CONTRACTS IN ISLAMIC COMMERCIAL AND THEIR APPLICATION IN MODERN ISLAMIC FINANCIAL SYSTEM

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Abstract

Contract is the very essence of various transactions without which transactions are void of legal significance. Islamic commercial law has laid down a fairly detailed rules leading to the formation of contract. On the other hand, Islamic commercial law is rich of various transactions useful to meet people's need in varied circumstances. Therefore, it is not surprising that Islamic financial system is equally workable and competitive with the conventional financial products in the modern times.

1.0 INTRODUCTION

Islamic commercial law, known as *fiqh al-mu'amalat* in an Islamic legal term, constitutes an important branch of law dealing with issues of contract and the legal effect(s) arising from a contract; be it a valid, void or voidable contract respectively. Contract in Islamic law, on the other hand, is a complex legal discipline in both its jurisprudential foundation and its practical function. Also, contract covers a variety of dealings and transactions to meet the needs of the society. No doubt, issues of commercial transactions, unlike devotional issues (*'ibadat*), are ever-lasting and bound to change due to the changing circumstances and situations of both the object and subject of the transactions. Therefore, it is not surprising that the first article of the *Majallah al-Ahkam al-'Adliyyah* (the Civil Code of the Ottoman Empire)[1] endorses the

1. The *Majallah* is the Civil Code of the Ottoman Government promulgated in 1876. The Ottoman administration decided to prepare a codified Islamic legal precept in light of the intensive modernization of the law based on the European model. A seven-man committee of jurists called the Committee of the Majallah was appointed aiming at 'preparing a book on juridical transactions which

idea that man is social by nature and that social life is essential to him, stating that, “In view of the fact that man is social by nature, he cannot live in solitude like other animals, but is need of co-operation with his fellow *men* in order to promote an urban society. Every person, however, seeks the things which suit him and is vexed by any competition. As a result, it has been necessary to establish laws to maintain order and justice”.[2] This approach of the *Mejelle* is seldom found in the other compilations of law.

As mentioned above, contract is a complex legal discipline both in its jurisprudential foundation and in its practical function. Intellectually, it is perhaps the most rewarding field of the law in action. The mechanism of contract formation depends on the fundamental conception of contract(s) under Islamic law, its interrelation with other modes whereby an obligation may be generated, the extent of the freedom of the parties and the grouping of contracts according to different classifications, of the close interaction of all these factors.

2.0 HISTORICAL EVOLUTION OF CONTRACT IN ISLAMIC LAW

As for the evolution of the law of contract, Islamic law of contract, unlike other legal systems, starts with Quranic verses which already contain both the rudiments of several types of nominate contracts as well as certain contractual maxims of general import. Thereafter, the Traditions supplement the Quranic groundwork. The jurists in all Islamic schools of law later developed the principles of contract. In the *Qur'an,* all in all, there are only over forty verses on a dozen types of' “commercial”' contract.[3] Apart form one important verse on performing contract, that is Qur'an 5:1 which enjoins believers to "keep faith with contracts" [*awfu bi al-'uqud*], and three verses

would be correct, easy to understand, free from contradictions, embodying the selected opinion of the jurists and easily readable to everyone". The Majallah comprises: 851 articles arranged in an introduction and sixteen books. The introduction consists 100 articles dealing with Islamic legal maxims. See Subhi Mahmassani, Philosophy of Islamic Jurisprudence, 43-44.

2. *The Mejelle* [Being an English Translation of Majallah al-Ahkam al-'Adliyyah and a Complete Code on Islamic Civil law] translated by C. y. Tyser (Lahore: Law Publishing Company, n. d.), 1 (article 1)
3. This is after excluding some thirty verses on the contract of marriage which has a special nature; contain verses on other related legal institutions, such as endowment or testamentary disposition and some verses on the good of making business or on forbidden aspects of business.

with a common theme of 'keeping promise',[4] *none* the less, there are few verses which reveal a relatively advances stage of commercial contracts, such as sale and hire, charges *in rem* or personal guarantee as security) fiduciary contracts such as deposit and the like. The whole idea of having a contract is to satisfy the consent of both parties to a contract and it seems, not only in Islamic legal system but also in other legal system, contract is the best available means to reflect the intention and accordingly the consent of the parties. To this effect, the Qur'an has already prescribed on the believers "not to devour your assets among yourselves in vanity, except in trading by your consent".[5] In addition, the Prophet (PBUH) is reported to have said that "The Property of a Muslim is not licit for others to enjoy unless by his consent".

In any case, until the 19th century, no definition of contract is to be found in the treatises of Islamic law. This is because Islamic law never developed a general theory of contract. Instead, the overwhelming majority of Muslim jurists have focused on the contract of sale which they regarded as the model for all sorts of contracts.[6] However, the Islamic Civil Law Codification which took place in the 19th century, namely both the *Majallah al- Ahkam al-'Adliyyah* and *Murshid al-Hayran* (the 1891 Egyptian version of the Ottoman's Maja11ah), started to give a precise definition to a contract. The *Majallah,* for instance, describes contract as little contracting parties obligating themselves with regards a given matter and binding themselves together with the same as a result of connecting an offer with an acceptance".[7] Also, according to the *Majallah, "*contracting is the connection of an offer with an acceptance in a lawful manner which marks its effect on the subject of that connection".[8]

4. See Qur'an 17: 34; 6: 152 and 16: 91.
5. Qur'an, 4:29
6. Nabil Saleh, "Definition and Formation of Contract under Islamic and Arab Laws", Arab Law Quarterly 5 (1990): 101
7. The Mejelle [article 103]
8. Ibid [article 104]

3.0 ESSENTIAL ELEMENTS OF A VALID CONTRACT

For a valid contract to take place in Islamic law, certain conditions are to be met. From the foregoing definition of the contract, it appears that a valid contract bases itself on six elements, namely the offeror and offeree; offer and acceptance; and the subject matter and consideration. As for the parties to a contract, they must be legally competent to enter into a contract. The competence to transact is Islamic law is measured largely by two aspects, namely prudence and puberty as revealed in the Qur'an 5: 4. “Prove orphans till they reach the marriageable age; then if you find them of sound judgment, deliver over unto them their fortune”. With reference to an expression of both offer and acceptance, Islamic law of contract recognizes both express contracts as well as what has been described as contract by conduct. It presupposes the making of an offer either ora11y or by writing or by conduct. In certain cases, acceptance may also be implied from a party' silence. However. Islamic law is distinct from other legal systems that it insists on the session of contract *(majlis al-'aqd)* in the sense that both the offer and acceptance are to be jointly connected in one single session without any gap in time or place. Therefore, the session occurs in any natural place where the parties meet to form their agreement. The session therefore creates the essential unity of time and place necessary for the dual declarations of intention and consent.

Based on the above prescription which is agreeable to all schools of law, it may be said that certain interruptions during the session such as stopping to pray, or discussing other subjects, changing positions or attitudes, or even falling asleep are held to terminate the majlis and therefore the offer. Also, under this principle of law, the acceptance should be immediate. However, before the offeree gives his acceptance, the offeror may withdraw his offer. Again, another provision of law which is attached to Islamic law is the notion of *khiyar al-majlis* i.e. right to revoke the concluded offer and acceptance, provided both the parties are still available in the session of the contract left the session, the right to do so ceases to exist. However, should one of the parties left the session, the right to do so ceases to exit. As there are various interpretations surrounding the exact meaning of majlis or session of contract,

the present writer, based on certain arguments, is more inclined to appeal to customary practice of any society to decide on the separation from the session of contract.

Pertaining to both offer and acceptance, classical Islamic law seemed to insist on the notion of contracts inter presentes in the sense that the contracting parties should hear other's declaration which is, it is respectfully submitted, devoid of legal relevance. The writer's opinion is that contracts *inter absentes* by means of representatives or modern communication systems such as the telephone, telex, fax, e-mail, letter are equally valid provided they are performed in one single session of contract.

As for the subject matter of contract, both the item and consideration, Islamic law stresses on the following matters i.e., lawfulness, existence, deliverability and precise determination. Lawfulness requires that the object must be lawful, that is, something which is permissible to trade. It must be of legal value that is, its subject matter *(maha11)* and underlying cause *(sabab)* must be lawful; and it must not be proscribed by Islamic law, nor a nuisance to public order or morality. Also inherent in the lawfulness of the object is the condition that the object must be lega1ly owned [or authorised] by the parties to a contract. The issues of existence presuppose that the object of a contract must be in existence at the time of contract. Thus, it is illegal, for example, to sell a foetus.[9] Delivery, on the other hand, indicates that the object must be capable of certain delivery. The classical jurists therefore, prohibit the sale of a camel which has fled, a bird in the air, or a fish in water. Finally, the object of a contract must be determined precisely as to its essence, its quantity and its value.

As for the consideration of price, Islamic law does not restrict it to a monetary price, but it may be in the form of another commodity. The Islamic prohibition against uncertainty requires that the price must be in existence and

9. Islamic law, however, excludes both *bay' al-salam* (deferred delivery sale) and *istisna'* (contract of manufacture) from the prohibition because the object in these two contracts is a promise to deliver or to manufacture. Accordingly, the object of that promise need not be in existence at the time of the contract, but must be possible and definite; that is it must be capable of being defined and delivered,

determined at the time of the contract and cannot be fixed at a later date with reference to the market price, nor can it be left subject to determination by a third party. In contract of money-exchange *(sarf),* the rule of *riba* must be adhered to render the contract valid. The delivery of the price, however, may be spot or in future.

The capacity of the parties to contract is of prime importance for the validity of the contract. In Islamic law, no person can validly conclude a legal transaction without first having attained physical and intellectual maturity that being the equivalent of majority To enjoy full capacity, a person, whether male or female, should attain physical puberty *(bulugh)* and enjoy sound judgement known also as prudence *(rushd)* in his or her judgment. The Shafi'i school of law adds a third requisite for majority and that is sound judgment in regard to religion.

Puberty is attained for boys and girls with (a) the appearance of coarse hair around the sexual parts of the body although this sign is not given any significance by the Hanafis with (b) voluntary or involuntary emission of seminal fluid or with (c) the attainment of a given age except for Malik himself (not his school), who do not consider age as indicative of puberty. Other signs of puberty particular to girls are menstruation and pregnancy. As mentioned above, for the majority of scholars prudence *(rushd)* equates to sound judgment in financial matters. As for the argument of the Shafi'is, this is weak simply because an impious Muslim might well be of sound judgment with regard to business matters. In brief, a person is deemed of age and enjoys full capacity.

However, between infancy and majority a minor will normally reach the age of discernment or age of reason (*sinn al-tamyiz*) admittedly being six or seven Hanafis and Malikis give value to some transactions performed by a discerning minor; the authorise the discerning minor to conclude contracts fully beneficial, such as acceptance of gifts or bequests, without his guardian's authorisation. He is forbidden ton conclude fully detrimental

which is not the case insofar the foetus is concerned.

contracts such as granting loans or guarantees, whereas contracts which could end up by being either beneficial or detrimental, are subject to the guardian's ratification. Under Hanbali teaching a minor, whether discerning or not, cannot enter any kind of financial transactions but the contracts are valid with the approval of the guardian. Shafi'is have disapproved the contracts of a minor out rightly.

Apart from this general requirement of the legal capacity to enter into any kind of contract, Islamic law also imposes certain legal interdictions in the interest of third parties. The third party may confirm or annul the disposition of a person who is interdicted from disposing of his property. Therefore, the insolvent *(al-muflis)* is interdicted from disposing of his property by the judge in the interests of his creditors. Also, a person ill with death sickness is interdicted in the interests of the person's heirs or creditors.

4.0 CLASSIFICATION OF CONTRACTS

Contract, from an Islamic legal perspective, is conceptually divided into two main categories, namely unilateral and bilateral contract. While the former is gratuitous in character and does not require the consent of the recipient, the latter is more bound to strict rulings and guideline since it requires the consent of both the parties to a contract Also what is normally 'tolerated' in unilateral contract, would not necessarily be the case in bilateral contract. Therefore, the (strict) conditions required for both the offeree and the subject matter of the bilateral contract would cease to apply in an unilateral contract. Unilateral contract comprises of transactions in favour of the recipient such as gift *(hadiah, hibah),* off-set of the debt *(ibra),* will *(wasiyyat),* endowment *(waqf)* and loan *(qard).*

The bilateral contract covers the remaining transactions in Islamic law which can be further divided into different classifications according to the very purpose and reason d'etre of the deal and agreement. In this regard, we may perhaps, classify these contracts to six classifications which are as follows:

(i) contracts of exchange *('uqud al-mu'awadat),*

(ii) contracts of security *(uqud a1-tawthiqat),*

(iii) contracts of parnership *(shirkah),*

(iv) contract of safe custody *(wadi 'ah),*

(v) contracts pertaining to the utilization of usufruct *('uqud al-manfa'ah)* and

(vi) contracts pertaining to do a work (e.g. *waka.lah* and *ju'alah).*

This classification is not meant to be exhaustive because, in the future, many new contracts with different features, would possibly come to exist on the basis of the doctrine of permissibility *(ibahah),* as previously discussed, that would render all commercial transactions permissible in the absence of a clear", prohibition. Nevertheless, the above classification seems to be quite comprehensive to cover all existing contracts found in Islamic fiqh literature.

Mention should be made that each of these classifications consists of different transactions but contribute to the same purpose and reason *d'etre* of the underlying contract. For example, contract of exchange, will primarily concern trading as well as selling and buying activities inclusive of their sub-divisions such as cash sale, deferred payment sale, deferred delivery sale, sale on order, sale of debt, sale of currency, auction sale and so on and so forth. Similarly other types of contracts also include many sub-divisions relevant to respective classification. For example, contract of security deal not only with surety ship *(kafalah)* but also with pledge *(rahn)* and transfer of debt *(hiwalah)* because the very purpose of these sub-contracts under contracts of security was to protect the interest of the parties to a contract particularly the interest of the party in whose favour the respective contracts are concluded. As far as contract pertaining to the utilization of usufruct are concerned, it also cover a few sub-contracts such as *ijarah* (hire and lease) *ariyah* (loan of tangible asset), *waqf* (endowment), *qard (loan* of money), etc. The contract of partnership *(shirkah)* also includes different types of partnership such as *mudarabah* (profit and loss sharing) *musharakah* (profit and loss sharing), *sharikah al-abdan* (partnership by contributing effort and

skill), *sharikah al-wujuh* (partnerhsip based on credit and reliability), *muzara'ah* (partnership in farming), *musaqat* (partnership in fruit-trees), etc.

5.0 REFLECTIONS AND OVERVIEW ON THE CLASSIFICATIONS OF CONTRACTS

Although contracts in Islamic law of transactions are classified into different categories, it seems that the basic contract, in many cases and situations are the contract of exchange and utilization of usufruct. The former presupposes the transfer of ownership while the later the transfer of usufruct of a property from one party to another. This is clear from the definition of both sale and hire in Islamic law Sale is defined as "the exchange of one commodity for another, one of which is called the object and the other the price", or "the transfer of ownership of property for another".[10] Hire or *ijarah* is defined as the transfer of the usufruct for a consideration. Both these two contracts constitute the main activities of commercial activities because the remaining contracts are largely dependent on these two contracts

Therefore, the law on sale as the contract *par excellence* and, next to it, on hire, was greatly expanded in Islamic law literature. These two contracts are the bases for the other contracts to take place. In other words, other contracts are dependant on these two contracts to exist and to give effect. On the contrary, these two contracts, relatively speaking, can be concluded between two parties without any need for other (supporting) contracts. For instance, *hiwalah, kafalah* and *rahn* cannot stand by itself in the sense that they are all dependent on the contract of exchange be it sale or lease/hire. In the case of *hiwalah* which means transferring a debt from one debtor to another, it cannot take place unless the debt relationship has already established between the transferee, the transferor and the principal creditor. The debt relationship, on the other hand, may take place either out of deferred payment sale or out of direct loan *(qard)* contract. Hence, it is

10. Al-Jaziri, *Kitab al-Fiqh 'ala al-Madhhib al-Arba'ah,* 2: 147. This definition is parallel to modern definition of sale as documented in various Civil Code in Arab countries, e.g., Article 489 of the UAE Federal Civil Code; " A sale is the exchange of non-money property for money"

obvious that *hiwalah* originates from the sale transaction (as well as from loan transaction) *kafalah, rahn,* etc.

This shows, inter alia, that contracts are inter-related to form a complete system of *mu'amalah* to ensure justice as well as to meet the needs of people which vary from one condition to another. Therefore, it is relevant to conclude that Islamic commercial law consists of many different types of contracts to suit different needs and circumstances In other words, theoretically, Islamic commercial law would be able to satisfy the need of a person to buy a commodity on credit, or the need to have the guarantor against the third party, or the need to have the fund for business enterprise purposes, or the need to have in advance the capital to manufacture or produce agriculture produce or perhaps the need to have a transferee to settle the debt owed by a third party (transferor) and the like.

6.0 CONTRACTS OF EXCHANGE *(MU 'AWADAT)*

The main contract of exchange in Islamic commercial law is the contract of sale. Sale, generally speaking, involves an exchange of a commodity for another commodity (barter trading) or of a commodity for *money* (sale) or of *money* for *money* (*sarf*). Interestingly enough, *riba* which is prohibited by Islamic law, originates or comes to exist from two types of exchange, namely unequal exchange of two *ribawi* or usurious commodities *(riba al-fadl* or *riba a1-buyu*') or an exchange of money for money with different quantities *(riba a1-fadl)* or without simultaneous transfer and immediate delivery *(riba al-nasi'ah* or *riba al-duyun)* or involving both possibilities which render the contract of exchange of money for money null and void based on both *riba a/-fadl* as well as *riba a/-nasiah.* The first impression that comes across to our mind is that both types of *riba,* while quite similar to both contracts of barter trading and currency exchange *(sarf),* are not similar in any way to an exchange of a commodity for money. This, among other reasons, makes the trading distinct and free from any element of interest. However, contracts of exchange dealing with barter trading and currency exchange are susceptible to *riba* elements and for this reason, Islamic law has relatively laid down more

strict principles to ensure the legality of these contracts and most importantly to free these two contracts from both *riba al-fadl* and *riba al-nasi'ah* respectively.

Trading activities i.e., contracts of exchange of a commodity for money however, are relatively more exposed to the element of *gharar,* literally hazard or risk. In Islamic legal terminology, this includes the sale of an article of goods which is not present at hand; or the sale of an article of goods, the consequence or outcome of which is not yet known; or a sale involving risk or hazard where one does not know whether the commodity will later come to be or otherwise. *Gharar* may render the contracts of trading void or voidable. Several reasons were given for the prohibition of *bay' al-gharar.* Some of them were related to fraud since such a sale amounts to obtaining the property of others by selling unavailable goods and also the contract may lead to disputes and disagreements between the parties in the contract. While in Islamic law, an agreement must bring an immediate and certain obligation.[11]

Therefore, it is not surprising to find that Islamic law has prohibited many pre-Islamic period's contracts of exchange because they were either uncertain or not known to one or
both parties to the contract which may eventually lead to dispute and injustice. Such contracts are like *bay' al-mulamasah*[12]*, bay' al-hasat*[13]*, bay' al-munabadah*[14]*, bay' al muwafah*[15]*, bay' muzabanah*[16]*, bay al-mukhadarah*[17]*,*

11. Abdullah Alwi Haji Hasan, *Sales and Contracts in Early Islamic Commercial Law*, Islamic Research Institute, Islamabad, 1994, p. 41.
12. A sale is concluded by merely touching an article without the right of option after seeing it.
13. A transaction which is determined by throwing stones.
14. It is a sale affected by throwing an article without any examination or mutual consent by explicit making of an offer and an acceptance.
15. A sale of goods which had not been possessed, or a sale of goods by describing them without any inspection.
16. It implies a contract of exchange of harvested dry dates by their calculated and definite measure for fresh dates or other fruit of the same species on the tree.
17. It is a sale that arise out of pressures on economic lives in which the farmers had to sell their fruits and green vegetables or grain before the benefit was evident. They did so for protection and security from their enemies, such as pests and thieves. This type of exchange gave rise to a lot of disputes and quarrels because of fluctuations in the quantity and quality. The Prophet (PBUH) is reported to have prohibited *bay' al-mukhadarah* i. e. forbade selling fruit until it ripe.

bay' al-muhaqalah[18]*, al-haml*[19]*, bay' al-hayawan bi al-lahm*[20], *bay' al samak fi al-ma*[21]*, darbat al gha'is*[22]*, bay'atan fi bay'ah* or *safqatan fi safqah*[23]*, bay' a1-kali bi al-kali*[24]*, bay' wa salaf*[25]*,* etc. A1l of the above examples reflect clearly the hazardous elements that each of them contains and therefore, render the contract either void or voidable.

From this brief introduction, we may infer that as far as barter trading and currency exchange are concerned, the principles of Islamic law which govern those transactions are more concerned with the questions of equality between two items of exchange and the immediate and simultaneous delivery or transfer of the items because these two types of exchange are vulnerable to *riba* element. On the contrary, the possibility of *riba* interference does not arise in the case of trading since trading activities are basically free from *riba* but are always exposed to exploitation and fraud. The question of equal amount and simultaneous transfer of the property being exchanged is irrelevant in trading activities simply because these two factors do not inflict any legal effect on the sale contract. Thus, the golden principle in trading is that the contract should not contain any element of either *gharar* or *jaha1ah* (lack of knowledge) because otherwise, the contract is deemed either void or voidable according to the degree of *gharar* or *jahalah* respectively.[26] Also, for this reason, it is respectfully submitted, that the issues of the first possession of the property before the second sale *(qabd),* the capacity to deliver the property, etc., are always questioned by, and debated amongst, the jurists

18. The exchange of seed-produce, still in the ear, for the grain of wheat.
19. The sale of embryo or the sale of a youngling to be brought forth later from the foetus of an animal, that is, what a female animal bears in the womb. Apart from *bay' al-habl,* it is also known as *bay' al habl al habalah* or *bay' nitaj al-nitaj,* etc.
20. Sel1ing animal in exchange for meat.
21. The sale of fish in the water
22. The transaction is effected by saying, "I shall dive into the sea, if I have anything (pearl or precious stone) it will be yours at such and such a price".
23. Two sales in one sale
24. An exchange of credit for credit.
25. Selling and lending and it take place when one man says to another, "I shall take your goods for such and such if you lend me such and such".
26. Al-Sanhuri explains the difference between *gharar* and *jahalah* as follows: *"Jahalah* brings about *gharar* in the following circumstances; *jahalah* means to sell something which exists but whose quantity is unspecified. *Gharar,* on the other hand, means to sell something whose availability is unknown". He (al-Sanhuri) further mentions that the jurists, however, mix up the two terms *gharar and jahalah* and use them interchangeably. See al Sanhuri, *Masadir al Haqq fi al Fiqh al Islami, vol. 2, p.232.*

only ill relation to trading (alone) because these two issues and the like are concerned with *gharar* and *jahalah* and not with *riba.*

On the contrary, the issues of *gharar* and *jaha1ah,* have no effect whatsoever on certain contracts in the Islamic law of transactions because the nature of this type of contract does not require and demand a precise specification and identification of the property being transferred from one party to another. This is absolutely applicable to the contracts of gratuity ('*uqud al-tabarru'at)* such as *hadiah, hibah, wasiyyat,* etc. Why *gharar* affects trading and not gratuity contracts is a question worth of reflection. The immediate answer would be that trading differs from gratuity contracts because the former is a bilateral contract which requires an exact knowledge of the property to fulfil the requirement of legal consent while the latter does not require such knowledge since the consent of the recipient is not necessary. Again, the classification of contracts as given earlier would help the jurists to ascertain the legal position of the respective contracts in a given situation. Interestingly enough, the difference between the two types of contract such as between the contract of exchange and gratuity would induce different legal effects e.g. *khiyar* or the right to revoke the contract. While *khiyar* (option) is undoubtedly part and parcel of the sale transaction, it finds *no* place in gratuity contract Should we continue to examine the similarity and dissimilarity between one type of contract with another in issues pertaining to legal position, rights, obligations, liability, risk, merits, *modus operandi,* etc., we would have certainly produced so many pages on the topic which is not the intention of the present paper.

To be more specific, we should confine our present discussion to the contracts of exchange *('uqud al-mu'awadat)* which will include a variety of contracts which differ from one another in terms of specific legal requirements, rights, obligations and liabilities but common to each other in terms of the result of the contract, namely the transfer of ownership from one party to another. Therefore, the element common to all contracts under contracts of exchange is the transfer of the ownership and possession from one party to another. Should this be absent and lacking in a contract, the

contract is no longer a contract of exchange. The relevant legal maxim which governs this situation is article 3 of the *Maja1lah a1-Ahkam a1-'Adliyyah* which reads as, "In contracts, attention is given to the objects and meaning, and not to the words and forms'. The maxim clearly states that it is the object and aim of a transaction which will be determinative to the legal position of that transaction. The maxim cited is related to another maxim describing the function of intention in all aspects of Islamic law which reads as follows, "matters are determined according to intention".[27] To illustrate the maxim governing the legal position of a contract as pointed out by article 3 of the *Majallah,* the drafters of the *Majallah* have cited the case of *bay' a1-wafa'. Bay' al-wafa'* is basically a sale of commodity on the condition that the seller be allowed to get the commodity back upon paying its price.[28] Therefore, in *bay' al-wafa',* the seller by returning the price, can demand back the thing sold, and the buyer, by returning the thing sold, can ask for the price to be reimbursed. Also, neither the seller *nor* the purchaser can sell to another a thing sold by *bay' al-wafa'.*[29] This transaction is perceived by the *Majallah* as a pledge contract, not because of the words and forms used in the offer and acceptance but rather due to the intention and meaning as it is clearly expressed in the maxim cited earlier.[30]

The case of *bay' a1-wafa'* attracts the attention of the drafters of the *Majallah* since *bay' al-wafa'* is a transaction peculiar only to the Hanafi school of law and furthermore, the *Majallah* is primarily based on the Hanafi point of view. In addition, *bay' al-wafa'* is so unique because it is termed as a sale while in actual fact, as endorsed by the *Majallah* itself, it is rather a pledge *(rahn)* contract. That is to say, the relationship between the two parties to that

27. To see the detailed application of the above two maxims in Islamic law, see the writer's paper entitled" *A Note on the Application and Raison D'etre* of *the Maxim relating to Intention",* presented in many seminars and workshops organised by QI Consultants and BIBM Institute of Research and Training Sdn. Bhd. respectively.
28. *The Mejelle,* 58-59. 29Ibid.
29. Ibid.
30. The sale of *wafa',* according to some scholars, is considered, in essence, as a loan for usufruct where the debtor 'sells' his property to the creditor on condition that it is returned upon his repayment of the price to the effect that the debtor has use of the property while the creditor has use of the property. However, to the best of the writer's knowledge, based on the maxim cited and the principles of Islamic law of transactions, the sale of *wafa'* should be perceived as the contract of pledge with the combination of *hibah* since the mortgagor has released his right to use the usufruct of the pledged property to the mortgagee.

contract could not be between the buyer and seller since the transfer of property and corresponding consideration is not final and ultimate. Rather, the contractual relationship would be between mortgagor (seller) and mortgagee (buyer) neither the seller nor the purchaser can sell to another a thing sold by *bay' al-wafa'* ".[31]

Contracts of exchange in the classical Islamic law of transactions, as mentioned earlier, include a number of contracts such as *bay' al-musawamah, bay' al-murabahah, bay al-tawliyyah. bay' al-wadi'ah, al-bay' al-mua'ajjal, bay' al-salam* , *bay' al- istis'na', bay' al-muqayadah, bay' al-sarf, bay' al-muzayadah,* etc. Apart from these types of sale, there are also other types of sale which are disputable among the jurists such as bay *a1- 'arabiin, bay' al-'ayyinah* and *bay' al-dayn.* In dealing with these different categories of sale contracts, the writer is more inclined to classify them into appropriate sections for the sake of clarification and distinction. The classification is based on certain factors which distinguish one contract of sale from another. Therefore, with special reference to the thing sold, sales are divided into four categories as follows:

(i) sale of property to another person for a price and this is the most common category of sale and is consequently specifically called sale

(ii) sale by exchange of money for money which is known as s*arf* transaction which consists of selling cash for cash

(iii) sale by barter i.e., exchange of object for object whereby neither of which is money payment; each of the two commodities constitute both the price and the object; and

(iv) sale by immediate payment against future delivery such as *bay' al-salam* (forward sale) and *bay' al-istisna'* (sale on order).[32] The item of the sale is yet to exist in the future date.

From another perspective i.e., the nature of profit agreed upon in the contract, sales are also divided into four categories as follows:

1. *Musawamah* sale which is basically a sale by mutual consent completed and concluded through negotiations between the seller and buyer in which no

31. Ibid (article 397)

reference be made to the original cost price.[33] It is also a 'profit sale' but the actual cost price and the amount/percentage of the profit is unknown to the buyer because the seller is not bound, in *musawamah* sale, to disclose the cost price.

2. *Murabahah* sale which is the sate of a commodity for the price at which the seller has purchased it, with the addition of stated profit known to both the seller and buyer. In short, it is a cost-plus-profit sale in which the profit is expressly disclosed by the seller. From this, we can infer that *murabahah* sale in its original Islamic connotation is simply a sale. The only feature distinguishing it from other kinds of sale is that the seller ill *murabahah* expressly tells the purchaser how much cost he has incurred and how much profit he is going to charge in addition to the cost. Therefore, if a person sells a commodity for a lump sum price or instalment basis without reference to the cost, this is not *murabahah,* even though he is earning some profit on his cost because the sale is not based on a 'cost-plus' concept In this case, the sale is called *musawamah.* Due to speciality of *murabahah,* it has been considered by the jurists as a sale based on trust *(amanah).*
3. *Tawliyyah* sale which is a sale at cost price without any profit for the seller. It is similar to *murabahah* with reference to the basis of the sale, namely *amanah.*
4. *Wadi'ah* sale which takes place when the seller agrees to sell a commodity at a lower price than that of the cost price. Since the seller is selling the commodity at a lower price, it is also a trust sale.

According to the manner of payment, there are three possibilities of payment pertaining to a sale contract as follows:

(i) Cash sale in which the purchaser is under obligation to settle the purchase price agreed upon when concluding a contract If the buyer could not settle the payment for one reason or another, the seller has a right of retaining the thing sold until he has received the payment of the price.

(ii) Deferred payment sale which is payable on instalment basis. This is permissible provided the period thereof is definitely ascertained and fixed

32. *Majallah a1-Ahkam a1-'Adliyyah,* article 120
33. Reyner, *The Theory of Contracts in Islamic Law,* Graham and Trotman, London, 1991, p. 104.

manner of payment is applicable to all types of sale except in the case of *bay' al- salam*

(iii) Lump sum payment payable in the future. This manner of payment is also lawful provided the date of the payment is fixed in advance. Also, this manner of payment would be applicable to all types of sale with the exception of *bay' al- salam.*

(iv) Earnest money *(bay' al-'arabun)* in which advance payment of sum of money is made to the seller which constitutes part of the purchase price should the buyer decides to buy the good. Otherwise, the advance payment is forfeited to the seller.

According to the subject mater of the sale, it can be divided into three categories namely, sale of commodity (movable and immovable), currency *(sari)* and debt *(dayn).* As for the very purpose of sale contract, it may classified into two categories that are exclusively of exchange purposes and the other *for* exchange as well as *for* financing purposes.

Apart from the previous perspectives on which sales are usually classified, sales are also divided into a few categories according to the nature of the price whether is has been fixed from the very beginning or otherwise. This is however, the writer's personal reflection on certain contracts of sale available in the Islamic law of transactions. These categories are as follows:

(i) The price is mentioned by the offeror and accepted by the offeree. This is the practice in normal sale transaction whether it involves *musawamah* or *murabahah* or *salam* or *istisna'* and other types of sale with the exception of *tawliyyah* sale since the price offered in the latter must not go beyond the original cost price.

(ii) The price is mentioned by the buyer and later accepted by the seller, seller, in this context, is not bound by any 'offer' of the buyer but, on the contrary .is bound to honour the highest price offered by the respective buyer or 'bidder'. This is called as *bay' a1-muzayadah* or *bay' man yazid* or sale based on auctioning. In this transaction, the price will be fixed only by the highest offer made by the bidders.

(iii) The price in some sale transactions, is divided into two stages; the second payment is pending on the ultimate decision of the buyer to proceed with the contract or otherwise. This takes place in *bay' al-'arabun* (earnest money) in which the buyer agrees to purchase a commodity and pays to the seller an amount of money in advance. If he decides to buy the commodity, the amount paid will be deducted from the purchase price, but if he declines or fails to buy the commodity, the advance payment is forfeited to the seller.

The fundamental basis of sale contract consists of one piece of property being exchanged for another. Offer and acceptance are also referred to as the fundamental basis of sale, since they imply exchange. As for the object, it must be in existence, deliverable and known to the purchaser. These conditions are applicable to many types of sales except in few contracts such as *bay' al-salam* and *istisna'.*

7.0 CONTRACTS OF UTILIZATION OF USUFRUCT *('UQUD AL-MANFA 'AT)*

The above type contract is divided into two categories which are the transfer of the usufruct for a consideration and the transfer of the usufruct without a consideration. The former is a bilateral contract while the latter is not. The former is known as contract *ijarah* while the latter is known as *'ariyah* contract. The details of these two contracts are as follows:

7.1 *Contract of Ijarah (transfer of usufruct for a consideration)*

Ijarah is a word that conveys the sense of both hire and lease. *Ijarah* is of two kinds, namely use of corporeal property which may take one of three forms:

a) Immovable property, such as land or premises
b) Merchandise, such as furniture, machinery, etc.
c) Animals

The second type of *ijarah* is personal service.

The salient features of *ijarah* contract are as follows

(i) The lessor must be the absolute owner of the thing or the agent of the owner of his natural or legal guardian.

(ii) The thing given for rent and the amount of rent should be fully and precisely known to both parties.

(iii) In a contract of hire, it is necessary to make known the use to which the thing hired is to be put, so as to avoid later dispute.

(iv) When land is taken for rent, the period must be fixed and the purpose for which it is rented specified

(v) In hiring an artisan, the benefit should be made known by a statement of the nature and method of workmanship.

(vi) It is the responsibility of the lessor to maintain the property leased in such a way as to retain the benefit of the property.

(vii) If the lessee damages the property hired, the lessor can annul the lease on application to the court.

(viii) The lessee can sub-let immovable property but not movable property

(ix) The thing hired should be treated as a trust in the hands of the user.

7.2 *'Ariyah (Lending for Gratuitous Use)*

In addition to the above general rules, the contract of ‘ariyah requires the following rules

(i) The lender may withdraw the loan whenever he wishes.

(ii) The thing lent must be capable of giving a benefit.

(iii) The thing lent for use must be defined.

(iv) The borrower becomes the owner of the benefit without giving any payment to the owner.

(v) The maintenance of the thing borrowed for use is the responsibility of the borrower.

(vi) When lending for use is restricted as to time, place and nature of use, the restriction are to be observed.

(vii) The borrower cannot let or pledge the thing lent for use, the borrower must immediately return it.

(viii) When the lender demands the thing lent for use, the borrower must immediately return it.

(ix) The expense and care of returning a thing lent for use fall on the borrower.

8.0 CONTRACTS OF SECURITY

Thus type of contract consists of three contracts which are *hiwalah, kafalah* and *rahn* explanation of each of the contracts is as follows:

8.1. Hiwalah (Transfer of Debt)

Hiwalah means transferring a debt from one debtor (transferor) to another (transferee). Once the transferee has accepted the transfer of debt, the transferor would be released from any obligation. Therefore, as a consequence of the transfer of debt *(hiwalah),* unlike suretyship, the debtor who transfer his debt and his surety, if ally, are freed from their respective obligations. The creditor can now claim his debt only from the transferee. The transferee, after payment, has aright to claim the amount so paid from the transferor. In such a case, the transferor's claim from the transferee, if any, will be adjusted towards the claim. However, the transferee would b e released from his liability in any of the following four situations:

(i) By payment of the debt

(ii) By further transferring the debt to another person if the creditor accepts.

(iii) By cantonments by the creditor

(iv) If the creditor dies and person who accepts the transfer is his heirs.

8.2. Rahn (pledges)

A creditor, whether an individual or a financial institution, prefers to secure a loan either through personal surety or a pledge. Pledge or *rahn* is to make a property a security in respect of a right of claim, the

payment for which may be taken from the value of the property. The main laws relating to pledge, *inter alia,* are as follows:

(i) The contract becomes irrevocable after the pledge is received by the pledgee.

(ii) One pledge may be exchanged for another

(iii) The pledgee may, on his own accord, a1lnul the contract.

(iv) Two different creditors may take a common pledge from a single debtor. This pledge will secure the whole of the two debts.

(v) When a debt is partly paid off, it does not become necessary to return the part of the pledge equivalent to it in full. The pledgee has a right to hold the whole until the debt is paid

(vi) If the pledgor has destroyed or damaged the thing pledged, he must pay compensation. If the pledgee has destroyed or damaged it, the amount of its value is struck off the debt.

(vii) If the time for paying the debt has arrived, and the pledgor refuses to make payment, the pledgee may approach the court to compel the pledgor to sell the thing pledged in order to pay the debt. On his refusal, the court may sell the pledge to pay the debt.

8.3. Kafalah (Suretyship)

Kafalah means to add an obligation to an existing obligation in respect of a demand for something. This may relate to a person, finance or act (performance). Kafalah relating to a person involves the production of the person for whom the kafalah (bail) has been given. Kafalah relating to finance implies an obligation to pay in the event of the principal debtor's inability to honour his obligation. Kafalah relating to an act or performance as to ensure the performance of a certain act, the failure of which may render the surety liable and responsible. One important point to be stressed is that kafalah, unlike hiwalah, would not release the principal debtor in whose favour the contract is concluded because kafalah is only an obligation in addition to the

existing obligation. Among other rules governing kafalah are as follows:

(i) It is lawful to become surety for surety.

(ii) There may be more than one surety for a single obligation.

(iii) If persons who are jointly indebted become surety for each other, each of them is liable for the whole debt

(iv) The discharge of the surety does not necessarily discharge the liability of the principal debtor concerned. The opposite scenario will be acceptable as far as the discharge is

(v) If a delay is granted to the principal debtor for the payment of his debts, a delay is also granted to the surety principal debtor. But a delay given to the surety is not a delay given to the debtor.

9.0 INTRODUCTION TO COVENTIONAL AND ISLAMIC BANKING

Conventional banking in the Western world has been evolved about two and a quarter centuries ago, having contemporary with the emergence of industrial civilisation, The industrial revolution saw a tremendous expansion in the number of traders, manufacturers, industrialists and other entrepreneurs but whose own financial resources were not enough for them to embark on their respective industrial activities. Hence a method had to be found. Thus, the need of financial intermediates gave rise to the conventional banking which later became the backbone of the *modern* industrial and financial system. This is simply because the rate of economic development is always constrained by the availability of financial resources Economic development needs mobilisation of financial resources and channelisation of these sources to appropriate interested sectors.

The banks in the conventional system, acting as intermediaries, accept deposits from the public and lend them to the borrowers, regardless of whether these borrowers are individuals or corporate entities. The bank's

profits are mainly attributed to the difference between interest expended (paid) to depositors, and interest earned (received) from borrowers.[34]

Banking and financial houses in Islamic civilisation are normally called *masarif.* Literally, *sari* means turning, sending and employing. In the technical usage, *musarafah* signifies the act of dealing, buying and selling and sometimes it has been attributed to change of money. The *sarraf* or the moneychanger became an essential feature of every Muslim market. A bank with headquarters in Baghdad and branches in other cities was mentioned in Arabic sources. They carried on business through an elaborate system of cheques and letters of credit which was so developed that is was possible to draw a cheque in Baghdad and cash in Morroco. Indeed, it was reported that in Basrah, the centre of trade in the East where each merchant had his own bank account, payment were effected in cheques and never in cash.

The idea of establishing an interest free bank goes back to as early as 1940s. However, the conditions then were not ready for actual establishment of an Islamic bank as not much thought had been given to technical details and actual operation of an Islamic bank. A pioneering experiment of putting the principles of Islamic banking into practice was conducted in Mit-Ghamr in Egypt from 1963-1967 with special emphasis in educating the rural Muslims on the operation of the banking system. In Mit-Ghamr project, a number of accounts were accepted, namely saving accounts, investment accounts and zakat accounts. In the saving accounts, *no* interest is payable to depositors but they were allowed to the withdrawals. Also, they were eligible for a small short term free loan for productive purposes. The funds deposited in the investment account were subject to restricted withdrawals and were invested on the basis of profit and loss sharing, On the other hand, the zakat account attracted the payment of zakat to be distributed among the poor and needy. Mit-Ghamr experiment was short lived up to the year 1967 due to political reason.

34. Presley (editor), *Directory of Islamic Financial Institutions,* Croom Helm, London, New York and Sydney, 1988, pp. 22-23.

In short, the establishment of an Islamic bank at Mit Ghamr in Egypt (1963), brought a remarkable impact on the real implementation of banking practices according to the Shari 'ah principles. Twelve years later, through the Organisation of Islamic Conference (OIC) an inter-governmental Islamic bank was established, known as the Islamic development Bank. Later, many private Islamic banks were established by Muslim entrepreneurs including Dubai Islamic Bank (1975). Faisal Islamic bank of Sudan (1977). Kuwait Finance House (1977). Dar al-Mal al-Islami (1981), Bank Islam Malaysia Berhad (1983) and a few other Islamic banks in Pakistan. Bangladesh. Turkey and others. There are also Islamic banking institutions operating on an International mandate in non-Muslim soil and environment such as the Dar al-Mal al-lslami (Geneva), Islamic Investment Company (Bahamas) and other places.

Having said this, the philosophy and principles of Islamic banking date back to more than 1, 400 years ago, to the Qur'an and the Sunn.ah of the Prophet (s.a.w.). At present, more than 150 Islamic financial institutions operating worldwide. Interestingly enough, Islamic banking is being discovered by western banks as a mechanism to gain access to the large pool of Muslim funds. It is not surprising, therefore, that there is an ever-increasing number of conventional banks providing Islamic investment services to their international clients.

The development of Islamic banking in the twentieth century witnesses the emergence of such institutions in certain countries where such was possible. This development marked the widening of the practice of the *Shari'ah* principles beyond the boundary of the realm of devotional matters *(ibadat)* and family and matrimonial matters *(al-ahwal al-shaksiyah).* The *raison d'etre* of Islamic banks, generally speaking, is the followings:

(i) the absence of interest-nased transactions
(ii) the avoidance of commercial transactions involving *gharar* (uncertainty)
(iii) discouragement of the production of goods and services which contradict the value pattern of Islam; and
(iv) the payment of an Islamic tax, the *zakat*.

10.0 ISLAMIC FINANCIAL SYSTEM IN MALAYSIA: AN OVERVIEW

The introduction of the Interest-Free Banking Scheme (known in its Bahasa Melayu acronym as SPTF, namely Skim Perbankan Tanpa Faedah) in Malaysia in 1993 was premised on a dual banking system; a full-fledged Islamic banking system operating on a parallel basis with a sophisticated conventional banking system. So far, Malaysia is the only Muslim country to implement such a dual system. Significantly, not only do the two systems work on a parallel basis they also utilise essentially the same set of banking infrastructure. This has significant implications in terms of the cost and speed of implementing the Islamic banking system.[35]

The Malaysian model has a number of advantages when compared to the other models of implementing Islamic banking Muslims in countries which have only a conventional system do not have the opportunity to benefit from the facilities of a modem system without being involved in riba. The same is true in the case of the conventional plus system, where the Islamic banking institutions operate on the fringe of the domestic banking system and the services they offer are neither as comprehensive nor as sophisticated as the conventional system. Among Muslim countries which fall under this 'model' are Saudi Arabia, Bahrain, Bangladesh, Brunei, Egypt, Guinea, Indonesia, Jordan, Kuwait, Niger, Qatar, Senegal, Tunisia, Turkey and United Arab Emirates.[36]

The Islamic banking products offered in Malaysia's dual system are therefore much more sophisticated and covering a wider range of services compared to the products offered in the conventional plus system as is the case in the countries listed above More surprisingly, the Malaysian model of a dual system has proved to overwhelm the model of Islamic banking in some countries such as Iran, Pakistan and Sudan which have an entirely Islamic banking system leaving no room and avenue for conventional banking system The advantages of the Malaysian model are as follows:

35. Nor Mohamed Yakcop, "The Development of Islamic Banking System", speech delivered during the award ceremony for Excellence and Significant Contributions in the field of Islamic banking and finance, The Star (Business), p. 6.
36. Ibid.

First, the range of Islamic banking products in a dual system tends to be wider when compared to the products in a single Islamic system, since in a dual system Islamic banks have to provide all the services provided by conventional banks.

Second, the Islamic banking products in the dual system, can also be expected to have a higher level of sophistication compared to the Islamic banking products in the single Islamic system In other words, Islamic banks operating in the dual system would have *no* choice but to create similar sophisticated products on an Islamic basis as did the conventional banks.[37]

11.0 SOURCES OF FUND IN ISLAMIC FINANCIAL SYSTEM

As far as sources of fund are concerned, the bank can raise its initial equity (or paid-up capital) in straightforward way through the Islamic equity-financing contract of *al-musharakah* among its initial shareholders. In the case of SPTF banks, the contributors would be the main banks which shall provide the paid-up capital either on the basis of *mudarabah, musharakah* or *qard hasan* respectively. The public could also be the contributors through saving accounts, current accounts and investment accounts respectively. While the first two accounts are basically based *on* the Islamic contract of *wadi 'ah yad dhamanah* (safe custody based on suretyship), the third account is originated from *al-mudarabah* contract. In short, the sources of fund for interest-free banks may come from these means which are as follows; shareholders equity, customers' deposit in current account, customers' deposit in savings account, customers' deposit in general investment accounts and customers' deposit in special investment accounts.

As mentioned elsewhere, it is not the institution which distinguishes Islamic financial system from the conventional one It is rather the functions and way they are performed that make the Islamic financial system distinct. Interestingly, deposit taking is one of the sources of fund in the Islamic financial system but the institutions do *not* pay any interest *on* the money

37. Ibid.

deposited at the bank. Under the conventional system, the nature of the contractual legal relationship between a bank and his customer is that of a debtor and creditor relationship in the sense that the bank is the debtor and the customer is the creditor. However, under Islamic financial system, particularly in Malaysia, the Islamic banks/counters accept deposit for both saving and current accounts under the contract of *wadi'ah* (safe-custody) coined together with another contract, namely *dhaman* (suretyship) contract. Ultimately, the accounts are opened under the purview of the contract of *Wadi'ah Yad Dhamanah* (safekeeping with guarantee).

The very essence of *Wadi'ah Yad Dhamanah* is that the custodian (the bank) would be able to utilise the money deposited since the custodian would be solely held liable for any damage inflicts on the deposited item. On the other hand, the depositors are given the assurance that they may withdraw their money at any time and above a1l, their money will be guaranteed from any damage and the like. Also, adopting this approach would entitle the banks to reward their depositors a discretionary reward i.e. *hibah.* The practice of awarding a *hibah* to depositors is deemed necessary as interest-free banking system is operating in a dual banking system and therefore, it needs to be competitive with the conventional banking environment. However, interest-free banks are not allowed to declare nor to promise any amount or rate of *hibah* up-front as this would be tantamount to *riba.*

Also, Islamic financial system accepts deposit from the public and private sectors under the contract of *mudarabah* (profit and loss sharing). This contract is the basis of both General Investment Account and Specific Investment Account. While in the former type of account, the investment project is not defined; the investment project is defined in the latter. Also, the ratio of profit distribution is norma1ly fixed in the former whereas in the latter, this may be usua1ly individually negotiated. The contract of *mudarabah* is a kind of partnership where one party provides the capital and the other provides the work and management. As in the case of Islamic financial system, the customers or depositors are the investors who provide the capital while the bank act as the manager to convert the capital to profit. The profit, if

any will be shared between the two parties based on certain ratio or percentage agreed upon in advance. However, in the event of a loss in the investment, the customers/investors bear all the loss as the manager will lose his time, effort and expected profit.

12.0 APPLICATION OF FUND IN ISLAMIC FINANCIAL SYSTEM

In the area of application of fund, interest-free banking system has relied heavily on two instruments of financing which are *murabahah* and *bay' bi thaman ajil.* As far as *murabahah* (cost-plus-sale) is concerned, interest-free banking system has considered it as a short term financing mainly used for working capital financing and Letter of Credit for trade financing. Under this facility, the customer may approach the bank to provide financing for his working capital requirements to purchase stock and inventories, spares and replacements, or semi-finished goods and raw materials.[38] The bank will subsequently sell the goods to the customer at all agreed price comprising its purchase price and a profit margin, and allow the customer to settle this sale price on a deferred term of 30 days, 60 days, 90 days or any other period as the case may be.[39] *Murabahah* as applied under interest-free banking is not only a financing facility granted for a short period of time but also a deferred payment sale which must be settled in lump sum because it is stated that on due date, the customer pays the bank the agreed sale price.[40]

As far as *bay' bi thaman ajil* (BBA) is concerned, this facility is used particularly in Malaysia for financing the acquisition of assets and the payment usually is based on instalment basis payable in longer period compared to *murabahah* facility repayment. The contract of BBA has been utilised by the bank to provide the customers medium and long term financing to acquire items which may include landed property, houses, motor vehicles, furnitures, stock and shares, etc. However, comparatively speaking, house financing is the most popular facility granted under BBA either to purchase a new house; or to purchase existing completed house; or to build a house *on*

38. *Islamic Banking Practice From the Practitioner's Perspective*, Bank Islam Malaysia Berhad, 1994, p. 103.
39. Ibid.
40. Ibid., p. 104

customer's land; or as a refinancing facility.[41] In addition to *murabahah* and BBA, the Islamic bank also offers *ijarah* or lease financing. It generally involves the purchase by the bank of a specific asset and its lease to the customer for a long or intermediate plan whereby the bank charges an agreed charge or rent.

One may question how Islamic financial system could be able to offer alternatives to the conventional interest-based loans such as housing loan, bridging loan, project financing, revolving credit/overdraft, share financing, infrastructure financing, discounting of commercial papers, etc. The following is a brief but comprehensive illustration of various products which are able to meet the modern needs of finance but at the same time are compatible with the *Shari'ah.* We have already dealt with both *bay' bi thaman ajil* and *murabahah* which are useful in terms of financing a customer to purchase a commodity be it houses, shop houses, land, motor vehicles, consumer goods, shares, education package and other suitable goods. They are also equally useful for refinancing purposes. In the area of revolving credit or overdraft, some banks have started introducing Islamic revolving credit and Islamic overdraft on the basis of *hiwalah* with the combination of *ju'alah* (contract of commission) or *wakalah bi al-ajr* (agency with fees) which seems to be a good alternative to revolving credit facility[42] or overdraft offered under conventional banking to finance the working capital requirement of the company including overhead expenses. Overhead or utility expenses may include *vis* a *vis* water bill, electric bill, rental bill, phone bill, custom duties, consultancy fees and the like.

In fact, interest-free revolving credit may be made available to a customer provided the facility is supported by *one* of the following trade transactions namely, imports documents, local purchase documents and overhead bill vis-a -vis utility bills and the like. This facility, in other words, can only be allowed for purchase of goods like raw materials, semi-finished or finished goods

41. *Islamic Banking Practice,* pp. 72-73.
42. Revolving credit facility is a credit facility that is good for a stated period of time, but does not have a fixed repayment schedule. The borrower may draw down the line of credit at any time, or repay in full without penalty. See *Dictionary of Banking Terms,* (ed. Thomas Fitch), Barron's, 1993, p. 526.

including goods like machinery, parts and utility bill. Interest-free revolving credit can only be given to an amount equal but not exceeding the financial value of the trade transaction as indicated in the supporting documents. However, it is to be noted that the proceeds of these expenses must be paid to the vendor or supplier either through the remitting bank or directly, depending on how the documents was received. Proceeds of this facility should under no circumstances be credited to the customer's account because otherwise it will be against the principle of *hiwalah.* Utilising *hiwalah* for a service charge would, it is respectfully submitted, efficiently replace the conventional overdraft and purchase of Bi11 of Exchange issued under Documentary Credit or Discounting.[43]

Modern Islamic financial system also witnesses the application of Islamic syndication particularly in major project and infrastructure financings. Syndication in financing takes place when a group of financial institutions agree to advance a portion of the fulfilling for a particular project. This kind of financing becomes more and more popular as the Ministry of Finance has issued a directive that all major Malaysian infrastructure projects have to have an Islamic financing component as in the case of Kuala Lumpur International Airport (KLIA) project at Sepang which has secured a portion of Islamic financing in all its stages of construction. As the projects are norma1ly large and require large financing, one bank may not be able to provide sufficient financing. Above all, the Central Bank of Malaysia has prescribed that banks may not provide financing to any single customer in excess of the Single Customer Limit which is defined as 30 % of the Bank's capital fund. In cases where the financing required is ill excess of the Single Customer Limit, the bank shall arrange for the balance of the financing to be provided by other banks. The arranger, also known as manager, lead manager and co-manager respectively, would be entitled for certain amount of fees on the basis of *wakalah* (agencyship) for his effort and expenses.

43. Since the practice of discounting of bills of exchange under the purview of *bay' al-dayn* is relatively questionable amongst the Middle-Eastern and Indian Sub-Continent scholars, the above proposal seems to be able to overcome the problem easily.

Also relevant is the introduction of Murabahah Notes Issuance Facility (MuNIFs) MuNIFs is the interest-free alternative to the conventional revolving underwriting facility. Under MuNif, the components of revolving and underwriting are also present. Being structured under the concept of *murabahah* or cost-plus, the tenderers bid for the purchase price of the underlying assets. Having purchased the assets they are then sold to the issuers at a mark-up price and on deferred periods ranging from one month to one year. This selling price, which the debt created under these contracts of sale, is evidenced by *murabahah* notes. The debts created out of the *murabahah* contracts are then securitised through the issuance of *Murabahah Notes.* The Notes will be traded on the secondary market among designated institutions under the concept of *bay' a1-dayn* (sale of debt).[44] Obviously, the notes issuance could be used, *inter alia,* for working capital requirements and capital expenditures which are useful for any project financing In addition to what has been said, the idea of Islamic Private Debt Securities (IPDS)[45] would also be significant in promoting the project financing under interest-free banking operations A good example of IPDS is the one issued under the contract of *al-musharakah* which was undertaken fnr Sarawak Shell Berhad in 1991. This *musharakah,* which falls under the category of musharakah *mutanaqisah* (decreasing partnerhsip) is a limited contract of participation in terms of duration. The holders of the securities are paid periodically a certain amount of profits from the production turnover of the oil wells based on an agreed proportion, with added bonuses should the turnover exceeds certain levels. In that scheme, the total amount of the facility was RM 560 Million (US $ 225 Million).

The issuance of Islamic private debt securities is basically based on the concept of securitization. Securitization refers to the creation of tradable certificates evidencing a debt arising out of financing facilities. In brief, securitization is a process that makes debt tradable on the secondary

44. For a practical example, see Murabahah Notes Issuance Facilities issued by Jati Discounts Bhd., a subsidiary of the Abrar Group International. For details of the modus operandi and arrangements, see *Islamic Banker*, May/June 1996, p.10.
45. Private Debt Securities represent the issuing corporation's promise to pay the noteholders/ debenture holders/bond holders a specific sum of money according to specific terms and conditions.

market.[46] The act of securitization is meant for having liquidity which is known in Islamic law as *suyulah.*[47] The process of securitization is a form of financing by converting the assets, tangible or otherwise, into cash without increasing the leverage on the balance sheet by selling those assets to a special purpose vehicle (SPV) which in turn issues debt securities to finance the purchase. By so doing, the company would be able to get cash which is needed for its projects. As for the SPV, it needs to securitize the debts purchased to be sold to the investors either on the basis of mark-up sale *(murabahah)* or profit sharing *(mudarabah)* by issuing *murabahah* and *mudarabah* securities respectively.

In Malaysia, the Islamic view point which is now prevalent is that the company may sell the debts to the spy under the purview of *bay' al-dayn* (sale of debt). Also, in respect to securitization, the financial guarantee is needed to ensure the commitment of the SPV to pay agreed profit and redemption amount of securities to the investors. Perhaps, the role of the Rating Agency Malaysia Berhad (RAM) would be very much relevant to measure the safety of the Islamic securities. Therefore, it has been suggested that the minimum rating to qualify as an investment grade instrument is triple 'B' ('BBB') whereby anything below triple 'B' will be considered as a speculative grade investment.[48]

13.0 NEW DIRECTION FOR ISLAMIC FINANCIAL SYSTEM

So far, Islamic financial system has been concentrated on debt-financing neglecting equity- financing which is more appealing for the development of Islamic financial system as the conventional banks may be likely unwilling or unable to undertake this type of financing. Equity financing is best

46. Wan Abdul Rahim Kamil, "Securitisation of Interest-Free/Islamic Asset", paper presented at *The Asian Dual Banking Conference,* organised by The Asia Business Forum, Kuala Lumpur, 26027 June 1995, p. 2.
47. Mohd Daud Bakar, "al-Suyulah : The Islamic Concept of Liquidity", paper presented at *International Islamic Capital Market Conference* 1997, organised by the Securities Commission, Kuala Lumpur, 15-16 July 1997.
48. Nor Mahamed Yakcop, "Is the Islamic Banking System in Malaysia Ready to Meet the Challenges of the 21st. Century", paper presented at *The Asian Dual Banking Conference,* organised by The Asia Business Forum, Kuala Lumpur, 26027 June 1995, p. 5.

represented by both *mudarabah* and *musharakah* contracts of partnership. The reluctance of modern Islamic financial system is likely caused by a few reasons which are interrelated and subsequently render the Islamic financing based on equity financing less popular. The first reason, undoubtedly, is due to the high risk to which both *mudarabah* and *musharakah* are exposed.

As both *mudarabah* and *musharakah* financing operate on a profit and loss sharing basis, they are considered as high risk tools because:

a) Returns to the banks are more uncertain as they depend on the performance of the business.
b) In conventional financing, banks on1y assume credit risk but in these two Islamic tools of project financing, the banks must also undertake the business risk.

Needless to say that banks are conservative and risk averse by nature as they are responsible not to their shareholders but also to their depositors As their depositors comprise both small and large depositors, banks look upon themselves as trustees for these funds. As trustees they are bound to protect these funds and their depositors to ensure that the banking system is fair, sound and most importantly safe. This can only be assured if the banks use less risky financing products.

The second obvious reason behind this reluctance is the question of moral hazard. Naturally, both *mudarabah* and *musharakah* require substantial trust between the banks and their customers If a bank acts only as a capital provider as in *mudarabah* or leaves all aspects of management to the customer as in the case of *musharakah,* the bank will have to totally trust the customer in terms of honesty, integrity, management and business ski11s. Equally problematic is the aspect of monitoring and supervision. *Musharakah* in particular requires more commitment and effort from the banks compared to other forms of financing as the bank assumes business as well as credit risks. Given the fact that both *mudharabah* and *musharakah* are equity financing in character, collateral is not a prerequisite.

This inability to secure a lien on the (partner's) assets of the business would require more careful evaluation of the prospects of the business and hence more precaution in extending financing. Sharing of business risks also entails more diligence in terms of market research on the company, the business, competitors, industry, etc by the banks. And, should the bank decide to participate actively in the management of the businesses, the bank must have qualified personnel who have the management skills to undertake such tasks. Most bankers are genera11y trained to do credit analyses, thus lacking in these management skills which are necessary to protect the banks' interest in *musharakah* financing.

In addition to these problems, perhaps the issue of matching of funds would be relevant to our discussion. The bulk of a bank's source of fund is from depositors in the saving or current accounts. The nature of such deposits is that withdrawals are on demand. The average tenure for general investment accounts is 24 months, which is not very long. In *mudarabah* and *musharakah financing,* banks are committing their *fund* in medium to long term ventures and as such resulting in mismatch of the tenures of sources and uses of fund Most Islamic banks, being very 'new' and 'young' cannot afford to undertake *musharakah* as they have not built up their equity and shareholders fund sources vet, Related to this is the longer period taken to realise the returns from *mudharabah* and *musharakah* financing Islamic banks, being business entities, are primarily concerned with profit maximisation especially at this stage of development. Social obligations are secondary until they could put themselves in a more stable financial position and establish themselves as better alternatives to the conventional banks.

Also relevant to the point of discussion is that most Islamic bankers were initially trained as conventional bankers. It will take some time for them to adapt their way of viewing financing from conventional perspectives to Islamic perspectives. The issues of collateral, guarantee, fixed and certain returns, creditworthiness, etc., are still of paramount importance to Islamic bankers Islamic bankers find it difficult to break away from comparing the return received from Islamic financing to conventional financing Direct comparison is

more straight-forward and easily done in *murabahah* and *bay' bi thaman ajil* than in *mudarabah* and *musharakah.*

One problem which is worthy of discussion is the structural issues pertaining to equity financing. Structural issues are issues related to the existing bank regulations, tax structure and other regulatory issues. Even though the Islamic Banking Act 1983 gives more flexibility to Islamic Bank in terms of financing products, other aspects are very similar to conventional banks, flexibility is not elaborated and in practice, the Interest-Free Banking Scheme (SPTF) guidelines issued by Bank Negara also do not clearly provide the guidelines for *mudharabah* and *musharakah* financing. Also, there is a limit of 10% shareholding by a bank in a particular company under the Banking and Financial Institutions Act 1989.[49] This amount is so insignificant that the entrepreneur has to approach several investors to take off a new venture.[50] Most banks are still unsure on what they can or cannot do, whether *mudharabah* and *musharakah* financing will affect their capital adequacy ratio, what are the relevant accounting treatment and the like. Confirmation on any issues requires clarification from Bank Negara or other regulatory agencies and this could delay a financing exercise. This eventually could lead to banks taking the easy way out and resorting to other more convenient tools of financing such as *murabahah* and *bay' bi thaman ajil.*

Last but not least, the above reluctance is probably due to the customer or potential partner's perspective. If they have good projects or business, customers generally would not want the banks to share the profits and therefore would prefer to borrow. On the other hand, if a project is not financially attractive and the customer wants the bank to participate in the equity, the project may be likely rejected by the bank for being not feasible. Also, most businesses do not want to relinquish management control of their

49. *Banking and Financial Institutions Act*, 1989 (Act 372), Section 46 (1) (a),
50. It is to be noted that Bank Negara of Malaysia has its reason for limiting the shareholding to 10%. It is to avoid formation of big conglomerate between banks and a big giant company which might lead to monopoly position. However, Bank Islam Malaysia Berhad (BIMB), as it is governed by Islamic Banking Act 1983, has the freedom to exceed the limit of 10% shareholding in one particular company.

businesses which may happen if they enter into *musharakah* financing contract with a bank.

The above list of problems which seems to discourage the role of equity financing requires a comprehensive response and solutions to overcome some, if not all, of the said problems In this context, the bankers must be creative enough, with the assistance of *Shari'ah* experts, to be able to undertake the above challenges positively and constructively and this, surely, will require the restructuring of the concept and *modus operandi* of Islamic equity financing to make it more feasible and attractive. Otherwise, the problems will render the Islamic equity financing unpopular and impractical from the modern banking perspective.

With regard to the issue of moral hazard and its relation to the question of collateral, it is respectfully submitted that a flew perspective from Islamic law point of view is deemed necessary. The writer is of the view that collateral could be brought in the agreement of the project financing particularly to secure the interest of the investor but this practice is meant only for compensating any negligence committed by the entrepreneur. The collateral however, cannot be used under any circumstances to redeem the loss due to 'genuine' reasons It is for this reason, it is respectfully submitted, that the classical jurists disapproved the practice of taking collateral *(rahn)* in partnership enterprise. The classical jurists were silent on the use of the collateral to compensate the loss caused by negligence and improper practices of the entrepreneur. Therefore, it seems to the writer that the issue is *ijtihadi* in nature and hence, it is open for alteration and modification especially to suit the needs of the modern requirement and above all to protect the interest of the parties involved in a partnership contract. Perhaps, this newly proposed practice of taking collateral upfront differs from the classical practice in the sense that the collateral will be ready for any compensation even before the negligence is committed but it is refundable should there be no negligence.

The above line of restructuring one aspect of equity financing would be helpful to overcome the reluctance of some of the financiers to take up equity financing. However, this may not in favour of the prospective entrepreneurs. They may now be reluctant to come forward to participate in equity financing since they have to furnish the collateral from the very beginning and this may put unnecessary burden on them. In this context, perhaps we have to examine thoroughly both the principle and institution of *rahn* in Islamic commercial law so as to contribute in giving some encouragements to the entrepreneurs. Otherwise, equity financing will remain unpopular.

It may be suggested that the party who shall provide the collateral would be a third party who is not related to either of the parties in a particular project financing. As Islamic commercia1law allows the third party to be the guarantor as well as to furnish the collateral on behalf of the entrepreneur on the basis of *wakalah,* it follows that this third party might be another financial institution which is willing to take the liability which might arise from both *mudarabah* and *musharakah.*[51] In this context, more research should be undertaken to examine whether the Islamic bankers could follow the practice of Credit Guarantee Corporation (M) Berhad which was established since 1972 whose shareholders, among others, were commercial banks, finance companies and Bank Negara of Malaysia. As the banking and financing sectors have their Islamic windows. the same would be equally applicable to Credit Guarantee Corporation This Islamic Guarantee Window will manage a separate pool of funds solely for the purpose of meeting the liability of guaranteeing financing facility granted under the Islamic Banking concept irrespective of whether the facility is a debt or equity financing. Or perhaps an Islamic Guarantee Window is to be created independently from the Credit Guarantee Corporation but to be participated by all financial institutions offering the interest free banking facilities so that a bigger pool of funds can

51. Of course, the institution which provides letter of guarantee or a security is entitled to a payment or a service charge or the like based on the golden principle of Islamic law that is "the benefit of a thing is a return for the liability for loss from that thing". For details, see articles 85, 87 and 88 respectively of the *Majallah a1-Ahkam al-'Adliyyah* [The Mejelle], Law Publishing Company, Pakistan, n.d.] This principle suggests that in any single transaction which could potentially create an advantage or benefit or profit to one party or both parties to a contract, the benefit he will be receiving should be met with a corresponding possibility of risk and liability to justify the benefit he will earn out of that transaction.

be created for this programme. This will be similar to the idea and practice of Islamic Inter-Bank Money Market facilities. Under this proposed structure, all participating interest-free financial institutions will be investing under the principle of *mudharabah* to meet the liability of the failure of equity financing due to wilful negligence or misappropriation or misuse of funds on the part of the entrepreneur. Profits arising from this investment will be set aside and accumulated as reserves to meet any liability in respect of financing facilities guaranteed under this arrangement. In the event this scheme ceased to operate, this fund may be refunded to all participating institutions provided that all guarantee covers have been terminated and the Window's liability under this scheme has been completely relinquished

The establishment of an Islamic Guarantee Window or even Corporation would be useful and workable provided it is governed by a detailed legal framework so as to establish negligence or otherwise on the part of the entrepreneur. The failure to have the legal support would create many tensions not only between the investor and entrepreneur on the one hand but also between all participating financial institutions in the above scheme of Islamic Guarantee Corporation on the other. A committee of experts of both Civil law and *Shari'ah* law is to be formed to look at the common principles of establishing the act of negligence in both legal traditions.

As mentioned elsewhere, in the modern application, the banks can screen the client, the prospective entrepreneur, appraise the project, monitor implementation and, if necessary, take part in actual management in order to ensure the anticipated results are achieved. These are issues which need proper and serious attention from all financial institutions participating in interest-free banking scheme. These issues, relatively speaking, are ever-lasting. For this reason, it is suggested that all financial institutions ought to contribute to *fund* and establish a central research body which will undertake the research pertaining to the above issues. The emphasis of the research body would be more on equity-based products and their implementation. The research team will include bankers legal, tax and Shari 'ah experts. It will be a cost rather than profit centre and contributing members will be required

to share in the cost of each product and its application. On the other hand, it is hoped in the near future, that the Islamic banks are able to have their own yardstick to screen and evaluate the potential entrepreneurs, to asses the project proposed not only in terms of profitability and feasibility but also, most importantly, in terms of enhancing the Islamic world-view in economic and commercial developments be it in manufacturing sector, service sector, agriculture sector, trading sector, construction sector, etc.

As far as the tax issue is concerned, it has been observed that the current practice that is dividends are distributed from the profits only after the payment of taxes has two major implications:

a) Dividend to a bank is one component of income and will be subject to taxes. This leads to the double tax deduction of dividend income; first at the business' level and later at the bank's level, which result in lower profit to the bank,
b) As dividends are declared after and not before the payment of taxes, a lower return will be received by the bank

Therefore, from the company's point of view, interest is an expense while dividend is not. As dividends cannot be used to reduce tax liability, a company would be more receptive to enter into an interest-based financing to equity financing. To encourage more equity financing by banks, dividends paid to the banks should be made from profits before payment of taxes, just like interest. This would address the current imbalance which is more favourable towards interest. Another approach could be to treat interest just like dividends so that equal tax treatment could be accorded to these two items. A more radical approach could be to "pena1ise" interest expenses or income so as to make dividend payments and income more attractive from the taxation point of view, thus encouraging more equity financing by the banks.

In the context of Islamic banking, the tax reform is deemed necessary whereby the tax rate should be commensurate the risk taken. Therefore, it is respectfully submitted that as *murabahah* is the least risky of the Islamic

financial instruments, the profit it generates should be taxed most heavily and in contrast, *mudarabah* which is the most risky of all should not be taxed at all. It should be pointed out that this proposal does not mean that there will be a loss in revenue for the country because the loss can be more than compensated for the tax potential of the newly created firms financed by *musharakah* and the individuals who are employed under these firms.[52]

As for the high risk that both *mudarabah* and *musharakah* would assume, it may be pointed out that some projects can be quite "safe" if for example the nature of the profit sharing is to cater for government contracts or established and reputable companies. For open market projects where the risk is higher, the returns can be negotiated to reflect the higher risks. For projects of this nature will "force" the banks to be "more professional" and more "business minded" rather than just be "bankers.

Above all, it is worth mentioning that *musharakah,* in particular, is a very flexible financing tool and the Islamic banks must exploit this aspect. In other words, it can be implemented in various ways for example through equity partnership, joint ventures, co-financing and venture capital. As venture capital funds are common in conventional banking and operations of such funds by Islamic banks will be quite similar, this will be easily accepted by most Islamic banks. The main difference is that the projects or businesses to be financed must be lawful from the *Shari 'ah* perspective.[53] Also, depositors of these funds must know from the outset that investments would be more long term in nature, returns are uncertain, irregular, and may be delayed. The

52. Murat Cizakca, "Venture Capital" , in *Encyclopaedia* of *Islamic Banking and Insurance*, Institute of Islamic Banking and Insurance, 1995, p. 154. It is a pre-mature impression of the writer that one should compare and contrast the rate of tax and *zakat* so as to ascertain the rationale behind the rate being imposed particularly in *zakat*.
53. It should be pointed out that although venture capital looks similar to Islamic equity financing, the former differs substantially in terms of contractual relationship between the investor and the entrepreneur. This is so simply because the investing companies are always given the preference shares. Preference shares are relatively similar to ordinary stock except that preferred stock will be having priority at the distribution of profit and in case of bankruptcy. In other words, these shareholders are given the first preference in terms of distributing the liquidated assets. Also, they are different from ordinary shares with regard to guarantees of the principal and return which render it similar to a bond (or debenture) and therefore it eliminates the element of an equity instrument and turn it into a guaranteed debt instead which is not acceptable to Islamic law.

potential for equity financing particularly *musharakah* in project or infrastructure financing is unlimited and Islamic financial institutions should be always encouraged to step out from their conventional banking mentality and conservative stance. Regulatory and tax incentives are always strong impetus for change. Research should be accelerated so that products are more marketable to both bankers and customers. Training is another key area to ensure the availability of a pool of well-trained Islamic bankers who are less resistant towards the Islamisation of the financial industry.

It is fair to note that the conventional banking system has evolved over a period of time on the basis of research and experience and stands institutionalised sophisticated infrastructure and regulated by coherent legislation. Furthermore, it is supported by a For the equity financing to flourish according to Islamic perspective, similar features of support as that of the conventional banking system are needed An. effective legal framework ensuring speedy justice is essential for a good banking system It is more so for the success of Islamic banking because its investment risk is more than that of a conventional interest-based bank as its dealings are on profit and loss basis. Last but not least, it is relevant to pinpoint that networking is very significant in *mudarabah* and *musharakah* financings. Taking the experience of venture capital companies which operate on the basis of 'networking' or ‘clustering’, the Islamic *musharakah* financing is urged to follow the same strategy. Under this structure, the Islamic banks (or perhaps the Association of Islamic Banks) will create the market for the demand and supply of the products within the network. In a way the investee companies are working in a 'protected and ready' market. This will likely ensure the success of all the investee companies.

14.0 CONCLUSION

The foregoing explanation has illustrated that the Islamic financial system has been closely attached to various forms of transactions available in Islamic commercial law It also explains that the system has been working quite well in the past 14 years as it has been able to meet various needs of the customers,

both the depositors and fund users. However, it is respectfully submitted that more emphasis should be equally given to equity financing particularly in the area of project financing which constitutes the current need of the nation.