

“O Believers! Take not doubled and redoubled interest and fear Allah so that you may prosper”. (Quran, Surah al-Imran, Verse no. 130.)

Therefore, in the opinion of Muslim scholars no financial transaction is to be made which violates the principles of *Shariah*, hence they formulated a contract of Diminishing *Musharakah*. Under this arrangement three independent transactions namely *Musharakah* (Partnership), *Bay* (Sale), and *Ijarah* (Lease) are involved. The customer and the bank enter in a contract of partnership and jointly own a house. The bank's shares in the house are divided into units, which the customer has to purchase periodically, until he becomes the sole owner of the house. Simultaneously, the bank will give its shares to the customer on the basis of *Ijarah*, and with the gradual purchase of the bank's units the rent will also decrease. All these three transactions are in conformity with *Shariah*, but the issue occurs if these transactions are combined into one contract and each of them become a condition on the other; as it is a well-established rule in the Islamic Jurisprudence that one transaction should not be made a condition on the other and cause uncertainty in the contract. Therefore, under this arrangement there is a promise on the part of the customer to buy the shares of the bank in a house, gradually, until the ownership is completely transferred to him and that buying and selling must be independent of the partnership contract. (Usmani, 2015)

Furthermore, after entering into the contract of house financing based on Diminishing *Musharakah*, the customer has to pay rent for the use of the bank's share in the house and also has to purchase the shares of the bank, periodically. Both these transactions should be treated separately, so that one transaction does not become a condition on the other. While in practice, the monthly payment which the customer has to pay is the combination of the price of the bank's unit and the rent for the use of bank's share in the house, hence both transactions are merged into one and are not managed separately and this makes these transactions dependent on one another, as the non-fulfillment of one also affects the other one. Furthermore, the Islamic Financial Institutions (IFIs) are required to adhere to all the essential elements of the three transactions involved in Diminishing *Musharakah* arrangement, namely, *Musharakah*, *Ijarah* and *Bay*, at their respective stages but this ruling is by-passed by the IFIs and it is the customer who has to bear all the expenses, fee and charges solely. Similarly, taking extra charges in case of late payment by the customer, also receives criticism.

Hence, the IFIs have somehow failed to offer the product completely *Shariah* compliant by not adhering to all the *Shariah* rulings, as the main objective of the Islamic banks should be to prevent the transactions from being based on *riba*, *gharar* and their contingency upon one another, therefore, Islamic banks in Pakistan need to make some changes in order to ensure its complete *Shariah* compliance.

LITERATURE REVIEW

Muhammad Imran Ashraf Usmani in his book *Islamic Finance* provides a brief concept of Home Financing based on Diminishing *Musharakah*. It describes that Diminishing *Musharakah* Home financing consists of different transactions such as *Shirkat'al-Milk* which is a joint ownership of a financier and the client, in a property and then it's a *Ijarah* contract between the financier and the client over the same property, where the financier gives his share on rent to the client, and the client also promises to purchase the units of the share of the financier in the property and then he purchases units at different stages and similarly the rentals will be adjusted according to the remaining shares of the financier in the property. It was also discussed that all of the above mentioned transactions are allowed, and the problem only arises

if these transactions are combined in a single arrangement and make each of them a condition on the other, then it makes the contract invalid as it is a well settled rule in the Islamic Jurisprudence that one transaction cannot be made a pre-condition for another. However if there is a one sided promise from the client, firstly to take the share of the financier on lease and pay the agreed rent, and secondly to purchase different units of the shares of the financier of the house at different stages, then this promise does not make a pre-condition for another and thus it does not go against the principles of *Shariah*. (Usmani, 2015)

As it is provided in AAOIFI (Accounting and Auditing Organization for Islamic Financial Institution) *Shariah* Standards that it is permissible to arrange more than one contract into one, without making one contract a condition on the other and provided that each contract is permissible on its own. (Sharikah (Musharakah), and Modern Corporations) This type of contract combination is acceptable unless it contravenes with the *Shariah* principles. Muhammad Hanif in his research paper “Differences and Similarities in Islamic and Conventional Banking” discussed a general idea of house financing through Diminishing *Musharakah* and states that under the conventional system a loan is provided for interest while under Islamic financial system facility is provided through Diminishing *Musharakah*. (Hanif, 2011). Noor Mohammad Osmani and Md. Faruk Abdullah, in their research paper *Musharakah Mutanaqisah* Home Financing: A Review of Literatures and Practices of Islamic Banks in Malaysia discussed the problems in implementing Diminishing *Musharakah* home financing contract such as changes in rental prices of a house, usually, the rental price increases with the passing of time which places the customers into difficulties. Another significant issue in this contract is the damage of the property. If the property is damaged by the client because of his negligence, then he should pay the compensation. Besides, if the damage is due to natural calamities and so on, then both partners have to share the loss according to their proportion as the condition of partnership. (Abdullah, 2010). However, this present research will provide a detailed study of the house financing contract by way of Diminishing *Musharakah* in order to highlight the issues involved in its current practice by the Islamic banks of Pakistan.

Diminishing Musharakah as a Mode of House Financing Product, Practices in Pakistan

In Pakistan Islamic Banking officially started its operation in 2002 when first Islamic Banking License was issued to Meezan Bank Limited by State Bank of Pakistan. (Meezan Bank Corporate Profile). House financing based on Diminishing *Musharakah* is offered by a number of Islamic banks and conventional banks through their Islamic branches in Pakistan.

The Practice of Diminishing *Musharakah* Product as Provided by Fully-Fledged Islamic Bank of Pakistan.

Meezan Bank Limited (MBL), a publicly listed company was first incorporated in 1997 and commenced its operations as first Islamic Commercial Bank in 2002. In 220 cities it has more than 760 branches where a number of Islamic banking products and services have been offered such as *Mudarabah*, *Musharakah*, Diminishing *Musharakah*, *Murabaha*, *Istisna*, *Salam*, *Musawahmah* and *Ijarah*. (Meezan Easy Home). MBL is offering the house financing facility by way of Diminishing *Musharakah* to buy, renovate or construct the house and named this product “Easy Home”. The basic structure of the Easy Home product is that the bank and the customer enters into a *Musharakah* agreement and jointly purchase a house where the bank finance up to 65% or 75% of the total house value and the rest of the payment is made by the customer. After the property has being purchased, the bank after dividing its shares into units,

gives them to the customer on rent, and the customer has to provide monthly payment which includes the rent and the other part of the payment includes the purchasing of the bank's share in the property. Customer shares in the property gradually increases with time, therefore the monthly payment also decreases and when the whole investment is made by the customer as required by the contract, he becomes the sole owner, and the title of the property is transferred to him.

MBL is offering Easy Home product to Pakistani nationals only and there can be more than one applicant, but that co-applicant must be a family member whose 50% income can make a joint contribution for acceptance in limit enhancement and if the co-applicant is the spouse then 100% of the income can be included for calculating income. Furthermore, in order to avail the Easy Home product, the requirement of income of salaried applicant is minimum PKR 40,000 and in case of a businessman the minimum requirement of income is PKR 75,000 per month. The salaried applicant must have a permanent job where he should have been working for at least two years and the self-employed must have been carrying on his current business for a minimum three years. The processing charges for the salaried and businessman applicants is PKR 8,000 and Federal Excise Duty (FED) on processing charges is PKR 1,280. Other charges such as legal report charges, property valuation charges and income estimation charges will also be borne by the customer. Similarly, documentation charges will also be obtained by the customer at the stage of signing the agreement of *Musharakah* in accordance with financing limit.

Moreover, by following the concept of Diminishing *Musharakah*, MBL provides 2 different models for the monthly payment of the Easy Home product, the Unequal Monthly Instalment and Step-up Monthly Instalment. The step-up model is introduced for the customers who want to have the facility with maximum financing and less instalment. To determine the profit rate for Easy Buyer the MBL uses the KIBOR (Karachi Inter Bank Offer Rate) as its benchmark and set different profit rate for the salaried customer and the businessmen customer. The profit rate for the salaried customer is:

Fixed – 1st Year: $K^* + 3.00\%$ p.a
Annual Re-pricing: $K^{**} + 3.00\%$ p.a
(Floor 8.00% p.a. and Cap 30% p.a.)

Whereas the profit rate for the businessman Customer is:

Fixed – 1st Year: $K^* + 4.00\%$ p.a
Annual Re-pricing: $K^{**} + 4.00\%$ p.a
(Floor 8.00% p.a. and Cap 30% p.a.)

MBL gives choices to the customers to avail the Life *Takaful* Coverage to cover the due amount in case of any unfortunate incident such as death or any natural or accidental disability of the customer, whereas Property *Takaful* is compulsory and the customer is required to undertake that he will take the property *Takaful* on those contribution and terms, as decided by the bank and the *Takaful* Company. (Housing Finance Application Form)

If a salaried customer wants to purchase a house worth ten million, by availing the facility of Easy Home, where he will contribute three million and the remaining seven million will be financed by the bank, then following would be the detailed payment schedule according to the MBL's payment calculator, provided on its website.

Table 1: Showing the Payment Schedule for Easy Home Customers

Cost Price	PKR. 10,000,000	Total Units	240
Customer's Share	PKR. 3,000,000	Unit Sale Price	PKR. 29,167
Bank's Share	PKR. 7,000,000	Monthly Rent Per Unit	PKR. 260
Profit Rate	10.69%	Total Starting Rent	PKR. 62,358
Tenure in Years	20	Starting Month Payment	PKR. 91,525
Segment	Salaried	Easy Home Category	Buyer (UMI)
Takaful Contribution Rate			

Data Source: Meezan Bank's Official Website

The monthly payment keeps on decreasing with the periodical payment by the customer, and in this example the total amount paid by the customer, at the end of the tenure of the contract, would likely to be PKR 14,723,648. After the lapse of one month, the client can purchase the bank's entire share and can terminate the contract, at any time during the tenure of the contract. The client must provide the bank, a ten days prior notice and to evaluate any changes in the house price will be assessed at customer's cost and if there is any appreciation of the price then the sale of bank's unit will take place at a 3% higher price. However, if the market price decreased or remained same then it will be sold at its face value. Furthermore, while entering into the contract, the customer undertakes that in case of a late monthly payment he will pay PKR 500 flat plus 20% per annum of the unpaid rental amount which would be utilised for charity purposes by the bank. Similarly, if there is a failure on the part of the customer to provide monthly instalments, the bank will issue a notice to the customer, and after the lapse of 90 days, if the customer does not respond to the notice issued or maintains that he is not able to fulfill his obligations, then the bank will sell the house by enforcing the undertaking and will recover its damages from the sale. After recovering the damages or outstanding amount, if there is a surplus that would be shared between the partners according to their investments at the time of the sale.

The Practice of Diminishing *Musharakah* Product as Provided by Conventional Bank through its Islamic Branch

Habib Bank Limited (HBL) is the first commercial bank in Pakistan, originally it was established in 1941, and in 1947, HBL made its headway in Pakistan, at the request of Muhammad Ali Jinnah. In 1951, HBL opened its first international branch in Colombo Sri Lanka. In 1974, the bank with a significant domestic share, was nationalized, while in 2004 it was privatised, and its management control was allocated to Aga Khan Fund for Economic Development (AKFED). In 2015, the entire (41.5%) shareholding of the Government was divested and HBL became the biggest private bank of Pakistan. (HBL)

HBL is providing Islamic house financing facility through its Islamic branch, to purchase a residential house or to renovate a house or apartment or to replace the already existing facility (BTF), formed under the concept of *Sharikat'al-Milk (Musharakah)*. Hence it

is a partnership,

Table 2: Showing the Profit Rate for Islamic Home Finance Customers

Parameters	Charges
Profit Rate	Variable to be repriced annually as follow
Existing HBL Customer – Salaried	1 Year KIBOR + 3%
Existing HBL Customer - Self Employed Professional	1 Year KIBOR + 3.1%
Existing HBL Customer-Self Employed Businessmen	1 Year KIBOR + 4%
New to Bank Customer - Salaried	1 Year KIBOR + 3.2%
New to Bank Customer – Self Employed Professional	1 Year KIBOR + 3.2%
New to Bank Customer – Self Employed Businessmen	1 Year KIBOR + 4%
Non-Resident Pakistani (Salaried)	1 Year KIBOR + 4%

Data Source: Official Website of HBL

where the bank and the customer by their joint investments, purchase a house and becomes its joint owners. The bank’s shares in the house are divided into units so that the customer can gradually purchase them. Simultaneously, the customer provides rental fee for the use of the bank’s share in the house, until he owns the property outright. To avail the facility of Islamic Home Finance, the customer who is a salaried individual should be a Pakistani citizen, along with the income from PKR 50,000 to PKR 100,000. If the customer is a businessman or self-employed professional then he should have income between PKR 100,000 to 150,000. (HBL Islamic Home Finance) Moreover, HBL offers different profit rate to its different customers as shown in the table below.

Property *Takaful* is compulsory against the risks involved to the property such as fire, flood, or any other relevant risk and the customer is required to fulfill all the obligations arising from the *Takaful* coverage. (HBL Islamic Home Finance) According to the HBL mortgage calculator provided on its website, if an already existing salaried customer wants to purchase a house worth ten million, by availing the facility of Islamic Home, where he will contribute three million and the remaining seven million will be financed by the bank, then following would be the detailed payment schedule.

Table 3: Showing the Payment Schedule for Islamic Home Finance Customers

House Cost Price	10,000,000	Segment	Existing Customer
Customer's Share	3,000,000	Bank's Share	7,000,000
Rent Price	60,526	Unit Sale Price	8,778
Profit Rate	10.52%	Monthly Payment	69,304
Tenure in Years	20	No. Of Months	240

Data Source: Official Website of HBL

HBL decreases the rent price while increases the units' price with the periodical payments by the customer, hence the monthly payment remains equal throughout the tenure of the contract. In the above situation the total amount, paid by the customer at the end of the tenure of the contract would be approximately sixteen million six hundred thirty-two thousand nine hundred sixty rupees (16632960).

If a customer is interested in ending the contract of Islamic Home Finance and wants to go for the early settlement of the contract, by paying off his outstanding amount at once, and also if he wants to purchase additional units in a month then the bank will increase the price of its remaining shares and will sell them at a 5% higher price to the customer, irrespective of the fact that whether there is any change in the market value of the house or not, it will sell it with the higher price anyway.

Furthermore, while entering into the contract, the customer is required to undertake that in case of a late payment of rent he will pay PKR 2500 towards a charitable purpose use by the bank. The bank will not add this amount in its income pool, rather it will go to the charity account which is under the supervision of the *Shariah* Board and administered according to the bank's charity policy. However, when a customer fails to provide monthly instalments then the bank will sell that house and recover its due amount and damages from the proceeds of sale and if there is still any surplus left that would be shared with the customer.

Shariah Appraisal of Diminishing *Musharakah* Practices in Pakistan

The basic structure of the contract appears to be *Shariah* compliant but after a detailed examination of the actual practice of the home financing based on Diminishing *Musharakah* by different banks in Pakistan, some loopholes can be identified. In Diminishing *Musharakah*, after entering into the contract the customer has to pay rent for the use of bank's share in that house and also need to purchase the bank's shares until he owns the house outright, and both these transactions must be treated independently while, in practice banks are failed in dealing both transactions separately, as the purchase of the units and the lease transaction exist side by side. For instance, the customer has to pay a monthly payment which is a combination of rent and the unit price of the bank's share, and the customer pays both jointly. When two different obligations are merged into one, then how can it be assumed that these transactions do not dependent on each other, and one's non-performance does not affect the other?

Moreover, with the gradual purchase of the banks share, the rent is supposed to decrease

whereas in conventional bank (HBL), which is offering this product through its Islamic branch, the monthly payment (which includes the rent and price of the units), remains same and does not reduce with the gradual purchase of the units which decreases the banks share in that house. Hence it is not compliant with the basic concept of Diminishing *Musharakah*, where the rent decreases with the gradual purchase of the bank's shares by the customer.

As Diminishing *Musharakah* involves three contracts, partnership, sale and lease, hence all the important rules prescribed for such contracts should be adhered to in this arrangement as also required by the AAOIFI *Shariah* standards and guidelines provided by State bank of Pakistan. Hence, in the contract of partnership all the obligations and liabilities should be borne by both partners, and not solely by the one partner (customer) due to the fact that it would be him who will own the subject matter solely in the future. Whereas, in practice the customer also undertakes that on the demand of the bank he will take the Property *Takaful* and also, he will be responsible for every type of taxes, expenses and stamp duties arising from the agreement and any other relevant documents. Hence, in both banks (MBL, HBL) the processing charges and Federal Excise Duty (FED) on processing charges along with the other charges such as legal report charges, property valuation charges, stamp duty and the property *takaful* costs will also be borne by the customer. Likewise, documentation charges will also be paid by the customer at the stage of signing the agreement of *Musharakah* in accordance with the financing limit. Hence, it clearly shows that under this arrangement the contract of partnership is not taken in its true sense.

When a customer wants to end the contract by paying off all the outstanding amount at once, then the conventional bank (HBL) sells its share at a 5% higher price, and same rule is applicable when instead of one unit the customer wants to purchase additional units in a month. This practice strictly goes against the spirit of *Shariah* as under *Shariah* there is a concept that "Debt cannot be forgiven, even in Death", (Syed Naeem Badshah) therefore stopping someone from fulfilling his obligations, or imposing penalty over his attempt to settle his outstanding amount before their due date, is not consistent with the true spirit of *Shariah*. When one wants to fulfill all the liabilities then the other party instead of creating hindrance, should encourage and facilitate them in every possible way. But here imposition of extra amount clearly discourages the customer to go for the early settlement in order to get rid of these liabilities or obligations. Therefore, if the early settlement by the customer does not result in any loss for the bank, then the bank should not charge any extra amount for it as the prime objective for the Islamic banks should be to carry on transactions by following the principles of *Shariah*, and not to make money in every possible way, as in the latter case there would be no difference between the transactions carried out by the conventional banks and the Islamic banks.

Similarly, paying extra amount in case of a late payment by the client has also received criticism. The critics maintain that charity cannot be given forcefully, hence it goes against the spirit of *Shariah* and they further maintain that by utilizing those extra charges for the purpose of charity, IFIs are earning good-will which also comes under the ambit of *riba*, as any excess over capital amount is considered *riba*. However, to deter the customers and to ensure the banking discipline, the imposition of some sort of penalty is necessary. But at the same time taking penalty charges from a client who cannot pay the monthly payment on time due to some valid reasons which are beyond his control is against the principles of *Shariah*. Hence, there should be a procedure under which the customers must be given a chance to provide the evidence for the reason of non-payment and if he fails in providing a valid reason, then in that scenario he must be held liable to pay extra charges, as the debtor who deliberately delays the payments is also condemned by the Holy Prophet (P.B.U.H) by saying that any financially

stable debtor who deliberately delays the payments, invites punishments and disgrace for himself. (al-Bukhari)

CONCLUSION AND RECOMMENDATIONS

To make this product *Shariah* compliant all the necessary elements or principles of the contracts involved should be adhered to and all these three transactions should be independent of each other, so one transaction's performance or non-performance does not affect the other, hence should be treated and documented separately whereas, in practice, it can be seen that these requirements are not ensured in its true sense. As there are three transactions involved in one arrangement, this makes it difficult to adhere to the principles of each transaction separately.

Therefore, if the IFIs want to carry out the contract through Diminishing *Musharakah* by carrying out three transactions; Partnership (*Musharakah*), Sale (*Bay*) and Lease (*Ijarah*) then they should make some changes. For examples when there are different transactions involved, there can be a requirement to have different applicants for each of those transactions. As MBL and HBL makes it optional to have more than one applicant, but that applicant should be a direct family member of the primary applicant. If IFIs make certain changes, and make it compulsory to have different applicants for the different contracts then the problem of combining different contracts into one could be resolved and it would make the contract more transparent and would make it easy to adhere to all the essential elements of each contract separately.

To explain it in detail, the bank and the customer enter into a partnership contract and jointly purchase a house, depending on their investment the bank owns majority of the shares, which would be divided into units and one partner (the customer) undertakes to purchase the shares of the other partner (the bank) gradually, until he owns the house completely. To get that house on lease, another application should be submitted by a different customer, who should be the direct family member of the first customer. The bank and the new customer will enter into a contract of lease, where the new customer will provide rent for the use of bank's share in that particular house, as the bank's share will decrease gradually the rental amount shall be revised accordingly. Imam Malik, Imam Shafi, and Imam Abu Yusuf are also of the opinion that undivided share can be given on rent to a third party. (Ayub, 2007) Hence it will make it easy to carry on the contract by applying all the necessary principles of each contract to ensure its *Shariah* compliance and it will also make the contract of sale and lease independent of each other and when any customer who will not fulfill his obligations arising from the contract will face the legal consequences.

Though this model involves a bulk of documents and contracts, but it will help in eliminating the *Shariah* issues which are involved due to the combination of three contacts into one and will make it easy to carry out contract without making one transaction, dependent on other.

The following points might be raised against this suggested model;

- i. The availability of direct family member cannot be guaranteed in every case,
- ii. The new applicant might not have any source of income in order to make a contract of lease.

To answer the first question, it can be said that a person who do not have any direct family member such as father, mother, sister, brother, wife or son would not think to enter into a such long-term contract because of his only use. Such single person would rather prefer to

live in a flat or a rented house. As far as the second disagreement is concerned that the new applicant might not have any source of income in order to enter into a contract of lease, an option can be given to him to have a co-applicant whose income can be clubbed for the approval of the lease contract. Hence, after the thorough research, it is believed that this product can easily be made *Shariah* compliant, with all the necessary changes that have been mentioned. This would leave many customers in a much better position financially as they would be avoiding *riba* and would not be stuck in two different contracts that are dependent upon one another.

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