Shariah Compliant Parameters Reconsidered

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Abstract

Purpose: This paper aims to explain three additional parameters, namely maqasid al-shariah, financial reporting and legal documentation of contract for determining Shariah legitimacy of financial instruments in Islamic financial institutions. Currently, contract (‘aqd) is the only parameter recognized by Shariah scholars at the supervisory level.

Design/methodology/approach: This analysis begins with examining of the pitfalls of contract approach and proceeds to present the maqasid, financial reporting and legal documentation approaches in ascertaining absolute Shariah compliant of financial products.

Findings: This paper argued that the four approaches must be applied in package in determining Shariah compliant status to avoid costly errors that might lead to litigations and lost of competitiveness in the Islamic financing business.

Original value: This study provides new insights and integrated analysis of Shariah auditing where knowledge clusters concerning the Shariah, economics, finance and accountancy and law are alga mated to ascertain wholesome Shariah viewpoint.

Keywords: Islamic finance, aqad, maqasid al-shariah, legal documentation, financial reporting.

Paper type: Research paper

1. Introduction

This paper intends to examine an issue in Islamic finance pertaining to the role financial reporting, legal documentation and intent of the Shariah in determining the legitimacy of Islamic financial instruments. Currently Shariah scholars constituted the only party responsible in determining Shariah compliant status of financial instruments. Their front-end role is common knowledge, namely issuing opinions on the legality of financial products offered by the Islamic banking, takaful, mutual funds and wealth management business based on the requirement of ‘aqd or contract. However, the push for innovation to satisfy commercial objectives has led many Islamic financial institutions (IFIs) to adopt conventional principles and instruments. Fatwas issued by Islamic jurists may run in conflict with their lucrative positions in international corporate Shariah Boards (Walid 2005). Issues include bench-making bank profit rates against interest rates, penalty charges on late payments, charging profit from delay or installment payment (murabaha), sale-buyback involving two parties (bay al-‘inah), sale-buy back using three interrelated parties (tawarruq munazzam), purchase undertakings in musharakah sukus, sale and repurchase agreement at par value in ijarah sukus, sale of debt at discount (bay al-dayn), promise (wa’ad) and the enforcement of contract (‘aqd), profit-rate swap and paying
upfront profit on Islamic investments, securitization of receivables and future cash flows. These unresolved issues have led many people including consumers to accuse Islamic finance as one that “closes the front door of riba while opening the back door of riba” or an activity only bearing “form over substance”. Disturbing mood such as these deserves an investigation.

In Islam, wealth can be created in many ways. Workers earn wages and salary by selling their labor. Retailers earn profits from the promotion and sale of their merchandizes. Lawyers and investment bankers earn fees by rendering their professional services. In other words, Islam cherishes the fact property changes hands by way of trade and commercial activities (al-bay’). When the transfer of property is transacted the wrong way (bathil), say by way of riba and gambling, rather than al-bay’, then injustice (zulm) prevails.

2. Four Methods in Determining Shariah Compliance

One who innovates will always go back to basic knowledge when something about his work is found inadequate. The same applies to innovation involving Islamic financial instruments. For example, it is of great importance to find ways to manage, say, liquidity. Through innovation, new methods are designed to improve liquidity in banking firms and hence increase efficient use of funds, thus maximizing bank’s earning. To avoid unnecessary losses arising from market volatilities by any means, hedging is inevitable. Innovation in Islamic financial instruments for hedging purposes help producers position themselves against these volatilities in a manner permitted by Islam.

The market is also looking for better ways to accommodate changes in the cost of funds in the existing home and car financing facilities. Entrepreneurial financing under a musharakah framework is yet to be employed by Islamic banks. Hence, to take a leading role in economic growth, Islamic banking must innovate in order to command a niche in specific areas that conventional banks cannot compete.

When innovation in Islamic finance is highly sought for by the industry and other stakeholders, it is usually conducted along certain explicit Shariah principles. The common use of the expression "Shariah principles" which is to convey full compliance with Islamic law in the financial transactions is a norm today. Usually, adhering to Shariah principles or staying "Shariah compliant" means observing strictly to the permissibles (halal) and abstaining from the prohibited (haram) as commanded by God. In current practice, Shariah principles may well imply the Divine rules (ahkam shari’) concerning interest (riba), ambiguities (gharar), gambling (maisir) and prohibited commodities such as intoxicants and pork. This method of aligning Shariah principles to the main and fundamental legal rulings (ahkam) concerning business and financial transactions as mentioned above, is both pragmatic and sensible. In this way, people can easily distinguish Islamic banking from conventional banking.

Principles can also mean values, major beliefs and doctrine rather rulings per se. In this way, it gives a broader perspective of the Shariah and helps accommodate a wider scope of thinking in Islamic finance. However, existing conventions may have positioned Shariah principles as synonymous with legal rulings. These principles such as the prohibition of riba,
gharar and maisir in financial transactions are also distinct Islamic legal rulings (hukm shari’). However, when Shariah principles are made equal to “legal rulings or values” (ahkam), it tends to narrow down the general meaning of Shariah principles into the purviews of permissables (halal) and prohibitions (haram) and hence, their technicalities.

It is here that the contract and aqad dimension of fiqh muamalat was raised to a level that have overlooked the role of financial reporting and legal documentation of financial transactions. When a Shariah compliant product is found suspicious, it does not fit well into the financial reporting of transaction. The same affects the welfare of customers when legal documentations favored the Islamic financial institutions. These events further raised questions whether the contract has readily fulfilled the intent of the Shariah (maqasid al-shariah).

The following sections examine each approach and argue that these approaches should be complementary to one another and most importantly to hold consistency in substance rather than form to further ascertain and confirm the determinants of Shariah legality in financial transaction. The four approaches are given below:

1. ‘Aqad
2. Maqasid al-Shariah
3. Financial reporting
4. Legal documentation

1.2 The ‘Aqad Approach

In developing new Islamic financial products, Shariah principles have been applied as the litmus test of legality. In the conduct of innovation, Shariah scholars however tend to align Shariah principles around the parameters of contract (‘aqd). In this way, the new product will received a Shariah compliant status when it has fully complied with the requirement of the contract at hand. Hence, halal and haram of actions pertaining to using the financial instruments are fully determined by the legality of a contract (al-aqd).

In Arabic, al-aqd literally means an obligation or a tie. It is an act of “putting a tie to a bargain”. The Mejelle has defined contract as “the obligation and engagement of two contracting parties with reference to a particular matter. Contract is a source of obligation and its faithful fulfilment is a duty in accordance with Surah 5, Verse 1 of the Qur’an: “Oh ye who believe, fulfill your undertaking” and then in another verse, the Holy Qur’an call upon believers to observe their engagement as they will be accounted for all their engagements. In the Quran, Surah 17, verse 34 reads: “And fulfill every engagement (ahd) for every engagement will be inquired into (on the day of reckoning)”. The validity of contract rests on the fulfillment of the four principles of contract namely: 1) buyer and seller 2) price 3) subject matter 4) offer and acceptance (Rayner 1991). For an example, a valid subject matter means that firstly, it is pure (mal-mutawawim) and secondly, seller holds legal ownership of goods. Valid price means that price must be set on the spot and make known to the buyer. Valid buyer and seller mean they are rational (aqil baliqh) enough to conduct the trade so as to understand their respective roles and obligations. In other words, the
elements of ambiguities (gharar) must be avoided in all contracts in Islamic law as its presence will cause defects to the contract and turn it null and void. When gharar exists in the contract, it will cease to become valid which also means counterparties receiving no legal protection. Some examples of contracts are given below:

1.22 Murabaha contract

From the aqad approach, the murabaha contract is valid because it has fulfilled all the requirement of a valid contract. The bank serves as the buyer while the customer as the seller. The object of trade is the home property. The price is known and agreed by both parties on the spot. But questions may be raised to further examine the validity of the contract. These questions include: 1) Does the bank actually buy the asset and hence holds ownership prior to sale? 2) How is the murabaha price determined? 3) To what extent profit determination implicate time value of money with fixed compensation since the murabaha deals with installment sale? 4) Who is liable when the asset sold is found defective upon delivery? 5) What happens when the customer defaulted on the murabaha facility? For this reason, it is imperative to further indulge into new boundaries of knowledge to tighten the meaning of Shariah legitimacy beyond the context of aqad.

1.3 The Maqasid Approach

Shari'ah principles can best be understood from an angle it is destined for, namely the purposes and objectives of Islamic law (maqasid al-Shari'ah) (Rosly 2006). This will prove more effective since it allows Islamic financial institutions to match their products and commercial viability more accurately to the demands of Islamic ethics and morality and hence justice ('adl). This is because the maqasid of Shari'ah serves to do two essential things, namely taiseel, i.e. the securing of benefit (manfaah) and ibqa', i.e. the repelling of harm or injury (madarrah) as directed by the Lawgiver (Masud 1977). In this respect, innovation in Islamic finance and all endeavours to test the legality of a new product must readily comply with the purpose (maqasid) of the Shari'ah.

Based on the above argument, it is worthy to examine what constitutes the maqasid al-Shari'ah. One purpose of the Shari'ah is the preservation and protection of the basic necessities (daruriyat) of man without which life would probably be filled with anarchy and chaos and thus become meaningless. Basic necessities in Islamic law are religion (Din), Life (Nafs), Family (Nasl), Intellect (Aql) and Property (Mal). For example, the prohibition on drinking wine (khamr) is based on two reasons. First, the intoxication effect will make one lose his senses. This prohibition therefore serves to repel the harm of losing one's senses. The second is the protection of the intellect which also means preservation of benefits so that he can acquire knowledge and seek the bounties of God.

In relation to the protection of property (al-mal), the prohibition of riba serves to repel the harm incurred by the payment of interest as it depletes one's property. Thus, by prohibiting riba, the harmful effects (madarrah) of poverty and widening of the income gap can be preempted. Likewise, the positive Quranic attitude towards trade and commercial activities (al-bay’) serves to secure the benefits of mutual help and equitable transactions ordinarily evident in the
business environment. People engaging in business will take a natural path in dealing with risk and return as both move in a harmonious fashion. By conducting al-bay and thus deriving benefits from it, it can make the business of money lending less profitable than trading.

The maqasid of Shariah will also assure that an Islamic financial institution will provide services that can repel the harm (madarrah) commonly found in the Western mode of financing. If the harm is still obvious in the new Islamic financing product, it must be eliminated at all cost. Otherwise, the product will not reflect the true ideals of Islam. For example, hedging against price volatility is an important ingredient in business today. Manufacturers who buy raw material as inputs are on the lookout to buy them at the cheapest cost possible. Some will buy forward, i.e. buy the commodity now to be delivered and paid for at a specific future date. The price is set on the spot on the day the contract is arranged. There are serious disagreements among Shariah scholars on this matter. Some say this kind of forward contract is permissible as it has fulfilled the requirements of a valid contract while others say the contrary as the contract involves betting against unknown events and thus akin to gambling (maisir) and therefore invites harm and injustice (zulm).

When the issue is examined from the contract ('aqd) perspective alone, i.e. applying rules of contract in determining legality, it may overlook the very purpose of the Shariah and hence unable to repel the harm it is initially intended to do. If it can be proven that forward contract is free from harm either from the gambling element or ambiguities (gharar), then it should prove beneficial to Islamic finance and hence be adopted by Islamic financial institutions. However, if it the contract is found valid (sahih) from the 'aqd perspective but has been shown to have adversely affected the general welfare, it should be reinvestigated with more rigour in juristic terms. When something has failed to repel the harm, it defeats the very purpose of the Shariah.

Fulfilling the maqasid Shariah should therefore serves as the underlying principle of Islamic financial innovations as it safeguards rulings based on fiqh from moving into unwanted territory. The purpose (maqasid) of Shariah and the rulings on contracts should not conflict with each other. If it does, the maqasid shall stand above the rulings of contracts. This is because the former is based on the Divine Law while the latter is founded on human understanding (fiqh).

In this manner, the legality of a financial contract is judged not only from the contract (aqd) aspect but equally important its economic and social impacts (i.e. benefits and disbenefits) to the general public. For example, if Islamic financial products are found to pull people to fall into debts and bankruptcy, how can one explain it is a worthy alternative to conventional financing? On the contrary Islamic products should enhance economic growth, reduce poverty and bring happiness to human beings.

The recent subprime crisis in the United States should be a lesson to Islamic banking. Sale of mortgage loans called for the issuance of mortgage backed securities (MBS) by special purpose vehicle (SPV) companies. The securitization of loan receivables by the SPV is an issue in Islamic finance in Malaysia. While Shariah allows securitization of physical assets, it prohibits the sale of murabaha receivables although Malaysia Shariah scholars at the bank supervisory level have allowed this (Securities Commission 2004). The subprime crisis is partly rooted in securitization of loan receivables as well as imprudent loan origination (Eichengreen 2008).
1.4 Accounting and Financial Reporting Approach

Accounting can be defined as the process of identifying, measuring and communicating economic information to permit informed judgement and decisions by users of the information (David and Nobes 2007). In Islam, accounting falls under the purview of hisb and part and parcel of the al-hisbah system (Islahi 1991).

The purpose of financial statements or financial reporting is to provide information about the financial strength, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions (Greuning 2006). It serves to eliminate ambiguities (gharar) and fraud (tatfief) in financial contracts through factual reporting of the said transaction. More importantly, financial reporting explained what exactly was transacted in the business dealings such that one is able to know whether, say, a transaction is a loan or a sale, whether a sale is a true one or not. This is important because accounting information is used by investors who make economic decisions by making predictions of future cash flows of company they invested in. For this reason, financial reporting should be understandable, relevant, reliable and comparable as laid by the International Financial Reporting Standard (IFRS). This is an Islamic imperative that all Islamic financial institutions (IFIs) must subscribe to such that stakeholders can gauge its real value to society.

In financial accounting, a balance sheet or statement of financial position is a summary of a person's or organization's assets, liabilities and ownership equity on a specific date, such as the end of its financial year. A balance sheet is often described as a snapshot of a company's financial condition (David and Nobes 2007).

A company balance sheet has three parts: assets, liabilities and shareholders' equity. The main categories of assets are usually listed first and are followed by the liabilities. The difference between the assets and the liabilities is known as the net assets or the net worth of the company. Thus, zakat can be computed on the net worth of the company. According to the accounting equation, net worth must equal assets minus liabilities.

The application of trading and commercial principles (al-bay) in Islamic banking requires banking firms to adhere to financial reporting standard whose purpose is to provide true information of business transactions. For example, when the transaction uses the contract of ijarah (leasing), then the leased asset must be reported in the balance sheet as fixed asset. The purchase of the leased asset is subject to tax whose payment is recorded as operating expense in the income statement. Depreciation allowances are recorded as an expense, thus the company that took the leasing option can benefit from the tax allowances to improve earnings. Some examples of Islamic financial products are given in the followings:

a. Al-ijarah thumma al-bay (AITAB) or al-ijarah muntahia bittamleek ie leasing with intention to own or buy, is currently a Shariah complaint contract applied for car financing. As specified by the contract of ijarah, the leased asset should be recorded as fixed (ijarah) asset. But when AITAB in Malaysia, operates under the conventional Hire-Purchase Act 1967, it (ie AITAB) is treated as a financing activity rather than a true lease as no recording of ijarah asset is evident in the balance sheet.
Instead AITAB transactions are recorded as financing and advances which is synonymous to loan and advances in conventional financing leasing or hire-purchase.

b. Murabaha or al-bai-bithaman ajil contract, the bank is expected to purchase the asset before making the sale. The principle that “one must not sell what one does not own” confirms that the bank must hold ownership of asset prior to sale and thus recording it in the balance sheet. Such accounting treatment is an inevitable fact and any Islamic bank that failed this test is guilty of riba since it indicates that no true sale exists. Although bank may hold the asset for a few days or even hours, proper accounting must be uphold.

c. Bay al-inah: Financial reporting and disclosure can prove that a bay al-inah sale is not a true sale but only a fictitious one. Although the aqad approach says bay al-inah is valid (sahih), but not actual sale ever took place between the financier and the customer since no recording of asset purchase is evident in the balance sheet of the bank. At this juncture, there is a conflict between juristic validity and financial reporting. Such inconsistency in the Islamic financial system, suggests that the contract approach cannot stand alone anymore and must find supplementary devices to secure complete Shariah legitimacy.

d. Sukuk Al-Ijarah: This participatory certificate is not similar with conventional asset-backed securities as the latter is based on lending and borrowing contract and the special purpose vehicle (SPV) holds legal and beneficial ownership of asset. The SPV issued fixed income securities in order to borrow from the investors. These securities are backed by the underlying assets such as mortgage receivables. In sukuk al-ijarah, the Shariah stipulated investors as legal and beneficial owners of the underlying assets. This condition however is not fulfilled in most existing sukukas. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) ruled in February 2008 that a sukuk is not Shariah compliant when the SPV fails to transfer ownership of asset to the holders or investors (AAOIFI 2007). When ownership is held by the investors, the underlying asset may decline in value in an event of falling real-estate prices or will increase during an economic upturn. As such, investment is deemed permissible as it has observed the legal maxim, al-ghorm bil-ghonm, meaning no profit without liability.

1.5 Legal Documentation of Contract Approach

The aqad Approach primarily pays attention to the fulfillment of the pillars of contracts. Indirectly, rights of contracting parties are defined and made explicit in contracts. The purpose of legal documentation is to provide security and protection to contracting parties when their rights, obligations and responsibilities are clearly spelt out in the terms of agreement or contract. This security enabled them to seek legal protection in case the outcome of the contract is not realized as agreed upon in the agreement.
In Malaysia, consumers usually receive legal protection from three legal principles and provisions under (Rosly 2006):

1. Contractual law: A contract is a legally binding agreement between two parties by which each party undertakes specific obligations or enjoys specific rights of that agreement. In Malaysia, the Law of Sale of Goods 1957 and the Law of Hire-Purchase 1967 provides ample provisions for consumer protection such as passing the asset’s title to the buyer.

2. Law of tort: The law of tort deals with liabilities of the seller. If the consumer suffers injury or harm from the goods sold (ie found to be defective and dangerous) the seller is liable to pay damages.

3. Regulatory (penal) statutes: These affect specific activities that directly or indirectly affect the consumer. They serve to impose standards on goods, services or safety measures by prohibiting specific activities or requiring certain things to be satisfied. Some examples of regulatory statutes in Malaysia are the Price Control Act 1946, Control Supplies Act 1961, Weight and Measure Act 1972, Trade Description Act 1972 and the Direct Sales Act 1993.

Business malpractices (tattifel) can take various forms such as large business organization to monopolize production and kill the competition, misuse of trademarks and patents, sale of duplicate goods by unscrupulous traders, malpractices in direct sales, misrepresentation of cheap sales, misleading price indications, deceptive labeling of products, exploitation and malpractices in housing and real estate transactions. Since the Islamic banking business is no longer confined to financial transactions alone but more importantly the conduct of buying and selling involving possessions and delivery of goods, it is now more exposed to moral hazards commonly evident in the retail and wholesale business. Thus, consumer protection is next in line to be seriously looked at in Islamic finance innovation.

Consumer protection is a form of government regulation which protects the interests of consumers. For example, a government may require businesses to disclose detailed information about products—particularly in areas where safety or public health is an issue, such as food. Consumer protection is linked to the idea of consumer rights (that consumers have various rights as consumers), and to the formation of consumer organizations which help consumers make better choices in spending.

Consumer protection law or consumer law is considered an area of public law that regulates private law relationships between individual consumers and the businesses that sell them goods and services. Consumer protection covers a wide range of topics including but not necessarily limited to product liability, privacy rights, unfair business practices, fraud, misrepresentation, and other consumer/business interactions. Such laws deal with bankruptcy, credit repair, debt repair, product safety, service contracts, bill collector regulation, pricing, utility turnoffs, consolidation and much more. There are many compelling reasons why consumer needs protection. Some major ones are as follows: Poor bargaining position, consumer safety, information gap and advertising practices.

In order to protect the consumers from business malpractices and manipulation, they can be informed about their rights. The International Organization of Consumer Union (IOCU)
outlined eight rights of the consumer, such as 1. Right to adequate product information 2. Right to quality and safety of goods and services 3. Right to choose 4. Right to be heard 5. Right to get consumer education 6. Right to healthy environment and 7. Right to redress (Sim 1991)

The concept of right in Islam lies in the definition of ‘huquq, pl. of haqq. The word haqq meaning “something right, true, just, real”; haqq in its primary meaning is one of the names of Allah (s.w.t), and it occurs often in the Qur’an in this sense, as the opposite of batil (vain, false, unreal). A further meaning of haqq is “claim” or “right”, as a legal obligation. Islamic Law distinguishes the haqq into two kinds: One is the rights relating to God, and the second is right relating to individuals. The rights relating to God are the rights that relate to public interest. They are linked to God due to the seriousness of the rights and the comprehensiveness of their benefit. The rights relating to individuals are those which are related to individual interest. Therefore, pardon and compromise is not permissible in the rights relating to Allah while in the rights relating to individual it is permissible (Sanusi and Rosly 2008).

Under Islamic jurisprudence, haqq is defined as “the exclusive power over something, or a demand addressed to another party which the shari’ah has validated in order to realise a certain benefit”. In Islamic finance, commercial right is confined to something that has monetary value (qima maliyya). The concept is confined to rights having monetary value which the law protects i.e. the right of maintenance for dependants, the right to demand wages for work done and the right to demand the delivery of object of the sale upon payment of its price. Such rights are personal and material, as they are designated in the law.

7.0 Legal Actions against Islamic banking customers

The need for protection the rights of the consumer in Islamic banking can be readily seen from four civil cases involving disputes between Islamic banks and their customers (Rosly 2005). These cases relate to defaults of murabaha facilities and its impact on the defaulting customers. There are four celebrated cases on Islamic banking disputes in Malaysia such as:

1) Bank Islam Malaysia v. Adnan b. Omar
2) Dato’ Haji Nik Mahmud vs Bank Islam Malaysia.
3) Tinta Press Sdn. Bhd vs Bank Islam Malaysia Bhd and
4) Affin Bank Bhd vs Zulkifli Abdullah.

7.1 Lessons

There are valuable lesson learned from the cases. In the first case, defendant did not understand the concept of al-bai-bithaman ajil (BBA) and how it affects settlement of debt outstanding balance. He thought all along that the contracted price under BBA is equal to the cost price of BBA asset sold. In the second case, the Dato’ Haji Nik Mahmud assumed that the facility is based on a buy and sell concept. But it did not appear to be so as no transfer of ownership is evident in the sale since the land is put under charge to the bank. In the third case, the customer has failed to understand the contract he has entered with the bank. He was made to understand that it was a like a loan but the contract is actually based on leasing. Finally, the fourth case
demonstrated the fact that an Islamic bank can freely imposed a selling price that surpassed the evils of riba when the customer is required to pay up all unearned (i.e accrued) profits when he defaulted on the financing facility.

The contract of *al-bai-bithaman ajil* or *murabahah* currently forms the basis of almost all Islamic financial products today, both in Malaysia as well as the Middle-east. It forms a component in *bay al-enah, tawarruq* and commodity *murabahah* and the sukus as well. Although BBA is theoretically a sale contract, it does not seem to conform to the Law of Good Sale Act 1957. There is an implied condition that the seller has the right to sell that readily transfer the title of ownership to the buyer. This implies that the seller must hold legal ownership of the goods prior to the sale.

In the case of Dato’ Nik Mahmod vs BIMB, a true sale is not evident since the transfer of asset title from the sale was not effected as the ownership of land remains with the plaintiff. In the case BIMB vs Adnan Omar, the land is put under charge with the bank which means that the defendant has remained the legal owner of the land over the financing period.

It is important that the rule of ownership must prevail in all sales bearing the contract of *al-bay*. Playing down with this rule can imply violation of the Law of Good Sale Act 1957. However, if the contract is written down to evident a financing agreement rather than a sale agreement, the judge will act on the former and not on the latter. As Islamic banking and finance in Malaysia is gaining more ground, legal cases may soon involve disputes dealing with *takaful* and Islamic private debt securities. It is important for the proper authorities to see that civil courts are able to preside over prospective cases to come.

### 7.2 Abandon Housing

Abandon housing problem usually emerge when housing developers failed to pay their contractors for the work done. Failure to pay up is explained by several factors including malpractices such as siphoning bank loans (i.e. bank payments on behalf of customers) by unscrupulous developers who divert the money to other activities not related to the development of estates or inability to obtain sufficient bridging loan facilities from banks. In the worst scenario, the housing project will fall under receivership while customers are forced to continue paying their monthly installments although the prospect of delivery is close to zero. The victims may end up making two payments, namely bank loans and rentals.

Consumers who purchase properties under *al-bai-bithaman ajil* (BBA) financing are not spared from the abandon housing debacle. Although no legal cases have emerged, complaints and grievances are not new in the media. Islamic banks as the selling party should be proactive in dealing with property developers as the latter are responsible to deliver the asset according to the specification agreed upon. However, it is common knowledge that Islamic banks remain to play as financiers rather than a true seller. The same applies to *bai-bithaman ajil* purchases via government financing scheme.

In principle, the BBA sale deals with two parties, namely the bank as the selling party and say, Mr. Ismail as the buying party. But prior the BBA sale, the bank must purchase the
The bank is not allowed to purchase and sell assets to earn money. In this way, banks cannot buy houses and other properties from vendors. They only provide financing, i.e., make loans.

The same does not apply to Islamic banking. Civil transactions require the customer to purchase the property from the housing developer. The Islamic banking Act (IBA) 1983 is a civil law and stays under the jurisdiction of the Civil court. It allows Islamic banks to buy property from the housing developer but only to see the banks refusing to do so. This is because Islamic banks do not want to assume the risk of ownership. They will incur losses if unable to make the sale.

When an Islamic bank is not keen to purchase the property and holds ownership risk, the customer usually do so with the housing developer. Assuming that the price of property is $60,000, Mr. Ismail met with a housing developer/vendor and signed a Sale and Purchase agreement (S&P) based on a 20% down payment, i.e., $12,000. In conventional practice, Mr. Ismail will look for a banking loan to finance the remaining balance, i.e., $48,000. Assume that Maybank has approved the loan and pays the developer the remaining balance on behalf of Mr. Ismail. Mr. Ismail uses a loan facility to purchase the property from the housing developer on cash basis. To secure payments over the duration of the loan, Mr. Ismail will pledge the property as collateral via the Deeds of Assignment. Given interest rate charges at 4 per cent flat over 20 years, Mr. Ismail will pay the bank an additional $38,400 in interest. His monthly installment payments amounts to $360, i.e., ($48,000 + $38,400) / 240. To sum up, conventional financing is made up of two basic contracts, namely, 1. contract of loan between the bank and Mr. Ismail 2. Deeds of Assignment/Charge.

The same procedure applies for Islamic banks. When bank refuses to purchase the property from the vendor, Mr. Ismail will instead buy the property from the housing developer. He puts up $12,000 as down-payment to secure the Sales and Purchase agreement on his favour. In this manner, Mr. Ismail becomes the legal and beneficiary owner of the property. But how could Bank A sell the property to Mr. Ismail via BBA contract when in the first place it does not own the asset? The Holy Prophet says “do not sell what you don’t own”. Bank A must be careful not to violate this critical Shariah injunction.

To do so, Bank A must purchase the property from Mr. Ismail via the Property Purchase Agreement (PPA). The current practice indicates that the bank pays the customer $48,000, which it passes down to the housing developer. Once the bank holds property ownership via PPA, it then sells the property to Mr. Ismail via the Property Sale Agreement (PSA). Here the terms are as follows: 1) Seller (Bank A) and buyer (Mr. Ismail). 2) Object of sale: Low-cost house 3) Price of object: Cost price $48,000 + profit margin ($38,400) = $86,000. 4) Monthly installment payments = $86,000/240 = $380

Similar with conventional practice, Mr. Ismail pledges the house as a collateral via the Deeds of Assignment or Charge. It says that the bank holds beneficial ownership of the property in the manner that it holds the right to sell it if Mr. Ismail defaults the BBA facility.

To summarize, BBA sale consists of three contracts, namely:

2. Property Sale Agreement (PSA) : Bank sells property to customer at BBA price.
3. Deeds of Assignment/Charge: Bank A holds property as collateral.

It seems that the above agreements were drawn to treat BBA as a loan rather than a sale (al-bay'). In a true BBA sale as spelt out by the Association and Auditing Organization for Islamic Financial Institution (AAOIFI), the bank should purchase the house from the housing developer/vendor. Sale and Purchase agreement (S&P) should have taken place between the bank and housing developer. In this manner, the bank will hold risk of ownership (ghorm) and thus holds and deserve the right to earn profits from the sale.

Buying properties and placing them in the banking book is a risky as well as costly business decision for Islamic bank managers. For this reason, Islamic banks in Malaysia have yet to conduct a true purchase from housing developers. Instead, S & P agreement has only involved customers and developers. To secure ownership (milkiyah), Islamic banks have instead introduced the Property Purchase Agreement (PPA) before executing the Property Sale Agreement (PPA).

When Islamic banks truly purchase the property from the developer, then the BBA sale shall consists of the following agreements:

2. Deeds of Assignment/Charge: Bank holds property as collateral.

When a housing developer is not able to deliver the houses during the stipulated construction period or failed to deliver at all, the customer who secured the purchase under conventional loan will take legal action against the developer. However, under current BBA financing facility, the same should apply since the bank does not actually own the property (Yasin 2003). In this way, the rights of the customer as a buyer are not protected well since he instead of the bank will take the trouble to take legal action against the housing developer.

7.3 Defective products

The law of torts usually handles the nature of liability held by the selling party. One example is property damages from construction or production defects caused by negligence of the manufacturer. For example, in a bai-bithaman ajil (BBA) financing purchase some defects are found in the houses newly delivered by a housing developer. Should the customer make complaints to the developer or should they leave the matter to the Islamic bank as the true selling party?

In conventional financing, the latter is true, but should Islamic banking do the same thing? By virtue of the BBA contract, it is apparent clear that the bank should take responsibility over the damages. The customer must be informed about their Islamic rights of option (khiyar) in the BBA contract. The right must be exercised by the buyer onto the bank as the selling party and not the developer instead.
The issue at hand is *khiyar al’-ayb* or option of defect. It is about the option given to the customer to cancel or annul the BBA contract when a defect on the goods sold is found. In the BBA agreement, the bank is expected to take forceful action onto the developer for instant remedies to see that the defects are removed. The *khiyar al’-ayb* or the option of defect is a legal right (Rayner 1991). This means the customer does not need to stipulate a special clause or provision of the option at the time of contracting. It comes automatically with the BBA sale. According to the *Mejelle*, “any buyer in Islamic law has an automatic implied warranty against latent defects in the goods purchased”.

The legal documentation approach should be able to lay out what is desirable in the contract approach in writing. Both should be in congruence and do not move in opposite direction. The documentation approach explain the rights and responsibility of contracting agents while the contract approach articulate what the transaction is made of.

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**8.0 Concluding thoughts**

It is important to see the consistency and stability of form and substance in the four methods explained above. As an example, when it is found that the *murabahah*/BBA contract is valid via the *aqad* approach, the financial reporting approach should be able to show that the bank has initially hold ownership prior to the *murabahah* sale in which the object of trade is recorded as fixed asset in the bank’s balance sheet prior to disposal. Once the *murabahah* sale is executed, the bank holds *murabahah* receivables instead. The legal documentation approach should evident transfer of ownership from the vendor to the bank and from the bank to the customer through proper registration of ownership. The sale contract should grant legal protection to the customer in case the asset delivered was say, defective. Likewise the bank should receive protection from the court if the customer defaulted on his *murabaha* debt obligation. Hence dispute resolutions
can be settled fairly. The *maqasid* approach should provide insights that the *murabaha* contract does not embrace riba values and lifestyles. If riba, through interest-bearing lending and borrowing is responsible for financial turmoils, *murabaha* financing is not expected to produce economic bubbles leading to similar crises. Usually the *aqad* approach resorts to screen the contract from the explicit contact with riba, gambling (*maisir*) and ambiguities (*gharar*) as well as the type of commodities traded. It however may not be able to test say, ownership risk unless it looks into the legal papers of the *murabaha* facility or studied banking book. Thus it is imperative for Shariah scholars at the supervisory level to recognize the role of legal documentation and financial reporting arising from contracts they have given approval to.

Likewise, the impact of the transaction on the society should also be acknowledged. This involves incorporating the *maqasid al-shariah* in the examination of contracts.

**References**


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