

# **THE UNDERLYING CONTRACTS OF ISLAMIC BANKING (IB) PRODUCTS AND SOME RELATED ISSUES IN THE CURRENT PRACTICE**

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## **Abstract**

*Ever since the establishment of the first Islamic bank in Malaysia, the progress and development of Islamic banking and finance have been tremendous and commendable. Various Islamic banking products are developed and introduced based on certain Islamic business contracts that comprise *‘uqud al-ishtirāk*, *‘uqud al mu‘āwadat* and others. Some products are even developed on hybrid basis while some others are based on controversial or disputable contracts. The tremendous development of the products nevertheless has stirred a string of discussions and arguments as the products are seen as just replication of the conventional products. This paper will therefore attempt to highlight several issues on some of the Islamic banking (IB) products. The underlying contracts and their current applications in Islamic banks are first explained to give preliminary understanding of the issues. It is believed that, by highlighting the issues, some appropriate measures could be explored in future research in order to materialise the true meaning of Islamic banks.*

**Keywords:** *‘Uqud al-ishtirāk, ‘Uqud al mu‘āwadat, Ribā, maqāsid al-shari‘ah*

## **Introduction**

As a complete and comprehensive way of life (*al-deen*), the Islamic system encompasses all aspects of human conducts including banking and finance. Being part and partial of an Islamic system, banking and finance operate on the revealed sources of Islamic laws (*Shari'ah*). Basically, there are two main sources of *Shari'ah*: primary and secondary sources. The primary sources of *Shari'ah* are the Qur'an and the *Sunnah*. The Qur'an is Allāh's revelations to the prophet Muhammad (Peace Be Upon Him [P.B.U.H]) that contain all basic principles, rules and regulations encompassing all human activities inclusive of business and finance<sup>1</sup>. The *Sunnah* refers to the life of the prophet (P.B.U.H) that reflects the way of life and behaviour as required by the Almighty Allāh as prescribed in the Qur'an<sup>2</sup>. Being the second source of Islamic law, the *Sunnah* explains the actual practice of the requirements in the Qur'an by way of giving true examples. In other words, the *Sunnah* contains the rules deduced from *hadīth* (the sayings of the prophet), actions and approvals of the prophet (P.B.U.H) either in specific pronouncement or action or in his approval of someone else's action or practice.

The principles of business and finance outlined in the two primary sources are mostly general in nature, and certain rulings which are sufficient to explain issues and problems then may no longer be sufficient to handle the upcoming problems. In this connection, Islam recognises *ijtihād* (individual reasoning) through devout and careful procedures to derive appropriate rulings in order to solve the problem at hand. Thus, in addition to the two sources of law, there are secondary sources namely *ijma'* (consensus) and reasoning by *qiyās* (analogy). This is where the flexibility and relevancy of Islamic law come in and this is where business and finance find room for further enhancement and innovation within the ambit of Islamic law. The authority to such resort to the secondary sources is attributed to a *hadīth* of the prophet (P.B.U.H) when he appointed Muadz ibn Jabal as governor to Yemen.

Islam as a system that differs fundamentally from the prevailing conventional systems has its *maqāsid al-shari'ah* (goals) to be attained through the practice and implementation of *shari'ah* so as to realise *falah* or success of man's life in this world and the world hereafter. These *maqāsid*<sup>3</sup> or goals are the safeguarding of our *al-daruriyyah al-khams* (essential needs) comprising *hifẓ al-deen* (the safeguarding of faith), *hifẓ al-nafs* (the safeguarding of life), *hifẓ al-'aql* (the safeguarding of intellect), *hifẓ al-nasb* (the safeguarding of progeny) and *hifẓ al-māl* (the safeguarding of wealth) (Chapra, 1992; Al-Omar and Abdel Haq, 1996; Mohd Daud, 2007; Abdulazeem and Asyraf, 2007). The safeguarding of faith is the utmost ingredient of *shari'ah* as faith puts human beings to behave on a proper foundation (the straight path or *ṣirat al-mustaqim*). It also provides moral filter (Chapra, 1992) for the utilisation, allocation and distribution of resources thereby the goals of Islamic finance that is to have a broad-based economic well being with full employment and optimum rate of economic growth, to attain socio-economic justice and equitable distribution of income and wealth, to have stability in the value of money, to have mobilisation and investment of savings for economic development in an equitable manner, and to have effective rendering of services normally expected from the

banking system (Chapra, 1985) can be materialised. In the context of business conduct, this manifestation of faith may become a powerful mitigating system against all sorts of misconducts or moral hazards in contractual business relationship.

In view of the *Shari'ah* and its *maqāsid*, the operation of Islamic banks, inclusive of their offered products, should comply with *Shari'ah* in order for the *maqāsid* to be achieved. The present IB practice nevertheless has created arguments and disputes among the respective scholars in the field as the practice is seen as replication of the conventional system minus the interest. This had caused the Islamic banks to be seen similar to the conventional banks. Of the whole Islamic Banking (IB) practice, the center of arguments is the products. Thus, this paper attempts to highlight several issues being raised against some of the IB products. Further details of the issues nevertheless, will not be explored in this paper as they need specific focus to address. Perhaps, by highlighting the issues, some appropriate measures could be considered for future research in the area. The philosophical foundation of Islamic finance will first be discussed as Islamic finance is a unique sub-system of Islam. The underlying contracts of IB instruments will then briefly be elaborated, as knowing only the instruments without the contracts could keep someone in haze, as each IB instrument is based on a certain underlying *mu'amalat* contracts.

## **Philosophical Foundation of Islamic Finance**

As a unique sub-system of Islam, Islamic financial system has its philosophical foundations as a basis of its operation. The foundations comprise mainly of the concept of *Tauhid*, *khalifah*, *amānah* and *ukhuwah*.

In Islam, man is a *khalifah* (vicegerent) of Allāh as far as the management of wealth is concerned. The absolute ownership of wealth in the world belongs to Allāh. In the Qur'ān Allāh says to the effect; "He is who created for you all that is in the earth...and when thy Lord said unto the angels; Lo! I am about to place a viceroy in the earth..." (Qur'ān, *al-Baqarah*: 29 – 30). The wealth itself is *amānah* (trust) for mankind. Man has been endowed with mental and physical capabilities to function as *khalifah*. Hence, as trustee of Allāh, man should thereby utilise and distribute the resources in conformity to His Prescriptions. The IBs and other financial institutions, as the trustee of wealth too, should therefore manage the financial resources according to the rules and prescriptions of Allāh. The resources should not be kept idle as it is a form of wastage which is prohibited by the Qur'ān. Therefore, any excess in financial reserve should be channeled to the entrepreneurs for productive purposes and the utilisation should also be assured to lead to an efficient and equitable allocation and distribution of the resources.

Islam has advocated that the utilisation of the financial resources should consist of a balance between individual right and the right of the community. Therefore, financial institutions have to extend the financial resources under its care to finance projects and development for the betterment of the community. Besides, they are expected to do

their social responsibilities in the form of promoting social welfare programmes and allocating more contributions towards the needy and the poor. Allāh says to the effect; “And in their wealth and possessions the right of the (needy), him who asked and him who (for some reason) was prevented.” (Qur’ān, *az-Z̄ariyāt*: 19)

Islamic teachings also promote the spirit of *ukhuwah* (brotherhood) among mankind (*hablumminan-nās*). Everyone is equal in the eyes of Allāh and no one has more privilege over the other, except of course those who are *muttaqin* (God-fearing). It is therefore implied that every individual has an equal right and opportunity in the access, allocation and distribution of resources endowed by the Almighty. Everyone is also responsible to care and help each other. As such, one’s attitude towards other human beings is not to serve his own self interest (Chapra, 1992). Instead, the spirit of cooperation and mutual conducts are very much promoted and encouraged. Having this spirit of brotherhood would allow for the attainment of social equality and dignity of men as *khalifah*. Hence, within this framework of the concept of brotherhood, individual partner in business inclusive of bank and other financial institution, should ensure that establishing justice in all conducts is upheld, the spirit of cooperation is inculcated, healthy competition is acknowledged and material well-being of the *ummah* (the people) is developed.

As the Islamic financial system is operating within the framework of Islamic law, it is expected that the system should have a philosophy which is different from that of the existing conventional system. The philosophy should therefore, be in line with the divine guidance of the Qur’an and the *Sunnah*. The Qur’an has made it very clear that *bay’* (trade and commercial activities) are permitted and encouraged while *ribā* (interest) is prohibited (Qur’ān, *al-Baqarah*: 275-81. These revelations serve a very clear philosophical foundation of Islamic finance; that *al-‘adālah* (justice) and virtue must be upheld in managing business affairs whereas any form of unjustified enrichment such as *ribā* (interest) must be avoided by all means.

*Ribā* is an Arabic word which literally means an increase, addition, expansion or growth. In *shari‘ah* (Islamic laws) term, *ribā* refers to the premium that must be paid by the borrower to the lender along with the principal loan as a condition for the loan or an extension on its maturity (Chapra, 1985). *Ribā* in *shari‘ah* context is classified into *ribā al-nāsi’ah* and *ribā al-fadl*. The term *nasi’ah*, which comes from the root word *nasa’a*, means postponement or delay. Therefore, *ribā al-nāsi’ah* refers to the additional time allowed to repay the loan by the borrower in return for the additional repayment on top of the loan. This addition can be in the form of fixed or variable percentage of the principal or absolute amount to be paid in advance or on maturity or any other positive return as a condition for the loan (Al-Omar and Abdel Haq, 1996).

*Ribā al-fadl* occurs when there is unjust exchange of commodity with the commodity involving the six *ribāwi* items as covered in the *hadīth*<sup>4</sup> namely gold, silver, wheat, barley, dates and salt. Of the six commodities, gold and silver represent money while the other four represent staple foods. There are differences of opinion by Muslim jurists

as to whether *ribāwi* items are restricted to only the six items covered in the *hadīth*. The detail of this issue will not be covered here as a matter of relevancy.

The strict prohibition of *ribā* in Islam is a way to establish justice in an economic system and to eliminate the form of exploitation and unjust practice. In a *ribā*-based debt financing, the financier is assured of getting the principal loan and positive return from the lending without sharing any risk of loss while the entrepreneur, in spite of the hard work, is not assured of getting such a return. This positive return on loan has no element of risk-sharing as the financier has the right to sell the collateral to recover the loan in the case of default payment. It is therefore a compulsion for the Islamic financial system to avoid any such element of injustice to happen in the system.

On top of that, financial institutions are imposed to conduct all their financing activities within the framework of the law of *fiqh ul-mu‘amalāt* (Islamic business transaction). This is to ensure the establishment of justice in contracts and the avoidance of unjust exploitative elements such as *ribā*, elements of *gharar* (uncertainty), *maysir* (gambling) and speculation. In this regard, the Qur’an emphasises the demand to uphold justice; “O ye who believe! Stand out firmly for justice, as witness to Allāh, even against yourself or your parents or your kin and whether it be (against) the rich or poor for Allāh can best protect both..” (Qur’ān, *an-Nisā*: 135).). In another verse, Allāh revealed that; “Allāh commands justice, the doing of good and liberality to kith and kin, and He forbids all shameful deeds and injustice and rebellion. He instructs you that ye may receive admonition.” (Qur’ān, *an-Nahl*: 90). These verses enforce the philosophy to uphold justice irrespective of status or blood relationships among man. In the context of business, these verses mean that the Islamic financial institutions must treat their customers equally and impose banks to distribute income and wealth equitably when fixing profit-sharing ratios with their investors and business partners (Sudin and Shanmugam, 1997). The following sections discuss further the basic contracts of *fiqh ul-mu‘amalāt* upon which the IB instruments are positioned.

## **The Underlying Contracts**

Hassanuzaman (1995) has classified entrepreneurs and businessmen into three categories according to their financing requirements. They are: (i) those who have entrepreneurship talents but have no money to venture into business such as skilled workman or artisan, (ii) those who have merchandise for sale or machinery for hire but need a market and (iii) those who have financial resources which are not sufficient to promote the project that their entrepreneurial ability has created. In the light of the above classifications, the underlying contracts of Islamic financial instruments can be classified into: equity/profit-loss sharing (PLS) contracts, debt financing contracts, and other contracts (Bank Islam Malaysia Berhad [BIMB], 1994).

## Islamic Equity Financing Contracts

Equity financing is the financing of equity acquisition or projects based on *‘uqud al-ishtirāk* (Profit-Loss Sharing Contract or PLS) (BIMB, 1994). The commonly practiced profit-loss sharing contracts are *Mudārabah*, *Mushārah* and *Mushārah Mutanaqisah*.

### i. Mudārabah

This is one type of profit sharing contract. *Mudārabah* is derived from the *darb fil-ard* which means journeying through the land seeking the bounty of Allah (Nyaze, 1997). It is also called *muqaradah*, derived from the root word *qard*, which means refraining or abstaining from something as the capital owner is refrained from the right of disposal in his own wealth after being delivered to the entrepreneur. Technically, it is a financing in which the owner of capital provides funds to the entrepreneur for productive activity or project (Al-Harran, 1993; Ausaf, 1995; Nyaze, 1997; Usmani, 2002, 2007).

The entrepreneur does not invest anything in the business except his human capital and is not entitled to a fixed remuneration or to an absolute amount of pre-determined profit (Chapra, 1998). The capital-provider, who is normally a sleeping partner, does invest a total sum of the project but he does not interfere in the management of the project.

The profit generated from the project will be shared between them according to the predetermined ratios agreed upon by both parties. The loss incurred, if any, shall be borne solely by the capital-provider except when the loss is due to neglect or misconduct on the part of the entrepreneur. The entrepreneur, on the other hand, will lose all his labour and hard work throughout the tenure of the project. If there is breach of *Mudārabah* conditions by the capital-provider i.e. by terminating the contract or withdrawing the capital before maturity, the entrepreneur shall be paid certain sum of compensation as a reward for the labour. Likewise, the entrepreneur should guarantee to return the funds if he breaches the conditions of *Mudārabah*. *Mudārabah* (or *Muqaradah*) application can be found in *Mudārabah* Investment Account, *Mudārabah* Inter-bank Investment and *Mudārabah* project or contract financing.

### ii. Mushārah

*Mushārah* is a contract by which two or more persons agree to participate in a business concern, contributing either capital or labour and distributing among themselves any resulting profit or loss (Ausaf, 1995; Nyaze, 1997; Razali, 1999; Usmani, 2002, 2007). In *fiqh*, *Mushārah* is a contract by which two or more persons agree to participate in a business concern, contributing either capital or labour and distributing among themselves any resulting profit or loss (Razali, 1999). Muslim jurists legitimise the different forms of *Mushārah* which are governed by a different set of rules and provisions. The forms of *Mushārah* commonly acceptable are *Inan* (limited partnership), *Abdan* (labor partnership), *Mufawadhah* (mutual partnership) and *Wujuh* (credit partnership).

In the context of financing, the most applicable type of *Mushārahah* is *Inan*. This *Mushārahah* refers to an agreement between two or more parties whereby each of them provides a portion of capital, and profits or losses are shared between them on a pre-agreed basis (Chapra, 1985, 1998). Simply, *Mushārahah* is a sharing of capital, profits and losses among the partners of a certain project. Unlike *Mudārahah*, capital owner(s) in *Mushārahah al-Inan* is (are) partners who may manage the funds by themselves, may delegate the work to any of the partners or may appoint agents to run the firm's business activities. In the case of IB, *Mushārahah* will enable the customer of the bank, who has insufficient capital, to get extended financing in order to run the project.

The essential difference between *Mudārahah* and *Mushārahah al-Inan* is that; the loss is borne solely by the financier in *Mudārahah* but in *Mushārahah al-Inan* the loss is shared among the partners according to the respective capital contributions. The *Mushārahah* mode of financing is suitable to finance private or public companies and in project financing for short and medium term periods (Razali, 1999).

### **iii. Mushārahah Mutanaqisah**

This is also one type of profit-loss sharing contract under the principle of *Mushārahah* where at least two partners share their capital and profit/loss of a certain project. The difference between this financing with the normal *Mushārahah* financing is the ownership of the equity at the end of contract period. Here, the equity of either partner is diminishing reciprocally throughout the period of financing till finally the ownership ends up at only one partner (diminishing *Mushārahah*). In modern practice, *Mushārahah Mutanaqisah* is applicable to finance the purchase of shares (equity financing) and to finance asset acquisition on shared rental basis (Usmani, 2002; Dzuljastri et al., 2006).

One such example is the case of a customer who needs financing for the purchase of equity of a certain company. The customer will pay; say ten percent as an initial share to co-own the equity while the financier provides the balance of ninety percent. The customer will then redeem the financier's share at an agreed portion periodically until the equity is fully owned by the customer. Another example of its application is the financing of asset acquisition between the bank and the customer on shared rental basis.

## **Islamic Debt Financing Contracts**

Islamic debt financing in Islam refers to financing the acquisition of assets, working capital or stocks on the basis of *uqud al mu'awadat* (exchange contracts) (BIMB, 1994). Among the prominent modes of Islamic debt financing are:

### **i. Murābahah**

The term *Murābahah* comes from the root word *ribh* which means profit (Al-Zuhayli, 1996, 2003; Muhammad Ayub, 2007)). In banking terminology, *Murābahah* is a cost-

plus contract in which a customer who wishes to purchase equipment or goods, requests the bank to purchase the required item and sell it to him at a cost plus a declared profit. This type of financing is commonly used to finance working capital on a short-term basis as well as to purchase imported goods under the Letter of Credit (LC) facility (BIMB, 1994).

#### **ii. Bay<sup>c</sup> bithaman Ajil**

The term *bay<sup>c</sup> bithaman ajil* or *bay<sup>c</sup> muajjal* literally means sale on a deferred-payment basis (BIMB, 1994). The modes of this financing is similar to *Murābahah* whereby the bank finances the purchase of assets or goods required by the customer at a price inclusive of cost plus profit or mark-up to be paid at a given date in the future on installment basis. The *shari'ah* allows the bank to sell goods on deferred payment basis at a price higher than the cash price with the condition that the agreed selling price is not changed even if the payment is not made on due date (Al-Omar and Abdel Haq, 1996; Al-Zuhayli, 2003). *Bay<sup>c</sup> bithaman Ajil* is commonly applied by banks to finance assets such as vehicles, houses, shop lots and shares. This type of financing is often securitised to create Islamic Coupon Bonds or *Al-bay<sup>c</sup> bithaman Ajil* Debt Certificates (ABBA), and is tradable in the Islamic capital market.

#### **iii. Bay<sup>c</sup> Salam**

This type of contract is similar to *bay<sup>c</sup> salam* in which the seller does not possess the goods at the time of conclusion of the contract but it is treated as valid on the basis of necessity or customary practice (Razali, 1999; Muhammad Ayub, 2007). *Bay<sup>c</sup> salam*, known also as *bay<sup>c</sup> salaf* or *bay<sup>c</sup> mafālisah*, is a sale contract in which advance payment is made to the seller for deferred delivery of goods (Hassanuzaman, 1995). In banking practice, *bay<sup>c</sup> salam* could be used to finance farmers, traders, importers or manufacturers who are in need of capital in advance but delay the delivery of the goods.

#### **iv. Bay<sup>c</sup> Istisnā'**

*Bay<sup>c</sup> istisnā'* is a sale contract that allows for an order to be placed with a manufacturer to make certain products where cash payment may be made in advance or on completion of the products (Al-Zuhayli, 1996, 2003). *Bay<sup>c</sup> istisnā'* opens the way to a number of opportunities in financing including some form of future contract trading of processed commodities on short term financing scheme as it permits deferral of delivery as well as payment (Al-Omar et al., 1996).

#### **v. Ijārah**

*Ijārah* refers to a contract that involves the transfer of usufruct (a use of property or the service of a person) for a consideration (rental or wages) at a certain determined period (Ausaf, 1995; Abdur Rahman, 1999). One common form of *ijārah* practically used by modern Islamic bank is *al-Ijārah thumma al-bay<sup>c</sup>* (AITAB) or lease purchase of assets such as plants and machinery.



**vi. Bay<sup>ʿ</sup> al-Ināh**

*Bay<sup>ʿ</sup> al-Ināh* is generally known as a twin-sale contract; one contract is done on cash basis while the other is on deferred. In this sale, the seller (prospective debtor) sells an item to the buyer (prospective creditor) for cash which is payable immediately, then the debtor immediately buys back the same item for a greater amount to be paid in the agreed future period (Usmani, 1992; Saiful Azhar and Mahmood, 1999; Kamali, 2002; Mohd Daud, 2002). Modern practice of *bay<sup>ʿ</sup> al-Ināh* is often found in Islamic overdraft, Islamic bonds, Islamic personal loan and Islamic credit cards.

**vii. Bay<sup>ʿ</sup> al-dayn**

Literally, *dayn* (debt) is defined as the things due by a debtor either in the form of money or commodity. In the modern context of banking and finance, *dayn* (debt) refers to a payable right that normally arises out of contracts of exchange or *uqud al-mu<sup>ʿ</sup>āwadat* such as trade financing (based on underlying *murābahah* contract) or asset sale (based on the underlying contract of *bay<sup>ʿ</sup> bithaman ajil*) which are securitised (Usmani, 1992; Kamali, 2002). *Bay<sup>ʿ</sup> al-dayn* is the selling of debt by the debt holder back to the debtor himself or to any third party. The *shari<sup>ʿ</sup>ah* permits the selling of debt at its equivalent amount by way of *hiwālah*. This debt trading is accepted by all *madhāhib* (Schools of Islamic law) provided it is paid in full and gives no benefit to the purchaser (Saiful Azhar and Mahmood, 1999). *Bay<sup>ʿ</sup> al-dayn* is commonly applied in trade financing and factoring.

## **Other Financing Contracts**

The other IBs financing contracts may fall under *uqud al-hifz* (safe-custody contracts) and *uqud al-Isqatat* (surety contracts). The following are some of the commonly applied contracts of safe-custody and surety.

**i. Al-Wadiah**

*Al wadiah* means a thing or commodity committed to the trust and care of a person (safe custody of a deposit) (Al Zuhayli, 2003). The term *al wadiah* was mentioned in the Quran: “*And if one of you deposits a thing on trust with another let the trustee (faithfully) discharge his trust, and let him fear his Lord*” (Al Baqarah: 283). In banking and finance it refers to a contract between a bank (the keeper and trustee of the funds) and a depositor (the owner of the funds) whereby the bank guarantees refund of the entire amount of the deposit or any part of the outstanding amount when the depositor demands. It has been applied in providing saving and current account services to the client.

There are two types of *al wadiah*. First, *al wadiah yad al amanah* (trustee safe custody) whereby the bank (a custodian/trustee) will take care of the funds and not guarantee the return of the fund in the event of a loss due to theft, fire or other natural calamities provided that there is no negligence, mixing or pooling the funds, using the funds, and charging fees for safe custody (Al Zuhayli, 2003; Razali, 1999; Kamal et al., 2008).

*Second, al wadiah yad al damanah* (guaranteed safe custody) which differs from *al wadiah yad al amanah* (trustee safe custody) in terms the bank has to guarantee the return of the funds due to loss and it being destroyed, mixing or pooling the funds, using/investing the funds, and charging fees for the safe custody.

Usually the bank uses the principle of *al wadiah yad al damanah* in providing saving and current account services to the client (Kamal et al., 2008). Besides the depositors are guaranteed the refund of their deposits, they also at the bank discretion may be rewarded by *hibah* (gift) as a form of appreciation.

## **ii. Al Kafalah**

*Al kafalah* literally means guarantee, bail, surety, responsibility as Allah has mentioned in the Quran: “*He (Zakaria) took care (as a surety of her (Maryam))*” (Ali Imran: 37). Conceptually, it refers to the pledge given by the guarantor or the surety to the creditor on behalf of the principal debtor to secure that the guaranteed person i.e. the debtor will be present at a definite place for example to pay his debt or fine, and to undergo punishment (Al Zuhayli, 2003; Kharofa, 1997). Hence it is a kind of gratuitous contract as well security contract.

There are two types of *al kafalah*. First, *al kafalah bi al nafs* (guarantee of person) refers to the guaranty for the appearance of the debtor or his agent in a lawsuit. Second, *al kafalah bi al mal* (guarantee by property) refers to the payment of the loan either by the debtor or the guarantor.

In banking and finance, *al kafalah* has been used to provide a security for the loan payment from either the debtor or the third party by necessitating for example letters of guarantee, promissory notes and third party guarantees and the bank as the guarantor can claim fee (*al ujr*) or commission (*al ju'alah*) from the debtor as a commitment given to settle the debt (Muhammad Ayub, 2007).

## **iii. Al Hiwalah**

*Al hiwalah* means to turn over or transfer. The Prophet (P.B.U.H.) says: “*Delay (in the payment of debt) on the part of a rich man is injustice, and when one of you is referred to a rich man, he should follow him*” (Abu Hurairah). It is an agreement of transferring of debt from one debtor’s account to the debtor’s account of another or of a claim of a debt by shifting the responsibility from one person to another (Al-Zuhayli, 2003; Kharofa, 1997).

In banking and finance, *al hiwalah* has been used in debt transaction that is a transfer of debt from the debtor’s account to the creditor’s account and remittance that is a transfer of fund from the depositor’s account to the receiver’s account (Muhammad Ayub, 2007).

## **iv. Al Rahn**

*Al rahn* means detained and confined or pledging and pawning. Narrated by Aishah (r.a): “*The Prophet (p.b.u.h.) had pledged his steel armor to a Jew (Abusy Syahmi) for a*

*loan of 30 sha' wheat for his family*" (Bukhari and Muslim). It is a contract between the pledgor (the debtor) and the pledgee (the creditor) to make a property a security in respect of a right of claim on the full payment from the property (Al Zuhayli, 2003; Razali, 1999). Hence, it is a contract of security because it secures the loan repayment in case of default by selling the pledged property, and it is also a contract of authentication because it authenticates the payment of the debt (Razali, 1999; Kharofa, 1997).

In banking and finance *al rahn* is used to facilitate the supply of necessary short term loan based on *qard hasan* provided that the borrower must put a valuable property as a security in respect of a right of claim on the full payment from the property. The lender (the Islamic pawn broking institution) will lend money to the borrower and is forbidden to ask for extra payment but is allowed to charge a reasonable fee (*al ujr*) for the safe keeping of the pledged property under the principle of *al wadiah yad al dhamanah*.

#### **v. Qard hasan**

*Qard hasan* refers to the loan of fungible commodities, usually currency or other standard medium of exchange, in which the borrower is required to return the equivalent or the like of what he has received (Al-Omar et al., 1996; Al-Zuhayli, 1996, 2003). In modern practice of *Qard hasan* personal loan, it is a hybrid contract whereby *al-Ināh* is combined to allow for a specific return to the financier.

## **Some Related Issues**

As mentioned earlier in the paper, many issues have been raised by scholars on the practice of IB instruments. This section highlights some of the issues.

### **Issues in Uqud al-Muawadat**

*Contract*: In order for an exchange contract to be valid and lawful, the essential conditions of contract must be fulfilled. One of the condition is ownership whereby the seller must first own the sold property. In the current practice of *Bay' bithaman Ajil* (BBA) home financing for example, the act of selling and buying back does not reflect the true contract of sale. The bank does not practically own the property. On top of that, the sold property is yet to exist in most cases of BBA home financing whereas existence of the subject matter is one of essential conditions of sale. The non-adherence of current BBA practice to the conditions of contract had caused it to be questionable in terms of its validity.

*‘Iwad* (equivalent counter-value): One of the essential conditions in the contract of exchange is the presence of *‘iwad* or equivalent counter-value. *‘Iwad* is necessary to be fulfilled as it brings the sense of equity and justice in business relationship. Scholars warned that any increase without an *‘iwad* is tantamount to *riba* (Saiful Azhar, 2005). Hence, the fixing of deferred selling price in *Bay' al-Ināh* for example is questionable in terms of its *‘iwad* as the customer does not pay the price of the item purchased. Rather, he pays back the money received from the 'sell and buy back' contracts. Indeed,

the contract itself is controversial as the majority jurists ruled it as non-permissible. The issue of *iwad* in BBA financing is questionable as well. This is due to the fact that the fixing of the mark-up, which normally amounted to double of the financed amount, is considered high. In addition, the mark-up is seen as a mere result of “time value of money” though there is claim that it is a result of “time value of asset”. The former looks more valid as the bank does not really own the asset sold.

*Dhaman*: Another important aspect in exchange contract is *dhaman* (guarantee). *Shari'ah* requires that seller (in this case the bank) has to hold all liabilities arising from the sold product including defects. Current practice (such as in BBA financing) however shows that the bank merely acts as the financier rather than the seller and it excludes itself of all liabilities. This definitely ignores the *Shari'ah* principle of no reward without risk (*al-ghurm bi al ghunmi*).

*Khiyar al-<sup>c</sup>aib*: *Khiyar al-<sup>c</sup>aib* or option due to defect is the right of buyer to continue or revoke the sale contract when the product delivered has defects (*al-<sup>c</sup>aib*). In the case of BBA financing for example, an issue arises as to which particular parties, the bank or developer, should the customer turn to whenever the house he purchased has defect upon delivery (Saiful Azhar, 2005).

*Discount*: In *Bay<sup>c</sup> al-dayn* contract, debt can be traded between the debtor and creditor for liquidity purposes. In other words, the debt holder (creditor) may sell his right of debt back to the debtor or any third party to get cash before maturity and *Shari'ah* does not allow any party to benefit from the selling as such benefit is equivalent to *ribā*. A discount is allowed to be given by the creditor for early settlement of the debt by debtor. An issue arises whenever the modern practice of *Bay<sup>c</sup> al-dayn* is done to a third party at a discount.

### **Issues in Uqud al-Isytirak**

*Agency problem*: The PLS equity finance (*Mudārabah* and *Mushārahah*) is formulated on a principal-agent arrangement through which conflict of interest between the two may occur. Scholars believe that this may cause agency problem if mitigating methods are not enforced stringently. The agency problem arises when the entrepreneur works in his own interest at the expense of the principals (Scholtens, 1999; Habib, 2002). The principals are anticipating for the investment to earn a return (profit). The entrepreneur on the other hand, upon receiving the funds, has the discretion to manage them in a way that may detriment the interest of the principals. The entrepreneur may misuse the funds, invest them at a risky business, and consume them for perquisites thus resulting in negative return in investment (Aggarwal and Yousef, 2000). Another problem relating to equity financing is ascertaining the actual return of the investment. There is a tendency for the entrepreneurs to under-report or artificially reduce the declared profit. As a consequence, the declared profit could not give a true reflection of the invested projects (Sarker, 1999). These moral hazard problems are seen more acute in *Mudārabah* financing as there is a clause in the contract for non-interference of fund provider in the management of project run by the entrepreneur.

*Adverse selection:* The lacking of information on the part of investors about the customers may cause the bank to have difficulties in sorting good projects for investment and this has led to adverse selection. As information is asymmetry, the banks have little knowledge about the feasibility and profitability of the existing enterprises. This may lead to the miss-channeling of funds to non-profitable enterprises, leaving the profitable one unfunded. Adverse selection problem may also arise when banks have to distinguish between good and bad entrepreneur. It may end up with funds falling in the hands of the wrong person, causing banks to bear unnecessary risks (Scholtens, 1999).

*Tradability:* Mark-up based products are tradable to any third party for liquidity purposes (particularly in Malaysia) as the *Shari'ah* experts allow the use of *bay' al-dayn* (debt trading) to trade debt instruments arising from the securitisation of such products (Dar and Presley, 2000; Saiful Azhar, 2005). The lack of such attributes in equity-based instruments had caused them to be unpopular as far as their practice is concerned.

## Conclusion

Islam has made it very clear that the implementation of *Shari'ah* will ensure the realisation of *maqāsid al-shari'ah* thereby our well being in the world and the world hereafter is safeguarded. As sub-system of Islam, the implementation of *Shari'ah* in banking and finance should ultimately reach the *maqāsid al-shari'ah* so long as their operations adhere to the rules and regulations in *Shari'ah*. As such, issues that arise should be taken into consideration seriously. Appropriate measures should be taken to overcome whatever loopholes. Otherwise, the true concept of IB and finance may not be realised and the *maqāsid al-shari'ah* may not be materialised.

## Notes

- <sup>1</sup> All translation of the Quranic verses are sourced from Ali, Abdullah Yusuf (1989).
- <sup>2</sup> All translation of the Sunnah are sourced to Khan, Muhammad Akram (1989).
- <sup>3</sup> *Maqāsid al-shari'ah* reflects the ultimate objectives of the *shari'ah* revealed by the Almighty Allah. The objectives of *shari'ah*, i.e. the safeguarding of five essentials of live (*al-daruriyyah al-khams*) are in fact constructed by Muslim jurists such as Al-Ghazali, Al-Shatibi, Ibn 'Asyur etc through *ijtihad*. See Mohd Daud (2007) for further elaboration.
- <sup>4</sup> The *hadith* is; "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like may be exchanged in such a manner that they are equal measure for measure, payment being made from hand to hand. If anyone gives more, he had dealt in *ribā*. The receiver and the giver are equally guilty."

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