



# Defaults In Islamic Finance: *A Shari'a Perspective*

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- Islamic Finance transactions are based on three main components:
  - Commercial viability
  - Shari'a compliance
  - Legal enforcement
  
- Shari'a compliance considerations restricts:
  - Riba (includes interest)
  - Maisir (includes speculation)
  - Gharar (i.e. Uncertainty)
  - Muharramat ( refers to certain business activities)

## Qur'an

“If the debtor is in a difficulty, grant him time until it is easy for him to repay. But if ye remit it by way of charity, that is the best for your if you only know”  
(Chapter 2: Verse 280)

“O ye who believe! when ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing..... And get two witnesses.....Disdain not to reduce to writing (your contract) for a future period, whether it be small or big: it is just in the sight of Allah, more suitable as evidence, and more convenient to prevent doubts among yourselves...take witnesses whenever ye make a commercial contract.....”  
(Extract from Chapter 2: Verse 282)

## The Prophet (PBUH) said:

“the hand continues to remain under an obligation until it returns what it has taken”

“deliberate delay on the part of a financially capable debtor is a form of oppression (dhulm)”

Contract	Nature	Type of Obligation	Default Rights
<b>Murabaha/ Musawama Mu'ajjal</b>	Deferred Payment Sale	Sale proceeds are considered debt	Full amount due, can be accelerated upon default
<b>Ijarah</b>	Lease	Ownership of usufruct/ assets. Lease Rentals accrued are considered debt	Only lease rentals are debt Right to cancel lease contract and sell assets
<b>Wakala bil Istithmar</b>	Investment Agency	Equity in investment assets	Trace and liquidate assets as specified in the contract, subject to other investor's rights, also see below
<b>Mudaraba</b>	Investment Management	Equity in investment assets (after payment of all debts/obligations)	Sue manager for negligent/fraudulent misconduct
<b>Musharaka</b>	Equity Partnership	Equity in investment assets (after payment of all debts/obligations)	Sue manager for negligent/fraudulent misconduct

- Default by debtor capable of paying is *haram* (prohibited).
- No additional financial compensation allowed upon default.
- Legal and other recovery expenses claimable
- Asset can be pledged and asset can be sold without recourse to courts
- Acceleration of payments allowed, subject to notice and grace period.
- Charity penalty provision permissible and exercisable
- Asset tracing permissible
- Excess payment permissible so long as not contractually stipulated.

- Under Shari'a, an obligation remains due and payable until settled or forgiven, totally or partially, by the financier.
- No increase in the amount of obligation is allowed due to delay in the repayment.
- If the obligor is in genuine difficulty, and subject to the financier's convenience, Shari'a requires that additional time should be provided to the obligor to work his way through the financial difficulty.
- It is accepted that upon a default, a financier can make the obligor bankrupt .
- Not all contracts result in clear determinable rights for investors
- It is sometimes preferable to engage in restructuring talks then to exercise rights which may lead to uncertain legal outcomes.

Any queries, please feel free to contact

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