

# Trading in Islam: *Shari'ah Rules and Contemporary Applications in Islamic Financial Transactions*

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## Abstract

This paper attempts to comprehensively highlight the various Islamic laws and guidelines which govern contracts of exchange involving selling of goods and trading of debts. Muslim jurists have extensively researched, reasoned and deliberated over centuries in order to compile a comprehensive framework of principles Muslims are required to adhere to when engaging in selling of goods and trading of debts. This compilation is based on the rulings derived from the Quran and Sunnah and other secondary sources of Islamic law. The paper introduces the readers to various categories of exchange contracts and examines the elements which may render them valid or void along with details on the general conditions and prohibitions in Islam when it comes to trading. More importantly, the paper discusses the contemporary applications of these contracts in the modern Islamic financial industry and appraises the readers of the current Shari'ah issues and challenges being faced by the Islamic financial institutions. The paper also highlights critical issues which the Islamic financial industry needs to overcome to sustain its tremendous growth along with a few recommendations for the industry to improve its practices in future.

*Keywords:* Islamic banking and finance; Shari'ah; Islamic Law of Contracts

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## 1. Introduction

The global Islamic financial industry flamboyantly progresses ahead with total assets forecasted to exceed USD 1.8 trillion as at end-2013, with more than 600 financial institutions across 75 countries offering Shari'ah compliant products and services (KFHR, 2013). Yet, in spite of this remarkable growth, the Islamic financial sector remains at its infancy, representing only about 1% of the total global financial assets (Reuters, 2012). It is intriguing to find large segments of the Muslim population in densely populated Islamic economies do not utilize Islamic financial services (KFHR, 2013). One of the major

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reasons, among many others, offered for this observation is the lack of understanding and acceptance among the demographics concerning the philosophical foundations of the Islamic financial system.

The sustainability and growth of the Islamic finance industry critically hinges upon the levels of public knowledge and acceptance concerning the products the Shari'ah compliant industry has to offer. There are still questions from most quarters regarding what does Islamic finance offer? How "Islamic" are its products? The traits and modus operandi of the Islamic financial sector, which by virtue is significantly different to the mainstream banking and finance business, is often misunderstood by the mass which fail to differentiate the unique value propositions of the Shari'ah compliant industry. In addition, profound differences within the scholarly community on what are considered permissible and impermissible practices for Shari'ah compliant banking and finance transactions further exacerbate the challenges for this infant industry.

To this end, this paper makes a humble attempt to introduce the readers to the various Shari'ah compliant contracts and concepts which are utilized by the modern Islamic financial industry to offer Shari'ah compliant financial solutions. The paper provides a thorough analysis into the numerous contracts of buying and selling of goods and debts which have been permitted by Shari'ah along with an analysis on the contemporary practices which make use of these Shari'ah compliant contracts to offer Islamic financial products in the modern Islamic banking and finance industry. The paper also dwells upon issues of contention involving certain disputed sale contracts, such as bay al inah (sale and buy back) and bay al dayn (sale of debts), which have divided the Islamic scholarly community on the basis of differences in opinions. The concise, yet in depth, analysis of this paper is highly beneficial for various readers keen on understanding the Islamic perspectives on trading and selling of goods and debts. In particular, the paper may prove to be useful to the academic community, banking and finance professionals, regulators, and other various individuals keen to develop a sound understanding of the Islamic principles of trading and how they are utilized in the modern Islamic banking and finance industry.

Following this introduction, the remaining sections of the paper are organized as follows: Section 2 explains the basic conditions and principles of Shari'ah which govern trading in Islam; Section 3 highlights the Islamic laws on contracts of exchange, including factors which are necessary for the validity of contracts; Section 4 then analyses in detail the various Islamic contracts of sales which are permitted by Shari'ah along with an identification of those which are prohibited. In addition, this section also analyses the contemporary issues in the Islamic financial industry's use of sale contracts along with a discussion on disputed contracts which have divided the Islamic scholarly community. Section 5 adopts a similar approach as section 4, except the analyses and discussions here involve the sale of debts and debt trading in Islamic financial markets. Finally, Section 6 highlights the various critical issues which the modern Islamic financial industry needs to overcome to improve its practices in future. Section 7 provides the concluding remarks and then references bring up the end of this paper.

## **2. Shari'ah rules for Trading in Islam**

The law governing Islamic economic activities comes under the Shari'ah branch of mu'amalat (transaction), which is different from the Shari'ah branch of ibadah that governs matters of devotion and worship. According to the great classical Islamic scholar Ibn Taymiyyah (pp. 16-18; 1987), the hikmah (wisdom) behind such differentiation is to allow flexibility for people to innovate in economic matters when transacting with each other. Thus, Muslim jurists may formulate specific rules that maybe

applicable at any prevailing moment, implying that the rulings in the mu'amalat matters are dynamic depending on circumstances. Nonetheless, Muslim jurists have derived a general framework of principles from the primary sources of Shari'ah which govern the rules of engaging in matters of mu'amalat. This framework of mu'amalat (highlighted in Table 1) incorporates all broad matters that fall under the classification of mu'amalat transactions including selling of goods and trading of debts.

Table 1. General Principles of Mu'amalat Transactions

<b>Principles</b>	<b>Shari'ah Source</b>
<b>Free Mutual Consent</b>	<p>“O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent.” [Chapter 4, Verse 29]</p> <p>“The contract of sale is valid only by mutual consent” [Sunan – Ibn Majah, No. 2245]</p>
<b>Prohibition of Gharar (Indeterminate and Speculative Transactions)</b>	<p>“Abu Hurairah (r.a.) narrated that the Holy Prophet (s.a.w.) forbade sale by pebbles and the gharar sale i.e. indeterminate and speculative transactions”. [Muslim, Vol. 3, No. 1513]</p> <p>“Ali reported that the Messenger of Allah forbade forced purchases from a needy person and gharar purchase and the purchase of fruit before it reached maturity”. [Sunan – Abu Dawud, Vol. 3, No. 3382]</p>
<b>Prohibition of Riba</b>	<p>“O you who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury) (from now onward), if you are (really) believers.” [Chapter 2, Verse 278]</p> <p>“And if you do not do it, then take a notice of war from Allah and His Messenger but if you repent, you shall have your capital sums. Deal not unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums).” [Chapter 2, Verse 279]</p> <p>“O you who believe! Eat not Riba (usury) doubled and multiplied, but fear Allah that you may be successful.” [Chapter 3, Verse 130]</p> <p>Jabir (r.a.) narrated: “The Prophet (saw) cursed the receiver and the payer of interest, the one who records it and the witnesses to the transaction and said ‘They are all alike’ [in guilt]” [Muslim, Vol. 3, No. 1598]</p>
<b>Prohibition of Qimar (any form of gain based on luck or chance) and Maysir (getting a profit without</b>	<p>“O you who believe! Intoxicants (all kinds of alcoholic drinks), gambling, Al-Ansab, and Al-Azlam (arrows for seeking luck or decision) are an abomination of Shaitan's (Satan) handiwork. So avoid (strictly all) that (abomination) in order that you may be successful.”</p>

<b>working for it)</b>	[Chapter 5, Verse 90]  “Shaitan (Satan) wants only to excite enmity and hatred between you with intoxicants (alcoholic drinks) and gambling, and hinder you from the remembrance of Allah and from As-Salat (the prayer). So, will you not then abstain?” [Chapter 5, Verse 91]
<b>Prohibition of Khilabah and Ghishsh (Fraud and Deception)</b>	“1. Woe to Al-Mutaffifin [those who give less in measure and weight (decrease the rights of others)], 2. Those who, when they have to receive by measure from men, demand full measure, 3. And when they have to give by measure or weight to men, give less than due. 4. Think they not that they will be resurrected (for reckoning), 5. On a Great Day,” [Chapter 83, Verses 1-5]  The Prophet (saw) said, “He who deceives is not one of us” [Muslim, Vol. 1, #102]
<b>Prohibition of Two Mutually Inconsistent/Contingent Contracts</b>	Abu Harayrah (r.a.) narrated: “The Prophet (saw) prohibited from two sales in one sale ( <i>bay atan fi bay</i> )” [Sunan Abu Dawud, Vol. 3, No. 3540]
<b>Conformity of Contracts with the <i>Maqasid al-Shari’ah</i></b>	The Prophet (saw) said, “Allah has made the life and property and honour of each one of you unto the other sacred and inviolable like this day of this month in this territory” [Sahih Bukhari, No. 7447]
<b>Profits with Liability</b>	Prophet (saw) said: “Usufruct devolves with liability”. [Sunan Abu Dawud, Vol. 3, No. 3508]  Prophet (saw) said: “A loan with a sale is not permitted, nor two conditions in a sale nor a profit of a thing allowed which is not in one’s liability, nor the sale of what you do not have in your possession”. [Sunan an-Nasa’i, Vol. 7, No. 4625]

Having highlighted the basic conditions and principles of Shari’ah which govern trading in Islam, the papers moves on to section 3 which examines the Islamic laws on contracts of exchange including factors which are necessary for the validity of contracts.

### 3. An Overview of Islamic Law of Contracts

Contracts in Islamic Law have been classified into several categories from various different perspectives in order to facilitate understanding. For instance from one perspective, contracts are conceptually classified into two main categories: unilateral contracts and bilateral contracts (Ahmed, 2011). Unilateral contracts refer to those contracts where one party bequests or provides benefit to another party unilaterally as is in the case of for example gift giving (Hadiyah; Hibah); offsetting of debt (ibra); endowments (waqf); inheritance through will (wasiyyah); etc. A key aspect of unilateral contracts which distinguishes it from bilateral contracts is that the consent of the other party is not a condition for

the validity of unilateral contracts. Bilateral contracts on the other hand consist of remaining transactions where two parties engage together and free mutual consent is required from either of them for the contract to be valid. Examples of bilateral contracts include all forms of buying and selling activities (Bay); partnership activities (Shirkah); activities providing service such as labour contracts (ujrah); lease and hire agreements (ijarah); safe custody and trust services (Amanah); etc. Another kind of categorization is based on the compensatory nature of contracts, that is, contracts are either commutative (Uqood-e-Mu'awadha) or non-commutative/gratuitous (Uqood Ghair Mu'awadha) (Ayub, pp. 124-125, 2007). Commutative contracts are those that allow one party to validly get compensation from the other in consideration of something provided to them such as sale of items, lease of assets, labour services, etc. Non-commutative contracts are those where there is no legal compensation or return to a party in consideration for their services to the other. Examples of this include gift giving, providing loans, offering guarantee or security, etc. Shari'ah dictates that these types of contracts cannot have any compensation provision between the parties for the services offered.

To be entitled as a "contract", it needs to essentially have three elements: a. sighth (consisting of an ijab (offer) and qabul (acceptance)); b. the contracting parties (aqidan); and c. the subject matter of the contract (ma'qud alayh). The jurists of the Hanafi School, however, are of the opinion that there is only one element of a contract which is sighth (form), as it already represents all other elements. Contemporary scholars such as Zuhayli (1984), for instance, introduced a fourth element in the essentials of contracts which is "purpose or motivating cause of contract" while the majority held this element to be within their third element of "subject matter". Nevertheless, these are not a contradiction, rather just a difference in using of terminologies.

With respect to their validity, the majority of Muslim jurists divide the contracts into two categories: sahih (valid) contracts where all the conditions required of a contract are satisfied and batil (invalid) contracts where one or more conditions required of a contract are not satisfied. The Hanafi's however introduce a third category in between Sahih and Batil contracts which they term as fasid (voidable/defective/irregular) contracts (Zuhayli, pp. 71-74, 2003). From the majority opinion, it is easy to distinguish between Sahih and Batil contracts. Sahih contracts are those that satisfy all the requirements of the pillars of contracts as well as meet the general conditions and principles of mu'amalat as required in Shari'ah and which we have reviewed earlier in this paper. Batil contracts on the other hand are those that violate one or more of the requirements of the contracts. However, it is pertinent to note here that there is no disagreement between the Hanafi's and the majority on the classification of Sahih contracts (Madkur, 1960). However, when it comes to violations of conditions, the Hanafi's distinguish between the asl (fundamental components of contracts) and wasf (external attributes of contracts). According to the Hanafi's, a contract which is legal according to its asl but not proper in terms of its wasf is not necessarily a void contract, but instead is a voidable (fasid) contract that can be regularized (made sahih) by removing the prohibited wasf elements.

Let's take an example of a transaction between A and B where A agrees to lend money amounting to RM 1000 to B, who then agrees to return an amount of RM 1000 principle + RM 100 interest to A at a certain specified date. According to majority, this contract is batil (void) as it possess element of Riba. The Hanafi's however will classify this contract as fasid and not batil because it satisfies the pillars of contract from the Hanafi perspective. As long as there is offer and acceptance (ijab and qabul) between the parties which takes place in the same session of contract (majlis al-aqd); and the contracting parties are sane, puberty and mature; and the subject matter is legal, deliverable and existing; the contract is said to be valid in its asl. It is only the element of Riba in this contract of debt which invalidates the contract.

Thus, the Hanafi jurists say that the contract is valid as a qard (loan) contract as Shari'ah allows it but is void due to the Riba attribute which is a wasf of the contract. Therefore, this contract can be regularized (made sahih) by removing the RM 100 interest portion according to Hanafi jurists (Sanhuri, Vol.2: pp. 147-151, 1964).

This section has elaborated on the general foundations of transactions and contracts as per Islamic law. The following section now focuses specifically on the Islamic sale of goods contracts.

#### **4. Sale of Goods in Islam**

##### *4.1. Definition*

The contract of sale in Islam is called 'Al-Bay' which literally means 'exchange' and applies to both sale and purchase transactions. However in the perspective of Islamic sale contracts, jurists have provided the definition that it is the "exchange of a useful and desirable thing for similar thing by mutual consent in a specific manner" (Ibn al-Humam, Vol. 5: pp. 73, 1995). The key idea in sale contracts is that there is a transfer of ownership of the subject matter from the seller to the buyer in exchange for an agreed consideration which is then transferred from the buyer to the seller. To allow for this idea to be incorporated in the definition, other jurists have extended the above definition to include "for the alienation of property" towards the end of the definition (Al-Sharbini, Vol.2: pp.2, 1958). This implies that following the sale, the ownership of the subject matter is exchanged between parties and the buyer is allowed to use the acquired property in any manner he likes within the limits of law.

##### *4.2. Mal (Subject Matter) of Sale Contracts*

In terms of what can become a valid subject matter (mal) for sale contracts, there are differences between the various schools of thought. For instance, the Hanafi's and Malikis consider subject matter of sales to be anything which is desired by people and that can be stored for use at a later date; these schools do not consider benefits and incorporeal rights to be valid subject matters for contracts of sale (Ibn Abidin, Vol.4: pp.3, 1982). The Hanbalis on the other hand include 'beneficial nature' in addition to the desirability and storability functions as valid subject matters. Therefore, they accept transfer of ownership in benefits as valid sales (Ibn Qudamah, Vol. 2, 1367AH). The Shafi's however hold the view that anything which has material value and can be sold is valid to be a subject matter (Al-Sharbini, Vol.2: pp.3, 1958). Some modern jurists have expressed dissatisfaction with the classical definitions and have included everything that has legal and material value amongst people to be valid mal of sale contracts (Zarqa, Vol.2: pp. 122, 1968).

From the primary sources of Shari'ah, Zahra and Mahmood (2001) claim to give evidence that mal is not restricted to corporeal or material property. The Holy Quran [Surah Nisa, Verse 24] stipulates that a husband must give his wife mahr (gift) from his property at the time of conclusion of a marriage contract. From the Sunnah (Sahih Bukhari), we have evidence that the Prophet (saw) advised a man who owned no property to teach his bride some verses from the Quran he had memorized as the Mahr. Zahra and Mahmood (2001) state that these make it clear that the Prophet PBUH recognized intellectual property as a form of mal.

Overall, majority of scholars classify the subject matter into three main categories: corporeal (ain) which refers to property with physical existence; usufruct (manfa'at) which refers to benefits of some kind and; rights (haqq) which refers to special rights over particular properties.

#### 4.3. Types of Permitted Sale Transactions

In terms of various types of sale transactions, Muslim scholars have identified and discussed about as many as thirteen different kinds of contracts of sale (Zahra and Mahmood, pp. 217, 2001). However, Mansuri (2006) lists seven of these contracts which he considers are the important ones in Islamic Law. This paper will consider these seven contracts as listed in Mansuri 2006 (p. 195) and will succinctly discuss each of them in Table 2.

Table 2. Types of Permissible Contracts

Contract	Attributes and <i>Modus Operandi</i>	Prohibition
<b>Bay Muqayadah</b>	Refers to barter trade: must be of the same genus and with immediate delivery and equality.	Barter of <i>Ribawi</i> items: Gold, Silver, Wheat, Barley, Dates, and Salt of different qualities, amount, and deferred ( <i>Sahih Bukhari, Volume 3, Book 38, Hadith No. 506</i> ). <i>Ribawi</i> items are those commodities that are susceptible to <i>Riba al-Fadl</i> (Ayub, pp.43-45, 2007)
<b>Bay Mutlaq</b>	Sale of goods for money	No Prohibition as long as the subject matter is not amongst the forbidden items (alcohol, pork, and other <i>haram</i> items) by <i>Shari'ah</i> .
<b>Bay Sarf</b>	Sale of absolute price for absolute price or money exchange. For instance: a new 10 RM note must be exchanged with an equal value of an old 10RM note; money exchange e.g. where 1USD equals to 3.1RM according to market rate at that time.	No Prohibition as long as the currencies are exchanged in the same session of contract (on-spot delivery and possession) and in equal quality and rate.
<b>Bay Salam</b>	Sale contract where payment is received in advance by the seller from the buyer; but the goods of purchase are delivered at a later date. The key feature of bay <i>salam</i> is that the seller need not be in possession of the goods he is selling in the contract. Conditions include: a. The date of delivery of the goods has to be fixed in <i>salam</i> sale. b. The subject matter in <i>salam</i> sale need not necessarily be in the possession of the seller. c. Sale through a <i>salam</i> contract is only	It is not permissible to sell identical goods, such as wheat for wheat, potato for potato, etc. A <i>salam</i> contract is binding and irrevocable in nature unless there are exceptional circumstances. Examples of exceptional circumstances include death of the supplier, damage to the goods while in possession of the supplier, etc. When the problem arises from the supplier's side leading to no deliverability of the goods, the buyer is entitled to full refund either from the supplier himself or his heirs in the event of death. However, should the buyer be

	<p>permitted for those commodities that can be precisely determined in terms of quality and quantity.</p> <p>d. Payment for the subject matter must be made at the time of contract in <i>bay salam</i> (Zuhayli, pp. 599-624,, 1984; and Mansuri, pp. 202-205, 2006).</p>	<p>the party to meet death, the contract remains in effect.</p>
<b>Bay Istisna</b>	<p>Sale contract that represents modern day order-to-manufacture sale where a manufacturer or artisan is given an order to produce something based on description provided by the buyer. In <i>Istisna</i>, the subject matter is something which needs manufacturing, and the price can be paid anytime during the contract, provided it is specified and agreed at the time of contract. Furthermore, <i>istisna</i> contract can be revoked unilaterally as long as the artisan has not started working on the goods (Al Kasani, 1998). However, <i>Majelle</i> of the Ottoman Empire stipulated that if the manufacturer has bought the goods as per order of the buyer, the purchaser is bound to accept them (<i>Majelle</i>, article 392). The contract is terminated either by completing the job and delivering the goods to the customer or the artisan meet death while his/her heirs are unable to deliver performance of the contract.</p>	<p>For a valid <i>bay' istisna</i>, the materials of the object being made must also come from the manufacturer. Otherwise, if the materials come from the buyer and the manufacturer just provides his labour and skill, the contract is that of <i>ijarah</i> (hire of workmanship services) (Al Kasani, Vol.5: pp.3, 1998)</p>
<b>Murabahah</b>	<p>Sale contract where the seller of an item discloses the true cost of the product to the buyer and both parties agree on a profit margin for the sale which would be the earnings for the seller. It is permissible to fix a profit in percentage such as 5% or 10% of cost. Therefore, the essence of the contract is based on integrity of the seller to disclose the true cost of the product. This contract is commonly known in English as a cost-plus-profit sale.</p> <p>According to Zuhayli (Vol. 4: pp. 704-706, 1984) some conditions for the validity of <i>Murabahah</i>:</p> <p>a. The original price of the commodity has to be necessarily declared during the session of the contract or else the contract is invalid if the parties depart without the original</p>	<p>If the buyer and seller agree on zero profit, that is, the resale of the item takes place at original cost (at par value), then it is known as <i>Tawliyah</i> sale. If the resale is at a lower price than the original cost, the sale is known as <i>wadi'ah</i> sale.</p> <p>Following the execution of a <i>Murabahah</i> contract, if the buyer realizes the seller has not been truthful about the original cost, then Shari'ah allows compensation to the deceived buyer (Sarakhasi, Vol. 13; pp. 86, 1978; Ibn Rushd, Vol. 2; pp. 162, 1950).</p>



	<p>price being stipulated.</p> <p>b. Similarly, the profit amount has to be agreed and added to the original cost price in the contract within the session of contract.</p> <p>c. The subject matter must have relevant cost value that can be precisely ascertained for it to be sold on a Murabahah sale contract. Items of which cost value is not certain or the seller is unaware cannot be sold on a Murabahah contract.</p> <p>d. The subject matter must originally have been procured by the seller through a valid contract in order for it to be sold on a second Murabahah contract. If the original contract was invalid, then the price of the product from that invalid contract is not a legal basis to form the cost of the product in the second Murabahah contract.</p>	
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#### 4.4. Types of Prohibited Sale Transactions

There are a number of sale contracts that are expressly prohibited in Shari'ah based on evidences from the Quran and Sunnah. Most of these sales were practiced by the Arabs during the pre-Islamic period and the Prophet P.B.U.H. forbade them as seen through various narrations of hadith (Shawkani, Vol.5; pp. 156-190, 1982). Some of these prohibited sale contracts are summarized in Table 3:

Table 3. Prohibited Sale Contracts

Contract	Attributes and <i>Modus Operandi</i>	Source of Prohibition
<b>Bay al-Mukhadarah</b>	Sale of fruits, vegetables and grains before they are almost ripe as there is risk of them being spoilt before they are ready for consumption	Hadith of Prophet (saw) quoted in Sahih Bukhari and narrated by Anas ibn Malik that Allah's Messenger (saw) forbade the sale of fruit till they were almost ripe.
<b>Bay al-Juzaf</b>	Sale of food items randomly without determining their quantity	Due to gharar on the quantity of the item. Moreover, food is one of ribawi items which must be free from gharar to make the sale valid.
<b>Bay al-Munabadhah</b>	Throw sale where the seller throws down the goods towards the buyer without the opportunity for him to inspect them. The prohibition is also on barter of goods where two parties mutually exchange goods without any examination by either of them	Al-Bukhari, Kitab Al-Libas (77) no. 967
<b>Bay al-Mulamasah</b>	The subject matter is bought without examining it but just by merely touching it	Same like prohibition of <i>bay al-munabadhah</i>

<b>Bay al-Muzabanah</b>	The sale of fresh fruits without determining its quantity in exchange for dry fruits whose quantity is measured	Al-Bukhari, Kitab Al-Buyu' (34) no. 985
<b>Bay al-Haml</b>	The sale of the unborn foetus of a female animal	Al-Bukhari, Kitab Al-Buyu' (34), no. 968
<b>Bay al-Hasat</b>	A kind of sale whereby the seller announces "from these pieces of cloth, I sell you the one on which falls the pebble thrown in the air".	"Prophet P.B.U.H. Bay al-Hasat" (Narrated by Sahih Muslim)
<b>Mu'awamah</b>	Selling of fruits on a tree, two or three years in advance.	Al-Bukhari, Kitab Al-Musaqah (42), no. 992
<b>Darbat al-Ghais</b>	A sale where the seller proclaims: "I dive into the sea; if I have anything (pearl), it will be yours at such and such price"	"The Prophet P.B.U.H. prohibited Bay Habl al-Habalah, buy the milk of cattle until it is measurable, buy a servant while he is away, buy ghanimah until it is divided, buy from sadaqat until its delivered, and darbat al-Ghais" (Narrated by Ibn Majah)
<b>Asb al-Fahl</b>	A male animal is rented to copulate with a female animal.	Al-Bukhari, Kitab al-Ijarah, no. 2164
<b>Sale of fish in water</b>	The Prophet (saw) forbade such types of contracts which were commonly practiced by the Arabs in pre-Islamic period.	Hakim ibn Hizam asked Prophet P.B.U.H.: "O The Messenger of Allah! A man comes to me and asks me to sell him what is not with me, so I sell him [what he wants] and then buy the goods for him in the market [and deliver]. And The Messenger P.B.U.H. said: "sell not what is not with you" (Sunan Abi Dawood, No. 3503)
<b>Bay Habl al-Habalah</b>	Sale of younglings of animals that have not yet been born	Al-Bukhari, Kitab Al-Buyu' (34), no. 968
<b>Bay al-Kali bi al-Kali</b>	Selling of one debt for another. For example, when the time comes for a debtor to make payment and he is unable to clear his debt, he offers to sell his existing debt in order to get further payment period and offers the buyer additional consideration (Hassan, pp65, 1994).	Al-Hakim, 2/66 no. 2343.
<b>Bay wa Salaf</b>	Simultaneous selling and lending in a contract where a man says to the other: "I shall take your goods for such and such if you lend me such and such".	"Prophet P.B.U.H. said: It is impermissible to combine a sale contract with a lending contract" (Narrated by Abu Dawood and al-Tirmidhi)

<b>Sale of Milk in the Udder of Animals</b>	Selling of milk still within the udder of animals (before milking) without ascertaining its quantity	Same like in the prohibition of <i>darbat al-ghais</i> .
<b>Sale of Food before Possession</b>	The Prophet (saw) forbade the resale of food items before taking actual possession of the items by the seller himself.	In the hadith narrated by Ibn Umar, it is reported that Allah's Messenger also forbade sale of goods on the spot they are bought.

#### 4.5. Contemporary Issues: Islamic Banks Practice of Murabahah

The sale of contract of murabahah is one of the most commonly used modes of financing by Islamic banks and financial institutions. It is normally undertaken in the form of 'Murabahah to Purchase Orderer' (MPO) where the bank itself does not own the subject matter to be sold at the time of client's request; but instead procures the customer's required subject matter from a third party and then sells it to the customer at a mark-up price on a deferred payment basis. Therefore, both the client and the bank are aware of the original price of the goods and subsequently the client is informed on the mark-up portion taken by the bank. So this mode of contract is in fact a combination of Bay al-Murabahah and Bay al-Muajjal (Ayub, 2007).

In Pakistan, the Muslim scholars have expressed doubts about the validity of Murabahah as practiced by the Islamic banks in Pakistan (Mansuri, pp 211-223, 2006). These are few of the issues they raise:

a. The Islamic banks in Pakistan do not in fact purchase the subject matter themselves which the customer requires; instead they provide the necessary finance (equivalent to the market price) required for the customer to purchase the product himself through the appointment of the client as the bank's agent. In this process, it is assumed that the bank has itself purchased the subject matter and sold to the customer at a profit margin. The scholars claim this is not a sale, but more of mark-up financing;

b. The mark-up price is often found to be associated (or basing) with such calculation on the market interest rate, such as BLR (Base Lending Rate), etc., which naturally leads to a suspicion whether it is a Shari'ah compliant product. c. In managing the risk, the bank seems do not take any ownership risk of the subject matter which is a requirement in Shari'ah (al-kharaj bi al-daman) as discussed in earlier sections. The goods ownership and possession of risk must be taken before they can be resold.

In Malaysia, Bay Bithaman Ajil (BBA) is the most widely used contract for home financing (Ramayah & Razak, 2008). BBA contract is also a combination of Murabahah and Bay Muajjal as the subject matter is sold to the clients at a markup and on a deferred instalment payments basis. This contract while being widely practiced in Malaysia is considered impermissible according to the Middle Eastern scholars. The arguments and criticisms of this contract, as seen in the case of Pakistan, is that the Malaysian Islamic banks never take the risk of ownership and liability of the property that they are supposedly selling at a mark-up to the customers. This contract is more like debt financing and not a real sale. Meanwhile, the mark-up charged by the banks on the financing is another issue facing controversy as the benchmark of the mark-up is market interest rates. The resale price of the house is normally calculated using the time value of money formula or future value formula in order for the banks to cover its cost of funds and this often results in very high resale price to the customers. The returns generated are more or less the same as a conventional debt financing contract. However, due to the controversy regarding this contract, a new

home financing concept known as Musharakah Mutanaqisah (Diminishing Partnership) has been developed that aims to mitigate the criticisms of BBA by making banks also take risk of ownership. It also attempts to overcome concerns of interest rates being used as benchmarks by replacing it with rental income.

#### 4.6. Disputed Sale Contracts

##### Bay al-Inah

Bay al-Inah refers to a contract where a person sells something he owns to a buyer on credit for a certain price and then simultaneously buys back the same asset from the same buyer at a lower price on cash payments basis. An example will make this contract clear: A sells his watch to B on credit for one year for RM 100 and then simultaneously buys the same watch back from B on RM 80 cash basis. The implications from this transaction are B receives RM 80 today and has to pay A RM 100 after one year. What this could translate in other words is as if A extended a loan to B of RM 80 today and will receive RM 100 back from B after one year. The difference of RM 20 is the interest on the loan extended by A today to B. Similarly, it can also be that A sells his watch to B on cash basis today for RM 80 and then buys it back from him on credit for RM 100, payable a year from now. The implications from this transaction are A receives RM 80 today and has to pay B RM 100 after one year. What this could translate in other words is as if A borrowed a loan from B of RM 80 today and will pay RM 100 back to B after one year. The difference of RM 20 is the interest on the loan borrowed by A today from B. In Bay al-Inah there is a double sale of the same commodity between the same two parties simultaneously and the original underlying commodity eventually returns to the original owner due to the buy-back nature of the double sale.

The majority of the Muslim jurists consider Bay al-Inah an impermissible contract as in their opinion this contract is a legal ruse (Hilah) to circumvent the prohibition of Riba (al-Badawi, pp. 203, 1940; Ibn Qudamah, pp. 174-177, 1367A.H.). This is not a real sale in their view. They also give evidence from a narration of Aisha where Umm Mahabbah informed her that she had a slave girl whom she sold on credit to Zayd ibn Arqam for eight hundred dirhams. Zayd then decided to sell the slave and Umm Mahabbah bought her back for six hundred dirhams on immediate payment. Aisha said to Umm Mahabbah, what you sold was bad and bad was what you bought. However, Imam Shafi'i did not consider the hadith of Aishah as established in his view and maintained that bay al-inah is permissible (Qurtubi, Vol. 3, pp. 359-360, 1935). Yet, it must be mentioned here that even the Shafi'is do not give bay al-inah tacit approval. According to a study by Rosly and Sanusi (1999), even though Imam Shafi'e adopted a different methodology than the other schools of jurisprudence, the level of his view is similar to the other schools and therefore, there is no significant Shari'ah justification of Bay al'Inah.

For the purpose of our case example, Islamic banks in Middle East do not adopt to Bay al-Inah practices (for example see Fatwa of Al Baraka bank). In Malaysia, Bay al-Inah is considered permissible. In Pakistan, banks had earlier practiced buy-back based mark-up transactions and these were declared non-Shari'ah complaint by the Shari'ah courts of Pakistan.

##### Bay al-Wafa

This sale contract refers to a transaction where a person in need of money (borrower) sells a commodity he owns to a buyer (lender) on the condition that whenever the seller (borrower) wishes, the buyer (lender) would have to resell the same commodity back to him at the same price (Ibn Rushd, Vol.2; pp. 118, 1950). For example, A sells his watch to B for RM 100 with a condition that whenever A wishes,

B will have to sell the watch back to A at the same price. This contract if examined from a different perspective could be considered a loan contract with an object as a pledge. From our example above, A as the debtor gets the RM 100 he needs and B as the creditor has the watch as a collateral. The benefit for B is the utility he can derive while being in possession of the watch as its owner.

Similar to bay al-Inah, this contract is considered as a legal ruse to circumvent the prohibition of Riba. The Hanafi jurists consider this contract valid as long as the condition of resale is not made part of the original contract. The Hanafi jurists suggest that as long as the original sale contract is done in the normal manner and subsequently, another promise contract is issued whereby the buyer (lender; B in our example) promises to resell the object to the original seller (borrower; A in our example), Bay al-Wafa is valid (Usmani, pp. 82-92, 2000). For the Hanafis, legal ruses (Hilahs) are permissible as long as they are compatible with the spirit of Shari'ah. The Shafi'is, Malikis and Hanbalis however have declared the use of Hilah as prohibited (Mahmasani, pp. 119-126, 1961).

#### Tawarruq

Tawarruq is where there are three parties involved in buying and selling transactions to generate liquidity. Similar to bay al-Inah, the underlying objective of this process is where a person needs liquidity and he arranges his required cash through a purchase of a commodity on credit which he then sells on spot for cash (Ayub, pp. 349-351, 2007). An example: B requires RM 100 cash today and he buys a watch from A on credit for RM 120 payable after one year. When B acquires the watch from A, he immediately sells it to C on spot cash sale for RM 100. B gets the RM 100 he needs today and after one year he pays the amount of RM 120 to A which he owed from the original sale. In Shari'ah, tawarruq is acceptable as long as the resale of the object is to a third party and not a buy-back arrangement with the original seller since that will become Bay al-Inah. This is the view of the majority of the scholars from all the four schools of Islamic Fiqh. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) also maintains this view. The Shari'ah scholars and experts in Islamic finance however advise that tawarruq may only be used where there is an unavoidable need for liquidity in the corporate sector.

Another example of tawarruq is when the process amongst the three parties is organized. For instance C tells B to buy the watch from A on cash for RM 100 and then sell it to him on credit for RM 120 (B sells to C on credit from RM 120). This transaction in form does not constitute Riba as long as parties engage in separate sale contracts and there is actual transfer of ownership and risk amongst the three parties. However, Ibn Taymiyyah suggests that if either of the parties B or C had the intention of earning/providing Riba, then this contract is prohibited since actions are to be judged by intentions. So if B cedes to the request of C in the above example with the pure intention of earning Riba profit, then this is a prohibited contract. If the above takes place with the genuine need of B requiring liquidity and it is difficult for him to borrow, then this tawarruq arrangement is makrooh (reprehensible) but not prohibited (Ibn Taymiyyah in al-Fatawa al-Kubra, 440/29 and 431/29, 1987).

Islamic banks employ tawarruq in order to shore up required liquidity. It involves for example Bank A (with surplus cash) buying commodities/stocks that are liquid in nature and selling them at a markup on credit terms to Bank B (that is in need of liquidity). Bank B then sells these liquid assets immediately on spot cash basis in the market to generate cash. In future, when the specified time for payment comes, Bank B pays Bank A the agreed amount in the original credit sale.

### Bay al-Arbun

Bay al-Arbun refers to an advance down payment sale contract where the condition is that if the buyer goes ahead in future and purchases the commodity, the initial down payment shall become part of the selling price. However, if he does not purchase the commodity, the initial down payment is forfeited (Al-Baji, Vol. 3; pp. 495, 1332 A.H.) The validity of this sale contract is disputed as there are two traditions narrated of Prophet P.B.U.H. One quoted by Imam Malik where arbun sale is prohibited and another hadith of Zaid ibn Aslam where Prophet P.B.U.H. permitted it. The majority of the traditional jurists considered the arbun sale as prohibited while Imam Ahmad permitted it. The majority considered it prohibited since this sale involves gharar, risk-taking and earning of money without consideration in return particularly if the down payment is to be forfeited.

However, the Islamic Fiqh Council of the OIC and AAOIFI have allowed arbun sale based on customary practice (urf) in the market place where parties engage in business with free consent and unforeseen events are taken into account. But they make it mandatory for a time limit to be specified in the arbun sale contract (Council of Islamic Fiqh Academy Resolutions and Recommendations, pp. 16-17, 2000). This brings us to the end of the section discussing the sale of goods in Islam. The next section shall now review the sale of debts as per Islamic law.

## **5. Debts in Islam**

### *5.1. Definitions and Classifications*

In Islam, providing loans is a virtuous act that does not call for any sort of compensation to be provided for the provision of the loaned item (Al Jaziri, pp. 300, 1973). Therefore, the debtor is obliged to return the creditor only the loaned item or its equivalent and any stipulation or demand from the creditor for compensation in excess would lead to *riba* which is forbidden. Thus, debt contracts in Islam are classified as non-commutative/gratuitous (Uqood Ghair Mu'awadha).

In Shari'ah, the terminologies used to refer to debts and loans are Qard, Salaf, Ariyah and Dayn. Qard literally means in Arabic 'to cut'. According to Muslim jurists, Qard legally implies giving of anything with value to the ownership of another so that the receiver may available the benefit of the lent item with the condition that the same item or its equivalent should be returned to the lender on demand or at a specified future date (Ibn Hazm, Vol. 6; pp. 347, 1988). Salaf literally means a loan with no profit consideration for the creditor. It is a loan however extended for a specified period and may not be demanded earlier than the specified time. The difference between Qard and Salaf is that Qard is payable whenever it maybe demanded but Salaf is a loan for a fixed time (Ayub, 2007). Meanwhile, ariyah is where one lends a particular commodity to the other for use without any consideration and the borrower has to return the exact same commodity to the lender. The difference between ariyah and qard is that qard is repaid in similar but not the exact loaned commodity whereas in ariyah, the exact loaned commodity is returned. For example, if A lends his car to B for a while and then B returns the same car back to him, this is an example of ariyah. If A however lent RM 100 to B, B will use up this RM 100 for his needs. B will then later repay A RM 100 he borrowed but with different set of currency notes and not the exact same notes originally provided by A in the first place. This is an example of qard.

Ad-Dayn on the other hand is an obligation created as a result of a credit transaction where one of the counter values is deferred. According to Syed Tantawi of Al Azhar (Egypt), "A dayn is incurred either by way of rent or sale or purchase or in any other way which leaves it as a debt to another. Duyun (plural of

dayn, or debts) ought to be returned without any profit since they are advanced to help the needy and meet their demands and, therefore, the lender should not impose on the borrower more than what he had lent" (Syed Tantawi as quoted in Shari'ah Law Reports, pp. 217, 2000 of the Shariat Appellate Bench of the Supreme Court of Pakistan). So for example, if A sells 10kgs of wheat to B on credit for RM 100, then RM 100 is a dayn owed by B to A. This RM 100 debt must be settled in its original principle value and cannot be increased in future should the debtor be unable to pay at the agreed future date because that leads to riba. The date for repayment can be negotiated and in fact Islam encourages creditors to extend additional time if the debtor is in dire straits.

It is useful to mention here that Shari'ah permits 'Husnal Qadha' or gracious repayment of loans/debts. Husnal Qadha is when a borrower repays the lender in excess of the principal out of free consent and without any precondition or demand by the lender. This is compatible with the sunnah of Prophet P.B.U.H. where in a hadith reported in Sahih Muslim, Jabir (r.a.) narrated that Prophet P.B.U.H. owed him a debt and he repaid Jabir in excess of the principal. However, caution must be taken in systemizing Husnal Qadha as it may lead to lenders forming by default explicit or implicit expectations of excess returns on loans and this is against the principles of extending debts in Shari'ah.

### 5.2. Sale of Debts in Islam

As defined earlier, dayn is an obligation created from a credit transaction where one of the counter values is deferred. Bay al-Dayn therefore refers to the sale of this outstanding obligation. Bay al-Dayn can be of two types in terms of consideration payment of sale: bay al-dayn naqd which refers to sale on spot for cash or spot payment of consideration and; bay al-dayn nasi'ah where the consideration payment is deferred. Furthermore, bay al-dayn can be sold to the debtor himself (known as bay al-dayn li al-madin) or to a third party (bay al-dayn li ghayr al-madin) (Al-Darir, pp. 330-335, 1995). We will consider each of these based on the jurists opinions regarding their validity.

#### Validity of Bay al-Dayn Transactions

First of all, bay al-dayn nasi'ah (which fundamentally is a sale of an existing debt on credit which creates another debt) is prohibited by most classical jurists due to its similarity to bay al-kali bi al-kali, which is a forbidden sale contract based on the hadith narrated by Ibn Umar that Prophet P.B.U.H. forbade bay al-kali bi al-kali (Kamali, pp. 127-128, 1998). In the second instance of bay al-dayn naqd, there are differences in opinion amongst the jurists regarding its validity. For bay al-dayn naqd, jurists have made a distinction between sales of debt to the debtor himself (bay al-dayn li al-madin) and sale of debt to a third party (bay al-dayn li ghayr al-madin) (Zuhayli, pp. 14-15, 1998).

When the bay al-dayn naqd is to the debtor himself, the majority of the jurists from the four main schools of Islamic jurisprudence have considered this sale to be permitted. They consider this permitted since this transaction does not have risk of gharar as the debtor himself is acquiring his own original debt. One the main reasons for invalidation of sale of debt has been considered to be the gharar involved should the debtor be unable to deliver. The sale of debt to the debtor himself is more of an offsetting transaction between a debtor and a creditor and the risks of non-delivery is not an issue here (Zuhayli, 1998). Some Hanbali jurists are of the opinion that the validity of bay al-dayn naqd li al-madin depends on whether the debt has been confirmed and due or otherwise. For a due debt, these jurists suggest that the creditor has the right to sell it to the debtor in order to clear the debt between the two parties. For a debt which has not been due yet, their opinion is that it is not permitted for it to be sold to the debtor (Zuhayli, pp. 46, 1998). The Zahiri school of thought however opposes selling of debts altogether regardless of whether it is to the

debtor himself or to a third party. The Zahiri opinion is that debts by their virtue of gratuitous contracts can only be waived and not sold (Moustapha, pp. 45, 2001). According to Ibn Hazm, one of the prominent Zahiri scholars, the sale of debt is not a valid transaction since the subject matter is unknown as its specific characteristics are not observable (Zuhayli, Vol. 5; pp. 345, 1997).

In the context of bay al-dayn naqd li ghayr al-madin, the disagreements amongst the jurists are wider. The Hanafis, Hanbalis, Zahiris and some scholars of the Shafi'i school prohibit sale of debts to a third party since they argue that the underlying transaction has high levels of uncertainty. In matters of debt, the seller (original creditor) does not have control over the fulfilment of the outstanding debt as it is up to the debtor to clear the dues in good faith. Therefore, there is uncertainty in terms of the parties being able to deliver the subject matter of the contract which is the original debt itself in bay al-dayn and not in possession of the seller (the original creditor). The opinion of these jurists is based on the hadith of the Prophet P.B.U.H.: "Sell not what you do not have" [Sunan Abu Dawud, No. 3503]. On the other hand, the Malikis, some Shafi scholars (such as al-Shirazi, al-Nawawi, al-Subki) and some Hanbalis (such as Ibn al-Qayyim) permitted selling of debts on spot payment to a third party arguing that there are no clear texts prohibiting such transactions. These scholars argue that the debt is a right in the possession of the creditor and he has full authority to dispose it of either to the same debtor or to a third party (Moustapha, pp. 50-53, 2001).

### 5.3. Contemporary Issues

The issue regarding sale of debts has become quite prominent in the Muslim world today particularly in Malaysia where efforts are made to establish a dynamic secondary market to enable trading of Islamic debt instruments. In context of modern capital markets, the Securities Commission of Malaysia defines bay al-dayn as a 'transaction that involves the sale and purchase of securities or debt certificates which are issued by a debtor to a creditor as an evidence of indebtedness while conforming to Shari'ah requirements'. The discussion now onwards shall take place on this type of bay al-dayn where the underlying subject matter is an Islamic debt certificate.

#### Validity of Bay al-Dayn Transactions: Contemporary Viewpoints

Amongst the contemporary scholars, bay al-dayn naqd li al-madin (sale of debt on spot payment to the debtor himself) has been upheld as permissible as was the opinion of the majority of the classical jurists. With regards to bay al-dayn naqd li ghayr al-madin (sale of debt for spot payment to a third party), amongst the contemporary scholars many are inclined towards the opinion that accepts its permissibility. The Shari'ah Advisory Council of Malaysia considers bay al-dayn as a permissible concept that can be used in developing Islamic capital market instruments (Shari'ah Advisory Council, pp. 19, 2002). One of the most accommodating contemporary opinions on sale of debts is offered by Dr Siddiq al-Darir (pp. 334-335, 1995) who says:

*"I am supportive of the permissibility of bay al-dayn whether the sale of debt is to the debtor or to a third party, be it for cash or deferred payment, provided that it is clear of riba, gharar of the kind that vitiates the contract due to inability of the seller to deliver, and also sale of what is not owned. This is because no reliable text has reached us on the prohibition of bay al-dayn, and also because the claim over the inability to deliver in bay dayn to a third party is unproven. For we are here concerned with dayn that is admitted, and which the debtor is able to pay. Then also because bay al-dayn responds to a genuine need and it is maslahah for the parties concerned."*



### Bay al-Dayn Transactions: At par or discount?

In conventional financial markets, debt instruments such as bonds are sold at par, at premium or at discount depending on the interest rates in the market rate. Is it permissible to sell the so-created Islamic debt instruments at price other than its par value? In order for this discussion to take place, the Islamic fiqh principle of 'dha' wa ta'ajjal' (debt discounting) has to be introduced and explained.

### Dha' wa ta'ajjal

Dha' wa ta'ajjal refers to the action of a creditor giving discount to a debtor in exchange for early payment of the debt. For e.g. A lends B RM 100 to be paid at 1st January 2014. If A offers B to repay only RM 90 in exchange for full waiver of the debt on 1st December 2013 instead, this action is known as Dha' wa ta'ajjal. There are two views regarding the permissibility of this action in fiqh literature: one view prohibits it and likens this action to 'reverse riba' while the other view permits it claiming that riba is only when a value is to be increased. To explain these views, two opinions of prominent scholars are presented below where one prohibits the action and the other permits it. According to Al-Sarakhsi (pp. 106-107, 2000):

*"If a man owes something to another man, to be paid later, and it is the price of something that has been bought, and he waives part of it in return for bring the payment forward, that is not good because this is the mirror image of increasing the debt in return for delaying payment, which is riba. Do you not see that in the case of a debt that is due, if they agree to increase the debt so that he can pay it later, do you not agree that this is not permissible? By the same token, with regard to the debt that is not yet due, waiving part of it in return for being paid sooner is the same." However, according to Ibn al-Qayyim (as quoted in Shari'ah Advisory Council, pp. 99, 2002), "Riba is not present in this issue whether in reality, language or urf (local custom). As a matter of fact, riba is something that increases whereas this does not happen in dha' wa ta'ajjal. Those who have forbidden it have compared it to riba, whereas there is a clear difference between the two in the words used; either you increase the payment (due to late payment), or settle the debt (in time) – this is riba; quickly settle your debt with me and as an incentive I will discount part of it – this is dha' wa ta'ajjal. Where is the similarity between the two? In addition, there is no nass (textual evidence), ijma (scholarly consensus) and validated qiyas (analogy) that forbid this concept."*

### Dha' wa ta'ajjal: Contemporary Viewpoints

Interestingly, the principle of dha' wa ta'ajjal as applied in bay al-dayn li al-madin transactions in modern times is no longer an issue as it has become a generally accepted practice nowadays. The Islamic Fiqh Academy of OIC (in Resolution No. 66/2/7, 1992) has permitted the practice of debt discounting in exchange for early payments but only for bay al-dayn li al-madin. In its resolution it states:

*"Reduction of a deferred debt in order to accelerate its repayment, whether at the request of the debtor or the creditor is permissible under Shari'ah. It does not constitute a forbidden Riba if it not agreed upon in advance and as long as the creditor-debtor relationship remains bilateral. If, however, a third party is involved it becomes forbidden since it becomes similar to the discount of bills."*

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) also recognizes this principle and remarked in its Shari'ah Standard No. (16) Commercial Paper that:

*"The legal validity of paying less than the value of the paper, when the transaction is between the holder and the first beneficiary, is that it belongs to the category of the issue known as "negotiating a*

*deferred debt for part of it paid promptly.” This is what is known as da wa ta’ajjal (reduce the amount for hastening payment), and according to one opinion it is permissible to undertake such a transaction...” (AAOIFI, pp. 289, 2004).*

Therefore, as seen above, majority of the contemporary scholars have permitted the application of dha’ wa ta’ajjal for clearing of debts between a debtor and a creditor. It must be cleared here however that there is no opinion which gives permissibility for increasing the value of the debt as that it is clearly riba. So sale of debts at premium is not allowed. So what about the case of bay al-dayn li ghayr al-madin that is sale of debts to third parties?

From the above Islamic Fiqh Academy resolution, it is observed that the act of discounting of debt when being sold to third parties is prohibited as it fears it may be equivalent to riba. The contemporary scholars’ state that the permissibility granted for bay al-dayn li ghayr al-madin is only for spot transactions and for selling at par values. The underlying fear is element of riba in these transactions as modern fiat money is considered equivalent to thaman from the Shari’ah point of view and is therefore subject to all the conditions of Shari’ah applicable on gold and silver contracts, riba, zakat, etc. Therefore, if a debt is in the form of money (which is most likely the case) and is being sold for money (again the likely case), then the rules of exchange on ribawi items applies that dictates transaction must be at spot and at par values. Violation of the par value condition is riba. Furthermore, the transaction must be with spot payment of consideration or else the prohibition of bay al-kali bi al-kali (sale of debt for debt) would apply.

#### Difference in Opinions of Islamic Fiqh Academy & Malaysia’s Shari’ah Advisory Council (SAC)

However, in Malaysia the SAC has taken an opposite stand to the Islamic Fiqh Academy’s rulings and considers the principle of dha’ wa ta’ajjal to be applicable on bay al-dayn li ghayr al-madin as well. The differences arise due to the varying interpretations of viewing "debt", whether it is a "dependent or an independent" asset. The SAC of Malaysia argues that when a debt is securitized as an instrument, the nature of the debt itself has evolved into an independent asset that represents a financial right of the owner – referred to as haq maliy’ ayniy (asset-backed financial right). The owner of this independent asset may dispose it off following the rules of sales of goods in Islam and the contracting parties may agree on any price between them. According to their view, this securitized debt is no longer comparable to money but is equivalent to asset-backed financial rights such as stocks, patent rights, etc. (Adawiah, pp 36-37, 2004).

Meanwhile, jurists of the OIC Fiqh Academy argue that the right of the creditor is solely on the receivables from an earlier transaction (Usmani, 2002). Even if the earlier transaction represented a sale of a non-ribawi asset, the creditor after conducting the sale transaction is no longer the owner of the sold asset. Hence, the creditor only has rights over the payment of consideration he is due to receive as a result of the credit sale earlier. Therefore, from this perspective, it is hard to accept that a receivable could be regarded as an independent asset in order for it to become the subject matter of a sale to a third party. Furthermore, the seller (i.e. the creditor) owns nothing other than the money receivable which cannot be sold at any value other than its par. To summarize this view point, Mufti Taqi Usmani (2002) states;

*“In fact, the prohibition of bai’-al-dain is a logical consequence of the prohibition of 'riba' or interest. A 'debt' receivable in monetary terms corresponds to money, and every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to 'riba' and can never be allowed in Shari’ah (p. 100).”*

### Selling of Debt when mixed with other Assets

Contemporary scholars however allow bay al-dayn li ghayr al-madin with discounting (or even at premium) when the securitized financial instrument consists of a combination of real assets ownership and monetary assets receivable as opposed to solely monetary assets. Non-ribawi assets can be sold at other than par values (Ismail, 2004). These Islamic financial instruments are known as sukuk and there are several types of sukuk being traded in the Islamic capital markets (Ayub, 2007). The majority of Islamic capital markets allow trading of financial instruments freely as long as they consist of at least more than 50% real assets and the remaining could be monetary assets. The evidence for this permissibility is taken by scholars from the fatwa on silk clothes where majority of the scholars allow men to wear clothes where the material is up to 49% silk and remaining non-silk. Pure silk itself is prohibited for men to wear in Islam based on a hadith of Prophet P.B.U.H.

The Islamic Fiqh Academy of OIC has discussed the issue of securitized financial instruments consisting of a combination of real assets ownership and monetary assets receivables several times but has not yet issued any official regulation on this matter. During one of the symposiums held at the Islamic Research and Training Institute of IDB on 10th March 2007 as quoted in Ghuddah (pp.9, 2008), the following recommendations were observed:

- (a) *“If the constituents of the sukuk remain cash, then the application of the rules of Sarf would apply.*
- (b) *If the constituents of the Sukuk become debts, then the rules for transactions involving debts would apply.*
- (c) *If the constituents of the Sukuk become “mixed assets that include cash, debts, tangible assets and usufruct, then trading of the mudarabah sukuk is permissible at a mutually agreed price, on the condition that the majority [of the assets] in this situation are tangible assets and usufruct.”*

Based on point (c)’s recommendation, several financial institutions and Shari’ah bodies derived their rulings that as long as tangible assets and usufruct are more than 50% in a securitized financial instrument (and the remaining maybe debt), it can be traded freely at any mutually agreed price. During another seminar of the Islamic Fiqh Academy of OIC also held at the Islamic Research and Training Institute of IDB in March 2007, most of the participants of the seminar arrived at a further recommendation that even if the majority of the assets in a securitized financial instrument are cash or debts, they may still be traded freely. The general guidelines as provided at the end of the seminar and agreed by most participants were:

*“It is permissible to trade the shares of companies, investment sukuk and unit investment trusts at a mutually agreed price, whether spot or deferred. [These shares and sukuk] represent shares in the diffuse, undifferentiated ownership of mixed assets, consisting of tangible assets, usufruct, rights, cash and debts. [The permissibility is] on the condition that those shares, sukuk and units are issued by institutions or companies whose objectives and core activities are lawful in Islam and that a majority of their transactions involve tangible assets (commodities), usufruct (services) or rights. That is based on the consideration that the cash and debts which form part of their present assets are subsidiary and not the primary focus of the activities of these companies or institutions. Their primary activities are trading of tangible assets or services or rights. The debts or cash ensuing from such business activities will not affect trade [in the shares], no matter what amount they are. If the company is new, then trading in [its*

*shares] should only be after the announcement of its establishment and the beginning of its activities with its wealth.” (Ghuddah, pp.10, 2008).*

The conference participants arrived at such a recommendation based on evidences derived from certain hadiths and Islamic Legal Maxims. To give one such evidence:

*Ibn Umar (r.a.) narrated that Prophet P.B.U.H. said, “Whoever buys a palm tree after it has been pollinated, its fruit belongs to the seller unless a condition (to the contrary) is stipulated by the buyer” (Al-Bukhari, Kitab al-Buyu' (37), No. 2090)*

The hadith is taken as evidence for the permissibility of the buyer stipulating a right to the fruit absolutely, whether its ripeness and freedom from defects has become clear or not, despite the authentic prohibition of selling fruit before it becomes ripe. The argument here is that the ripeness of the fruit is subsidiary to the primary intended subject of sale and so the prohibition is overlooked. If the unripe fruit had been the primary objective of the sale, the prohibition would never have been excused.

It is pertinent to sum up the arguments presented in this section and state that the permissibility of bay al-dayn contracts in its various forms is disputed amongst the Muslim jurists. The paper has attempted to illustrate the various views of the Muslim scholars and their reasoning and evidences for their differences in opinion with regards to bay al-dayn contracts. What is more important at this stage, in the author's opinion, is for Muslims to shun the conventional products which are definitive haram and support the Islamic finance industry where there are a few grey areas but is still a better alternative to conventional products. These grey areas need to be further researched by Muslim scholars and Islamic finance experts in order to arrive at clearer solutions.

## **6. Critical Issues and Challenges**

Manifestly, the conventional financial industry practices are predominantly based on 'interest rates' as their driving force along with some other principles of capitalism that are unacceptable in Islamic Law. With the end of the colonialist era and independence of the Islamic nations, there is a re-emergence of Islamic values amongst Muslims which has led them to once again seek compliance with principles of Shari'ah in all matters of life including business transactions.

Nonetheless, there remain a few critical issues which need to be addressed in order for the Islamic finance industry to continue the excellent rates of progress it has made over the past few decades. This paper attempts to highlight a few of these below.

### Education and Awareness

The sustainability of the growth of the Islamic finance industry is significantly dependent upon the levels of public knowledge and acceptance of the products it has to offer. This is quite a big challenge which the industry has to overcome in the following years to come. Comprehensive informational campaigns need to be conducted to educate the masses about the Shari'ah principles that allow the formation of Islamic banks and render its practices permissible. More importantly, the religious leaders who are opposed to the concept of Islamic finance need to be taken on board to explain them the frameworks and principles which make the practices of Islamic finance institutions Shari'ah compliant. Quite ostensibly, levels of public acceptance is key to success.

### Integrity and Credibility

On the onset of the Islamic finance industry, there is a strong calling from the West that morality and financial and banking transactions could not and should not be decoupled. Behavioural finance as a science corpus expanded rapidly, as more and more focus is placed on the issue pertaining the link adjoining finance and good society. Indeed, as we have learned throughout the discussions in sections 2 and 3 that morality and social justness is the inseparable core proposition of doing transactions in Shari'ah and the Islamic financial industry. Undeniably, there exists a sizable proportion of Muslims that explicitly or implicitly doubt the characteristics and true intentions of the Islamic finance industry and its participants. This proportion of Muslims includes some prominent scholars, academics, regulators, and other notable individuals that doubt the Shari'ah position of the Islamic banking products. The reasons for this are several such as some mistakes made by Islamic banks themselves initially; to a lack of understanding about Islamic finance practices on part of individuals. Whatsoever, this issue needs to be addressed. Morality and social justness is the core of doing transactions in Shari'ah and the Islamic finance institutions need to instill this confidence amongst the masses by ensuring good governance and strict implementation of Islamic behavioural principles and business ethics in their operations. Perhaps the industry requires a universal code of best practices formulated especially for the Islamic finance industry and which shall be applicable on all institutions who wish to raise the banner of Islamic finance.

### Shari'ah Interpretations

Several criticisms of the industry are due to differences in opinions of scholars on what is regarded as permissible or impermissible practices. This paper had illustrated quite a number of these differences amongst scholars regarding permissibility of certain modes and concepts of contracts in Islam. As such, this creates confusion amongst the market participants and allows room for doubt amongst Muslims whether an Islamic finance product is really halal or not. The industry experts, Muslim scholars, bodies such as Islamic Fiqh Academy OIC and AAOIFI should move forward towards achieving broader consensus on all disputed issues in order to avoid inconsistencies in industry practices. The Islamic system of governance and rule was historically based on a Caliphate structure where under one Caliph (head of state) all Muslims were united. Perhaps a same Caliphate system is required in the Islamic finance industry where one Caliph (organizational body) represents all institutions and this Caliph decrees what is permissible and what is not.

### Regulatory Frameworks

This issue is particularly important from a corporate perspective. Investors need protection; clients need protection; Islamic finance institutions themselves need to be competitive against non-Islamic firms; someone has to audit and supervise the operations to ensure Shari'ah compliance; etc. Currently, the industry institutions face a number of different legal, regulatory and taxation problems across countries as there are no laws designed for Islamic finance institutions keeping their unique Shari'ah compliant structures in mind. The industry firms are subjected to conventional regulations that are not suitable and which often create uncompetitive burdens for them. Therefore, regulatory frameworks for the Islamic finance industry need to be developed that are distinct from the conventional finance frameworks.

### Product Development

The complex business and trading structures in today's globalized world require equally complex financial instruments and products that are needed by organizations to compete for survival. The conventional finance markets have regularly responded to such needs by means of financial engineering to create products that match firms' requirements. It is a challenge for the Islamic finance institutions to be able to respond to the world markets requirements by developing appropriate products that are

Shari'ah compliant and at the same time competitive enough to be used by firms. This requires substantial efforts by the major Islamic finance bodies around the world that are recommended to collectively research and come up with Shari'ah compliant products based on the needs of the markets today. The key is to ensure the products innovated are acceptable to majority of the scholars in order to avoid loss of integrity for the industry.

#### Appropriate Benchmarks

A large number of skeptics argue that the entire purpose of Islamic banks is defeated when they use conventional interest rates as the benchmark for profitability calculations and therefore most Islamic finance products end up costing the same to a customer as if he were to subscribe to a conventional finance product. They argue that there is a form over substance issue as the Islamic finance products are a mere change of labels and terminologies and structures on paper, but the end substance is to make profits equivalent to what the conventional banks make. This is another major challenge to overcome collectively by all the Islamic finance stakeholders. Scholars have permitted the use of conventional rates as a tool and basis for pricing goods and their usufructs, but the broader challenge is to develop suitable benchmarks which are representative of real profit margins which Islamic institutions may rely on. Conventional interest rates are merely price of loaning money and their use by Islamic finance institutions does not justify their purposes of achieving socio-economic justice as propagated by Shari'ah.

#### Human Resources

In the end, a well-qualified supply of human resources is required to support the industry growth. As per industry estimates, the global Islamic finance industry is poised to require one million professionals by 2020 in various job functions and roles to meet the human capital needs of the Islamic financial institutions (MIFC, 2013). Quite often it is regarded that there is a shortage of experts in the current financial industry workforce who understand the principles and depth of Islamic financial markets. Islamic finance requires experts who not only have comprehensive knowledge of finance, but also technical knowledge on Shari'ah. Some of the critical job functions where talent is needed in the sector include Shari'ah compliant product developers and financial engineers who are responsible for structuring innovative Shari'ah compliant financial solutions tailored to meet the dynamic market needs. In addition, the industry stands to benefit substantially with the addition of talented business leaders who understand the ethical principles of Islamic finance and, in turn, can generate wider acceptance of Islamic financial products from all segments of the market.

### **7. Concluding Remarks**

The global financial crisis has exposed serious underlying weaknesses in the conventional financial system and this has created an opportunity for the Islamic finance industry to prove its worth by making known its distinct values and legal principles. As a result, practitioners and Shari'ah scholars should place more emphasis on innovation to produce Islamic finance products that are true representatives of the Shari'ah principles. By encouraging and supporting factors that make Islamic finance different from the conventional options, the long term value and confidence in the Islamic finance industry could increase. At the moment, there is a risk of losing credibility and reputation as Shari'ah principles are diluted and Islamic finance products are mere replications of the conventional ones.

In order to support this innovation, appropriate legislations for the Islamic finance industry need to be drafted along with competent regulatory bodies to keep a check on industry practices. In this regard, notable efforts have been made by Islamic Development Bank (IDB), Islamic Financial Services Board

(IFSB) and AAOIFI but more needs to be done. It is also recommended that the Shari'ah scholars involved in advisory boards of Islamic finance institutions have an in depth understanding of the financial instruments used in transactions and this is in line with the legal maxim which states 'a ruling is decided based on the understanding (of the issue at hand)' (Ahmed et al, 2010). This could be achieved through more two-way collaboration between industry practitioners and Shari'ah scholars and together they may collectively assess from all angles the Shari'ah compliance aspects of a financial instrument or product.

This paper has attempted to provide a detailed analysis of the Islamic law perspectives regarding sale of goods and trading of debts transactions. Furthermore, it has reviewed the contemporary issues currently facing the Islamic finance industry. The author ends with a reminder of the verse in the Holy Quran: "... whereas Allah has permitted trading and forbidden Riba (usury)". [2:275]

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