Islamic Finance Basics

Islamic finance is a way of providing finance that follows the principles of Islamic law, or Shariah. Today it is offered by banks, insurers and investment firms in many countries, to Muslim and non-Muslim customers alike. It does not stop finance; it changes how finance is structured, so that money is linked to real assets and, in partnerships, to shared risk. This guide explains the core principles and the most common contracts in general terms, and it is not a religious ruling.

1. The Core Principles

The best-known principle is the prohibition of riba, which includes interest charged on loans. Contracts must also avoid gharar, which means excessive uncertainty about what is being sold, and maysir, which means gambling and games of chance. Finance should be linked to real assets or real business activity, not only to money lent for money. Finally, in partnership contracts, profit is justified by sharing in risk, so investors and businesses carry the results of a project together. Sale and lease contracts, such as murabaha and ijara, instead use a price or rent agreed in advance.

Example: A family wants its savings to grow without riba. Instead of an interest account, it chooses a profit-sharing account, where the return depends on the real results of the bank's investments.

At work: Maryam, a finance officer at a medical supplies company, reviews a supplier contract with no clear quantity or delivery date. Applying the principle of avoiding gharar, she asks for clear terms before the company signs.

2. Sale and Lease Contracts

Many Islamic finance products are built on trade and leasing instead of loans. In murabaha, a cost-plus sale, the bank buys an asset and sells it to the customer at its cost plus a profit that is agreed in advance. The customer then pays this fixed price, often in instalments. In ijara, a lease, the bank buys an asset and rents it to the customer, while the bank keeps ownership and its main risks. Some leases end with the ownership passing to the customer.

Example: A family needs a car, so it uses murabaha. The bank buys the car and sells it to the family at a disclosed price, paid in equal monthly instalments.

At work: Maryam's company needs a delivery van, so it uses ijara. The bank buys the van and leases it to the company for a monthly rent, and at the end of the lease the van passes to the company.

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3. Partnership Contracts

Partnership contracts are the clearest form of risk sharing. In musharaka, two or more partners put capital into a project, share the profit by an agreed ratio, and share any loss according to the capital that each one invested. In mudaraba, one party provides the capital and the other provides the work and the expertise. The profit is shared by an agreed ratio, while a financial loss falls on the capital provider, unless the manager was negligent.

Example: An investor and a skilled baker open a bakery through mudaraba. The investor provides the money, the baker runs the business, and they share the profit sixty to forty, as agreed.

At work: Maryam's company and a distributor open a new showroom through musharaka, each paying half of the capital. They agree to share the profit equally, and they know that any loss would also be shared by their capital.

4. Sukuk and Standards

Sukuk are certificates that give their holders a share in the ownership of assets or projects, or in their income. They are often called Islamic bonds, but their return comes from the underlying assets, not from interest on a loan. To keep practice consistent, the Accounting and Auditing Organization for Islamic Financial Institutions, or AAOIFI, issues Shariah, accounting and governance standards. It was established in 1991 and is based in Bahrain, and most Islamic banks also have their own Shariah board.

Example: A government needs money to build a new road, so it issues sukuk. The holders share in the income of the project instead of receiving interest.

At work: Before signing the van lease, Maryam checks that the product follows AAOIFI standards. She also confirms that the bank's Shariah board has approved it.

Conclusion

In summary, Islamic finance avoids riba, gharar and maysir, and links money to real assets and, in partnerships, to shared risk. Its common contracts include murabaha and ijara for buying and leasing, musharaka and mudaraba for partnerships, and sukuk for raising large amounts. Scholars and countries can differ on some details, so for a personal ruling it is best to ask a qualified scholar. Understanding these basics helps us talk clearly with banks, partners and customers.

Sources

- AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions): About AAOIFI – https://aaoifi.com/about-aaoifi/?lang=en
- World Bank: Islamic Finance (brief) – https://www.worldbank.org/en/topic/financialsector/brief/islamic-finance
- Islamic Financial Services Board (IFSB) – https://www.ifsb.org/
- General education only; not a fatwa or religious ruling. For personal rulings, consult a qualified scholar.

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