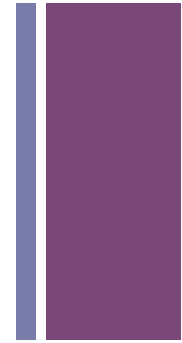


## Issues and Challenges in Islamic Finance

**Zulkifli Hasan, PhD**

# + Contents

- Issues and Challenges in Islamic finance

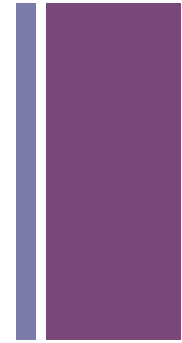


## + Issue 1: Legal Ruses

- El Gamal, (2006) severely criticizes the existing practice of Islamic finance by claiming that IFIs have heavily used ruses in their products and services to circumvent Islamic prohibitions. Shariah arbitrage that increases the transactional cost which is unnecessary.
- Saleem, (2006) posits that Islamic finance is 'deception' and 'charade'

## + Issue 2: Formalist Deadlock

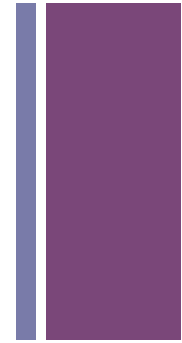
- Balz, (2010): Islamic finance is experiencing a ‘formalist deadlock’ where the industry is more concerned with formal adherence to Islamic law instead of promoting Islamic ethical values.
- Siddiqi, (2004): the existing practice of Islamic finance in which too much focus and reliance on jurisprudence and little weight given to the scientific aspects of the discipline.





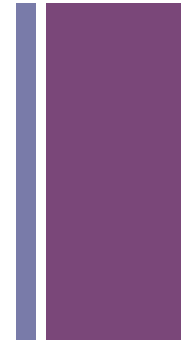
## Issue 3: Theoretical Underpinning

- Kuran, (2004): Islamic economic does not have a comprehensive framework for modern economy.
- Asutay, (2007): “rather than being part of the Islamic political economy, Islamic finance has been pursuing policies away from the theoretical underpinnings and systemic understanding of Islamic economics and has located a surrogate financial framework in neo-classical economics”.
- Al-Attas, (2010): Islamic finance remains very much wed to neo-classical economics and employs Keynesian economic model to prove that interest-free economic system is workable and superior to conventional finance.



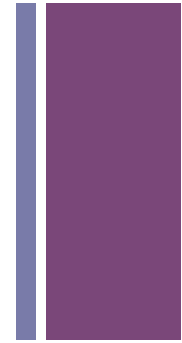
## + Issue 4: Convergence

- Chapra, (2010): the practice of Islamic finance seems unable to attain its authenticity and share many common similarities with conventional finance.
- Hossein Askari, Zamir Iqbal and Abbas Mirakhor (2009): Islamic financial products emulate conventional-style fixed-income debt-like and defeat the objective of Islamic finance.
- El Gamal (2006): Dilution of Islamic brand name.





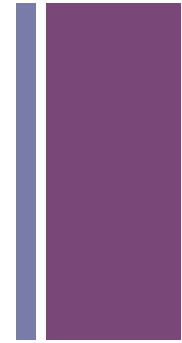
## Issue 5: Lack of Socio-Dimension



- Asutay, (2008): Islamic finance has failed to realize the very reason of its existence in providing socio-economic development for the larger parts of the Muslim world and communities.
- Usmani, (2002): philosophy of Islamic finance is not only motivated by profit per se but more important to establish distributive justice based on the principle of *Shari'ah* without any exploitation

## + Issue 6: Ownership

- Beneficial ownership and full ownership
- the bank holds beneficial ownership of the asset (motor vehicle/house), while the customer, having his name in the document of title, becomes the legal owner
- Profits in trading are allowed because they are not free from risks, losses, and uncertainties.
- The SAC accepted and recognised both concepts of ownership namely the legal ownership and the beneficial ownership





## + Issue 7: Compensation For Late Payment

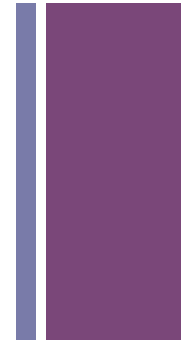
- **E.g.** Defaulters under conventional hire purchase will be charged 8.0% per annum; while in an AITAB scheme, the compensation for late charges is only 1%.
- **Penalty: Gharamah Ta'widh: Compensation**
- **Compensation for late payment-**
  - **Prior 1998- Cannot impose compensation**
  - **Post 1998- Can:- i. La Darar Wa la Dirar ii. Al-Darar Yuzal iii. Fatwa Al-Zarqa: Bay Al- Arabun iv. Based on economic loss.**

## + Cont....

- View 1: No compensation.
- 1. once due, become a debt obligation payable by the hirer and are subject to all the rules prescribed for a debt.
- 2. This compensation, if meant to add to the income or generate profit for the owner, is not warranted by the *Shariah*.
- 3. A monetary charge from a debtor for his late payment is exactly the *riba* prohibited by the Holy *Quran*

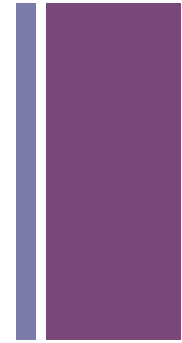
## + Cont..

- View 2: Compensation is allowed:
- A compensation can be charged to the customer for delayed payment, though the amount recovered is only to be used for charitable purposes by the bank
- BNM: the customer shall pay to the bank the sum equivalent to the costs incurred by the bank in the maintenance on such default amounts or such rate as prescribed by the Bank Negara Malaysia.



## + SAC's Ruling 1998 and 2010

- Late payment charge imposed by IFIs encompassing both concepts of gharamah and ta`is permissible
- i. Ta`widh may be charged on late payment of financial obligations resulted from exchange contracts (such as sale and lease) and qard;
- ii. Ta`widh may only be imposed after the settlement date of the financing became due as agreed between both contracting parties;
- iii. Islamic financial institution may recognise ta`widh as income on the basis that it is charged as compensation for actual loss suffered by the institution; and
- iv. Gharamah shall not be recognised as income. Instead, it has to be channeled to certain charitable bodies.



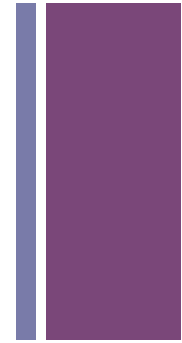
## + Sample clause on Ta'widh

- Notwithstanding anything contained in this Agreement, the Customer hereby undertakes to pay to the Bank, compensation on overdue instalments and payments of the Sale Price on the date of maturity of the Facility as follows:
  - for failure to pay any instalments of the Sale Price from the date of first drawdown until date of maturity of the Facility, the compensation rate that shall be applied is one per centum (1%) per annum on the overdue amount or any other method approved by BNM;
  - for failure to pay any instalments and which failure continues beyond the maturity date of the Facility, the compensation rate that shall be applied is the Bank's current Islamic Money Market Rate on the principal balance or any other method approved by BNM; and
  - the amount of such compensation shall not be compounded on the principal amount.



## MK Associates Sdn Bhd v. Bank Islam Malaysia Bhd [2015] 6 CLJ

- The plaintiff must know of the imposition of Ta'widh so that consent could be given freely. Obviously, the plaintiff in this case did not know the imposition of Ta'widh on the financing facility granted to it.
- At the time the agreements were entered into Ta'widh was not practised by the IFI. Ta'widh was only introduced after the SAC's Resolution in 1998. The said resolution was to take effect only on 1 January 1999 to existing and new agreements. Therefore, Ta'widh shall be applicable only on or after 1 January 1999.



## Issue 8: Ownership risk and maintenance

- Ownership risk and maintenance is upon the Lessor.
- Article 529 Mejelle “It is the duty of the lessor to put right things that detract from the intended benefit.”
- Eg road tax, maintenance, services,
- maintenance responsibility is undertaken by the customer.  
*Shariah* scholars held that this condition does not nullify the contract because the practice is based on *uruf* (local custom) and market practice
- Call Option and Put Option
- CO- Buy the asset PO- Sell the asset
- Whether it is lawful in syariah?- Lawful

## + Issue 9: *Bay al-Dayn*

### ■ *Hanafi madhhab* –

- selling of debt to a third party is not permissible because of the risk cannot be overcome in the context of debt selling.

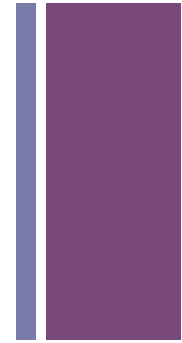
### ■ *Shafii madhhab*-

- selling of the debt to third party was allowed if the debt was guaranteed and was sold in exchange for goods that must be delivered immediately.
- When the debt is sold it should be in cash or tangible assets as agreed.



## + Issue 10: *Bay al Inah*

- **Shafii-** The contract is valid provided that it complies with all conditions of contract
- **Jumhur-** The contract is invalid. Considered as back door to riba.
- The SAC of SC, in its 5<sup>th</sup> meeting dated 29 January 1997, has resolved that *bay al inah* is permissible.



## + The SAC SC- 2014 The SAC BNM-2012

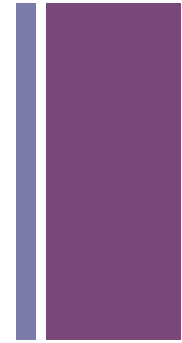
- Shall conform to and comply with the following conditions:
- The sale and purchase of asset shall be executed via two clear and separate contracts;
- The sale and purchase of asset shall not have the conditions for repurchase or resale of asset.
- Both sale and purchase contracts shall be executed at different times
- Sequence of execution for each sale and purchase contract shall be based on proper sequence
- The sale and purchase of asset shall give effect to the transfer of ownership of asset and the existence of possession or holding of asset (*qabdh*) which is valid according to Shariah and customary business practice (*'urf tijari*)

# + Issue 11: Bay al Tawarruq

- Siddiqi (2007) views the impermissibility of *tawarruq* financing facility being due to its inherent *mafsadah*.
- The Fiqh Academy of the Muslim World League has earlier issued two resolutions at the 15<sup>th</sup> meeting on 31<sup>st</sup> October 1998 and 17<sup>th</sup> meeting on 13-17<sup>th</sup> December 2003 where the former approved all kinds of *tawarruq* and the latter disapproved *tawarruq munazzam*.
- Omar, (2015) provides six strong reasons of why IFIs need to stop using *tawarruq* namely (i) It disconnects the real and the financial economy; (ii) Debt accumulation out of line with economic growth; (iii) Outcome similar to interest-based system; (iv) Rise in systemic risk due to unhealthy financial innovation; (v) It hinders healthy innovation; and (vi) A moral question.

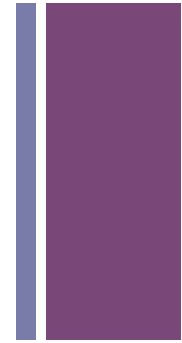
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- 15<sup>th</sup> meeting: Fatwa of the Islamic Fiqh Academy ruled to permit tawarruq on an individual basis.
- 17<sup>th</sup> Meeting: Organised tawarruq is not permissible.
- BNM in 2015: Issued Parameter on Tawarruq
- The Council in its 51st meeting held on 28th July 2005 / 21st Jamadil Akhir 1426 resolved that deposit product and financing based on the concept of tawarruq is known as commodity murabahah is permissible



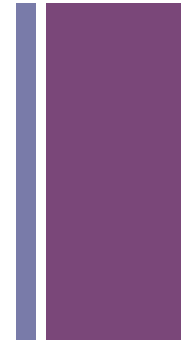
## + Issue 12: Ibra'

- ibra' refers to rebate given by one party to another party
- Most Islamic financial institutions do not include the ibra' clause in the financing agreement entered with their customer due to the concern that this will give rise to the issue of uncertainty (gharar) in the selling price.
- However, the exclusion of ibra' clause from the agreement may also lead to a dispute between the customer and Islamic financial institution on the customer's entitlement to ibra' arising from early settlement of outstanding debt.



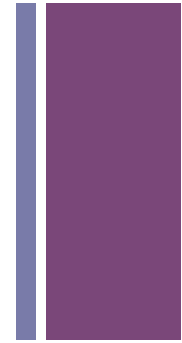
## + SAC's Ruling

- In the 101st Meeting on 20 May 2010, the SAC issued:
  - (i) BNM as the authority may require the IBIs to accord *ibra*' to their customers who settled their debt obligation arising from sale-based contract prior to the agreed settlement period;
  - (ii) BNM may also require the terms and conditions on *ibra*' to be incorporated in the financing agreement to eliminate any uncertainty with respect to the customer's entitlement to receive *ibra*' from the IBIs; and
  - (iii) The *ibra*' formula will be standardised by the BNM.



## + Issue 13: Hibah

- Hibah means transfer of ownership of an asset to a person without any consideration in return. It is a unilateral contract and also a benevolent act.
- whether the investee financial institution may give hibah to the investor financial institution in a mudarabah contract such as the Interbank Mudarabah Investment contract in order to give a competitive return in the market.



## + SAC's Ruling

- The SAC 1998: the practice of giving hibah by the investee financial institution to the investor financial institution that amounts to a guaranteed profit (rate) in Interbank Mudarabah Investment contract is not allowed..
- The SAC, in its 35th meeting dated 22 May 2003, has resolved that the practice of giving hibah by Islamic banking institutions to wadi`ah depositors is permissible. Nevertheless, such practice shall not become a norm in order to avoid this practice from becoming an `urf that resembles a condition in a deposit contract based on wadi`ah.



## + Issue 14: Guarantee in Mudharabah

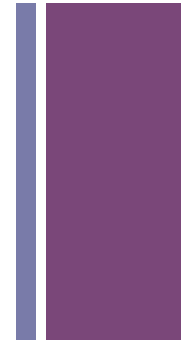
- Basically, a mudarib shall not guarantee the mudarabah capital. However, the SAC was referred to on the issue as to whether a third party may guarantee the liability of any party who deals with the mudarib in mudarabah transaction.
- Third party guarantee of capital and performance on the liability of the party who deals with the mudarib in mudarabah transaction is permissible based on the consideration that such third party guarantee is consistent with the permissibility of kafalah contract.
- In a kafalah contract, the third party guarantor shall be a party with no direct interest in the mudarabah business.

## + Issue 15: Wa'd

- Wa'd is unilateral in nature, as it occurs when only one party gives a promise to the other.
- It is apparent from this definition that in order for a proposal by the customer) to be known as a 'promise', the Act requires that the proposal must be accepted by the Bank).
- (i) The fulfillment of a promise is recommended, but not obligatory from both religious and legal perspectives (the majority opinion of scholars).
- (ii) The fulfillment of a promise is religiously and legally obligatory, and thus enforceable in a court of law (the minority view of scholars).
- (iii) The fulfillment of a promise is legally obligatory if it is contingent upon a condition (according to Hanafi madhhab), and if the promise is attached to a cause and the promisee has engaged in or acted upon the cause of the promise (the famous view of Maliki scholars).

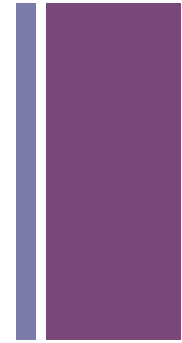
## + Issue 16: Debt Financing vs Equity Financing

- **Economist- Criticize the players for depending much on the instrument based on debt financing.**
- **Not truly Islamic. It does not represent actual difference with conventional banking system.**
- **Practitioners, Legal and Syariah Scholars- Both represent their functions and meet the market needs.**



# + Issue 17: Court Jurisdiction

- **Civil Court or Shariah Court?**
- **Banking and finance under the federal list**
- **Only person profess Islam- Shariah Court**
- **IB is a company established under the Co. Act.**



## + Issue 18: Real Property Gains Tax Act

- **Any transfer of ownership- pay the tax.**
- 10% be applied to properties held and disposed of within two years.
- A rate of 5% for properties sold within the third, fourth and fifth years after purchase.
- **Eg. BBA transaction will trigger double taxation since it involves 2 transactions.**
- **The govt amended the RPGT- One taxation only**

# + Issue 19: Stamp Duty

- **Every transfr of property- Stamp Duty.**
- **Ad valorem:** a **tax** based on the value of real estate or personal property
- Nominal: fixed eg. Duplicate or counterpart
- **The govt amended the stamp duty act 1949**
- Tax exemption for 3 consecutive years for IAP

