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# Islamic Finance within Trading Framework: The Way to Legitimate Profit

Ahmad Faizal Abdul Aziz<sup>1</sup>

## Abstract

Traditional financing has been viewed as exploitation of the poor debtor by the rich creditor where an increase to the borrowed amount (*riba*) is imputed to the loan. The prohibition in Islam is strict, absolute and unambiguous in all forms and intent. Bank interest has been traditionally associated with *riba* and widely discussed by scholars. Sheikh Muhammad Sayyid Tantawi declared that interest-bearing bank deposits are perfectly Islamic, more than Islamic accounts that impose disadvantageous terms on the customer. OIC Fiqh Academy echoed the *fatwa* by upholding the historical consensus on the prohibition of interest. In Malaysia, prohibitions of conventional bank interest have been formalized by the National Council for Islamic Religious Affairs. Acknowledging this fact from the beginning, Malaysia has taken tremendous effort in establishing banking system based on the teachings of Islam but there are still issues raised about the Islamic banking particularly on the lack of innovation in Islamic financing products, operating within the conventional banking framework, compliance issues, and so on. Due to the issues, this paper shall relate the contemporary products of Islamic banking to the framework of sale as outline by the *Shariah*, in order to illustrate whether these products confine to the true spirit of trading while eradicating the bad influence of *riba*. This paper is also supplemented with some practical solutions on the discussions.

**Keywords:** *Islamic Finance, Fiqh Muamalat, Trading, Profit*

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## 1.0 INTRODUCTION

Islam stressed on the needs of positive injunctions to do good and forbid evil (*amar makruf nahi mungkar*). Financial tools like other tools of social and economic interaction can be used for either good or evil. Using the tools of finance for good rather than evil is of primary concern of Islam (**Mahmoud Amin El-Gamal, 2000**) in order to avoid injustice, specifically in the context of Islamic financing. Traditional financing has been viewed as exploitation of the poor debtor by the rich creditor where an increase to the borrowed amount (*riba*) is imputed to the loan. It is therefore *riba* is prohibited in Islam in all forms and intent. This prohibition is strict, absolute and unambiguous. It was reported by Ibn Abi Hatim that Prophet pbuh had made the following declaration pertaining to *riba* during his last sermon on the occasion of his last Hajj.

*"Listen, every amount of interest that was due in Jahiliyyah is now declared void for you in its entirety. You are entitled only to your principal whereby neither you wrong nor be wronged. And the first liability of interest declared to be void is the interest of Abbas ibn Abdul-Muttalib which is hereby declared void in its entirety."*

During the days of *Jahiliyyah* Arab, *riba* was widely practiced. For them it is part of the trade whereby rich merchants can sell goods or rent his money for profit. It had been proven a problem where people in dire needs have no choice but to borrow and incur increment on their borrowing sum. Due to the higher repayment, debtors may not be able to pay back in full in due time and the debt will again be increased. It was observed to lead to injustice (*zulm*) and therefore prohibited by Islam, unlike trade which is encouraged in Islam.

*Those who devour usury (riba) will not stand except as stands one whom the evil one by his touch hath driven to madness. That is because they say: trade is like usury, but Allah hath permitted trade and forbidden usury.*

**(Quran 2:275)**

However, the meaning to the term *riba* is debatable (**Muhammad Taqi Usmani 2001**). The issue of whether the modern interest charged by financial institutions is *riba* has been widely discussed. It has been argued that interest is not *riba* because the increment is small and it is a compensation for loss in purchasing power. The most controversial example came from the mufti of Egypt, Sheikh Muhammad Sayyid Tantawi, who in 1989 declared that interest on certain interest-based government investments was not the forbidden *riba*, and thus permissible. This *fatwa* aroused a storm of controversy, with opposition from nearly all traditional religious scholars and warm praise from secular modernizers. Later Sheikh Muhammad Sayyid Tantawi went even further by saying that interest-bearing bank deposits are perfectly Islamic, and more so than Islamic accounts that impose disadvantageous terms on the customer. He called for change of legal terminology used for bank interest and bank accounts to clarify their freedom from the stigma of *riba* (**Vogel & Hayes, 1998**).

Echoing the *fatwas* by Sheikh Muhammad Sayyid Tantawi, the Islamic Fiqh Academy of the Organization of the Islamic Conference (OIC) has issued a verdict upholding the historical consensus on the prohibition of interest (**Mohammad Omar Farooq, 2006**). In Malaysia, interest charged by banks has always been associated with *riba* and the ruling is formalized during the 32<sup>nd</sup> Muzakarah of the Fatwa Committee of the National Council for Islamic Religious Affairs. Among the decisions, it was declared that conventional loans are forbidden unless due to emergency and interests from bank or financial institutions are unlawful for personal use and the money should be given to the Baitulmal.

With such association, there is no denial that under the interest-based banking system, depositors as well as borrowers are exploited in one form or the other. Acknowledging this fact from the beginning, Malaysia has taken tremendous effort in establishing banking system based on the teachings of Islam starting from the establishment of Tabung Haji, founding of the first full-fledge Islamic bank, the establishment of the National Shariah Advisory Council and so on. Despite the effort, there are still issues raised about the Islamic banking particularly on the lack of innovation in Islamic financing products, operating within the conventional banking framework, compliance issues, and so on.

Due to the issues raised, this paper shall relate the contemporary products of Islamic banking to the framework of sale particularly on the salient features of sales as outline by the *Shariah*. The author is not commenting on whether or not a product is *Shariah*-compliant, but shall illustrate whether these products confine to the true spirit of trading while eradicating the bad influence of *riba*.

This paper shall be structured in the following manner: The following section presents a literature review on the subject; and section 3 illustrates the framework in which Islamic banking is operating. Section 4 will discuss on contemporary Islamic banking products vis-à-vis trading framework; Section 5 provides some practical solutions on the issues; and Section 6 concludes the paper.

## **2.0 LITERATURE REVIEW & METHODOLOGY**

**Mohammad Omar Farooq (2007)** labeled conventional financing is unjust due to interest charge on borrowing and payment to depositor. The gap between income from lending and small commitment to depositors is the profit for the conventional banks. However, based on his research he noted that Islamic financial institutions (IFI) themselves does not truly implement profit and loss sharing, thus calling for innovation and moving away from conventional finance. According to him, IFIs are no different from conventional banks because uses *hiyal* to legitimize transactions and this is a reason for conventional banks jumping into the market as they can easily adapt with the similarity of business. In his research, he noted that the Islamic banking is even more attractive to conventional banks because they can have less risk and bigger margin.

It was reported by **Karen Remo-Listana (2009)** that analyst unanimously said lack of credibility and innovation is hindering leapfrog growth of Islamic finance. This is due to the fact that the industry is still stuck within the conventional banking framework, whereby there is lack of effort in bringing it closer to a *Shariah*-based financing. It was further reported that a member of the Islamic Finance Council of United Kingdom and Executive Board Member of Ernst & Young, Omar Shaikh, **(in Karen Remo-Listana 2009)** said that public is still skeptical on the product whereby the Islamic financial

products does not look as different as conventional products. Additionally, **Parvez Ahmad (2010)** cited findings in a research by Islamic Development Bank on the attitude of customers and bankers of Islamic Financial Institutions (IFIs). He reported that 7 out of 10 do not see the difference between the profit rate and interest, and 7 out of 10 are unwilling to patronize IFIs because there is no difference with the conventional banks.

Financial reporting of Islamic banks as witnessed by **Zainal Azam Abdul Rahman (2010)** show no proof of asset trading. He pointed out an interesting question on how do the IFIs generate profit if there is no evident of trading? It is as if IFIs are purely dealing with financial assets like the conventional banks. In conclusion, he warned that if Islamic banks do not realign themselves to the true teaching of Islam, they may face a massive financial crisis like the conventional banks did.

Existence of the trading framework can be felt and attested if there is consistency and stability of form and substance in *aqad*, legal documentation, financial reporting and *Maqasid al-Shariah* (**Saiful Azhar Rosly, 2010**). For instance in BBA, the contract is valid via *aqad* and the financial reporting of the bank should also show that the bank has initially hold ownership prior to the *murabahah* sale. The sale contract should grant legal protection to the customer in case the asset delivered was defective and with the same respect, bank should receive protection from the court if the customer defaulted on his *murabahah* debt obligation. The *Maqasid* approach should provide insights that the *murabahah* contract does not embrace *riba* values and lifestyles. If *riba* through interest-bearing lending and borrowing is responsible for financial turmoil, *murabahah* financing is not expected to produce economic bubbles leading to similar crises.

**Muhammad Ibrahim (2010)** acknowledges the gap between the practice of contemporary Islamic banks and the trading framework. However, he assures that Bank Negara Malaysia (BNM) is in the position to fix the gap to bring Islamic finance to the next level. Since 1983, the industry had rapidly changed showing BNM's agility and commitment to ensure that Malaysian Islamic financial system remain competitive and relevant. It is hoped that the Islamic banking industry in Malaysia would continue to evolve and move towards the true teachings of Islam.

As a caution to the readers, this paper was not written based on extensive scientific research and employing rigorous methodology in concluding the findings. The author regrouped previous findings and added in his own observation on the operation of Islamic banks. While no current primary research had been conducted for this paper, it may somehow give loose and outdated remarks on his findings if it has been effectively addressed.

### **3.0 ISLAMIC FINANCE WITHIN CONVENTIONAL BANKING FRAMEWORK**

Conventional banking is basically a business of collecting deposit and renting it out for profit. It makes money either way from people keeping their money and those who borrow money from the bank. It is seen that the bank exploited both depositor and borrower in making profit. Islam prohibits commercialization of credit and loan because loan is supposed to be benevolence. It should help people without additional return on money lend.

*Abu Dawud narrated on the authority of Ibn Masud a.s. that Prophet pbuh cursed the one who devours riba, the one who pays it, the one who witnesses it, and the one who documents it.*

Islamic bank is said to be an alternative for conventional banking in offering financial services without charging interest. The Islamic banks in the early days face the reality in their noble effort whereby nearly all laws governing banking and provision of credit were designed for the operation of conventional banks. In this framework, banks are only authorized as financial intermediary. Banks are not supposed to lose depositors money and make money from other means of business except lending money. Islamic banks were allowed to operate in the same framework as conventional banks by circumventing the interest charged in order to make money for their survival.

Another reality that Islamic banks have to face is that they are regarded as substitutes to conventional banks. Public are not ready to patronize the real Islamic bank in their genuine trading business. For many hundred years with conventional banks, deposits

are suppose to be safe and public cannot accept that they are investing in the bank. Depositors are not ready to deposit for free, what more to lose money in the bank's business. All they ever wanted is better return from their deposits. The customers (those who need financing) on the other hand are not ready to pay more to the bank if for instance the outcome of their borrowings yielded huge profit but expects Islamic banks to give out interest free loan (*qard*). The Islamic bank is in the dilemma of surviving and therefore has to follow the market and compete with the conventional banks in terms of rates paid or charged to their customers. This poses problems for the Islamic banks whereby earning fixed long-term income and sharing floating short-term profit with depositors.

Banks are not running charity business therefore they cannot avoid the main purpose of their existence that is to make money. Whether they like it or not, they have to adapt with the conventional framework while not doing it impermissibly. Islamic banks have no choice but to resort to trading in order to make money but it is not done in substance, whereby they are still acting as financial intermediaries as to protect their business. The author argued that such conduct of business does not even transit the assets via their balance sheet and most countries' jurisdiction prohibits investment in assets such as real estate and motor vehicle except for the banks' own use.

The public were soon to realize and argued that the current conduct of Islamic banks is similar to conventional finance and trade is only to facilitate the extra charge on the loan. People later have a negative view on Islam as it allows such transaction to legitimize *riba*, but the actual fact is they are conducting permissible transactions but are unable to move away from conventional framework due to the local jurisdiction, expectation from public and the need to make money and survive in business.

IFIs in running business mirroring the conventional banks induced itself to risks faced by the conventional banks. The bulk of their assets are financial assets i.e. cash and receivables that normally sold to third parties to raise cash and keep the business rolling. The *fatwa* on selling off debts to third party came in time for the Islamic bank to grow and multiply their business. As assets of the Islamic bank is heavy in terms of financial assets, investor may be trading (buying) stocks that mainly have financial

assets as their assets. This may also constitute to *riba* if stocks purchase price is lower than its financial assets.

Despite the pressure upon Islamic banks, some jurisdiction has now open up doors for Islamic banks to own assets for their trading activities. However, the question is how many of these banks have taken the challenge to do the real trading? The truth is Islamic banks are mainly run by bankers who used to have extensive experience in conventional banks and their minds are stuck to conventional banking framework in avoiding risk at all cause even if they have to transfer it to the customers. It seems that Islamic banking is stuck within the conventional banking framework where market instability is self-induced by allowing financial assets to be freely traded.

Having said that, the following section shall illustrate in detail on the trading framework as compared to the current practice of Islamic banking.

#### **4.0 TRADING FRAMEWORK AND ISLAMIC BANKS**

Trade can be defined as exchange of a valuable asset for another or for a consideration with mutual consent. Trade has been encouraged by the Prophet pbuh himself via the following Hadith. Due to the encouragement of trade, Islamic jurisprudence has laid down enormous rules governing the contract of sale, and the Muslim jurists have written a large number of books, in a number of volumes, to elaborate them in detail so that the practice does not go astray from the teachings of the Prophet pbuh.

*Al-Suyuti mentioned a Hadith narrated on the authority of Rafi' that: The Prophet pbuh was asked: "Which are the best forms of income generation?" He replied: "A man's labor, and every legitimate sale"*

Modern Islamic banks were also founded on the basis of trade as an alternative to money renting business conducted by the conventional banks. Nevertheless, as mentioned in the previous parts of this paper, there is skepticism that the conduct is not confine to the real trading framework but rather conventional bank's framework. Let us

review the salient features of the trading framework and compare it with the current conduct of Islamic banks.

### **Existence of the subject matter**

In order to conduct trade, there must be a subject matter (*ma'qud alayhi*) or asset of value that may interest customer. For instance, a car dealer must have cars in his showroom or access to supply of cars from the manufacturer, furniture shop must have furniture, hawkers selling fruits must have fruits and so on. The requirement is strict as one cannot sell something that he does not have as mentioned in the following Hadith. Profits can only be generated from owned assets that usually come with ownership risk if one wanted to avoid what is described as *ribh mala yudman*. The only exception to this rule is in the case of *Salam* and *Istisna'*.

*Ahmad and Ibn Majah narrated on the authority of Abu-Said Al-Khudriy a.s. as The Prophet pbuh has forbidden the purchase of the unborn animal in its mother's womb, the sale of the milk in the udder without measurement, the purchase of spoils of war prior to their distribution, the purchase of charities prior to their receipt, and the purchase of the catch of a diver.*

The benefits of the exception can also be clearly seen in the genuine trade in the modern times. For instance, a merchant may want to buy a truck load of durians to be traded in the next durian seasons. If he waits until the start of the season, he may not be able to secure the stocks for his trade. Instead, he could secure the products from now to be delivered in the future i.e. the next season. This is somehow similar to the modern time forward trade but the consideration must be made at spot in order to avoid sale of future for future (*bai' al-kali bil-kali*). Another example is on *istisna'*. Not every furniture traders run an IKEA or a readymade furniture store. As there is a demand for custom made furniture, the subject matter may not be available on the date of order. The customer may require the furniture to be of certain specification like specific size, design, color, materials, and so on. As this furniture requires some time to be made, *istisna'* allows this kind of trade to be conducted. The same concept applies to the construction of a house, manufacturing of a custom made car, tailoring and so on.

In relation to Islamic banks, trade is conducted to generate profit. For instance, if loans are extended to customer to purchase a house and the repayments are to be in stages (i.e. *bai' bithaman ajil*), profit is not to be made because loans are suppose to be benevolence in nature. Therefore, banks usually buy the house from the customer, mark-up some profit and sell it back to the customer (*bai' al-inah*) on differed terms. By doing this, banks would have make profit upfront only to be recognized in stages since the payment is made in stages. One of the issues would be, since the trade i.e. the buy and sell is almost instantaneous, what justifies the banks to charge such a high profit margin? While it can be argued that the trade is made between willing buyer and seller and the selling price is fixed in advance, there is no evidence to show that the asset changed hands except those stipulated in the Property Purchase Agreement (PPA) and Property Sales Agreement (PSA). The asset does not even enter into the accounting books of the bank.

Another issue would be, in the case of property which is bought from the developer and yet to be constructed, asset would only be delivered to the customer upon completion of the project. Since it is yet to be constructed or halfway in construction, can the asset be traded to the bank and the same is bought back by the customer? In the event of default by the developer i.e. if the property is left abandoned, who should bear the risk? In this case, banks are doing the trade but assume no risk on the delivery of the property. The effect of this is similar to conventional banking whereby risk of ownership is entirely borne by the customer. No wonder Islamic banks prefer to embed BBA property financing with *bai' al inah* rather than *murabahah* where they would be made liable by the customer if the project is not completed on time.

Another issue relates to the Islamic credit card, which is based on the concept of *bai' al-inah*. A *bai' al-inah* credit card should not only be perfected at the sale and buyback process but also the modes of doing the sale and buyback. Some banks confined to the written agreement to conclude the two contracts but certain banks however, are satisfied with verbal *aqad*. While both conducts are acceptable by the *Shariah*, equal attention must be paid on the mechanics of both types of contracts. In other word, *Shariah* risk mitigation should be embedded during the development stage itself. If the

bank is not sensitive towards the conduct of the underlying trade, they might miss out fundamental *Shariah* non-compliant issue like selling the same assets concurrently to different parties at the same time by different staff or worse, selling assets that had been sold off for good.

### **Ownership of the subject matter**

The asset must not only be in existence but also owned by the seller. Logically, a person cannot sell assets owned by another without prior consent. Although it can be argued that certain assets or goods are homogeneous and can easily obtain elsewhere, not all assets can be fit into this category. For instance, although apartment unit of the same block is developed by the same developer using the same building materials, these units are however unique by itself in terms of size, layout design, location of the unit, view, accessibility, location of the parking lot and so on. Further, if one is allowed to sell asset that he does not own or yet to procure, it would constitute to short selling.

In relation to the previous home financing example, the conduct of Property Purchase Agreement (PPA) and Property Sales Agreement (PSA) poses another issue. Usually, the PPA and the PSA are signed before the appointed solicitor and none of the agreement is signed before the customer signed. If properly explained and guided by the solicitor, the customer may first signed the PPA, agreeing to sell his property to the bank and then sign the PSA in purchasing it back from the bank. Since the bank yet to sign the PPA, there is no indication that the bank has already purchase the asset from the customer. Without purchasing it first from the customer, how can the customer agree to purchase a property that belongs to him and not the bank? In another scenario, say the bank signs the PPA before the customer signs both PPA and PSA. This may seems to settle the issue but what if after signing the PPA, the customer decided not to continue with the purchase and reluctant to sign the PSA? Would the bank take ownership of the property? If not, can the trade be considered as a genuine trade?

Another issue of selling asset that is not owned relates to the Islamic credit card. Usually, Islamic banks that are subsidiary of conventional banks do not really have assets of their own. It is due to the fact that they are sharing resources with their conventional parent

bank. This is sanctioned by the *Shariah* as fundamentally the Islamic banks appoint their conventional parent to conduct day-to-day business according to strict *Shariah* rules in selling their products and services, processing the application of Islamic financing, up to the daily squaring off the financial position via the Islamic Interbank Money Market (IIMM). As for their office, they rent part of their parent's office which is already located in prominent business district known to their customers and potential customers. The author does not intend to comment on the conduct of their business but wish to highlight that Islamic banks have minimal non-financial assets of their own.

Due to the fact that they have minimal assets, it would be difficult for these Islamic banks to conduct business based on *bai' al-inah* concept. *Bai' al-inah* can be conducted in both ways, either by buying and selling of customers' asset or the bank's asset. If the bank insist on trading customers' asset, it would be troublesome especially for customers having no equivalent value of assets. If the bank allows the customer to trade their assets that have lower market value than the bank's purchase price, it is a risk for the bank if the customer is reluctant to purchase back the asset at higher price. Therefore, Islamic banks may prefer to trade with asset of value that they do not own i.e. belongs to their conventional parent, for instance ATM machines, car, piece of land or office lot and so on. This issue can further be argued in a different angle.

Firstly, the Islamic bank may argued that they had been allowed to trade the asset of their parent, but the issue is whether they are acting as an agent to their parent or acting on their full capacity as an owner? If acting as an agent, should the parent enjoys the entire sum of profit while the Islamic bank take a meager *wakalah* fee? It can also be argued that the parent acts as an investor (*rabbul mal*) providing asset as capital and the Islamic bank act as entrepreneur (*mudharib*). However, at least part of the profit should go to the conventional parent. It can further be argued that in many cases, these assets are in active use to generate business for the conventional parent. ATM machine may be use to dispense money made from *riba*-based deposits, cars may be used for site visits in *riba*-based financing, office lot may be housing conventional banks, and so on. As the usage of these assets is doubtful, should the Islamic banks involve in trading such assets on behalf of their conventional parents or worse doing it in their own capacity as beneficial owner of the asset?

Another issue would be on the detail of the asset sold. Since the assets are used to facilitate the *bai' al-inah* transaction, certain banks may not pay full attention of the asset like a genuine sale transaction. For instance, if a car is an object of trade, the bank should by right disclose on the detail of the car similar to the event that they wanted to sell off the car for good, but how many of the Islamic banks does inform the customer about the model, maker, registration number, chassis number, engine number, current location, condition of the car and so on and whether it is based on as is where is basis? Further, since the asset is up for sale, should it be listed as current or non-current asset in the accounting books of the bank?

The issue does not end there. This transaction involves selling and buying of assets which either belongs to the Islamic bank or their conventional parent. There is a gap when the asset is sold to the customer and the time it is purchased back by the Islamic bank. It is the period whereby the asset is actually owned by the customer. Since the assets are being actively used by either the Islamic bank or their conventional parent, should the customer be compensated in terms of rental for the usage of the assets during such period despite being a short period of time? It can further be argued that some of these assets may have market value higher than the selling price of the Islamic bank. Since the transaction is legal in Islam where it is based on mutual consent, the customer is not bound to sell back the asset to the bank at a price quoted by the bank. The customer can decide to keep the asset for himself and collect rental generated from the asset or resell it in the open market or even back to the Islamic bank at market price. It is a huge risk for the Islamic bank to lose their critical asset such as ATM machine or office lot to the customer but would this scenario happen? Should the Islamic bank honor the first contract of sale or consider the entire contract as incomplete should the scenario happen?

In order to avoid these problems, the banks may use less important or valuable assets to facilitate *bai al-inah* transactions. In some cases, the bank uses its computer equipment or office equipment that has been fully depreciated. Although buyer and seller is free to fix their own price, would it be sanction by the *Shariah* that the subject matter of trade is of no value and traded at a very high price?

Another issue on ownership relates to *ijarah*. It should be clear for both parties that in *ijarah*, the asset belongs to the bank and the customer is just a lessee or a tenant. Nevertheless, usually the customer would be required to pay a down-payment for the asset. If say 10% of the purchase price is paid by the customer and the balance 90% is paid by the bank, does it mean that the asset is jointly owned by the both customer and the bank, or the bank just purchased the asset for 90% of the price from the customer?

It is common practice for the customer to maintain the asset in terms of paying for services, repairs, road tax and even *takaful* in insuring the asset from calamities or destruction. Additionally, if the asset is being destroyed by natural forces that is neither due to the negligent of the customer nor covered by the insurance, the customer would still be required to pay the rental despite not enjoying the benefit of the asset, as if the asset is his. In these cases, although the asset belongs to the bank, the risk of the ownership is borne by the lessee or tenant. In the worse scenario, if the economy is not well, the customer may not be able to pay his rental. However, he would not be allowed to walk-off just like that. The bank shall auction off the asset and the proceed is used to pay off the outstanding balance as calculated using conventional depreciation method i.e. reducing balance or sum of digit approach. If the amount fall short, the customer must make good of the difference.

We can argue that Islamic banks are just like their conventional counterparts do not favor risk in ownership of asset. The banks however have different view on this. In leasing motor vehicle for instance, the rental charge by the bank is much lower than the market rental rate as quoted by leasing companies. Further in the case of renting property, the bank as the owner of the property should enjoy the rental income and the appreciation of the property value. However, the bank argued that it is common for customer to favor ownership risk and commitment to be borne by the bank i.e. do not want to pay for the property's maintenance, quit rent, assessment and so on but after 20 to 30 years of renting, they do not want the bank to enjoy the ownership gain i.e. to pay for the market price of the property in acquiring it. This is an evident that the mentality of both the bank and the customer still stuck within the conventional banking mentality.

For conventional hire purchase contract, once the contract is signed debt obligation is created. As such, it can be traded to third parties for liquidity purposes. However in *ijarah*, debt is not created until the asset is utilized. Potential debt should not be created because there should not be an obligation by the lessee to rent the asset in the future. Subsequent sale (*thumma al-bai'*) should not come into the picture because the transaction is separate from the *ijarah* contract and shall be entered in the future. Incorporation of subsequent sale will complicate the case further as it would attract the issue of having two contracts in one (*bay'ataan fi bay'ah*). Therefore, future obligations should not be reported in the financial records of the bank and not to be sold to the third party (even by way of *bai' al-dayn*) for liquidity purposes.

Next, we look at *sukuk*. It is also involving assets to be sold to a special purpose vehicle (SPV) for cash, that had subsequently raised cash from investors around the world in a form of *mudharabah* investment. Again, the focus is not on the permissibility of the *sukuk* but whether actual trade had taken place. SPV is acting as a *mudharib* but there is no profit sharing between the SPV and the investors. Further, asset transferred to the SPV is owned by the SPV. However, can the SPV act independently in charging or disposing the assets according to its rational business strategy that is to maximize the wealth of its investors? In comparison to conventional bond, *sukuk* would not suffer default arising from non-payment of coupon. If the original owner of the asset fails to pay rental of the assets (assuming the case of *sukuk ijarah*), the SPV on its own accord can rent the asset to other parties or can sell off the asset to a third party. Either way, the investors should have free hands on the asset but in the case of contemporary Islamic banking, are they allowed to liquidate or transfer the asset without consent from the original owner? Perhaps it is due to the fact that SPV is not an orphan company that is independent from the original owner of the asset. Therefore, there is some conflict of interest issue when it comes to whether it should act in the best interest of the investors (*rabbul mal*) or the defaulting tenant which is also the owner of the SPV.

## ***Hiyal in trade***

It was argued by some that *hiyal* is allowed in Islam to dodge *riba*. Some even use the following Hadith to justify their case about *hiyal* which they claim as advised by the Prophet pbuh:

*Muslim narrated on the authority of Abu Said Al-Khudriy: Bilal visited the Prophet pbuh with some high quality dates, and the Prophet pbuh inquired about their source. Bilal explained that he traded two volumes of lower quality dates for one volume of higher quality. The Prophet pbuh said: "This is precisely the forbidden Riba! Do not do this. Instead, sell the first type of dates, and use the proceeds to buy the other".*

The author however has different opinion on the Hadith and *hiyal* implemented in the modern days financing. The Hadith is more related to genuine trade because dates are the subject matter that is *ribawi* in nature. As such, it cannot be traded with similar subject matter i.e. dates despite having different characteristic in term of quality, but to be traded in the market and consideration received is to be used to purchase another subject matter. But in the modern time, the consideration is used to purchase the subject matter which in turn be sold for a higher consideration. The issue is totally different from the Hadith.

In the Hadith, there are two subject matters of different quality while in the modern sell and buyback or buy and sellback, there is only one subject matter. Further, the calculation of the higher consideration when it is sold (or purchase in certain scenario), corresponds to the calculation method in conventional financing. It may be argued that the higher consideration is resulting from delayed payment by the customer. However, the author is not denying the authority by the *Shariah* to conduct *bai' al-inah* but making a point in his humble opinion that the Hadith does not show any *hiyal* and certainly does not relate to the sell and buyback or buy and sellback. Even the terms buyback and sellback correspond to the same subject matter but in the Hadith, it involve different subject matter.

## **Possession of subject matter**

An owner must have physical or constructive possession of an asset. Assets that cannot be delivered to the customer cannot be sold. For instance, banks are not in the business of selling cars. For banks that are using *murabahah* for their car financing product, effectively do not possess the cars. However, it can be argued that cars are mass produced and the bank can easily get the model requested from any dealer. However, it can be counter-argued that in the case of pre-owned car, the possession is still with the owner or the car dealer. If the bank sells the car to the customer before procuring it in the first place, it may constitute short-selling.

Another similar example is related to the above example of selling asset that belongs to the conventional parent for the purpose of *bai' al-inah* transaction. Certainly the asset is not in the possession of the Islamic bank. It can be argued that it should not be a problem because the asset is owned by the conventional parent and procuring it would not be a problem. However, the asset is specific in nature i.e. a particular car, and it should at least in the Islamic bank's constructive possession. If not, the bank may mistakenly sell off the asset that has been stolen.

## **Certainty of sale and delivery**

Sale and delivery should not subject to preconditions that may lead to uncertainty of the contract. Uncertain outcome may have rendered the sales to be invalid due to *gharar*, and it is prohibited as per the following Hadith. Contemporary options were also discussed by jurists as conditional sale (*al-bai' al-mu'allaq*) because the conclusion of the sale may or may not happen.

*Muslim, Ahmad, Abu Dawud, Al-Tirmidzi, Al-Nasa'i, Al-Darami and Ibn Majah narrated on the authority of Abu Hurairah a.s. that The Prophet pbuh prohibited the pebble sale and the gharar sale.*

Apart from options trading, one can also argue that preconditions are implicit in certain financing although it is not explicitly mentioned. For instance, facility agreement or the

offer letter of the BBA property financing mentioned about both buy and sellback of assets by the bank. As such, it can be construed that the first contract is dependent on the second contract, and they are inseparable. Implicitly, bank does not have intention to purchase such property unless it can immediately and effortlessly sell it back for a profit.

Further, in accelerating the process, the bank may sign off the contracts with list of condition precedents as practiced by conventional banks. While most of the conditions due are supporting documentations, banks have the right to change its mind due to poor supporting and may not proceed with the financing or the trade.

### **Effective transfer of subject matter**

In Islamic contract, the change of subject matter and the price should be instantaneous or hand-in-hand. However, exception is given for BBA, *salam* and *istisna'*. In BBA, subject matter is delivered at spot while payment is deferred, in *salam* payment is made at spot while delivery is at agreed future date, and in *istisna'* payment and manufacturing or construction of the subject matter is made in stages. Nevertheless, we should be cautious that none of these contracts are of future consideration for future subject matter as practiced by conventional derivatives.

In the case of BBA refinancing (with embedded *inah*), the customer enters into a contract with the bank to refinance his house. The house would first be sold to the bank for cash and bought back by the customer for credit. As previously discussed, the two contracts are independent from each other. After the first contract, the bank effectively owns the house even for a short period of time. If the customer stays in the house, should the issue of paying rental to the bank be left silent?

### **Transactions based on promise**

Derivatives are seen as essentials even by genuine business community as a form of hedging against market speculation. However, it is prohibited in Islamic finance due to trading of both subject matter and the price to be affected in the future date (as termed by classical jurists as *al-bai' al-mudaf*) and equivalent tool for hedging in Islamic finance

is yet to be discovered. Therefore, *wa'ad* is used as an alternative solution. This is another issue that has been hotly debated because *wa'ad* is a promise, morally but not legally binding and not enforceable in court unless the promisee suffers actual losses due to the promise (Ismail Wisham, Aishath Muneeza & Rusni Hassan, 2011). Proponents of *wa'ad* said that it is essential especially relating to the need of derivative instruments structured as *wa'ad* in managing risk. Nevertheless, the actual conduct of *wa'ad* does not seem to hold up to the concept whereby the promisee is also binding in delivering the promise made by the promisor.

### **Customer acting as an agent**

As discussed in the previous sections, the banks are not fully and actively involved in trading. This can be seen where even the purchase of asset to be used in their *murabahah* transactions are done via agent. In order to effectively and efficiently purchase assets that needed by their customers, banks are allowed to appoint their own customers as agent. While there is no problem in appointing customer as an agent but the conduct by Islamic banks may pose several questions. Firstly, rarely the banks affect the appointment in writing. Since it is made verbally and it is only a part of the overall contract, the appointment is sometimes ignored either consciously or subconsciously. Next would be the issue of payment. Appointment of agent does not come free and the customer should be compensated for his effort.

Thirdly is the issue of interest. Since the agent is buying an asset which he would later bought from the bank, should the agent act on his or the bank's interest? It is however argued that the bank may have asked the agent to purchase the asset that suits his requirement because it would be later sold to the customer. Since the bank has the intention to sell the asset to the customer, it would be logical for the bank to delegate the preference of the asset according to the customer's preference. Finally is the issue on timing. In some cases, the asset has already been bought by the customer. Therefore the bank actually does not have the option to appoint the customer as an agent to purchase the asset, mark-up the price and sell it to the customer on deferred payment term but to resort to BBA embed with *bai' al-inah*. If this happen the bank has to be cautious about

the documentation involved and be mindful whether their product had been structured in such manner.

### **Intention of the parties**

Intention or *niyyah* plays an important role in determining whether or not the whole conduct is a genuine sale. Intention is always a subject of issue because Islamic banks are viewed like conventional banks as financial intermediaries. As such, like-minded customers patronize Islamic banks to deposit and borrow money rather than doing some investment or trade with the bank. It is argued that in certain *bai' al-inah* or *tawarruq* transactions conducted by Islamic banks, the customers never have the intention to purchase any of the assets sold, be it a piece of land, office lot, office equipment, palm oil, air-conditioners, and so on. The real intention is for cash, which cannot be lent for extra payment. Further, the transactions are conducted by parties known to involve in *riba* for instance the conventional banks running Islamic windows or Islamic banks that belong to conventional banks. Therefore, such organized trading is criticized as a way for banks to legalize *riba*.

## **5.0 WAY FORWARD**

The plausible main issue is that Islamic banks are operating within the conventional bank framework whereby banks are acting as financial intermediaries rather than a true merchant. It seems that *hiyal* is all over Islamic financing as if Islamic way of financing is all about circumventing *riba*. This is a very serious issue especially from the eyes of the public whom do not see the difference between Islamic and conventional financing. It would be a monumental task for Islamic financing to build trust and respect and it is also questionable whether Islamic financing can ride the storm similar to the one faced by conventional banks if the current state of practice is not change. Addressing issues in isolation is likely to cure the symptom but not the disease.

Radical move is needed to shift the Islamic banks from their current comfort to be more active in trading and share the risk and profit of their efforts. For a heavily regulated environment like Malaysia, the regulators willingness to shift the industry plays an

important role in realizing the aspiration. Banks may not be ready for such change of role, for a start perhaps that Islamic bank can be allowed to establish their own boutique finance house that shall be actively involved in trading activities and financed by both unsecured deposits from the public and investment from their parent. This would eliminate the mismatch between deposit and financing while giving better returns for the depositors that willing to share risk and reward with the discount house. The finance house should employ experts in relevant field for their day-to-day operation i.e. real estate investment, leasing, trading of assets and commodities, and so on. Involvement of bankers is to be minimized as not to move the operation back to the conventional form of financing and distort the makeover of the banking sector. Market players have to be innovative in coming up with products that confine to the spirit of *Shariah* while providing solution to the customers. Here are some of the measures or role that could be taken by the finance house.

### **Property financing**

The finance house can undertake to finance the entire project via *istisna'* or *ijarah* eliminating the need of bridging finance or term financing by the developer. The project is owned by the finance house and developer earns fixed profit or fees for their work. Without the need to cover finance cost or even downside risk of material price fluctuation especially in the case of *ijarah*, price of the property can be controlled and minimize by the discount house. The development can also be finance via *mudharabah* or *musharakah* where the finance house would end up purchasing the entire share of the development.

Properties can be sold directly by the finance house as the owner of the project at mark-up price (*murabahah*) to its customers whether on cash or credit terms. Cash buyer would be given discount (*ibra'*) on the purchase price and credit purchaser would need to place a booking deposit (*hamish jiddiyah*) for their purchase while waiting for credit evaluation. Upon approval of credit facility, customers would be given a specific term to settle their purchase price (BBA). Customers who fail to secure financing should be advised on their credit standing and given an option of whether to finance with other finance house or be refunded with their deposits.

Customers whom do not wish to finance their purchase via the finance house that owns the project can do so via other finance house. If there is an integrated system between the finance houses, properties can easily be selected at their preferred finance house. Once confirmed, the preferred finance house shall purchase the property from the owner and pay it in cash at a discounted price. It will then be sold to the customer at a mark-up price in credit terms. This would eliminate the risk of developer abandoning the construction of the house whereby the finance house is the owner and undertake to deliver the property. The trust is even greater for the finance house as compared to the developer. Customer that ends up in difficulty and are unable to pay their instalment can either sell it back to the finance house or external market at market rate. Property sold to the finance house can be leased back to the customer on *ijarah* term.

Apart from *murabahah*, the property can be leased out to customers who do not wish to own it. The finance house can continue act as the landlord and collect rental while enjoying capital appreciation of the property. This would also benefit the customer in renting property from reputable and more responsible landlord i.e. the finance house. On the other hand, customers who wish to share the benefit and risk of movement of the property value can enter into *musharakah mutanaqisah* arrangement with the finance house where both partners would earn income from the rental of the property, incur ownership expenses and dispose-off ownership share at market price of the asset. Customers with financial difficulties can opt to pay the rental portion or rent elsewhere cheaper. The finance house would not suffer any non-performing financing (NPF) as this is their investment together with the customer.

### **Vehicle financing**

In a similar operation, the finance house owns the cars traded by the car dealer. Car dealer act as agent and earns *wakalah* fee. This eliminates the need for floor-stocking facilities by the car dealer and benefited the finance house as the owner in terms of price. Similar to the sale of properties, cars are sold directly by the finance house at mark-up price (*murabahah*) on cash or credit terms. Cash buyer would be given discount (*ibra'*) on the purchase price and credit purchaser would need to secure

financing for their deferred payment (BBA). Similarly, the cars can also be bought at different finance house via the integrated system.

Finance house can also act as a leasing company. Cars can be leased out for a pre-determined period i.e. 1 year, 3 years, 5 years and so on where all ownership expenses are borne by the finance house. Maintenance of the car should be made via appointed workshops as to maintain integrity and cost of the vehicle. Rental fee differs between the cars depending on their age, model, make, resale value and so on. As such, cars that has higher resale value and lower maintenance cost like Perodua Myvi would be cheaper to rent as compared to other cars with similar retail price but higher maintenance cost and lower resale value. This arrangement provides a peace of mind for the lessee despite paying a higher leasing fee as compared to conventional hire purchase, the rest of ownership cost is taken care by the finance house. The only downside of this arrangement is perhaps the car can only be bought by the lessee at a price instead of free even after leasing it for seven to nine years and they cannot modify the car as they wish during the lease term.

### **Credit line**

The use of *bai' al-inah* should be restricted to credit line purposes such as personal financing, credit card, working capital and so on. Finance house that have the facility and access to commodity market should use *tawarruq* instead. Customers should be educated that money can be made via trading. They can either trade their asset for the cash line or purchase commodities from the bank in credit terms and sell it to the market for cash. Independent traders can be housed in the trading hall (or banking hall) and customers are free to trade with them. Discount house that does not have trading facility can keep some amount of precious metals that does not fall under the category of *ribawi* items to be sold on credit terms to the customers which can later be traded to the market for cash. This would avoid the bank to trade the same item for multiple times, trade it concurrently, trade items that does not exist, and so on. Perhaps with the existence of the Bursa Suq al-Sila', trading can be done more effective and efficiently via electronic trading platform. However, finance house have to be mindful that the use of

such mechanism should be limited to credit line requirement, not on all modes of financing.

### **Business financing**

Business financing is seen very risky by bankers even when then return is fixed. As a result of such high risk, conventional banks charge high interest rate for business financing. Co-owning a business with the entrepreneur is a big no for the bankers. However, Islamic banks should rethink in co-owning the business if they are to move away from their traditional function as financial intermediaries. Perhaps another subsidiary with a role similar to venture capitalist should be the solution. This vehicle (VC) would be financed by investors and depositors that can tolerate high level of risk. Other Islamic banks can also invest in one another's VC in order to diversify their risk and return. This setup need to be big enough as to attract expertise to advice on their venture. The VC would not only do the evaluation part mimicking the conventional credit evaluation but also run and monitor the business on daily basis consistent with the mode of financing extended, *musharakah*.

### ***Sukuk***

In the case of *sukuk ijarah*, there will never be NPF if rental payment is not considered as coupon payment like conventional bonds. Rental payment should be allowed to be deferred for few times when the lessee is in financial difficulty. It should also be made known to the lessee that failure to pay the rental will enable the lessor to evict them from the property or worse auction off the properties. It is also plausible to structure it as a real estate investment trust (REIT) whereby the Islamic bank is the trustee. The lessor is given the first option to purchase the entire stake of the REIT whenever they are ready, but at prevailing market value.

The author would also like to highlight a solution given by **Saiful Azhar Rosly & Mahmood M. Sanusi (1999)** in using *sukuk mudharabah*. Corporations raised *sukuk* for one reason, to fund their business. Rather than using debt instrument or asset as a tool, they should consider accepting the financing as investment to their business or project.

Investor should also accept it as investment whereby they shall share the profit of the investment instead of coupon payment and risk in terms of losing part or all of their capital.

The options listed above are non-conclusive and it can be further explored in order to bring the Islamic banks back into genuine trading. Not only the agreement and the structure shows trading made with different parties and risk are shared but the accounting record also shows that the main asset of the Islamic banks or the finance house in this example is made up with tangible rather than monetary assets. The key point here is innovation. Taking the lesson learned from the “blue ocean strategy”, the new framework should not race for the market with conventional bank but we create a niche market of its own. Once the new framework starts to show lucrative profits, then everyone else would start to jump on the bandwagon.

## **6.0 CONCLUSION**

Traditional financing has been viewed as exploitation of the poor debtor by the rich creditor where an increase to the borrowed amount (*riba*) is imputed to the loan. It was observed to lead to injustice (*zulm*) and therefore prohibited by Islam in all forms and intent, unlike trade which is encouraged in Islam. Banking charge of interest has been historically observed to be linked to *riba* and the prohibition is respectively confirmed by the OIC Fiqh Academy and the *Fatwa* Committee of the National Council for Islamic Religious Affairs. Acknowledging this fact, Malaysia has taken tremendous effort in establishing banking system based on the teachings of Islam.

Islamic banks are business entity and therefore have to make profit in order to survive. As money is not allowed to be traded as a commodity, Islamic banks have to resort to trading. Nevertheless, there are still issues and skepticism about the Islamic banking particularly on the lack of innovation in Islamic financing products, operating within the conventional banking framework, compliance issues, and so on. The paper illustrates salient features of trading and compares it to the conduct of Islamic banks.

In order to trade, the subject matter must be in existence and own by the trader. The author brought up some of the issues, for instance the following which related to the *bai' al-inah* credit card transactions:

- Conduct of *hiyal* sale which could lead to selling off the same asset concurrently or selling off assets that has been sold or stolen;
- Selling (or purchasing) assets that has not been properly purchased (or sold) in the context of signing of the PPA and PSA before the appointed solicitor;
- Willingness of the bank to “detach” the two independent contracts (PPA and PSA) in relation to losing crucial assets or end up owning unwanted customers’ assets;
- Issue of profit categorization and legitimacy of the Islamic bank in the case of selling assets that belongs to the conventional parent which is in use for *riba*-making business;
- Transfer of ownership along with risk and reward associated to the asset to the customer;
- Depth of information communicated to customers on assets sold to them;
- Same asset sold to customers repeatedly but not treated as current asset in the balance sheet;
- Intention of the parties whether to trade assets or to borrow and lend money; and so on.

The list is non-conclusive and will never be unless the Islamic banks move away from the conventional framework and acting as the financial intermediaries rather than merchant. In doing so, radical move is needed to shift the Islamic banks from their current comfort to be more active in trading and share the risk and profit of their efforts. For a heavily regulated environment like Malaysia, the regulators willingness to shift the industry plays an important role in realizing the aspiration.

Banks may not be ready for such change of role, for a start perhaps that Islamic bank can be allowed to establish their own boutique finance house that shall be actively involves in trading activities and financed by both unsecured deposits from the public and investment from their parent. This would eliminate the mismatch between deposit and financing while giving better returns for the depositors that willing to share risk with the discount house. The finance house can employ experts in relevant field for their day-

to-day operation i.e. leasing, trading of assets and commodities, and so on. Involvement of bankers is to be minimized as not to move the operation back to the conventional form of financing and distort the makeover of the banking sector. Market players have to be innovative in coming up with products that confine to the spirit of *Shariah* while providing solution to the customers. We should be mindful that commercialization of loans in any forms or name would bring us more harm than good of as the following quote by Ibn al-Qayyim. Total refurbishment is needed for Islamic finance to move on into the next phase rather than sitting at the infancy stage.

*“When people start treating money as commodity of trade, they only have to wait until a crisis come to them, the magnitude of which only Allah SWT know; what must be stressed is that money must be used as capital for business/investment and not as a commodity to be traded in itself”.*

*Wallahu a’lam.* Allah knows best.

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