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LAPORAN AKHIR PENELITIAN



ISLAMIC FINANCIAL CONTRACTS IN ADDRESSING THE SHORTCOMING OF CONVENTIONAL SYSTEM

PENYUSUN:

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Islamic Financial Contracts in Addressing the Shortcoming of Conventional System

Abstract

The financial mode of financing under conventional system is based on Riba', Gharar and Maysir which is prohibited under Maqasid al-Shariah principles. Therefore, the Islamic bank arises as an alternative solution to fulfill the need of financing scheme that in the line of Shari'ah. The objective of this paper is to address the shortcomings of conventional system and how the Islamic system can be an alternative system. The study finds that there are differences based on conceptual and operational framework among the two systems. However, there are issues that occur in the debt-based financing in Islamic financial contracts which have the similar concept as interest, which are Bay' Al-Murabahah, Bay' Bithaman Ajil (BBA), Bay' Al-Inah, Bay' al-Dayn, Ijarah (Al Ijarah Tsumma Al-Bay'/AITAB). In this paper, we will explain in terms of concept, application, formulation and also case study of court cases.

Keyword: Riba', Islamic financial contract, debt-based financing

1. INTRODUCTION

Allah S.W.T allows human beings to enjoy the good things in this world. It is recorded in the Qur'an, *Al-Mulk*, (67:15)

*"He it is who has made the earth subservient to you (i.e easy for you to walk on, to live in and to cultivate, etc.), so walk in the path thereof and eat of His provision, and to Him will be the Resurrection."*¹

Muslim therefore should realize that by implementing good deed will bring them closer to Allah SWT. Not only by practising *Habblum Minallah* acts (prayer, remembrance, 'umrah, hajj, charity and other typical acts), but also *Habblum Minannas* acts should be implemented as well based on the Law of Islam. These acts can be reflected by putting effort on *halal* professions and business according to *Shari'ah* law. In this way, it gives a broader perspective of the *Shari'ah* and helps accommodate a wider scope of thinking in Islamic of every transaction.²

As conventional system is based on *Riba', Gharar and Maysir*, the Islamic financial institutions arise as an alternative that is not consisting these elements which is prohibited by the *Shari'ah*. To replace interest, "Financing on Profit and Loss Sharing" basis is the ideal mode of financing of Islamic banking system. In 1975, the first *Shariah*-compliant bank in the world was established, moreover, the Islamic Finance started to grow. Among Muslim nations, the development of Islamic financial institution grew faster than the conventional in the last three decade. A determinant factor for the growth of the Islamic finance industry because it complies with the *Shariah* and the characteristics of the Muslim societies in the Nations.

To understand more about the concept and operations of Islamic financial institutions, we need to know how the conventional financial system was being set up. In this study, we

¹ Abd Rahman, Z. (2009). *Money, You and Islam*. Malaysia : True Wealth Sdn Bhd

² Rosly, S. A. (2010). Shariah parameters reconsidered, *International Journal of Islamic and Middle Eastern Finance and Management*, Vol. 3 No. 2, 2010, pp. 132-146.

will indicate the alternative counterparts of the conventional system (in terms of financing) in the Islamic finance, on how the conventional financing is differ from the Islamic, and how the current practise of Islamic financing is implemented, as well as the issues that happened.

By acknowledge the issues, we can strive with a better concept and application to enhance the future of Islamic banking system and spread the opportunity of this field, as it is needed by the Muslim society.

1.1 PROBLEM STATEMENT

The study is conducted to show the concept of Islamic Financing and how the Islamic financing modes are being structured. Are the Islamic financing modes truly different from conventional system and whether the Islamic financing modes are based on the *Shari'ah-compliance*?

1.2 RESEARCH OBJECTIVE

- To differentiate between banks financial contracts (financing) in terms of Islamic and conventional.
- To identify issues arise in the practice of the bank financing modes.
- To analyze relevant court cases that lies in the Islamic bank financing modes.

1.3 RESEARCH METHODOLOGY

Data and information that are used in this paper consists of secondary data. The primary source of this study is the Qur'an. Other primary source which has been used in this study is the *hadith* of the Prophet, which is based on *Sahih* Bukhari and Muslim. Additionally, other popular books were used to support the study and other several sources in relation to the topic, which are journal articles and case study (court cases) of the Islamic financing modes.

1.4 EXPECTED SIGNIFICANCE OF THE STUDY

Justification for using sale-based concept is that, money is not a commodity, and the rationale of using current conventional standard is discouraging the development of an Islamic Institution that complies with *Shari'ah*. The study comes out with ideal modes of financing which is the alternative of interest-based concept which are *Musharakah* and *Mudharabah*. The study expects that readers can understand the current financing modes that exist in the current practise, both strength point as well as the issues. We are hoping that the study can be reference for further studies for Islamic Banking students, Islamic Banking player and other related parties to be more knowledgeable of the financial contracts of financing in term of Islamic and conventional.

1.5 LITERATURE REVIEW

The study of analyzing on how the financing mode in the conventional and Islamic may differ from its illegitimacy, current practice, features, attributes, benefit and concept, has been conducted by many scholars nationally as well as internationally. The weakness of conventional system (in terms of financing) is the existence of these elements (*Riba, Gharar, and Maysir*). Islamic system appears as an alternative. Even tough, Islamic financial contract (financing) may counter this elements, however, it has unsolved *fiqh* issues. In the paper we will elaborate each of the Islamic mode of financing and also the issue among them. In this section; few of them are comprehensively summarized as below:

Lewis (2009) elaborates about the prohibition of *Riba* and why it creates unfair and injustice situation. The author stated that there is a little difference between the two systems

because the Islamic system is based on profit-and-loss sharing (PLS) compares to conventional, and the weaknesses of most of financing Islamic mode are based on the fixed returns. Writer analyse about how Islamic is the Islamic financing. However, the scheme of financing operation of the two systems is not clearly explain.

Gamal (2000) supported that Islamic Finance is not similar with conventional finance. The misuse of the term “Islamic banking and finance” in a number of Islamic countries have the scepticism among Muslim society. In this book, the author gives explanation the prohibition of *Riba*, and *Gharar*, the permissible financing methods in Islamic system, supported by reliable Qur’an verses which explained the Islamic finance is different from conventional in terms of theory. On the other hand, the current situation of the Islamic financing appears to be different.

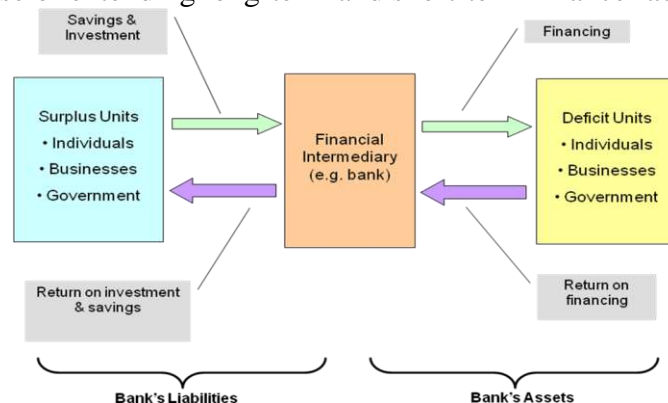
Hassanudden (2009) addressed different parts of Islamic banking business. Here, we can absorb the underlying differences between the two systems; various funds in Islamic banking, its differences from conventional one, importance of it and what need to be improved for future.

Siddiqi (2006) address a fundamental issue of several Islamic financing modes and how it has unresolved *fiqh* issue. He suggested that the current Islamic system should implement the *Maqasid* value to make it better and also suggested further studies to come out with better Islamic system and not be a system that replicate the conventional one. The weak point of this journal is that he didn’t elaborate in example and practical cases (issue) of the current Islamic system.

Siddiqi (1992) stated that the expansion on Money Supply (Monetary expansion) in the Islamic financing modes will be smaller than conventional due to the creation of additional wealth in real sector is happened and the ratio of current deposits to total deposit. From the study, we may notice that the importance of Islamic banking sector to the economy, and the need of interest free loan basis.

2. CONVENTIONAL FINANCIAL CONTRACTS (FINANCING)

The word “bank” is said to have been derived from the Italian word “banco”, meaning shelf or bench, on which the ancient money changers used to display their coins. The bench of a medieval banker or money changer was broken by the people if he failed in business and this probably is the origin of the word “bankrupt”.³ Bank is an institution authorized to take deposits for the purpose of extending long-term and short-term finance facilities.⁴



³ Muslehuddin. (1993). cf. *Encyclopedia of Banking and Finance*, Boston, 1962; also see the relevant text in *Encyclopedia Brintannica*.p.5

⁴ Muhammad, Ayub, (2007). *Understanding Islamic Finance*, British. Wiley. p. 179

Bank is a financial intermediary, acting as a middleman between cash surplus unit (savers) and deficit spending units (users of funds). The relationship between the banker and the customer is as a “borrower-lender” basis. The conventional bank scheme is to take profit in order to cover its operational expenses by implementing interest into the system.

The main purpose of a commercial bank consist of receiving deposits of various nature, granting short and medium-term loans by way of overdrafts, discounting of bills and commercial papers, advances against securities for business and households, long-term mortgage financing and investment in capital market. All this fund-based on interest that is charged from the fund users and paid to the depositors/investors. Commercial banks also take part in foreign currencies, money changing and perform a number of services like issuing letters of credit (L/C) and letters of guarantee (L/G), payments made /received on behalf of their clients, safe custody of valuables and a number of advisory services against service charges or commission⁵.

The interest-based system is not only based on injustice and unfairness, but also encourages the profit maximization principles. As one party will earn the increase value of their money which is predetermined up front and other party will bear with the burden of such increasing value. A provider of fund is entitled of return if he or she takes part of the risk ownership of the business. In contrast, if the transaction is based on the interest-based system, it will be consider as exploitation. The narration of the prohibition of *Riba*’ will be stated as follow:

"Those who devour Riba will not stand (on the Day of Resurrection) except like the standing of a person beaten by Satan leading him to insanity. That is because they say: 'Selling is only like Riba,' whereas Allah has permitted selling and forbidden Riba. So whosoever receives an admonition from his Lord and stops eating Riba, he shall not be punished for the past; his case is for Allah (to judge); but whosoever returns (to Riba), such are the dwellers of the Fire - they will abide therein forever. Allah will destroy Riba and will give increase for Sadaqat (deeds ', alms, etc.). And Allah does not like every disbelieving sinner" (Al-Baqarah 2: 275-276)

"And cooperate in righteousness and piety, and do not cooperate in sin and transgression" (Al-Ma'idah 5: 2).

The problem discusses above may contradict the Islamic concept. This is because the establishment of conventional bank as the financial intermediaries is not emphasizing on the basis of *Maqasid al-Shariah*. As all wealth and property are belong to Allah, man as a trustee should be responsible to utilize the resources in the right manner and uphold the *Maqasid al-Shariah*. The importance of this is to the *maslahah* or right of the other people. As an absence of the goal of *Shariah* will lead to several issues in conventional banking, the establishment of Islamic banking which based on the underlying *Shariah* try to encounter the conventional bank issue.

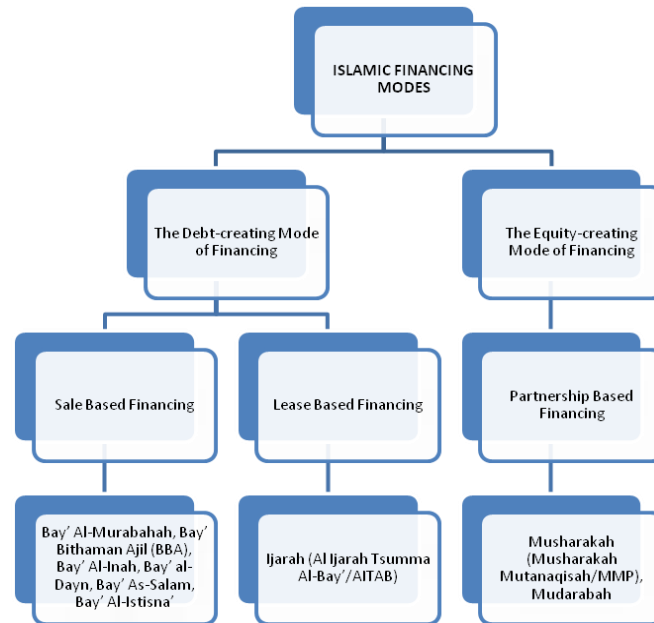
The main difference between them is the nature of the underlying asset of the contracts. The nature of Islamic modes of financing will be explained as follows.

⁵ Muhammad, Ayub. (2007). *Understanding Islamic Finance*, British. Wiley. p. 181

3. ISLAMIC FINANCIAL CONTRACTS (FINANCING)

The main features of Islamic financial institutions is the products and operational must be in the line of *Shariah* and free from ‘*usury* or interest. Islamic banks financing should be in the basis of trading, which is allowed by Islamic law.

Islamic Financing Modes:



3.1 The Debt-creating Mode of Financing

1. Sale Based Financing

1.1 *Bay' Bithaman Ajil (BBA)*

Bay' Bithaman Ajil (BBA) has been widely practiced in Malaysia although it brings to a contradict issues for many fuqaha in GCC countries with regards to the permissibility. *Bay' Bithaman Ajil* (BBA) is a sale contract with deferred payment and for long-term financing. In modern application it is used in various items of financing such as house, shares, land, motor vehicle, consumer goods, shares, personal financing and asset refinancing. Modern definition, it defines as a sale and purchase transactions for the financing of an asset on a deferred and an instalment basis with a pre-agreed payment period, and the sale price will be including a profit margin which is disclosed to the customer⁶.

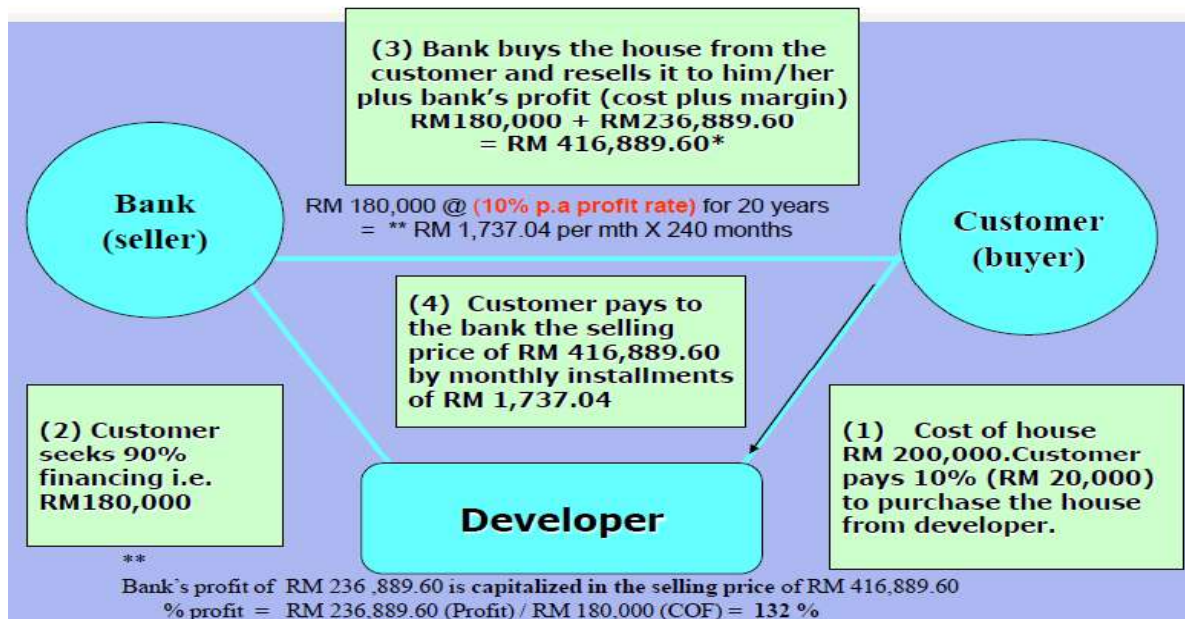
Generally speaking, there is not much different between the conventional and the Islamic mode of home financing (modern BBA practice). Conventional mode of home financing is interest-based, while Islamic mode (BBA) is profit-based which is derived from sale and buy transaction with a deferred payment. Other operational for both of home financing is the same.

For the early stage of the Islamic industry grown up, the BBA is based on novation agreement. However, current practice is without novation agreement. Novation agreement is referred to the act of either replacing an obligation to be performed with new obligation, or

⁶ Asst. Prof. Dr. Rusni Hasan's lecture note

replacing a party to an agreement with a new party⁷. All original parties (customer, bank, and developer) or called as tri-partite agreement must be agreed on the novation agreement whereby the bank will act on the behalf of the customer related to the payment. Meanwhile, BBA without novation agreement is a bi-partite agreement whereby bank will be related directly to the customer in selling and purchasing back the house. This kind of BBA without novation agreement created many issues since bank is not taking any risk in financing the customer. The modern application of BBA in Islamic banking and finance normally without novation agreement which consists of three stages as shown in the modus operandi of house financing below⁸:

BBA Financing Model



The first stage is where the customer purchases a house from the developer which involving the Sale and Purchase Agreement (SPA). The second stage is purchasing the house by the bank from the customer which required the PPA (Property Purchase Agreement). Lastly, the third stage is when the customer repurchases the house by executing a PSA (Property Sale Agreement). For the computation the monthly instalment for BBA home financing is the same as the conventional home financing.

As mentioned earlier that the modern application of BBA has created some issues. The issue is related to the liability for maintenance, repair and other concerns which supposed to be fallen on the owner of the asset. However, when the sale contract is created, the bank transfers all rights and liabilities to the customer. Then, the issue has also risen on the existence of the asset since the house is still under construction or non-existent. This would tantamount to an uncertainty of delivery. Furthermore, BBA is equated with *Bay' al-inah* which is prohibited because it can be considered as a legal device (*hilah*) or a backdoor to *riba* and involved “two sales in one” contract. This “two sales in one” contract is totally not permissible by the Prophet SAW in hadith:

“It is prohibited to have two sales in one single sale”

⁷ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 225

⁸ Assoc. Prof. Dr. Dzulfajstri's lecture note

However, in reality of the Malaysian practice the BBA is the most preferred and acceptable types of Islamic financing.

For a better understanding on how BBA application has been practicing in Malaysia, we provide readers some court cases about BBA. First case is:

Bank Islam Malaysia Bhd v Lim Kok Hoe & Anor and Other Appeals
[2009] 6 MLJ 838⁹

Facts:

This judgement concerned an appeal by the Bank Islam Malaysia Bhd ('BIMB'), the appellant, against a common judgement delivered by the High Court for 12 cases ('the common judgement'), which invoked Islamic financing. The respondents in all the 12 cases were BIMB's customers who had entered into *Bai Bithaman Ajil* contracts ('BBA contracts') with BIMB.

A BBA contract, the most common form of financial transaction used in Islamic banking, is a deferred payment sale contract that is used to finance bank's customers to purchase their own properties. In such a contract the customer first sold the property to the bank under the property purchase agreement ('the PPA'), which was a cash sale. With that purchase, the property belonged to the bank and the customer had to buy it back from the bank at a sale price that included the bank's profit on the sale. In effect the bank would sell the same property it had purchased from the customer to that customer under a second document known as the property sale agreement ('PSA').

In the common judgement the High Court judge ('the trial judge') questioned the validity and enforceability of the BBA contracts on two main grounds, namely that he found the BBA contracts to be more onerous than the conventional loan with *riba* which was prohibited in Islam; and that he found that the BBA contract practiced in this country was not acceptable by all the four *madzhabs* in Islam. He thereby concluded that the BBA contracts were contrary to the basic principles of Islam. Based on such a conclusion the trial judge found that an Islamic bank could only recover the balance of the facility plus profit on the balance principal calculated at a daily rate until payment. The main issues for determination in this appeal were thus whether the BBA contract was more onerous than the conventional loan agreement with *riba* and also whether the BBA contract was prohibited in Islam.

Held:

1. The trial judge's comparison between a BBA contract and a conventional loan agreement was not appropriate. A BBA contract was a sale agreement whereas a conventional loan agreement was a money lending transaction. As such, the profit in BBA contract is different from the interest arising in a conventional loan transaction. Thus, the trial judge was plainly wrong when he equated the profit earned by BIMB as being similar to *riba* or interest when the two types of transaction cannot be similar and when the BBA contract is in fact a trade transaction. Further, the comparison between a BBA contract and the conventional loan agreement is of no relevance and serves no purpose as the law applicable in a BBA contract is no different from the law that is applicable in a conventional loan agreement. The law is the law of contract and if the contract is not

⁹ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 178-180

- vitiated by any vitiating factor, such as fraud, coercion or undue influence, the court has duty to protect the sanctity of the contract entered into between the parties.
2. By replacing the sale price under the PPA with an equitable interpretation of the same and by substituting the obligation of the customer to pay the sale price with a loan amount and profit computed on a daily basis, the trial judge was in fact rewriting the contract for the parties. It is trite law that the court should not rewrite the terms of the contract between parties that it deems to be fair or equitable.
 3. The trial judge had misinterpreted the meaning of “Islamic banking business” under section 2 of the Islamic Banking Act 1983 (‘the Act’). “Islamic banking business” as defined in Section 2 of the Act does not mean banking business whose aims and operations are approved by all the four *madzhabs*. Further, the judges in civil courts should not take it upon themselves to declare whether a matter is accordance to the religion of Islam or otherwise as it needs consideration by eminent jurists who are properly qualified in the field of Islamic jurisprudence. Moreover, as we had the legal infrastructure to ensure that Islamic banking business as undertaken by the banks in this country did not involve any element not approved by Islam, the court had to assume that the Shari’ah Advisory Council under the aegis of the Central Bank of Malaysia had discharged its statutory duty to ensure that the operation of the Islamic banks was within the ambit of Islamic.
 4. In any event it was clear that the validity and enforceability of the BBA contract had been ruled upon by the superior courts. It is trite law that based on the doctrine of *stare decisis* a decision of the superior court is binding on all courts below it. In light of this, the trial judge ought to have held himself bound by those decisions instead of ignoring or disregarding the decisions of the Supreme Court or the Court of Appeal as that would create misapprehension in judicial system.

The second court case is:

Malayan Banking Berhad v Ya’kup bin Oje
[2007] 6 MLJ 389¹⁰

Facts:

The plaintiff had granted the defendants an Islamic banking financing facility amounting to RM 80,094 under the *Shari’ah* principle of *Al-Bai Bithaman Ajil* (BBA) to finance the purchase of a property. The defendants defaulted after paying the sum of RM 16,947.62. The plaintiff sought an order for sale under s 148(2)(c) of Sarawak Land Code (SLC) in consequence of the defendants breach by non-payment of the sum of RM 167,797.10 due and owing the plaintiff as at 26 June 2006. The sum actually the received by the defendants was only RM 80,065 but the amount they had to repay was RM 167,797.10 which the sum would be seen to be excessive, abhorrent to the notion of justice. The question to be decided was whether the plaintiff was entitled as of right to the full profits in the event the BBA was terminated very much earlier taking into consideration of Section 148(2) (c) of SLC.

Held:

The court ordered accordingly by applying equity to both of the parties as Section 148(2) (c) makes it mandatory to exercise equity and the court may not grant the order if it is going to be preserve to the defendants. An opportunity was given to the plaintiff to demonstrate equitable conduct by filling an affidavit stating (i) that upon the recovery of the proceeds of sale, they will give rebate and (i) specify the rebate. If the court is satisfied that the proposed

¹⁰ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 185-186

rebate is just and equitable, it shall make an order in terms of the plaintiff's application, subject to the terms set out in the proposed affidavit. Otherwise, the court may not make the order as prayed or may make some other order as the justice of the case requires.

1.2 Bay' Al-Murabahah

Murabahah comes from the word *al-ribh* which means profit or gain¹¹. Literally *Murabahah* means increase in capital or profit trading. *Murabahah* sale is defined as selling commodity for its purchase price plus a specified mark-up or profit agreed upon. The price mark-up may be lump sum or certain percentage of purchase price. In Malaysian context, *Murabahah* is used for short-term transactions while BBA is used for long term transaction. Islamic banks have to observe certain conditions in practicing *Murabahah* such as the *Murabahah* contract should not lead to *riba* and cost price and mark up (profit) must be disclosed to the contracting parties. Furthermore, the original price should be of fungible things which are weighable, measurable, and countable. Prior the sale to the purchaser, the bank should acquire ownership and possession of the goods carry the risk of loss before delivery.

Murabahah contract can be divided into two types¹². The first type is ordinary *Murabahah* whereby is a contract in which the seller buys the commodity without relying on any prior promise to purchase or to sell. The seller later will resells it on a *Murabahah* basis for a price plus profit to be agreed upon in the contract. The second type is *Murabahah* to the Purchase Order (MPO). MPO is a contract which involves the sale of a commodity through a *Murabahah* contract to purchase order for a pre- agreed selling price, which includes a pre-agreed profit mark up over its cost price. This is clearly specified in the customers to purchase the asset. It is called (MPO) because this transaction includes a prior promise to buy or request made by a person interested in acquiring the goods on credit from any financial institutions. The payment is payable within a fixed future date by lump sum or fixed instalments. The MPO comprises three different contracts:¹³

- a. The main contract connotes the overall financing, followed by an agreement (unilateral contract) to purchase or promise by the customer to purchase when offered by the bank.
- b. An agency contract whereby the agent who could be the customer or third party to purchase the commodity and possess it on behalf of the bank.
- c. The actual *Murabahah* contract where it is to be concluded when the commodity is transferred to the bank.

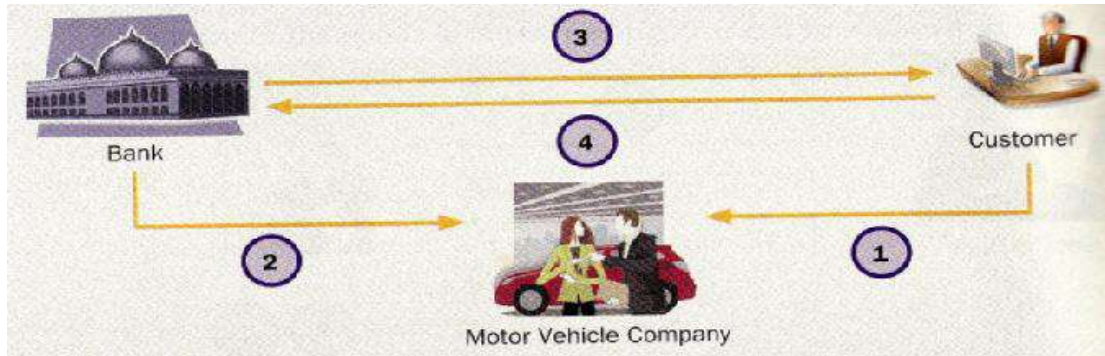
The concept of *Murabahah* can be found in financial contracts and banking products such as Car Financing, House Financing, Personal Financing, Trust Receipts, and Letter of Credit in the modern application of Islamic banking. However, the current practice of Islamic banks is to use the Modern *Murabahah* or known as (MPO) concept. Conventional mode of car financing is interest-based, while Islamic mode (BBA) is profit-based which is derived from sale and buy transaction with a deferred payment.

The diagram below had shown the *Murabahah* structure flow for motor vehicle financing that currently practice:

¹¹ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 53

¹² ISRA. (2012). *Islamic Financial System Principles and Operations*. Pearson Custom Publishing. pg.205-206

¹³ Muhammad Ayub. (2008). *Understanding Islamic Finance*. Wiley Finance.



Sources: ISRA, Islamic Financial System Principles and Operations. Pearson Custom Publishing, 2012. p. 206

In the first stage the customer will identify the motor vehicle to be acquired. Then, at the second stage, the bank will purchase the motor vehicle that the customer wants on a cash basis. The third stage, the bank sells the motor vehicles to the customer on a cash basis. Finally, the customer will pay to the bank according to the agreed terms of financing.

Murabahah in its classical form may not give rise to many *Shari'ah* issues. However, *Murabahah* in its modern structure (MPO) may result in many *Shari'ah* issues when it involves undertakings like agency (*wakalah*) and purchase undertaking (*al-wa'd bi al-shira*).¹⁴

Among the main issues is when the customer himself acts as a seller and the buyer. The purchase of the commodity from the customer himself on a buy-back agreement is not allowed in *Shari'ah* because it reflects an interest-based transaction. In MPO transaction, the customer will be appointed as an agent to purchase the commodity on its behalf and purchase back the commodity afterwards. Another issue is the *Murabahah* contract must be distinguished from the *Musawamah* (bargaining) contract. The seller is obliged to disclose the actual cost price or purchase price of the asset. If the exact cost cannot be ascertained, the sale must be conducted on *Musawamah* basis, not *Murabahah*. Another criticism of the *Murabahah* contract that has been practiced by Islamic Financial Institutions is the practice of using LIBOR (Interbank offered rate in London) as the criterion to determine their profit or mark-up on the basis of the current interest rate. This practice is being criticized since profit based on the rate of interest should be prohibited as interest itself. For a better understanding of how BBA application has been practiced in Malaysia, we provide readers with court cases on *Murabahah*:

Light Style Sdn Bhd v KFH Ijarah House (M) Sdn Bhd
[2009] 3 CLJ 370¹⁵

Facts of the case:

The defendant offered revolving trade line facilities up to a sum of RM 5,600. The plaintiff had utilized the facilities on 17 separate occasions. The plaintiff then requested the defendant to purchase the goods, which are mainly lighting products. Both parties took and undertook by entering into the Promise Purchase Agreement. In furtherance of the agreement, the parties entered into *Murabahah* Sale Agreement. With the effect of this agreement, the defendant would sell the lighting products to the plaintiff at an agreed price and a lump sum payment would be made six months after the defendant paid the supplier. The plaintiff defaulted in his payment. Thus, the defendant proceeded with a demand and

¹⁴ ISRA. Islamic Financial System Principles and Operations. Pearson Custom Publishing, 2012. p.206-207

¹⁵ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 180-181

statutory notice. However the plaintiff contended that the agreement was illegal and invalid by seeking injunctive relief against winding up. The plaintiff contended that the sale agreement were contravention of BAFIA, and Money Lenders Act 1951 (MLA)

Held:

However, the plaintiff's application was dismissed with costs. The court held that:

1. Although BAFIA only permits leasing business but it could not be interpreted that defendant could undertake any other business outside BAFIA. Thus, there was no basis to say there was a contravention of BAFIA.
2. Providing financing alone does not come within the ambit of 'banking business' as defined by IBA. It is undetermined whether the defendant was operating banking business either under IBA or BAFIA.
3. The *Murabahah* sale agreement is straightforward sale and purchase agreement and not a money lending transaction. Thus, it could not be said that the transaction was in contravention of the Money Lenders Act 1951.

1.3 *Bay' Al-Inah*

Bay inah refers to a trading or sale contract whereby it involves the sale and buys back transaction of an asset by a seller. Literally, *'inah* is a loan or advance payment. The objective of *Bay inah* is obtaining liquidity in form of cash rather than to acquire the object of trading.

The legality of *Bay inah* is disputable among the jurists. Majority of jurists including Malikis and Hanbalis agreed that *Bay inah* is not permissible and is regarded as a legal device (*hilah*) to facilitate *riba*. However, according to Shafie, Abu Hanifa and Ibn Hazm for instance, are on the view that the validity of a transaction is determined by its expression or the form of the contract. In their opinion, *Bay inah* contract cannot be nullified only because of the existence of an illegal ulterior intention to legalise *riba*. Accordingly, the contracts are valid by virtue of the external evidence that is properly concluded and that unlawful intention of the parties is immaterial. It does not invalidate their action, unless if the parties expressly declare their intention to do legal trade. Thus, the Shafies view the intention of the parties is taken into account only when invalid intention is explicitly mentioned in the contract¹⁶.

In Malaysian practice, it is called *Bay inah* when the bank sells the asset first. However, if the customer sells the asset first, it is known as BBA. The basic structure of *Bay inah* can be seen as follow:

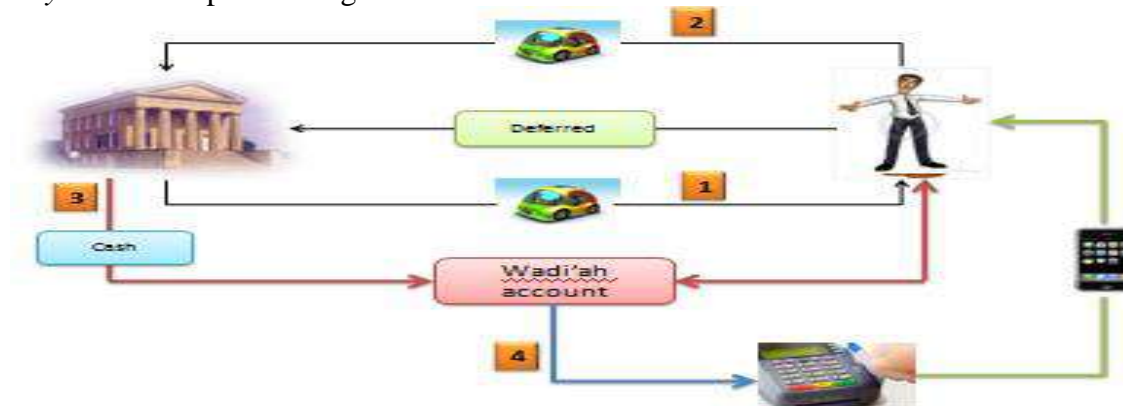
- i. A financing contract which involves the sale and buy back transaction of an asset by a seller which will pay at cash basis.
- ii. A seller will later buy back the same asset on deferred payment whereby the price is higher than first price.

Bay inah also can be conducted on reversed basis whereby deferred payment in first transaction, and cash payment in the second transaction but the cash price always be lower than deferred price.

The concept of *Bay inah* can be found in financial contracts and banking products such as for financing facility like personal financing, asset financing, cash line facility and working capital financing. The *Bay inah* concept can be found in liquidity management and debt structuring as well through Negotiable Islamic Debt Certificate (NIDC) and Islamic Private Debt Securities (IPDS). Recently, *sukuk* issuance also used the *Bay inah* concept like

¹⁶ Saiful Azhar rosly & Mahmood M.Sanus (2001), *Shari'ah Issues and challenges* p.8

sukuk ijarah and *sukuk murabahah*. the diagram below illustrated the common mechanism of *Bay inah* concept for charge card service.



At the first stage, bank will sell the asset to the customer at deferred payment at the real cost plus the profit margin that is equivalent to the maximum amount to be paid by the customer. Then, the customer will resell the same asset to the bank at the cash basis that is equivalent to the limit of the card. This amount will be credited into a marginal *Wadi'ah* account of the bank for customer's use which also becomes the card limit. The customer will pays the bank the amount he utilizes by instalments or full amount at once.

The issue raised in the case the second contract in *Bay inah* was executed instantly and serves as a condition for the first transaction. Shafie and Ibn Hazm did not prohibit *inah* based on *niyyah* since only Allah knows what is in man's heart. However, they did prohibit two sales in one sale, and they also prohibited the specification of additional conditions to a contract.

The Malaysian Shari'ah Advisory Council's resolution in its meeting held on 12 December 1998, acknowledge the fact that the issue of *Bay inah* is still a matter of juristic disagreement among *Shari'ah* scholars. However, the *Bay inah* concept is still necessary in the context of local Islamic finance development. Consequently, the Council during the regional Shari'ah Scholars Dialogue on 29 June 2006 resolved that IFIs need to limit the use of *Bay inah* concept in their product. Furthermore, the market players are required to strengthen and enhance their operational processes and documentation to comply with the features of *Bay inah* as permitted.¹⁷ For a better understanding on how BBA application has been practicing in Malaysia, we provide readers court cases on *Bay inah*:

Majlis Amanah Rakyat and Bass bin lai
[2009] 2 CLJ 433¹⁸

Facts of the case:

The plaintiff had agreed to re-purchase of these properties for cash at a discount in the sum of RM 21,000 in accordance with Islamic principles of *Bay al-Inah* to a customer. The defendant was a third party who executed a charge securing the transaction. The said customer and the defendant had defaulted in the repayment of the sale price under *Bay Al-Inah* thus the plaintiff filed an action against them. The pertinent issue discussed in this case is whether *Bay Al-Inah* facility contravened to the *riba* rule and whether the order of sale should be allowed. The plaintiff argued that the court must apply the same procedure done in conventional bank facilities even though it involves Islamic

¹⁷ Bank Negara Malaysia (2007) Shari'ah Resolution in Islamic Finance, 1st edition, Kuala Lumpur.

¹⁸ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. p. 182-183

Banking facility. Whilst the defendant argued that the facility given by the Plaintiff has transgressed the *riba* rule which is prohibited in Islam.

Held:

The court held that Bay Inah is not factitious transaction which transgressed the *riba* rule and was pursuant to the *Shari'ah* principle. In addition, the court held that the proper procedure in law is to be chosen in order to challenge the legality of a contract. The order for sale in this case was granted.

1.4 *Bay' As-Salam*

Literally *salam* means giving (ita'), advance (*taslif*) and leaving.¹⁹ Technically, *salam* is the contract whereby a buyer purchases a commodity for future delivery in exchange for immediate payment.²⁰ The purpose of *salam* contract is to meet the needs of the small farmers who need the money to grow their crops and feed their family until the harvest time. However, not every commodity suitable for *salam* contract and usually applicable for fungible commodities.

The legality of *salam* contract comes from various sources such as Quran, Sunnah, and Ijma'. One of the Hadith narrated by Ibn Abbas mentioned about *salam* contract:

*"Allah's Apostle came to Medina and people used to pay in advance the price of fruits to be delivered within one year or two years. (The sub-narrator is in doubt whether it was one to two years or two to three years.) The prophet said," whoever pays money in advance for dates (to be delivered later) should pay it for known specified weight and measure of the dates)"*²¹

The Salam contract have to follow some basic rules and conditions such as the price should be paid full at the time of contract and exact time and place of delivery must also be specified. Furthermore, goods whose quality and quantity cannot be determined by specification cannot be sold through *salam* contract. Moreover, the goods that can be sold only by specifying the attributes and not be particularized to a given farm, factory or area²².

The Salam contract can be divided into two types. First type is the ordinary *salam* contract that involves only two contracting parties which are the buyer (*musallim*) and the seller (*musllam ilyah*). The second type is known as *parallel salam* contract. It is the contract that consists of two different and independent contracts. In the first contract, bank is the buyer whereas in other contract bank is a seller. However, the two contracts cannot be tied up and performance of the one contract should not be dependent upon the other.

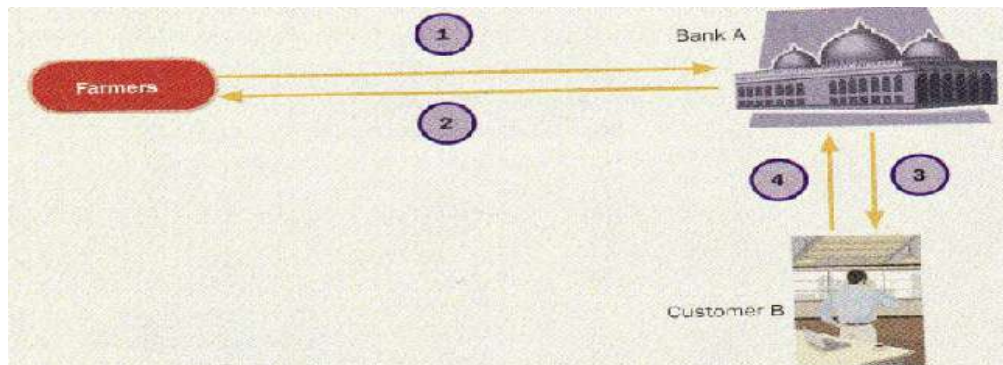
The *salam* contract is very useful for small and needy farmers to get the financing. This kind of contract gives benefit for both parties. For the bank, they get the payment in the sport basis whereby the bank is safe from the deferred contract. On the other hand, seller will benefited from this contract by having the fund which will enable them to produce the commodities. The following diagram is the mechanism of *Salam* contract in agricultural financing:

¹⁹ ISRA. (2012). *Islamic Financial System Principles and Operations*. Pearson Custom Publishing. p.210

²⁰ Sulaiman, M and M. Ariffin, N. (2011). *Manual to Accompany Accounting and Auditing for Islamic Financial Institutions*, International Islamic University Malaysia, p 125

²¹ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. p. 72

²² Ibid Pg. 182-183



Sources: ISRA. Islamic Financial System Principles and Operations. Pearson Custom Publishing. 2012. p. 214

At the first stage, the farmers enter into a *Salam* contract to sell a specified amount of wheat in advance for RM 15 million to bank A. the wheat is to be delivered on 1 April 2012. Then at the second stage, Bank A pays RM 15 million on a spot basis to the farmers and also stipulates from where to take delivery on 1 April 2012. Then Bank A enters into a promise with customer B undertakes that he will purchase wheat from Bank A for 20 million on 1 April 2012 a gain of RM 5 million. The farmers supply the specified wheat to Bank A on 1 April 2012, bank A informs customer B to execute the sale and take delivery.

In current practice of Islamic bank, they are not so much in favour of salam contract due to the exposure of the number of risk. The common risk that Islamic banks may face is the price risk whereby at the time of the goods received, the price may be lower than the original expected price. It will cause the seller to pay more due to variation of market price.

1.5 Bay' Al-Istisna

The word *istisna'* is derived from the Arabic verb "*istasna'a*" which means to request someone to manufacture an asset.²³ Technically, *Istisna'* is a contract to manufacture the goods to specification and deliver the manufactured goods to the buyer at an agreed future date. We also can refer *Istisna'* as the contract where a sale contract made without the subject matter of the contract being existence at the time of contracting. The payment can be in advance, deferred or paid in instalments.²⁴ The legality of *Bay Istisna'* is established in the Hadith of where Nafi' reported that Abdullah ibn 'Umar has reported to him that:

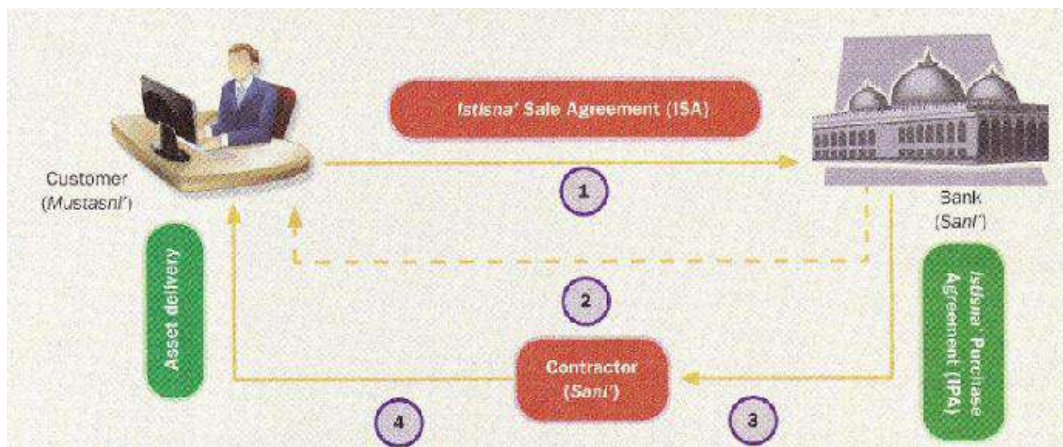
"Prophet Muhammad (S.A.W) has requested the manufacturing of golden ring for him"

An *istisna* contract should follows the certain basic rules and conditions such as the object to be manufactured should be described precisely in terms of type, nature, quantity, quality. Furthermore, the object must be something that the people are familiar contracting on *istisna'* basis such as buildings, houses, or heavy machines. In terms of payment, it could be deferred to a future date or made by instalments within a fixed time. An *Istisna* contract can be divided into two types. The first type is a classical *istisna'* which involves only two parties which is the buyer (*mustasni'*) and manufacturer (*sani'*). The second type is parallel *istisna'*. It is the contract when the *mustani'* (ultimate purchaser) does not stipulate in the *al-istisna* contract the the *sani'* (manufacturer) should manufacture the subject matter but himself, then the *sani'* may enter into second *istisna'* contract in order to fulfil his contractual obligations in the first contract. The second contract is called *parallel istisna'*.

²³ ISRA. (2012). Islamic Financial System Principles and Operations. Pearson Custom Publishing. p.207

²⁴ Sulaiman, M and M. Ariffin, N. (2011). Manual to Accompany Accounting and Auditing for Islamic Financial Institutions, International Islamic University Malaysia p.132

An *istisna'* contract can be applied for constructed or manufactured by specification such as housing construction and advance technologies industries like aircraft, automobile and ship. The diagram below shows the application of *parallel istisna'* for house financing:



Sources: ISRA. Islamic Financial System Principles and Operations. Pearson Custom Publishing, 2012. p. 210.

At the first stage, the customers will sought finance from the bank is in capacity as a seller. The *Istisna'* Sale Agreement will be sign between them. Subsequently, the bank will enter into the second contract in the capacity as the buyer with another party to manufacture the commodity as agreed in the first contract. In this stage, they will sign *Istisna'* Purchase Agreement.

The *Shari'ah* issue in *Istisna'* contract arises when the manufacturer fails to deliver the manufactured goods on the agreed time. One of the solutions of this issue is by allowing the stipulation of (*al-sharat al-jaza'i*) upon the manufacturer.²⁵

In relation to the permissibility of accepting a conventional bond as a security for Islamic financing, some scholars recognize such practice since the pledge is not made for the purpose of ownership, but merely as security. A conventional bond is a type of liquid asset that fulfils the requirements of chargeable items. The following is one of the court cases regarding Bay *istisna* which is

Tahan Steel Corp Sdn. Bhd. and Bank Islam Malaysia Bhd
[2004] 6 MLJ 1, [2004] 6 CLJ 25²⁶

Facts of the case:

In this case, the *Al-Istisna'* plaintiff had undertaken a development and construction of Steckel Hot Strip Mill Plant to produce Hot Rolled Coils ('the said project') which was to be carried out on a piece of land in Klang. The land, a leasehold property was purchased from the Selangor State Development Council at RM128 million in which they secured a RM97 million loan facility from the defendant bank by using the *Shari'ah* principle of *Al-Istisna'* facility.

Under this concept, the defendant purchased the said project from plaintiff for a purchase price of RM97 million which was disbursed immediately into a financing payable account. From that account, the monies were paid out to the plaintiff upon meeting with all the conditions contained in the *Al-Istisna'* Purchase Agreement (APA). Simultaneously, with the execution of the APA, the defendant sold back the said project to the plaintiff by way of the Sale Agreement (ASA) for an agreed price comprising the

²⁵ ISRA. (2012). Islamic Financial System Principles and Operations. Pearson Custom Publishing. p.209

²⁶ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 171-172

purchase price together with an agreed profit margin. Two tranches of the facility amounting to a sum of RM 58,215,984.84 m had been released by the defendant bank to the plaintiff. The defendant has refused to release the balance of the facility amounting to RM 38,784,015.16 m from the financing payable account.

As a consequence of the said refusal by the defendant to release the balance of the facility, the plaintiff had filed a writ alleging the breach of contract on the part of the defendant bank. The plaintiff also sought by way of interim injunction to prevent the defendant from exercising its lawful rights under the security documents executed by the plaintiff in favour of the defendant pending the outcome of the writ action.

It was contended by the defendant that the Plaintiff had failed to meet up certain conditions precedents of the APA, namely to secure facilities totaling approximately USD80 m or such other amount as the defendant reasonably determines from EXIM banks for the purpose of part financing of the said purchase. They also contended that the plaintiff had unilaterally decided to substitute the EXIM loan condition with a bond issue.

Held:

The court dismissed the application and held that:

- a) The defendant is a licensed bank governed by the Islamic Banking Act 1983. It is not allowed to participate nor conduct any business that contravenes the *Shari'ah*. The defendant does not charge penalty interest by whatever name one wishes to call it for late payment and also single instalment that is paid late to the defendant for the period delay. Viewed in this context, the grant of an injunction to the plaintiff would cause irreparable damage to the defendant.
- b) The defendant as the lender and being an institution operating under the Islamic Banking principles would be made to suffer loss of use of its money by the delay in recovering monies from the plaintiff in the event that the High Court cannot compensate this loss since the defendant is prevented by its strict adherence to Islamic banking principles from taking any penalty interest or *riba*.

1.6 *Bay' Al-Dayn*

Bay' al-Dayn defines as the sale of debt. According to the *Mejelle* "al-Dayn defines as the thing due as the amount of money owed by a certain debtor²⁷. This is kind of constructive property sale which established from the liability of the debtor and based on future receivables for cash.

In general, the majority of jurists have agreed in the permissibility the sale of the debt but the legality is depending on the number of parties involved (whether two or three), the party to whom the debt is sold (whether to the debtor or non-debtor) and the modes of delivery (on spot basis or credit)²⁸. Most of Hanafis, Hanbalis and Shafies jurist agreed that *bay' al-dayn* is not permitted to non-debtor or a third party. However, *bay' al-dayn* to a third

²⁷ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 69

²⁸ ISRA. (2012). *Islamic Financial System Principles & Operation*. Pearson Custom Publishing. Pg. 214,

party for spot and equivalent in quantity and time of maturity is permissible by majority of Islamic law schools.

As we realized that the sale of debt basically is not acceptable except in some term and conditions. That is why some *Shari'ah* issues have been raised related to the sale of debt. Some arguments said that if debt is considered the money itself, so it can be only be traded at par value and in the same amount, it cannot be higher than the price in order to avoid the occurrence of *riba* which can be involved in the between of two debts. Otherwise, the sale of debt should not be considered as a currency but regarded as a real property. The issues in the sale of debt contract also lies in the legal status of the subject matter (certificate of debt), whether it is a commodity or money since the transaction cannot be in the form of out of money-for-money.

In Malaysian practice, *bay' al-dayn* has been implemented the concept of attachment the underlying of asset or certificate of debt because it can qualify as having a financial rights, so it can be sold at whatever price. *Bay' al-dayn* is also being structured in various Islamic finance facilities such as Islamic money market, Islamic treasury bills, etc. Consequently, the *bay' al-dayn* is allowable in Malaysia. However, the said concept is not allowable in the Middle Eastern because in their views the payment of monetary debt is still remained as monetary, hence money-for-money exchange must be equal exchange and spot.

2. Lease Based Financing

2.1 *Ijarah (al-ijarah AITAB)*

Lexically can be defined “to give something on rent”. It can be used for two different conditions, in the first place is *ijarah al-'amal* means to employ the services of a person on wages given to him as a consideration for his hired service (lease of usufruct of labor, employment and services). The second place is *ijarah al-ayn* (lease of usufruct of property) means to transfer usufruct of a particular property to another person in exchange for rent claimed from him²⁹. Literally means the reward given for service rendered and/or sale of usufruct (*bay' al-manfa'ah*). According to the *Mejelle* Art 405 means the sale of usufruct for a known return. Technically, it means a contract for the transfer of ownership of usufruct for compensation³⁰. Although there two types of *ijarah* in the literature of Islamic jurisprudence as mentioned before, but we only discuss the second type of *ijarah* which is more relevant to the application of Islamic banking presently.

Generally, the rule of leasing (*ijarah*) is very much similar to the rule of sale which is transferring something from someone to another person for a valuable consideration. However, there are some differences between *ijarah* and *bay'*. In the normal sale contract, the corpus of the property is transferred to purchaser, whereas in *ijarah* contract, the corpus of the property remains in the ownership of the transferor, only its usufruct to be transferred and it may be occur immediately or at a future date, while sale contract must be carried out immediately.

Since *ijarah* is a leasing transaction which governed by the rules of *Shari'ah*, this indicates that *ijarah* contract is permissible in Islam with the purpose of facilitating the public who do not plan to own the property but need to utilize the benefit of the property (the usufruct of the asset), and *ijarah* is a binding contract. The *Shari'ah* legality of *ijarah* which deals with employment's contracts described in *Surah Al-Talaq:6*

“*And if they suckle your (offspring), give them their recompense*”

The other legality is based on hadith from Said ibn Musayyib:

²⁹ Muhammad Taqi Usmani. (2003). *An introduction to Islamic Finance*. Kluwer Law International. Pg.69

³⁰ ISRA. (2012). *Islamic Financial System Principles & Operation*. Pearson Custom Publishing. Pg. 233

“We used to lease out land for some portion of the agriculture products, and the Prophet SAW prohibited us from such practice. Instead he asked us to lease it out for gold or money”

Besides, Ijma' of the companions' Prophet SAW also confirm for the legality of *Ijarah* is based on real need for such transaction.

To fulfil *Shari'ah* requirements, the salient features of *Ijarah* contract must be concerned³¹:

1. The asset (subject matter) must have valuable use or usufruct (manfaat)
2. The asset must not be consumable or it cannot be returned
3. The ownership of the asset must be remained with the lessor, only the usufruct is transferred to the lessee
4. The liabilities and the risk of the ownership will be borne by the lessor except everything which related to the use of the lease asset
5. The usage of the leased asset must be clearly determined
6. The contract is terminated when asset is not utilizable
7. The period of the lease must be in clear term
8. The rental payment commences after delivery of the leased, actually or constructively

In modern practices of banking sector, *Ijarah* is used in financing the acquisition of an asset. Generally there are various types of *Ijarah* contract and each type is structured to meet its specific purpose, however there are two types of *Ijarah* contract which specifically created to be applicable in the banking system, namely operating lease and financial lease.

▪ Operating Lease

This operating lease is not tied with purchasing agreement, there will be no an option for the customers to purchase the asset at the end of the leased period. Here, the lessee will deliver back the asset to the bank as a lessor at the end of the period. During the lease contract, the asset will remains as the bank's property. This operating lease is appropriate for costly asset such as ships, aircrafts, industrial equipments, etc. and as result the charge is higher due to higher risk to be borne by the lessor. Also, this type of *ijarah* is relatively for short period of time.

▪ Financial Lease

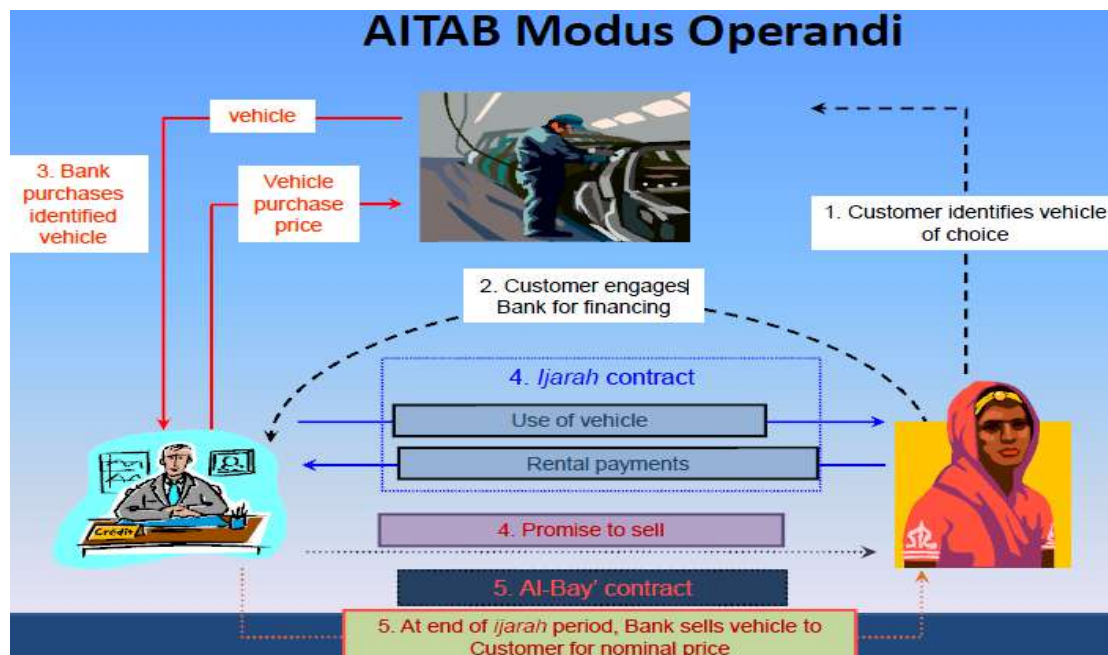
This type of leasing is tied to purchasing agreement or gifting. The financial lease contract usually will be ended up with the ownership of the asset to the lessee since there will be transferring of the asset from the bank (lessor) to the customer (lessee), also the rental paid will be constituted as the purchase price of the asset. Financial lease is a combination of various contract which is agency + leasing + sale/hibah. Financial lease transaction is usually used in real estate, machinery, and equipment. Basically, there are three contracts will be used when transferring the asset to the customer (not at the same time):

- i. Call option for the customer to purchase the equipment after the lease, called “*al-ijarah thummah al-bay'* (AITAB)”
- ii. Bank unilaterally promises to give hibah to the customer, known as “*al-ijarah al-muntahiyah bittamluk* (AIMAT)
- iii. The promise upon the remaining payment instalment, called “*al-ijarah thummah al-iqtina'*”

³¹ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 97

Al-Ijarah Thummah al-Bay' (AITAB)

AITAB is *ijarah* contract which comprises two different contracts, namely contract of leasing (*ijarah*) and contract of sale (bay') but it is functioning in separate and at different stages of transaction. AITAB is a current innovative product of Islamic banking. In Malaysian practice, AITAB is governed under civil law, the Hire-Purchase (HP) Act 1967. It specifically designed as real property or motor vehicle financing. The said Act does not provide specific regulatory law on Islamic Hire Purchase transaction; hence the parties in the contract must have full understanding and knowledge in the real nature of AITAB. For further understanding, the modus operandi is provided³²:



Although *Ijarah* is widely applicable and acceptable product in modern banking system, but *Shari'ah* issues and problems are still raised.

- ✓ Most of scholars agreed that there is not permissible to have tied one transaction with another transaction in order to make the former precondition for the other. Therefore, to be fully *Shari'ah* compliant in *Ijarah* contract the lessor may enter to the unilateral undertaking for selling the asset at the end of the period, it means that only the lessor is binding into the underlying.
- ✓ Some said that *Ijarah* transaction is similar to interest-based financing. The unknown and the variation of rate which tied with the rental will involve *gharar* which is strictly prohibited in *Shari'ah* and *gharar* may lead to unfair situation between parties. And using the interest rate as the benchmark is driven to join the parties to the prohibited elements. That is why the Muslim Jurists ruled that in *Ijarah* contract, in long-term lease transaction may either stipulate condition by increasing the rental rate with certain percentage after specific period of time.
- ✓ Furthermore, a big problem can be occurring in the case of default in rental payment by the lessee when the penalty would be taken for the late payment, and the penalty should be given to the charity.

³² Assoc. Prof. Dr. Asyraf Wajdi Dusuki's lecture note

The solution to the above issues are underlying on two points: first, the risk should not be separated from ownership as the leased asset is remained in the lessor, then the lessor should take the responsibility of the leased asset. Second, lease and sale contracts are two different contracts in nature, so the two contracts must be separated and independent each other³³. Consequently, *the Ijarah* contract can be fully *Shari'ah* compliant.

Here is the reported court case about *Ijarah* in Islamic banking application in order to see how the judges rely more on the application of the current banking product rather than the underlying *Shari'ah* principles.

Tinta Press Sdn. Bhd. v Bank Islam Malaysia Berhad
[1987] 2 MLJ 192³⁴

Facts:

On 9 December 1983, Bank Islam Malaysia Bhd. ('the respondent'), by a letter of offer to the appellant, approved the appellant's application and agreed to provide facilities by issuing letters of credit for the purchase of printing equipment amounting to \$ 3,832,000.00, which would be leased to the appellant.

In accordance with the letter of offer, the lease was for a period of seven years commencing from 30 December 1983, and the rentals were payable in advance in the sum of \$ 72,762.40 per month by eighty-four monthly instalments. The appellant had also to pay two rental deposits valued at three months' rental of the machinery for each deposits according to the dates specified at para 11 of the letter of offer. The first deposit was to cover the rental for the first three months. The rentals for the fourth month onwards had to be paid in advance at the beginning of each month.

The appellant paid the sum of \$ 105,000.00 by cheque towards the rental deposit on 9 December 1983, and on 6 January 1984, paid further sum of \$ 113,287.20 towards the same making a total of \$ 218,287.20. However, the appellant had failed to pay further monthly rentals of \$ 72,762.40 per month as agreed, but made only two-part payments of \$10,000 each on 13 April 1984, and 24 July 1984 respectively.

The appellant by letter dated 23 March 1984, requested the respondent to allow them to defer four months towards the payment of the rentals. The respondent, however, informed the appellant that they could defer payment of the deposit instead but not the rentals. On 5 May 1984, the appellant was in arrears of rents to the tune of \$175,899.75 as stated in their letter of reminder. On 28 June 1984, the respondent wrote again reminding the appellant that he was in arrears of \$245,806.75 in rentals.

On 2 August 1984, they executed a lease of printing equipment agreement ('the Lease Agreement') incorporating some of the terms of the earlier agreement whereby the respondent at the request of the appellant agreed to purchase the said equipment for the purpose of leasing the same to the appellant. The lease was to commence on 30 December 1983, as agreed upon and expressly provided by item (4) to the Schedule of the Lease Agreement.

³³ Muhammad Ayub. (2008). *Understanding Islamic Finance*. Wiley Finance. Pg.296

³⁴ Hassan, Rusni. (2011). *Islamic Banking and Takaful*. Pearson Malaysia Sdn Bhd. Pg. 169-171

The respondent became the lessor and the appellant became the lessee. The facility granted was based on the Islamic banking business, which included the appellant's profit margin, and was subjected to the terms and conditions stated in the Lease Agreement. By this Lease Agreement, some of the terms contained in the letter of offer of 9 December 1983. There is no provision for rental deposits in the lease agreement. Instead it provides for security deposit of \$209,721 which was to be paid by the appellant on execution of the lease agreement. It was provided that the security deposit shall be retained by the lessor (i.e. the respondent) as security for the due observation and performance by the lessee (i.e. the appellant) of the stipulations, terms and conditions of the lease agreement, and the security deposit shall not be treated as payment of rent or any part thereof.

It is clear that by 10 August 1984, the appellant was in arrears of rentals due and had not paid the security deposit as agreed in the lease agreement. On that date, the respondent's solicitors wrote a notice demanding payment within seven days. On the appellant's failure to comply with their request, the respondent after making known to the appellant of their attention by letter took possession of the equipment under the provision of the lease agreement. They succeeded in dismantling and removing one unit and while in the process of removing the second unit, the appellant and his servants or agents closed and locked the premises, thus preventing the respondent from making possession of the rest of the equipment.

Subsequently the respondent filed a writ against the appellant and the three guarantors and on the same day, i.e. 13 September 1984, filed the *ex parte* application for mandatory injunction which was granted by the Court on 25 September 1984. Subsequently on 10 October 1984, the appellant argued that it was not a lease agreement but a mere loan arrangement and the equipment thus belong to the appellant. It was further argued by the appellant that the respondent should sue the appellant for the defaulting loan transaction rather than suing to repossess the equipment as a course of action.

Held:

The court held that applying common law principles, the above mentioned transaction was indeed a lease agreement and accepted the affidavit of the respondent that only granted loans on *Qard al-Hassan* (benevolent loans). The Supreme Court says that the facility was in fact based on a lessor-lessee relation and Bank Islam as the lessor is the legal owner of the equipment and the defendant only has the right to use it. Again in this case, the judge failed to appreciate the contract of leasing and in deciding the case no reference was made with regard to Islamic law of transactions and Islamic banking system.

4. The Equity-creating Mode of Financing

1. Partnership Based Financing

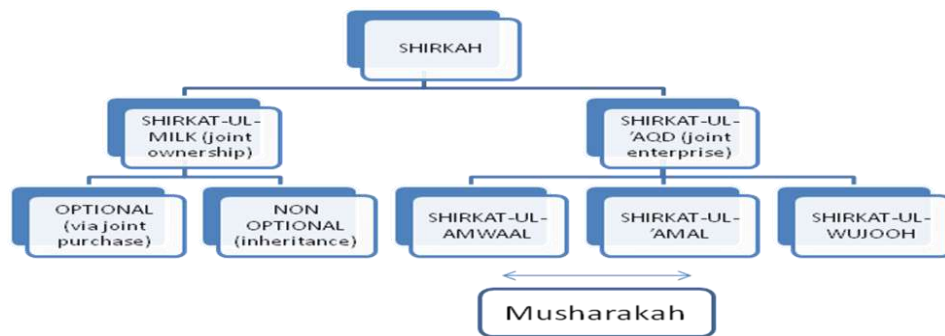
The financing models that are ideal to be an alternative to interest-based banking are *Musharakah* and *Mudharabah* and if it implemented on a national level will cause in much fairer distribution on the public.

1.1 *Musharakah* (equity finance)

"Musharakah" literally means sharing. *Musharakah* is derived from *"Shirkah"* which means "being a partner". *Musharakah* is a joint enterprise formed for conducting

business in which all partners share the profit according to an agreed ratio while the loss is shared according to the ratio of investment.”³⁵

Musharakah is different from the conventional system, as its system is profit-and-loss basis, which means the rate of return is based on the actual profits earned by the business and the loss will be share among the debtor and the financier according to their capital contribution.



Despite of the contract of *Musharakah* has to comply with the Islamic *Shariah* some legal principles of *Musharakah* transactions need to be fulfilled:

Competent contracting parties; The capital shall be in cash, gold or silver or equivalent, realty (goods, real estate machines), or intangible rights (e.g. patents) or equivalents; The partner does not guarantee another partner’s capital or funds except in case of negligence or omission; Any exchange or sale of capital to the other partner should not be at historical cost but at the fair value at the time of sale; Profits can vary with the agreement and capital contribution and to be distributed upon completion; Loss to be shared according to capital contribution (credit guarantee) and can be carried forward or offset.

The computation of profit ratio is difference between scholars. According to Imam Maliki & Imam Shafi’e, ratio of profit must be equal of investment, while Imam Ahmad belief that the ratio does not have to be equal.

A *Musharakah* agreement is terminated if the following situations occur:³⁶ Every partner has a right to terminate the contract at any time after sufficient information or notice; If one party dies during the contract, then the contract will be terminated, however, the heir will have the option either to continue or terminate the contract; Or if any one of the partners is not a competent party (become insane); The contract also terminated if the whole capital of the venture is lost; Other situation is when the purpose of establishing the venture is fulfilled in case of a specific contract (purpose).

The application of *Musharakah* are in investment accounts (depositors are sleeping partners, and bank also invests its own funds); stock companies; mutual funds; project financing; import/export financing; and others.

We will study more on one of *Musharakah* contract which is *Musharakah Mutanaqisah Partnership* (MMP) to elaborate about the concept and the practice of *Musharakah*.

³⁵ www.alqalam.org.uk

³⁶ Muhammad Ayub. (2007). Understanding Islamic Finance. Pg 318

MMP is a contract when one party has the right to purchase a part of the other party's share which declines until one becomes the sole proprietor of all capital (*Diminishing to Ownership*). The customer's equity (ownership) of the asset in period it will keep increasing until the customer has owned the property. The MMP house financing example can be observed in APPENDIX 1. As we can see from the appendix the customer will fully own the house (the ownership is kept increasing until RM 3,000,000) after 20 years with monthly installment (RM 19,343.64).

From above example, we can infer that the risk is borne by both parties according to the capital contribution. This is the basis formation of contract is fairness and justice, as mentioned in Al-Qur'an 4:29

“O You who believe, eat not up your property among yourselves in vanities; but let there be among you traffic and trade by mutual good will; nor kill or destroy yourselves; for verily God hath been to you Most Merciful.”

The criticism is regarding the method of determining the annual interest rate and using the market interest rate as a benchmark. The monthly payment should be more on the rental rate payment which may differ based on the location, characteristic, and risk of the asset.

1.2 *Mudarabah*

The other type of partnership-based financing is *Mudarabah*. *Mudarabah* is a contract in which one party provides capital (*Rabbul Mal*/capital provider) and other party provides work (*Mudarib*/entrepreneur).

There are some legal principles of *Mudarabah* transactions that are needed to be accomplished which are: Offer and Acceptance; Capital (can be trade & non-monetary assets); No debt to be treated as capital; Manner of disbursement (lump sum or in several installments); Profit: the amount received that exceeds the capital; Profit Sharing Ratio should be determined at the time of contracting and profit to be shared should be known; Capital provider bears the loss unless due to trespass or omission; No work interference by capital provider; The entrepreneur should comply with *Shari'ah* rules; The entrepreneur should comply with capital provider's instructions; No guarantee of recovery of fund except for betrayal guarantee (performance bond).

Termination of contract can be happened anytime, however, there are two situations in which the *Mudarabah* contract cannot be terminated³⁷. When the parties agree on certain duration of the contract cannot be terminated before the expiry of that period unless they agree mutually to do so; when the *Mudarib* has already started the business, so the contract is binding.

From the example (APPENDIX 2), we can infer that the revenue/profit earned and also the risk is borne by both parties according to the profit sharing ratio that has been agreed by both parties. We can conclude that *Mudarabah* contract is a fair and justice practice.

CONCLUSION

Islamic financial mode is a complex discipline in terms of conceptual and theoretical framework. The Islamic financial contracts have direct link to the real asset with the purpose

³⁷ Hassanuddeen Abdul Aziz. *Islamic Banking*. 2009. First Edition. IIUM Press

to avoid any prohibited elements in the contract such as *gharar*. All the contracts must be in line with the *Shari'ah* principles and transaction must meet the need of the society in order to achieve *Maqasid Shari'ah*. Therefore, Islamic contract must be fair between parties and involve *iwad* (equivalent counter value) to make it difference with the conventional. Partnership modes such as *Musyarakah* and *Mudharabah* is the best alternative for productive enterprise because it will increase the real value of good and service at the same time provides the fair return between contracting parties. The same thing also will apply to the Sales based modes such *Bay Bithaman Ajil*, *Bay Inah*, *Bay Salam*, and *Bay Istisna* whereby involves physical exchange of commodities.

Therefore, the writers hope this paper can give the clear picture and comprehensive understanding in Islamic and conventional financial contract for financing and the different between two contracts. Furthermore, the writers also hope that this paper can be beneficial for further study of Islamic banking players and student in this field.

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