assets in the form of capital goods or construction of certain infrastructure projects such as rail, roads, schools, bridges, buildings and etc.

5.0 Conclusion.

Islam has formulated very firm principles of the law of contract in financial services. Islam is actually offering a very flexible mode of financing in every field of entrepreneurship either for SME or to big conglomerate. In relation to the contract in financial services and entrepreneurship, Islamic law emphasizes on

the clarity, fairness of the transaction including the prohibition of interest, the elimination of uncertainty and the promotion of risk.

In entrepreneurship, most of the Islamic mode of financing available refers to the primary modes and the secondary modes of financing. The primary modes of *mudharabah*, *musyarakah* and combination of both are much preferable by majority of Muslim scholars. These modes promote the spirit of Islamic economy whereby they provide greater reliance the determination of profit which is depending on the effort, risk, and expertise and business viability.

Islam also recognizes other type mode of financing which is known as the secondary modes such as *murabahah*, *ijarah*, *ijarah wa iqtina*, *hiwalah*, *salam*, and *istithna'*. These modes also are able to provide financial needs to the entrepreneur especially in financing a project or working capital such as machineries, factories equipment, and land.

In developing the ummah, the entrepreneurship sector will be very much important to the Muslims economy. Therefore, Muslim entrepreneur in Malaysia as well as Muslim of other countries shall develop a cooperative framework to promote Islamic entrepreneurship, particularly in mobilizing financial resources to meet the needs of the ummah through utilizing the existing Islamic mode of financing under various contracts or *'uqud*.

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