Rehabilitative Measures for Islamic Financing: Hiwala

By Fakihah Azahari

In the present environment of high interest rates with a possibility of further hikes, it is critical to consider some measures for corporate facilities with the primary aim of mitigating accounts before they are classified as non-performing loans. Malaysia is moving towards this, with the central bank and finance ministry urging banks and financial institutions to reschedule banking facilities.

Mitigation — Actions prior to litigation

The mechanisms for rehabilitative measures currently available include restructuring, rescheduling and private treaty. Another measure which has been adopted in many corporate cases is the assignment of debts. These measures are categorized as mitigative actions, defined as actions prior to litigation. They have a two-fold objective — provide an alternative for both the financier and the corporate customer to negotiate terms of settlement while maintaining good accounts, and prevent costly litigative proceedings.

Assignment of debt is not a new mitigation measure but its use is not widespread in comparison to restructuring and rescheduling. The assignment of debt is a situation where an outstanding balance facility is assigned to a third party who has agreed to continue with the payment of the monthly installment under the customer's account from the date of the assignment of debt until the expiry of the facility tenor. A customer who opts to negotiate for settlement of his obligations in this way not only assigns his debts to a third party with the financial capacity to continue with the monthly payments but also releases himself from his financial obligations towards the financier.

The third party is usually one with a close relationship with the customer such as from father to son or from a company to its director or shareholder. This third party would be in a position to take over the debt due to the proximity of the contractual duties, fiduciary duties or relationship. Since the accounts have been serviced for a few years, the third party would be taking over an account that has an outstanding facility reduced from the original facility. Where the facility is for purchase of an asset, the third party would be taking over a reduced debt and acquisition of asset at a price below the market price. These are factors that may persuade the third party to consider taking over the assigned debt.

The financier has the opportunity to evaluate a myriad of mitigating actions including the assignment of debt which may be suitable for a situation as envisaged above, as the customer is relieved from the obligation of making a lump sum settlement payment. This will greatly assist in the settlement of the account, which can then be reclassified as a performing loan from a non performing loan or stave off from being declared a bad loan.

The Shariah perspective

The Shariah encourages financiers to extrapolate terms of payment that are designed to assist the customers to fully settle their financial obligations. The Quranic injunction that recommends financiers to formulate such terms is in verse 280 of Surah 2: "…and if he (the debtor) is poor, he must be given respite till he is well off. However, if the debtor has delayed the payment despite his ability to pay, he may be subjected to different punishment…" This stipulates that a debtor in genuine financial distress has to be given respite.

The Shariah requires that latitude be shown in a time of hardship. Legal rights such as debts and Hiwala are branches of this legal maxim and such reliefs available to the debtor are deduced from this legal maxim — Article 17 of the Al Mejelle Al Ahkam Al Adaliyyah. Article 18 explains "Where a matter is narrow, it becomes wide," meaning that where there is hardship experienced in business, latitude and indulgence is allowed.

The Shariah offers dynamic forms of financing envisaged for every situation and seeks to provide solutions for each circumstances. The current economic environment merits exploring the remedial measures available to a straitened debtor. For an assignment of debt, Hiwala is the Shariah instrument. Literally it means "turn", in Islamic law the transference of a debt from one person to another.

"The Shariah offers dynamic forms of financing envisaged for every situation and seeks to provide solutions for each circumstances"

Hiwala is an agreement under which a debtor is freed from a debt by another becoming responsible for it. A contract may be discharged by express agreement or by substituting different duties for the old ones. In the modern context, this is evidenced by the execution of an assignment of debt where the debtor legally transfers his debt to another party by way of assignment of debt with the consent of the financier.

In guidelines issued by Bank Negara Malaysia, Hiwala is often equated to remittance. However, the act of remittance referred to under the guidelines is the liability created as a result of the customer purchasing the bank draft from the financier for purposes of remitting money to a third party.

Once the bank draft has been purchased, the liability of honoring the bank draft is transferred from the issuer of the bank draft to the drawee bank which will cash the bank draft into the third party's account. Therefore, the act of remittance here means more than mere transmitting money to a third party. It is in fact the act of transferring liability by the issuer bank to the recipient bank. In essence, it is an assignment of debt from the issuer bank to the recipient bank.

A hadith of the Prophet says: "Delay in payment by a rich man is injustice, but when one of you is referred to a solvent man for payment, let him accept the referral." According to Article 673 of the Mejelle Al Ahkam Al Adaliyyah, "Hiwala is to make a transfer of a debt from one account to the debtor account of the other".

The definition of Hiwala by the Malaysian Securities Commission Shariah Advisory Council is "debt assignment contract". The Accounting and Auditing Organization for Islamic Financial Institutions

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Rehabilitative Measures for Islamic Financing: Hiwala (continued)

(AAOIFI) states that this is permitted in order to facilitate payments and recovery. It is a legitimate and independent contract made out of courtesy and is not a contract of sale.

Hiwala as compared to a contract of sales

A common perception about Hiwala is that it is a form of a contract of sales. However, according to the Shariah, contract of sales is a division of general contract where the general principles of contract and contract of sales are applicable.

There are many types of contracts for example, Ijarah (leasing), Murabahah (mark up price), Mudarabah (profit sharing) and sales. Each contains elements essential for its validity. In a contract of sale, the essential elements are the seller and buyer, the offer and acceptance, the subject matter and the consideration. Contract of sales derives its basis from a contract of exchange described as a contract for the exchange of values; that is exchanging goods between seller and buyer for an agreed price.

Hiwala, on the other hand, ~~is not listed as a type of contract as it~~ falls within the purview of legal rights. It derives its basis from the legal maxim that permits indulgence in times of hardship suffered by the straitened debtor. The elements necessary in Hiwala are the acknowledgement of the debt and consent of the parties to effect the Hiwala, for example, the assignee (person accepting the debt), the customer and the creditor (financier). It is also a condition that the debtor who has assigned his debts to the third party is released from his obligations towards the debts.

Bai Dayn is a deferred liability that arises from a contract involving an exchange of values whereby the payment and delivery are in future. “Dayn” refers to an asset which has no tangible existence but represents an obligation on the bearer.

“Hiwala, on the other hand, ~~is not listed as a type of contract as it~~ falls within the purview of legal rights. It derives its basis from the legal maxim that permits indulgence in times of hardship suffered by the straitened debtor”

According to fatwas published by the Malaysian Securities Commission Shariah Advisory Council, discussions of Bai Dayn are confined to

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Main differences between Hiwala, sale contract and Bai Dayn

Item	Differences	Hiwala	Sale Contract	Bai Dayn
1.	Definition	Transfer/assignment of debt	Contract of exchange for consideration	Contract for the sale of debts
2.	Origin	Legal maxim that permits indulgence in hardship	Quranic verse that enjoins man to engage in trade and business activity	Quranic verse that permits sale of intangible assets
3.	Nature	Continuity of legal rights/ obligations	Exchange of values; for example, exchange of goods for price	Exchange of values where its payment and delivery is deferred
4.	Parties	Debtor, creditor and assignee	Seller and buyer	Seller and buyer
5.	Subject matter	Debts	Tangible goods	Intangible goods
6.	Purpose	Assist a straitened debtor	Obtain lawful profit	Redeem the goods at maturity date
7.	Consideration	Not required due to it being a unilateral contract	Consideration is required due to it being a contract of exchange	Consideration is required due to it being a contract of exchange
8.	Elements	Parties, acknowledgement of debt and consent from all parties to take over the debt	Parties, goods, and price	Parties, goods, price and capable of being delivered in future
9.	Effect	Passing of obligations to the assignee	Passing of ownership of the goods from seller to buyer	Passing of rights to redeem the debt
10.	Price	Debt may be discounted	Price is inclusive of purchase price + profit margin = sale price	Price of Bai Dayn based on market price
11.	Feature	Security subsists and not discharged	Security discharge and recharge	Bai Dayn may be repurchased
12.	Delivery	Delivery upon obtaining consent from financier	For non ribawi delivery may be deferred For ribawi item, delivery on spot	Delivery of receivables on cash basis Delivery on spot
13.	Opinions of jurists	Unanimously accepted by Shafie, Hanafi, Maliki and Hanbali	Unanimously accepted by all jurists	Not accepted by Hanafi. Shafie allows if the debt is guaranteed and delivered on the spot

From the differences listed above, Hiwala is distinct from a contract of sale and a contract of Dayn with the differences being even in terms of definition and nature.

Rehabilitative Measures for Islamic Financing: Hiwala (continued)

Islamic capital market instruments. On that basis, the Council accepts Bai Dayn as a trading activity in the Malaysian capital market. The issues raised are primarily on whether the debt can be sold to a third party and the Shafie Mazhab school of thought (which is followed by a majority of the Muslims in Malaysia) prescribes that the Dayn is guaranteed and paid in cash or tangible asset.

In Hiwala, the assignee would not be able to pay the debt in cash as the assignee is continuing with the obligations of the customer until the expiry of the facility tenor.

> "In Hiwala, the assignee would not be able to pay the debt in cash as the assignee is continuing with the obligations of the customer until the expiry of the facility tenor"

Rationale for Hiwala

The benefits of exploring Hiwala as a form of mitigative actions are:

- Provide another option for the financier and customer to resolve the issue of non-payment of the customer's debt.
- Facilitate the terms of payment of the customer's debt.
- Illustrate the financier's efforts in assisting the customer in managing high costs.
- Create loyalty among the financier's customers towards the financier's institution especially after the end of the economic crisis.
- Offers a wide range of products under Islamic financing schemes.
- Effect a positive response towards efforts to prevent litigation and maintaining the account as a performing account.
- May be seen as an innovative and creative effort by the financier and ultimately the financier projects itself as a market leader in Islamic financing schemes.

Assignment of debt is a process of mitigation providing parties with further avenues to explore settlement initiatives prior to proceeding with litigation. It is appropriate for various facilities including mortgage and corporate facilities and applicable for conventional and Islamic facilities.

For Islamic facilities, it has the added advantage of availing the stamp duty benefits. Implementation of Hiwala reflects the fact that the Shariah is not an archaic form of financing and has in fact provided a solution for all problems including cases of indebtedness; nor does it seek to cause hardship for parties undertaking the Islamic finance transactions.

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MALAYSIA

Cagamas hits big time

All-round success for Cagamas MBS (CMBS) yesterday as its residential mortgage-backed securities of RM2.41 billion (US$694.72 million) nominal value attracted a book size of RM9.10 billion (US$2.6 billion) from a diverse group of domestic and offshore investors, giving an over-subscription rate of close to four times.

Approximately 51.9% of the bids came from institutional investors, with the remaining coming from government agencies (22.6%), asset management companies (13.9%), insurance companies (11%) and corporates (0.6%) (see Islamic Finance news, Vol. 4, issue 31, page 1 for more details).

Despite market jitters in the US sub-prime debt market, investor confidence in the domestic asset-backed securities market was seen from both local and foreign fixed income investors.

SINGAPORE

Trust withdrawn

Arcapita Bank has withdrawn the proposed S$300 million (US$198.29 million) IPO of Arcapita Unit Trust in Singapore. The strengthening of private markets for wind and water assets has caused a widening of the valuation gap between private and public markets, thus disrupting public market expectations.

Arcapita thus believe that divesting assets via a listing would be sub-optimal at present.

The IPO had already been registered with the Monetary Authority of Singapore, and was slated to be the first Shariah compliant business to list in the country.

MAURITIUS

Getting down to business

The Mauritian ministry of finance has passed the 2007/2008 bill on tax measures, which encompasses Islamic banking services.

Rama Sithanen, the country's minister of finance, elucidated: "Mauritius has a great opportunity to diversify its financial sectors and provide foreigners with new services in the fields of wealth management and investment. Existing and new banks will be able to provide such services."

Rama added that Shariah compliant institutions are now able to carry out activities under the existing regulations and legal framework for conventional banks.

GLOBAL

All-time Sukuk high

According to latest reports, the global Sukuk market is valued at US$24.5 billion as at the end of June 2007. This marks a 75% growth over last year.

The Malaysian Sukuk market experienced a growth rate of 71.4%, while the international markets have expanded by 83.3% over the last year. Sovereign Sukuk issues also grew by 521% to US$4.4 billion, with Malaysian ringgit-denominated Sukuk accounting for 70% of the market.

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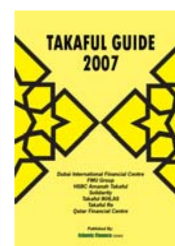

MRTA Packaged Islamic Property Financing: Is it Shariah Compliant?

By Fakihah Azahari

Islamic property financing packages

In Malaysia, real estate financing under Islamic financing packages forms a substantial contribution to the whole Islamic financing sector. It is secured, profitable and provides a beneficial service to the customer. As long as the customer is able to fulfill the criteria set out by the financier, the customer can avail himself of a broad range of services from Islamic property financing packages.

An Islamic property financing package utilizes the mechanism of buy and sale, whereby the financing package is secured and evidenced by way of property purchase agreement, property sale agreement and the charge/deed of assignment (wherever applicable). The financing package is made sweeter with an insurance package thrown in to secure the interests of both the customer and the financier. A financier would probably impose a requirement that the property which forms the security for the financing package is insured up to the full insurable value against fire risks and such other risks as the financier may require.

Insurance scheme part of Islamic property financing packages

Fire risk insurance, which is mandatory in most, if not all, of insurance coverage, aims to protect the property and household goods against loss or damage to property, building and contents, caused by fire, lightning or explosion of gas used for domestic purposes. If customers wish to insure against fire risk, houseowner and householder risk, this is termed as comprehensive risk.

In common situations, a customer applying for a property financing package would be required to subscribe for a Mortgage Reducing Term Assurance (MRTA), whereby it would insure against death and permanent disablement. Similarly, Takaful provides the same protection scheme for customers applying for an Islamic financing package. Notwithstanding this, the financier is at liberty to stipulate to the customer the types of policies for the customer to subscribe to, depending on the risk management policies of the financier.

Insurance contract scheme from the Shariah perspective

In pre-Islamic days, tribal society had a major influence in the lives of each individual belonging to the tribe. Whenever an individual was exposed to a liability beyond his own capacity whilst in the pursuit of a duty towards the tribe, the tribe would assume the obligations to share the burden of the individual. This was based on the concept of mutual interest towards securing the protection of the lives and property of the tribe, and this concept receives the seal of approval from Islam, as it does not contravene the principles of Shariah. From this custom arose the concept of co-operative mutual effort and the promotion of enforcing equity amongst the members of society, a duty which the state is also obliged to protect.

Therefore the concept of "insurance," from the Shariah perspective, has its roots in the institution of "aqilah," whereby initially the tribe would be responsible for the payment of blood money in cases of incidental death committed by a member of the tribe. The payment of blood money ensures that the wronged party would not prolong the dispute between those involved. The modern contract of insurance, therefore, is in conformity with one of the objectives of the Shariah in ensuring generally that the welfare of the community is looked after, especially upon the occurrence of mishaps befalling a member.

Option at the instance of the customer

In an Islamic property financing package, customers have the flexibility to exercise the option to decide on the type of insurance scheme they would like, whether it is MRTA or a Takaful scheme ("the option"). The principle of option (khiyar) in an Islamic contract allows the parties to the contract to exercise the power of choice, option, or refusal or right of withdrawal. This is premised on the basis of mutual consent being an integral part of the contract.

According to a hadith, the Prophet said: "The buyer and the seller have the option to cancel or confirm the bargain before they separate from each other or the sale is optional." Therefore, the customer has the right to exercise his option to decide on the insurance scheme in order to enjoy the best premium rates offered by the insurance scheme. Similarly, the financier is at liberty to offer to the customer both alternatives and, in so doing, the financier is deemed to be in a position to cater to the requirements of the customer in the selection of the more viable insurance scheme.

Shariah issue: can customers opt for MRTA instead of Takaful?

Since an Islamic financing package is always accompanied by its twin sister, that is the insurance scheme, a Shariah issue that constantly places itself before a financier is whether customers who opt for an Islamic property financing package are allowed to subscribe to conventional insurance (MRTA) instead of Takaful scheme. Ideally, an Islamic financing package should be provided together with an Islamic insurance scheme (i.e. Takaful).

However, this may not necessarily be viewed as a viable option, considering that a financier may be under an obligation to promote the business activities and services of its affiliate company which is offering conventional insurance services for property financing packages. Therefore, such a financier may offer an Islamic financing packaged together with its conventional twin – the MRTA scheme, which is deemed to be a non-Shariah scheme.

Formulation by Malaysian jurists

The view taken by the Shariah advisory board of Bank Negara Malaysia advises that a financier may offer an Islamic financing package together with a Takaful scheme or alternatively an MRTA scheme. The condition stipulated by the Shariah advisory board is that if the financier intends to offer an MRTA scheme together with the Islamic financing package, the MRTA should either be paid by way of cash or alternatively, if the customer requires financing of the MRTA, the MRTA shall be financed by way of an Islamic financing scheme.

The basis for the formulation

There are two instances whereby a customer may subscribe to an

continued...

MRTA Packaged Islamic Property Financing: Is it Shariah Compliant? *(continued...)*

MRTA scheme in compliance with the Shariah and thus convert the MRTA into a Shariah compliant scheme. First, the customer may pay by cash for the MRTA scheme; and secondly the customer may take up the option of financing of the MRTA scheme. This may be illustrated as follows:

Payment of MRTA by cash

Financing package		Purpose		Nature
(a) Islamic house financing (e.g. Bai Bithaman Agil)	→	purchase house	→	Islamic
(b) Cash/Islamic financing scheme	→	purchase MRTA	→	Islamic

Rationale for the first ruling

As illustrated in the first instance, where customers are allowed to exercise the option of payment by cash or utilizing an Islamic financing scheme, the activity of the conventional MRTA transaction per se is not prohibited, compared to the act of co-mingling Islamic (halal) and non-Islamic (non-halal) funds. The issue of co-mingling the Islamic and non-Islamic funds does not arise in a cash transaction or an Islamic financing scheme. This transaction does not contravene the Shariah.

Payment of MRTA by conventional financing

Financing package		Purpose		Nature
(a) Islamic house financing (e.g. Bai Bithaman Agil)	→	purchase house	→	Islamic
(b) conventional financing	→	purchase MRTA	→	Non-Islamic

Rationale for the second ruling

According to the Shariah, financing facilities compliant with the Shariah are only permissible for goods (or activities) that do not contravene Shariah principles. As conventional insurance is deemed to be a non-halal activity, the MRTA scheme packaged together with an Islamic financing package and financed via conventional financing is not allowed, as the transaction is viewed as being in contravention of the Shariah.

Authorities

According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the statement of objectives should provide information on the grouping of assets and liabilities in accordance with their nature (Islamic or non-Islamic), and to assist in separating earnings and expenditures prohibited by the Shariah. The guidelines clearly specify that the halal and non-halal source of funds are to be separated. A hadith of the prophet in this respect mentions: “The halal and haram will not mixed except that the halal will prevail.”

Conclusion

We have examined the rationale for the prohibition of the financing of an MRTA scheme by way of conventional financing and understand that our jurists allow the purchase of MRTA for an Islamic financing package based on the above-mentioned provisos. The fundamental basis for the prohibition of financing of MRTA by way of conventional financing is to ensure the separation of the halal and non-halal funds.

As may be observed, the activity of subscribing to MRTA is allowed if the customer pays for the MRTA in cash, or the MRTA is financed by way of an Islamic financing scheme. The activity which is prohibited, therefore, is the mixing of Islamic and non-Islamic funds. An Islamic financing package cannot co-mingle with non-Islamic funds in the form of the MRTA financing scheme, as envisaged in the above-mentioned second scenario.

Financing an MRTA scheme utilizing conventional financing effectively combines the Islamic funds with a conventional fund, which is prohibited by the Shariah. In Islamic financing, one of the cardinal principles to be adhered to is the separation of the source of funds. Therefore, the Shariah is not against the MRTA scheme per se, but seeks to protect the sanctity of the source of funds for Islamic financing packages.

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Contract of Ijarah – Practical Implementations:

A Comparative Analysis with the Malaysian Hire Purchase Act 1967

By Fakihah Azahari

The contract of Ijarah is a widely used concept primarily based on the premise that the jumhur ulama' (majority jurists) are unanimous in their opinion of its acceptability as a form of Islamic financial instrument, as opposed to other Islamic instruments such as Bai Bithaman Ajil, Bai Dayn, Salam and the controversial Bai Inah (to name a few), which are more controversial.

The basis of Ijarah's acceptability lies in the fact that certain issues are ascertained outright. In other contracts of exchange, such as those mentioned above, jurists are divided in their views as to whether discounting is allowed and whether the deferred payment basis is free from elements of riba (unlawful income). An Ijarah contract, on the other hand, is an exchange between mal (property/asset) and manafaah (usufruct/benefit), whereby a person can avail himself of the services of another via the benefit of utilizing a property for a certain rental rate and for a fixed duration. As such, the contract of Ijarah can be defined in various ways and according to its suitability of the usage of mal (property/asset) to derive its benefit.

In Malaysia, the contract of Ijarah has been applied to vehicle financing and certain trade financing instruments. For the purposes of this discussion, we are limiting our scope to Ijarah for vehicle financing. In Ijarah vehicle financing, the general principles of Islamic contracts are applicable, and specifically the principles of Ijarah. It has been the usual practise of financial institutions to assume that Ijarah falls within the ambit of the Hire Purchase Act 1967, due to the familiarity of the Act, which is applicable to all hire purchase agreements, and the convenience of adopting the standard clauses provided in the Act.

Is it necessary for this situation to occur, or is it possible for the Ijarah contract to find its own sovereignty within the context of Malaysian law?

Does Ijarah fall within the ambit of the Hire Purchase Act 1967?

Definition

The contract of Ijarah is a contract of hiring. With some semantic additions, Ijarah can further include Ijarah Thumma Bai. This is a form of contract of hiring with the added feature of "option to purchase" by the customer upon the expiration of the Ijarah contract.

The definition according to Al Mejelle Al Ahkam is as follows:

> "in letting the subject matter of the contract is the benefit of the thing (menafaat)"

The abbreviation "Ijarah" means "letting, hiring or leasing." The sighah (words) "thumma al bai" means "to purchase thereafter." "Thumma" means "after" and "al bai" means "the sale."

Malaysian jurists have included "thumma bai" to protect consumers (customers) against unscrupulous dealers/sellers, as in the past there have been instances where the ownership of the goods was not passed to the customer, despite the customer having fully paid the hire purchase installments. This is also to regulate procedures for repossessing the vehicle, to ensure this is not done in a manner prejudicial to the interests of the customer, and due notice has been given.

In an Ijarah contract, the subject matter is the ability of the customer to utilize the goods in order to derive benefit from them. The key factor in an Ijarah contract is the benefit (manafaah) of the goods. Therefore the Ijarah contract is wider in scope than a hire purchase contract, as it may be applied to movable and immovable goods, as well as to the services of man, as long as the benefit can be ascertained and forms the subject matter of the contract.

For a better perspective, from the owner's point of view, the owner provides goods for hire in order to gain profit by way of rental installments. From the hirer's point of view, he hires the goods in order to derive the benefit from their usage.

As illustrated above, the Ijarah contract differs from the Hire Purchase Act in terms of definition. It is necessary, however, in order to avoid possible future contention, for us to weed out other similarities under the Ijarah scheme with the Hire Purchase Act, and propose other features consistent with the Shariah to further distinguish the differences between Ijarah and the hire purchase agreement.

Hire Purchase Act 1967

The relevant sections under the Hire Purchase Act include section 1(2):

> "This Act shall apply ... in respect only of Hire Purchase agreements relating to the goods specified in the First Schedule."

Section 2 defines consumer goods to mean "goods purchased for personal, family or household purposes."

The Hire Purchase Act attempts to regulate the form and content of the hire purchase agreements. It applies to (as per the First Schedule):

i. all consumer goods;
ii. motor vehicles.

Section 2 defines a hire purchase agreement to mean the letting of goods with an option to purchase and an agreement for the purchase of goods by installment (whether the agreement described the installment as rent or hire or otherwise), but does not include "any agreement."

- section 2(a), whereby the property in the goods comprised therein passes at the time of the agreement or at any time before delivery of the goods; or
- section 2(b), under which the person by whom the goods are being hired or purchased is a person engaged in the trade or business of selling goods of the same nature or description as the goods comprised in the agreement. Option to purchase is automatic upon the expiry of the hiring period.

"Property in the goods" here refers to rights to the goods, which includes rights to sell and/or to repossess the goods by the financier.

In examining sections 2, 2(a) and 2(b) above, for a transaction to satisfy the requirements of a hire purchase agreement, the agreement must be: (i) for a letting of goods with an option to purchase; (ii) the option to purchase is by installment in the form of rent or otherwise; and (iii) the "property in the goods" shall pass at the following instances:

continued...

Contract of Ijarah – Practical Implementations *(continued...)*

Hire Purchase Act 1967	Ijarah
1. Applicable to goods described in the First Schedule of the Hire Purchase Act.	1. Applicable to: (i) movable (including merchandise and animals) and immovable goods (including land and buildings); (ii) services of man (eg the hiring of artisans or people who have special skills in certain areas); and (ii) leasing contracts for manufacturing, trade finance, etc.
2. The terms and conditions in the hire purchase agreement shall fully comply with the Hire Purchase Act, e.g. relating to technical requirements.	2. As the terms and conditions in Ijarah are not bound by the technical requirements of the Hire Purchase Act, parties may vary the terms and conditions accordingly, in accordance with the Shariah.
3. The hire purchase agreement shall be effected in writing.	3. The Ijarah contract may be effected in writing, through correspondence, given that possession and silence is regarded as consent and acceptance.
4. The option to purchase the goods is automatic upon the expiration of the hire purchase.	4. An option to purchase may be stipulated in the Ijarah contract, with a time period for the hirer to exercise his option.

- after the delivery of the goods;
- upon the expiry of the hire purchase agreement;
- upon exercising the option to purchase by the customer.

To summarize, where the "property in the goods" passes at the execution of the hire purchase agreement and at any time before the delivery of the goods, the transaction does not fall under a hire purchase agreement and consequently, the Hire Purchase Act. It is submitted that the Ijarah contract comprises and encompasses all of the above, and more. As such, the scope of the law that governs it may be beyond the Hire Purchase Act.

The objectives of the Hire Purchase Act

The objectives of the Hire Purchase Act 1967 can be outlined as follows:

> "The Act (besides the protection afforded to the consumer by way of a notice system ensuring that goods bought by way of hire purchase are not repossessed without affording the consumer proper notice of his default and the intention of the owner to repossess) attempts to regulate the form and contents of the hire purchase agreements and the rights and duties of parties to such agreements."
> *(excerpt from the Malayan Law Journal (1968) 1 MLJ)*

Thus, the Hire Purchase Act came into being to afford consumers protection when dealing with financial institutions offering such services. Currently the Hire Purchase Act does not specifically state that the Ijarah facility falls within the purview of the Hire Purchase Act. Furthermore, the Hire Purchase Act was formulated and came into effect prior the advent of Islamic banking in Malaysia.

Whether Ijarah falls under the Hire Purchase Act or otherwise may be argued both ways. Transactions or instances or situations that satisfy the requirements of a hire purchase agreement may fall under the Hire Purchase Act. Where the Ijarah contract is able to define and distinguish itself from the Hire Purchase Act, it may also fall under the purview of the Contracts Act and the Sales of Goods Act. The courts would most likely refer to the Hire Purchase Act as the subject matter of an Ijarah contract primarily concerning motor vehicles.

Having considered the primary objectives of the Hire Purchase Act, it is submitted here that the applicability of the hire purchase provisions are relevant insofar as ensuring that the objectives of the formulation of the Hire Purchase Act by Parliament are met.

A brief comparison between the Hire Purchase Act and Ijarah can be seen in the table above, which illustrates that the Ijarah contract covers a wider scope which may include, for example, a contract for hiring consultants in certain industries and leasing for manufacturing and its related trade industries.

What recourse is possible in the event of default by the customer?

The main concern for the adoption of the terms and conditions of the Hire Purchase Act is to enable the owner – in this case, the financier – to take repossession of the goods in the event of the hirer defaulting on his monthly installment. According to the Hire Purchase Act, the owner may repossess the goods by complying with the provisions specified in the Hire Purchase Act.

Similarly, under Ijarah contracts it is permissible to include terms and conditions with regards to the operations of the Ijarah contract, including provisions on events of default, whereby the owner may specify that failure to pay one of the monthly installments constitutes a default on the hirer's part, and consequently action available to the owner may be taken. Upon default the owner may send a notice to demand the arrears, terminate the Ijarah contract and take repossession of the goods.

We may look to the existing clauses of the Hire Purchase Act for applicability, as the main contention is that the clauses in an Ijarah contract should afford the same, if not better, protection to the customer than a hire purchase agreement. Therefore the Ijarah contract can be structured to be consistent with the main objectives of the Hire Purchase Act in terms of ensuring adequate protection to the customer.

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Rulings On Penalty Charges

By Fakihah Azahari

The issue of legitimacy of penalty charges has been discussed by a group of international jurists at the seminar conducted and published by the Al Baraka Investment & Development Co as follows:-

Issue: *Is the principle of holding a dilatory liable to pay damages to the creditor legitimate from the point of view of the Islamic law.*

Answer: *"In Islamic law it is permissible to hold responsible a financially capable debtor who delays payment of debt without any genuine reason, and to compensate the Financier for any loss resulting from late payment. Such a debtor is unjust as the Prophet said "A debtor who delays payment of debt is unjust. The case of such person is similar to that of an unjust decreed that besides returning the capital he should also be made to return any profit made by him on the usurped penalty. This was the majority opinion. Some are of the view that the obligation to pay this amount is a sort of penalty clause based on the principle of public welfare provided any income obtained is spent on legitimate charitable works."*

Jumhur ulama' has taken the view that a person who has the means to repay his debt but delays in doing so is actually committing an unjust act. The liability of the Customer is also subject to the proviso that he is unable to offer any genuine reasons for his delay. It may be constructed that the appropriate rate to be determined may be influenced by factors such as whether there was a willful intention on the part of the Customer to delay his payment or there are other extraneous factors beyond the control of the Customer.

If we were to stretch the element of public welfare evident in the opinion, it is also possible to look at the culpability factor that contributes to the injury committed. Culpability factor occurs where the act of delaying the payment of the debt was due directly by the actions of the person committing the act and precipitated by extraneous factors. The culpability factor may be relevant at arriving at a fair rate of penalty; depending on the circumstances of the case to be weighed by the authority imposing the penalty rate.

When the element of public welfare is taken into further consideration, any penalty charges imposed may be channeled through charitable institutions, subject always to the institution overseeing and supervising the collection and distribution of the penalty charges.

Stipulating a penalty clause (opinion published by international jurists)

Issue: *Is it permissible to stipulate a penalty clause in the case of those who delay paying their debts while they are able to pay.*

Answer: *"It is permissible to stipulate a penalty clause as a deterrent against those who are well off and still delay paying their debts provided the money received from these penalties is spent on works of charity and special welfare. In case there is any taxes to be paid on the amount of penalty the Bank is entitled to deduct these expenses from the penalty for late payment".*

Jumhur ulama are of the opinion that it is permissible to stipulate a penalty clause in the contract between the Financier and the Customer. A valid contract is one that fulfils the conditions if a *sahih (valid)* contract namely; offer and acceptance, subject matter and the contracting parties. It is a fundamental *Shariatic* principle that consent/mutual agreement of both parties to the terms of contract are given effect to. Parties to the contract may stipulate their agreement to a penalty clause in the contract. This will effectively prevent any dispute between the parties in the future as to the rights of the Financier to impose a penalty charge on the Customer. *Jumhur ulama* nevertheless put a condition that any income received from the imposition of penalty charges should go to charitable purposes and welfare.

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Rulings On Penalty Charges *(continued...)*

The rate of penalty charges

Jumhur ulama have left the question of the appropriate rate to be imposed to the experts; the Bankers and Financiers. They have provided some guidelines for consideration namely; whether the debtor is able to offer a genuine and reasonable explanation for their delay; whether willful intention was present at the time the wrongdoing was committed and whether there was a culpability factor.

The injured party may have to decide on what amounts to extraneous factors which gives rise to the culpability factor. Is high interest rate due to recession an extraneous factor or simply a business risk to be shared between the Customer and the Financier. It may be argued by the Financier, that they are the party more vulnerable as high interest rates directly affect its cost of fund. Islamic banking in Malaysia is based on a fixed rate mechanism and Islamic banking would have to absorb the gap between the cost of fund and the profit it has fixed for the Customers in a situation of interest hike.

The rate of the penalty charges to be imposed is dependent on many factors namely the Financier's cost of fund, the administrative charges, expenses, legal costs, etc. The principle in charging penalty charges is to compensate the Financier for any loss or injury suffered by the Financier. The difficulty here would be to actually quantify the actual amount of the losses or injury suffered and determine what was the losses or injury suffered.

The Supreme Court of Pakistan in the case of Dr. M. Aslam Khaki v. Syed Muhammad Hashim 2000 Shariat Law Reports states that "...a service charge based on the actual (eg. Secretarial) expenses incurred by the financier, in advancing a loan can be claimed by him from the Customer.

This principle is derived from the following Quranic verses:

Al Baqarah: 82

> "And the indebted person shall dictate (the document evidencing the debt)"

Here the preparation of the document of loan has been held to be the responsibility of the Customer which naturally means that if this documentation involves some expenses, they will be borne by the Customer. It lays down the principle that the expenses of such nature in a transaction of loan can be claimed by the financier, on condition that they are really based on actual expenses.

It is submitted that a parallel reading of the word "service charge" to include charges incurred by the Financier as a result of the Customer's default is not contrary to the Shariah, Further the Court were of the opinion that if some additional expenses were incurred after the default through sending reminders, they were not necessarily at the same rate the service charge was calculated. They can be less or more if the Financier has to take a legal action against the Customer.

In qualifying the actual losses or injury suffered, the Financier shall have to be able to provide in detail the actual amount and to be able to justify the amount to be charged.

The dividing line between a ribawi (interest based) and non ribawi (non-interest based) transaction here depends to a large extent whether the Financier is able to justify the penalty charges imposed and it is fair and legitimate in the event the Customer challenges the penalty charges. The principle of determining a fair penalty charge therefore should be on the basis of justification.

In examining the concept of ribawi, we find that the majority jurists have unanimously agreed by way of ijma' that 'riba' does not refer to an amount of money or its equivalent, but encapsulates elements of oppression, exploitation and uncertainty.

In the above stated case an opinion submitted by a representative of the Islamic economic scholars on the definitions or 'riba', states "...in order to come within the term 'riba', such return would have to reflect exploitation of the Customer by the Financier..'. It is submitted that the element of 'exploitation' or 'uncertainty' may be contained where the Financier is able to provide the correct information and such information has not been withheld or manipulated to serve their own interest.

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Compensation in Islamic Banking

By Fakihah Azahari

Introduction

In deciding the right principles of compensation in Islamic banking, we must first distinguish the categories of wrongdoing for which the compensation is awarded in Islam. Generally, Islam categorizes wrongdoing into two broad categories, namely torts and crimes.

Tort refers to civil matters, which may include commercial transactions including banking, while crimes are the violations of certain public primary rights, which affect property, the human body, reputation, religion, the state, public peace and tranquility, decency or morals.

The line which divides the two types of wrongs – torts and crimes – is sometimes very narrow or, as the Islamic jurists put it, there are some matters in which the rights of the public and the rights of individuals are combined. The test is to whom the law grants remedy, the public or the individual. In tort cases the remedy is usually awarded to the individual, whilst in crimes the remedy is for the benefit and welfare of the state.

Remedies for torts

The remedies for torts are retaliation (qisas) and compensation (diyah). The legal definition of diyah is remedies for the infringement of man's rights to the safety of his person. Therefore, it is also known as compensation, which is paid by a perpetrator either to the victim himself or to his nearest relatives.

In cases of infringement of a man's right to the safety of his person, restitution and compensation are the remedies provided for the violation of a man's proprietary rights and for other wrongs of a similar character. The authorities for diyah are in 2:178 and 4:92:

> "O you who have attained faith! Just retribution is ordained for you in the case of killing: the free for the free, and the slave for the slave, and the woman for the woman. And if something of his guilt is remitted to a guilty by his brother, this remission shall be adhered to with fairness and restitution to his fellow-man shall be made in a goodly manner." (2:178)

> "... And upon him who has slain a believer by mistake, there is a duty of freeing a believing soul from bondage and paying an indemnity to the victim's relations, unless they forego it by way of charity. Now, if the slain, while himself as a believer, belonged to a people who are at war with you, the penance shall be confined to the freeing of a believing soul from bondage; whereas, if he belonged to a people to whom you are bound by a covenant, it shall consist of an indemnity to be paid to his relations in addition to the freeing of a believing soul from bondage. And he who does not have the wherewithal shall fast (instead) for two consecutive months." (4:92)

While the retaliation is the principle which is most consistent with the peace and progress of society, retaliation is not solely a private right – the right of the public is also mixed up in it. Hence, the state takes charge of its supervision and imposes strict conditions, with a view to preventing the injury caused to the wrongdoer being in excess of what was inflicted by him.

Remedies for wrongdoing in banking

The uncertainties with regard to resolving the issues of remedies in Islamic banking arise from the non-existence of literature by the recognized madzahibs that discusses banking in specifics, or as a form of muamalah. There is no equivalent word for banking in Arabic. The closest is "muamalah" which literally means "activity, manufacture, production" (as an action done as part of practical work or as commonly accepted transactions).

It is erroneous, however, to conclude that the Islamic economic system is a backward system due to the non-existence of a sophisticated and efficient institution such as banking. The Islamic state focused on the establishment of various institutions like zakat, baitul mal, profit-sharing enterprises, trading and commercial houses which performed, amongst other things, the economic functions and mechanics of banks effectively and with precision.

These institutions performed such functions with the objective of ensuring a measure of wealth division and circulation that led to the eradication of poverty, creation of employment, maximization of economic growth, establishment of an equitable distribution system, socio-economic justice and the creation of an environment conducive to economic activity.

Our jurists nonetheless wrote at length on commercial transactions and each madzahib (recognized school of thought in Islam) compiled their opinions on commercial transactions (with a special emphasis on sale and buy) in their respective treatise, which are referred to as guidelines in the present day.

Modern day Islamic banking mainly operates by utilizing the mechanism of selling and buying, and applies the principles of such transactions in their banking products. It is reasonable, therefore, to categorize banking as commercial transactions, and the remedies that a banker can avail himself of lie in torts.

The principles applied would be on the basis of qisas and diyah. Diyah may be applied in cases of infringement of individuals' rights and/or properties and to institutions that represent a certain group of people. As mentioned earlier, retaliation cannot be allowed to award the injured party more than the injury suffered. Similarly, compensating the injured party should be commensurate with the injury suffered, or achieve the objective of restoring the injured party to his circumstances before the injury was committed. In an ideal situation, it is necessary for the state or, under the present circumstances, an authority (Central Bank) to decide on the appropriate penalty.

The legal rule

The legal methodology (fiqh) utilized in proving the rule of diyah as an appropriate form of compensation for Islamic banking is based on qiyas. Qiyas is a process of systematic reasoning to discover the outcome of analogical deduction.

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Compensation in Islamic Banking *(continued...)*

In fact, most of the legal material contained in the fiqh literature is a result of analogical deduction. Literally, qiyas means to measure or to compare. Thus, qiyas suggests an equality or close similarity between two things, one of which is taken as the criterion for evaluating the other.
For example, wine (khamr) has been clearly prohibited in the Quran. The basis of its prohibition is its character of causing intoxication and inability to utilize one's mental capacity to the fullest. By analogy, every other material that can cause intoxication with this effect is prohibited.

In Islamic banking, a wilful default by the customer has the same effect of infringement and/or violation of the rights of the individuals or groups of people as in diyah. Thus the effect of infringement and/or violation of such rights is the criterion for evaluating the legal application.

The majority of jurists are of the opinion that a just and equitable principle of restituting the injured party is based on the principle of compensation (diyah). The differences of opinion lie in the rate of compensation and in whether the financier is entitled to the compensation, or such compensation should be channeled to charitable organizations, such as zakat or baitul mal.

Imposition of penalty charges in Islamic banking

A landmark case decided by the Supreme Court of Pakistan and reported in its *Shariat Law Journal* discusses at length the definition and forms of riba and whether the commercial interests of the modern financial system fall within the definition of riba as prohibited by the Quran. It also discusses the imposition of late charges in commercial banking transactions. The learned judge brought forth the following arguments:

> "According to the Quran, a person who is unable to pay his debts because of poverty should be given more time till he is able to pay without the imposition of any additional sum over and above the principal he is supposed to repay."
>
> "And if he (the debtor) is poor, he must be given respite till he is well-off. However, if the debtor has delayed the payment despite his ability to pay, he may be subjected to different punishment." (2:280)

A person who is unable to pay due to poverty will, according to the clear Quranic command, have to be given further time, but if he is purposely delaying the payment, he will be subjected to punitive steps. As the court did not elaborate on the form of punishment, it can be surmised that the competent authority (Central Bank) has the legal right to formulate the appropriate form of punishment.

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