



Munich Personal RePEc Archive

A Holistic View of Legal Documentation from Shari'ah Perspective

Eddy Yusof, Ezry Fahmy

International Centre for Education in Islamic Finance
(INCEIF), Malaysia

November 2009

Online at <http://mpa.ub.uni-muenchen.de/20721/>

MPRA Paper No. 20721, posted 16. February 2010 / 07:26

A Holistic View of Legal Documentation from *Shariah* Perspective

Ezry Fahmy Bin Eddy Yusof

Abstract

The legal documentation having several features tends to make legal writing formal. This formality can take the form of long sentences, complex constructions, archaic and hyper-formal vocabulary, and a focus on content to the exclusion of reader needs. Some of this formality in legal writing is necessary and desirable, given the importance of some legal documents and the seriousness of the circumstances in which some legal documents are used. Yet not all formality in legal writing is justified in the *Shariah* point of view. It may sometimes to the extent that formality hinders reader comprehension, and do not reflect clear communication. This paper will explore some clauses of the legal documentation and analyze it check and balance from the *Shariah* perspective. In the second part of this paper, we will investigate some of controversial clauses that are deemed as prohibition elements. This paper conclude by proposing some suggestion in Islamizing the currently practice legal documentation in order to incorporate with the *Shariah* requirement.

Objectives of the research:

The objectives of this paper are:

- (i) To analyze the legal documentation that being practice currently.
- (ii) To investigate whether there are any prohibition elements included in any clause of the legal documentation.
- (iii) To propose some suggestion in Islamizing the currently practice legal documentation in order to incorporate with the *Shariah* requirement.

Key terms of the research: Legal documentation, rights and liabilities, *Shariah* requirement, prohibitions in legal documentation.

Table of content

- 1.0 Introduction**
- 2.0 Main functions of the legal documentation from Islamic perspective**
- 3.0 Incorporation of *Shariah* requirement into legal documentation in Islamic banking**
- 4.0 Specific prohibitions in legal documentation**
 - 4.1 Prohibition Interest (*Riba'*)**
 - 4.2 Avoiding Uncertainty (*Gharar*)**
 - 4.3 Avoiding *Maysir* or *Qimar***
 - 4.4 Two Contracts in One Contract**
- 5.0 Terms and conditions in legal documentation**
 - 5.1 Terms and conditions which affect the rights and liabilities of parties in Islamic financial contract**
 - 5.1.1 Right to recall**
 - 5.1.2 Cross default**
 - 5.1.3 Consolidation and set-off**
 - 5.1.4 Pre-Payment**
 - 5.1.5 Penalty or compensation**
- 6.0 Resolution of dispute over legal documentation of Islamic financial transaction**
- 7.0 Conclusion**

1.0 Introduction

The focus of Islamic finance industry has been on contract forms used in various financial transactions. Contract is a very essence of various transactions which without it may lead to void of legal significance. Islamic commercial law laid down fairly detailed rules in leading to the formation of contract. We could see that Islamic commercial law is enriching with various types of contracts that are useful to meet people's need in varied circumstances. The core of transactions in Islam emphasizes in ethical, social and dimensions of financial transactions to enhance equity and fairness for the general good of society. This ideal environment can be explain through the important verses in the Quran which stressed out the importance and how it enjoins believers to "keep faith contracts" (*Awfu bi al-Uqud*), "keeping promise", "mutual consent" (*At-Taraadhee*) and many more.

The law of contract in Islam is developed starts with *Quranic* verses which already contain both the fundamentals of several types of contracts as well as certain maxims of general import later developed by the Islamic jurist. A contract under Islamic law is expected to exhaust all its purposes as soon as it is concluded. It is to be found in the *Shariah* requisite that transactions enters by any parties in a contract must abide by the rules and regulation set under *Shariah* in order to protect all parties involved.

According Nabil (1990) and Mohd (2008), there is no exact definition of a contract as such is to be found in the treatises of Islamic law until the 19th centuries. This is because Islamic law never developed a general theory of contract, thus majority of Muslim jurist have focused on the contract of sale which they regarded as the model for all sorts of contracts. Only the *Majallah al-Ahkam al-'Adliyyah* and *Murshid al-Hayran* are two manuscripts that started to give a precise definition to a contract as the Islamic Civil Law Codification.

2.0 Main functions of the legal documentation from Islamic perspective

Nowadays, to become an integral part of an economic system, the Islamic banks need to have a variety of legal documentation to meet all the requirements of every sector of the economy, mainly such as industry, mining construction and agriculture, as well as commerce and services, and it is the job of a bank personnel to find the optimum solution for each client. Legal documentation can be defined as a document that documented some contractual relationship or grant some right to the parties involved in. It is important for those who

involve in any transactions to come out with written or legal documents to reflect the agreement between both or more parties that stated what has become into agreement between them. Muhammad Ayub (2007) believes that Islamic banks and financial institutions are required to adopt transparency, disclosure and documentation to a greater extent than the conventional banks.

The Quran enjoins us to write down and take witnesses in all transactions that involve credit one way or the other. It is clearly mentioned in the Quran: “O ye who believe! When ye contract a debt for a fixed term, record it in writing. Let a scribe record it in writing between you in (terms of) equity. No scribe should refuse to write as Allah hath taught him, so let him write, and let him who incurreth the debt dictate, and let him observe his duty to Allah his Lord, and diminish naught thereof...”¹. The verse explained that the person who makes contract a debt on a fixed term, he or she need to record it in writing and the writer must be write in truth. In addition, this verse also mentions that the person who is in debt should to dictate and observe his duty to Allah. That person also needs to ensure that the total debts are not reducing. This is the view that every rule in the *Shariah* is meant to bring benefit or prevent harm, which is a prominent theme in the work of most pre-modern jurists and legal theorists.

Gamal (2008) quoted from Ibn `Ashur that explains how `Izzuddin ibn `Abdel-Salam says in his book that there is a verse in the Quran which contains within it the canonical *Shariah* roots for all branches of jurisprudence., the verse is: “Verily, God enjoins justice and beautiful dealing, and generosity toward relatives, and He forbids shameful, blameworthy, and unjust activities; He exhorts you so that you may remember”.² This is important verse which reflects the essential of doing justice in any transactions made.

Islam view legal documentation not as from a western perspective or their legal aspect, but it’s being part of faith since there are many verses in the Quran which mentioned about the important and/or how to deal in the transaction with justice, not only from what people’s sees it, but as well as the acceptance of God. Whereby from the verses mentioned earlier we can understand that, in legal documentation that the writer must ensure that the

¹ Al-Baqarah 2 Verse 282

² Al-Nahl 16 Verse 29

guardian of the interests dictate in term of equity for the person who owe the debts is low understanding, or weak, or unable himself to dictate. Moreover, in order to deal with this transaction, need to call for the two witnesses among the men. If there are no men, then a man and two women can be call for approve as witnesses, so that if one of them forgotten the others will remind.

The writer must know the purpose of recording those transactions is in order to ensure that there is no harm to scribe or witness. Besides that, when the person deal with trading, they also need the witness and ensure that if one of them entrusted to another let him who is trusted deliver up that which is entrusted to him (according to the pact between them). With the faith that the person must observe his duty to Allah because of Allah is Aware of what they do, it is hopefully that the contract can be fulfil accordingly.

Other aspect that may reflect the main function of legal documentation is in order to make sure that there is no prohibited element or anything that against the *Shariah* exist in the contract. The *Shariah* requisite that transactions should be devoid of *riba* (unlawful advantage by way of excess or deferment), *gharar* (uncertainty, risk, speculation), *maysir* (gambling) and so forth (will be discussed further). Whenever a transaction involves the exchange of two counter values, it was strongly advised that this exchange should be made forth- with in order to eliminate any possibility of prohibited elements. Nabil (1990) feel that all these were the ideal contract, if not idealistic way to secure a just balance between the contracting parties and to prevent exploitation of the weak.

In current state, all these are the essential elements that need to be taken into consideration to all parties involved in a contract. Through a proper legal documentation, the parties involved able to establish their rights and liabilities as well as to render them enforceable by the courts of law (if necessary) if any of the party did not exercise their obligation that already agreed upfront.

3.0 Incorporation of *Shariah* requirement into legal documentation in Islamic banking

The knowledge in Islamic commercial law, known as *fiqh muamalah* in Islamic legal term, constitutes an important branch of law dealing with issues of contracts and the legal

effects arising from a contract; be it a valid, void or avoidable contract respectively. The injunctions of the *Shariah* are directed towards the realization of various objectives for the welfare of mankind. Legal documentation from *Shariah* perspective must covers a variety of dealings and transactions to meet the needs of the society. The legal documentation that incorporate with *Shariah* in Islamic banking should have certain criteria which would make it effective serve it purposes. Some of the criteria that could think of are:

- (i) The documents must be valid according to Islamic law
- (ii) The document must also comply with the existing legal requirements. Or in other words, comply with various laws applicable to financial transactions
- (iii) The document should be structured in a manner that can be enforced in the Civil Court.

All the above criteria plays a vital role in order to make the legal documentation exercisable in the practical system that protect all parties involved in certain transaction. Iraj (2009) believes that:

None of the Islamic contracts must have, or give the impression of having; any involvement with the interest and it is the responsibility of the bank's economists and *Shariah* scholars to ensure that all is well in this regard. Recognition of *riba*-involvement in a contract is the most delicate of tasks, and lies far beyond the scope of laymen (p.271).

Islamic legal documentation may sound awkward since the current way of doing documentation more or less are the same as what been practice by conventional banking system. However, the legal documentation of Islamic banking must adhere to Islamic law principle of transaction or known as *fiqh muamalat*. It is an ideal Islamic legal documentation to reflect true intention of the contracting parties and maintain the *Shariah* principles according to the applicable Islamic contracts. What it means by Islamic legal documentation is if the legal documentation of Islamic financing contract should be different than what being used by conventional financing. Each Islamic contract has its special features using different Islamic finance concepts. Conventional contracts are merely on loan under interest based system for the past six decades. Thus imitating the conventional ways of legal documentation will not reflect the speciality and differences of Islamic legal documentation.

This is due to the relationship that binds over the contracting parties whereby in conventional it is solely based on lender and borrower relationship while in Islamic legal documentation, the contracts may vary according to the concept used. The Islamic contracts need to be classified into several categories, depending on their legal character, effectiveness and economic consequences. According to Iraj (2009), among the Islamic contracts that can be used for specific categories are in the area of production (manufacturing), trade, services, housing and household needs. We can narrow the categories into three different contracts that are widely used which are sales and purchase contracts, partnership contracts and leasing contract.

Thus good Islamic commercial products must be backed by a clear legal protection. There must be sound and legal documentation to protect the interest of all parties and appropriate sanctions which are enforceable in the courts of law. How Islamic commercial law plays its role in the legal documentation mainly it acts as legal mechanism that work in a manner to resolve all dispute effectively and expeditiously. It is clearly importance to demonstrate the *Shariah* rules and regulation into the legal documentation and make it *Shariah* compliance.

It is important to note that Islamic system disapproves of any exploitation or injustice on the part of any of the parties involved. To achieve this objective, the *Shariah* has advised some prohibitions and recommended some ethics. Detailed study of the rules and norms reveals that Islamic finance is, in essence, an ethical system and ethics need to be an inseparable part of the system. The incorporation of shariah into the legal documentation is in order to make it become into a valid contract from Islamic perspective. According to Muhammad Ayub (2007), a valid contract is essential and must comprise the following intrinsic elements:

- The form, i.e. offer and acceptance, which can be conveyed by spoken words, in writing or through indication and conduct. The acceptance should conform to the offer in all its details.
- The contracting parties, who must have the capacity for execution.
- The subject matter, which must be lawful, in actual existence at the time of the contract and should be capable of being delivered and precisely determined either by description or by inspection/examination.

4.0 Specific prohibitions in legal documentation

Exclusion of the specific prohibitions is important in securing the validity of legal documentation from Islamic perspective. It is reasonable to state that all Islamic financial experts generally agree that any Islamic contracts should exclude *riba*, *gharar* and *maysir* (Al-Zuhaily, 1997; Muhammad Ayub, 2006; El-Gamal, 2008). This is because primary purpose of transaction law is often the enhancement of economic efficiency.

Moreover, prohibition of certain types of financial transactions is not unique to Islam. El-Gamal (2008) proven that the Jewish *Halakhah* plays the same legal role as the Islamic *Shariah* in certain extent of prohibitions (of course we discuss about financial affairs), where some of the religions prohibitions was stricter than the Islamic. Some of the examples are the interest based-lending, two prices in one contract made, and so forth. Thus Islamic banking and finance practices should avoid any specific prohibitions in Islam in the legal documentation in order to abide by the *Shariah* law. Thus we will discuss some of the prohibitions that are relevant to be address in making the legal documentation are incorporate with *Shariah*.

4.1 Prohibition Interest (Riba')

Restrictions on the settlement of obligations represent the core of the doctrine of *riba* as this prohibition was set forth expressly in the Quran³. The prohibition of interest is not only recognised by the religion of Islam, but as well as the Jewish⁴, Christianity⁵ and many more in their Holy Book. We can clearly see in the Bible for example, that who lend their brothers with extra charges or so called interest is considered as unethical act.

Thus it is importance that any contract made between parties involved in Islamic financial contract is prohibited to include any elements of interest. Especially if there is any misuse of word that try to confuse the customers with other terms such as 'service charge', 'administration cost'(in percentage throughout the period of lending without any specific

³ Wahbah Alzuhayli, Financial Transactions In Islamic Jurisprudence 311 (Mahmoud A. El-Gamal Trans., Dar Al-Fikr, 2003)

⁴ Refer to Old Testament, Sifr al-Khuruj/Exodus (25:22), Sifr al-Lawiyyin/Leviticus (25:37), Sifr al-Tathniyah/Deuteronomy (23: 19,20)

⁵ Matthew (5:34), Luke (6:30), Luke (6: 35)

mechanism to evaluate the charges), ‘penalty for late payment’ and so forth. This will jeopardise the Islamic financial contract that is deemed as *Shariah* compliant.

4.2 Avoiding Uncertainty (Gharar)

Avoiding *gharar* is another main principle that should be taken serious consideration in preparing legal documentation. *Gharar* is a wide subject that has been discussed thoroughly by Islamic jurist. In the scope of legal documentation, any ambiguity terms should be avoided to be included in any documents except if the client is fully explained what it really meant. Avoiding *gharar* give a major impact in implementing a just transaction in the course of the transparency and disclosure made by parties involved in the contract.

Why this is consider as serious matter especially when we discuss on legal documentation? Muhammad Ayub (2007) again explains that the dangerous of *gharar* is seen as “entering into a contract in absolute risk or uncertainty about the ultimate result of the contract and the nature and/or quality and specifications of the subject matter or the rights and obligations of the parties” (p.75).

The statement above can be explained using many examples whereby in the legal documentation, it must be:

- (i) Agreeable by parties involve
- (ii) Using simple terms (using terms that already known by those whether into the contract) without trying to manipulate any terminology used that may lead to dispute among the parties in the future.
- (iii) It must stipulate the general terms and conditions of the transaction.
- (iv) Stated clearly the rights and obligations of the contracting parties.
- (v) Avoid all types of ambiguities that may occur in the future that causes by *jahalah* (ignorance) from any of the parties.

All these are some of the general principle that must be included in the legal documentation in order to avoid any uncertainty that could lead the contracting parties come into dispute in the future. A clear and understandable documentation could help parties to execute their obligations well and avoid any lack of adequate value-relevant information or

inadequacy and inaccuracy of any vital information which leads to uncertainty and exploitation of any of the parties.

The Holy Prophet (pbuh) himself encouraged disclosure of all features of goods being traded and the competitive environment in which people get sufficient information about goods and their prices in the market. Thus any bilateral contract must be free from excessive uncertainty about the subject matter or the consideration (price) given in exchange.

4.3 Avoiding *Maysir* or *Qimar*

Maysir or *Qimar* can be defined as gambling or games of chance respectively. All transactions that include these both are prohibited in Islam. Both are more or less are the same since it is sort of getting something valuable with ease and without paying an equivalent compensation (*Iwad*) and both words are applicable to games of chance. Allah warned the believers in the Quran, “O you who believe! Intoxicants and gambling, sacrificing to stones and divination by arrows, are abominable actions of Satan; so abstain from them, that you may prosper.”⁶

It also can be considered a form of *gharar* since the gambler is ignorant of the result of the gamble. For example in our current reality cases are such as lotteries and prize schemes based purely on luck would clearly come under this prohibition. Dicing and wagering are rightly held to be within the definition of gambling and *Maysir*. Therefore, Islamic banks cannot launch any such schemes or products and any influence of *Maysir* or *Qimar* should not be recorded into the legal documentation since it is clearly under the prohibition of the *Shariah*.

4.4 Two Contracts in One Contract

Shafqatayn fi shafqah, or *Bay'atayn fi bay'ah*, (namely two types of trading contract in one) is forbidden by the Prophet (pbuh): “Prophet Muhammad prohibited from making two purchases (aqad) in one aqad”⁷ Two mutually contingent and inconsistent contracts has various definition and interpretation by scholars. Muhammad Ayub (2007) gives some examples whereby:

⁶ Al-Maidah 5 Verse 90

⁷ Reported by Imam Ahmad, Imam al-Bazzar, Imam Al-Haithami.

1. The sale of two articles in such a way that one who intends to purchase an article is obliged to purchase the other also at any given price.
2. The sale of a single article for two prices when one of the prices is not finally stipulated at the time of the execution of the sale.
3. Contingent sale.
4. Combining sale and lending in one contract.

Therefore, rather than signing a single contract to cover more than one transaction, parties should enter into separate transactions under separate contracts. Among the examples given by the scholars are:

- (i) When the buyer did not decided on a specific manner and amount of payment when he or she accepted the offer which entails either a cash or credit term payment.⁸
- (ii) When the buyer gives option to the seller to sells the product in cash basis or exchange with other product in future without specified any of these payment methods (either pay in cash or pay in future).⁹
- (iii) When the seller gives conditions to the buyer to sells his property in order for him (the seller) to sell his property.¹⁰
- (iv) When the seller sells two different products with two different specific prices, but the seller tied both of the products together with condition that the buyer have no choice but to buy both of the product once.¹¹
- (v) When the seller sells a product in deferred payment (higher price) with condition the buyer sells it back to seller in cash basis that is lower price than before. This is also known as Bay al-‘Inah.¹²

Islamic banks may come across a number of transactions in which there could be interdependent agreements or stipulations that have to be avoided. This has become an issue in some of the Islamic banks products such as AITAB (*al-ijarah thumma al-bay*) in Malaysia when the product is being sign by the customer simultaneously upfront (Saiful, 2005).

⁸ Zaharuddin (2009), Money, You and Islam - the author referred to Syarh as-Sunah, Al-Baghawi, 8/142 ; ‘Aridathul Ahwazi, 5/240 ; Al-Mughni, Ibn Quddamah, 6/333; Al-Mudawwanah, 9/191.

⁹ Zaharuddin (2009), Money, You and Islam - the author referred to ‘Aridathul Ahwazi, 5/240

¹⁰ Zaharuddin (2009), Money, You and Islam - the author referred to Al-Mughni , 6/332 ; Al-Um, 3/67 ; ‘Aridatul Ahwazi, 5/239.

¹¹ Zaharuddin (2009), Money, You and Islam - the author referred to Al-Qabas Syarah Al-Muwatta', 2/842 ; Al-Muntaqa , 5/36

¹² Zaharuddin (2009), Money, You and Islam - the author referred to Mukhtasar Al-Fatawa Lib Ibn taymiah, hlm 327 ; Tahzib Mukhtasar Sunan Abi Daud, Ibn Qayyim, 5/100.

However, the combination of some contracts is permissible subject to certain conditions. Among that allowable to be combine are when it is being done separately, like *Musyarakah Mutanaqisah* that is consist of two contract mainly *musyarakah* and *ijarah* contract. This is permissible according to Taqi Usmani (2005), he explains that:

The answer is that if all these transactions have been combined by making each one of them a condition to the other, then this is not allowed in *Shariah*, because it is a well settled rule in the Islamic legal system that one transaction cannot be made a pre-condition for another. However, the proposed scheme suggests that instead of making two transactions conditional to each other, there should be one sided promise from the client, firstly, to take share of the financier on lease and pay the agreed rent, and secondly, to purchase different units of the share of the financier of the house at different stages (p.60).

Besides *Musyarakah Mutanaqisah* contract, there are various examples of this combination, for example:

1. Contracts of agency (*wakalah*) and suretyship (*kafalah*)
2. Contract of sale or lease with secured by pledge (*rahn*) or suretyship (*kafalah*)
3. Contract of *tawarruq* where the client appoints the bank as an agent (under *wakalah* contract) and many more of structured products and many more example in current practice.

In conclusion to this matter, each of the lease and purchase contracts must be executed separately although they relate to the same subject matter. Thus prohibition of two mutually contingent contracts needs to be taken into serious consideration by any Islamic financial institution to make sure whatever their offer to the clients is a *Shariah* compliant products.

5.0 Terms and conditions in legal documentation

The validity of a financial or commercial transaction does never depend on the financial position of the parties. It rather depends on the intrinsic nature of the transaction itself. If a transaction is valid by its nature, it is valid irrespective of whether the parties are rich or poor. Sale, for example, is a valid transaction whereby a lawful profit is generated. It

is allowed regardless of whether the purchaser is rich or poor. On the other hand, the terms and conditions which already set up upfront through a legal documentation, will bind both neither the seller nor the buyer as well as the lender or the borrower in a particular contracts made. In other words, it reflects the bound to which all parties to a contract have agreed to subscribe.

5.1 Terms and conditions which affect the rights and liabilities of parties in Islamic financial contract

There is no doubt that there is no specific Islamic template or standard format to draft a legal documentation, but there are some clauses that are being widely use in current legal documentation that need to be closely review from *Shariah* perspective, especially on how it could affect the rights and the liabilities of those who involved into it.

5.1.1 Right to recall

The “right to recall” clause is being practiced both by conventional and Islamic financial institutions. It refers to the rights of the bank to terminate or cancel to proceed to the agreement made in the event of the default or breaches of any conditions by the customer. According to this clause, the customer also will be liable to pay any of the payment outstanding. The clause example is as follows:

Notwithstanding any provision hereof, it is hereby expressly agreed that upon default or breach by the Customer of any term, covenant, stipulation and/or undertaking herein provided and on the part of the Customer to be observed and performed, the Bank shall hereafter have the right to exercise all or any of the remedies available whether by this Assignment or the other Security Documents or by statute or otherwise and shall be entitled to exercise such remedies concurrently, including pursuing all remedies of sale or possession and civil suit to recover all monies due and owing to the Bank provided that nothing herein contained shall be construed as imposing any obligation (whether at law or in equity) upon the Bank to exhaust its remedy to sell the Property before commencing any separate action or before enforcing any other remedies or exercising any other rights against the Customer or any other security party; AND the Customer hereby irrevocably and unconditionally agrees and consents to the Bank commencing separate proceedings, enforcing other remedies and exercising any other rights which the Bank may have against the Customer or any other security party simultaneously or consecutively in

any order as the Bank deems fit with or without having exhausted its right to sell or to proceed against the Property or to realise its security hereunder.¹³

However, what the clause meant in conventional could not be the same as what or how Islamic financial intuition should view it. If according to this clause the bank may terminate the contract, in Islam, however delay in payment or a non-payment do not render the contract terminated. The right to recall clause will be discuss further in the rebate issue.

5.1.2 Cross default

A cross default can be explain as the default of payment by the buyers or lender from other financing or lending facilities that he made before or after the contract agreed, thus default in other facility will affect the others as well. The example of clause may sound like:

The Customer hereby expressly agrees that if any sums shall be due from the Customer to the Bank or with any of the institutions within the Bank X group of companies from time to time or at any time or if the Customer may be or become liable to the Bank or with any of the institutions within the Bank X Group of companies anywhere on banking account or any other account current or otherwise in any manner whatsoever or if default is made in any provisions of such accounts or in any other banking facilities granted by the Bank or with any of the institutions within the Bank X Group of companies to the Customer or in any of the provisions herein, then and in such event, the Indebtedness together with all monies payable under such accounts or other banking facilities aforesaid shall immediately become due and payable and the security herein shall become immediately enforceable.¹⁴

The cross default clause does not reflect the principle of justice and equity that being stress by *Shariah*. Therefore, it is in the opinion that the clause should be taken into serious consideration whether it is subset with the *Shariah* principle or otherwise? First the bank should refer to the *Shariah* Advisor for further recommendation and since there must be various opinions of scholars regarding this issue, it must be thoroughly check and balance in all aspects since this clause may deemed injustice in the eye of *Shariah*.

¹³ Sample of clause in an agreement with some modification.

¹⁴ Sample of clause in an agreement with some modification.

5.1.3 Consolidation and set-off

Consolidation and set-off is inter-related with cross default. It explains as right to set-off customer's funds may be extended to customer's other funds provided that the term of the other fund allows for such action. It also can be defined as the discharge of a debt receivable against a debt payable. AAOIFI respond towards this current practice stating that:

The agreement of contractual set-off of future debts, commonly known as set-off and consolidation is a practice employed by a large number of financial institutions. This form of set-off may take place either compulsorily or contractually depending on whether the state that give rise to this set-off meets the conditions of compulsory set-off or the conditions of contractual set-off. Moreover, a pre-agreed contract of set-off of this kind would make it possible for the parties to dispense with any fresh agreement at the time of set-off when the two currencies are different or two debts are not equal.¹⁵

The clause may goes like this:

The Bank further reserves the right at any time at its absolute discretion and without notice to the Customer to combine or consolidate all or any of his accounts including jointly with others (of any nature whatsoever whether subject to notice or not) wheresoever's situate with any liabilities and obligations owed or incurred by the Customer to the Bank and set-off or transfer any sum standing to the credit of any one or more of such accounts in or towards satisfaction of all monies obligations and liabilities due and payable to the Bank.¹⁶

The consolidation of set-off is seen not contradict with the Objective of *Shariah* since it applicable to discharge individuals from liability of debt and set off is one way to discourage debt liabilities. If it is execute based on contract agreed, then it is in line with the hadith of a Prophet (pbuh) that : “Muslims are bound by the conditions and agreements they have made, except a condition that has rendered the unlawful lawful or rendered the lawful unlawful.”¹⁷

5.1.4 Pre-Payment

¹⁵ AAOIFI *Shari'a* Standard. (2008). *Shari'a* Standard No.4, Settlement of Debts by Set-off. p.49

¹⁶ Sample of clause in an agreement with some modification.

¹⁷ Reported by Imam at-Tirmidzi in Sunan Tirmidzi, Volume 3 page 634.

The pre-payment clause or early settlement is allowable according to the *Shariah*. But the financier must provide adequate notice to the customer. Thus the customer is entitled for a rebate due to this. Rebate known from *Shariah* perspective as *ibra'* has been widely discussed by the scholars.

As in AITAB case, the rebate usually or maybe given by the banks when the banks give notice to the customer for an early settlement which is before the maturity period. The calculation of rebate in AITAB clearly follows the standard formula accorded under the HP Act 1967. However, it is not in cash basis but more towards reducing the outstanding balance that need to be paid (Razli and Haslinda, 2007, p.20)

The AAOIFI *Shariah* standards allow the bank to give a rebate in the case of early payment at its sole discretion. The AAOIFI *Shariah* Standards states that:

The basis for the permissibility of discount or rebate for earlier payment is because discount for early payment is a form of settlement between the creditor and the debtor to pay less than the amount of the debt. This is the among settlement that are endorsed by *Shariah* as stated in the case of Ubay Ibn Kaáb may Allah be pleased upon him (and his debtor) where the Prophet peace be upon him suggested to him in word: *write off upon a portion of your debt*.¹⁸ The International Islamic *Fiqh* Academy has issued a resolution in support of this rule¹⁹.

However, the AAOIFI *Shariah* Standards also prohibit giving rebate to the client on early payment on a contractual basis, as under *Murabahah*, the price has to be fixed once and for all. However, if there is no commitment from the bank in respect of any discount in the *Murabahah* price, it is allowable. The AAOIFI *Shariah* Standards state that: "It is permissible for the institution to give up part of the selling price if the customer pays early, provided this is not part of the contractual agreement"²⁰.

In general, the majority of contemporary *Shariah* scholars, however, do not allow remission for earlier payment in *Murabahah* operations by banks. The International Islamic *Fiqh* Academy, the *Shariah* committees of Islamic banks in the Middle East and *Shariah* scholars in general consider that it would be similar to interest-based instalment sales techniques. Experts

¹⁸ Sahih Bukhari Volume 1 Hadith No. 179, Volume 2 Hadith No.965.

¹⁹ AAOIFI *Shari'a* Standard. (2008). *Shari'a* Standard No.8, *Murabaha* to the Purchase Orderer. p.134.

²⁰ Ibid. p.124.

therefore recommend that the matter should be brought to the knowledge of the *Shariah* advisor, who may decide each case of rebate on merit.

5.1.5 Penalty or compensation

According to Razli and Haslinda (2007) that according to Bank Negara Circular on compensation charges, a rate of 1% per annum is chargeable by Islamic financial institutions to the customer on rental arrears as long as the facility has no matured. After its maturity date, the financier (mainly Islamic financial institutions) may charge the 12 month General Investment Account (GIA) deposit rate, or popularly known as the 'r' rate. The amount must not be in compounded. However the rules stated that it must not exceed 100% of the remaining total purchase price. According to *Murabaha* Paramater of BNM (2009), it is clearly stated that:

The IFI may include a clause in the Murabahah contract, stipulating a “compensation for late payment” as determined by the relevant authorities, which is claimable by the IFI from the customer as income. Alternatively, the IFI may include a clause stipulating late payment penalty which shall be channelled to charity. The IFI may also require the customer to prove any claim of non-delinquent insolvency in order to be exempted from penalty (p.28).

In sample of AITAB agreement, the clause maybe as follow:

The Hirer shall pay to the Owner by way of late payment charges such amount as determined by the Owner in accordance with the rulings of the *Shariah* Advisory Council on any monies payable under this agreement which may from time to time be overdue from Hirer.²¹

A different kind of contract may state it differently under a different title. But the objective will be clearly stated such as this:

Without prejudice to the rights of the Bank under Section XX hereof and notwithstanding any provision herein, the Customer hereby expressly agrees that If the amount realised by the Bank pursuant to the proceedings referred to in Section XX hereof after the deductions thereof is less than the amount due and payable to the Bank and whether at such sale the Bank is the purchaser or otherwise, the Customer shall pay to the Bank the difference between the amount due and the amount so

²¹ Sample of AITAB agreement according to Razli and Hasleeza (2007), *Islamic Hire Purchase-Ijarah Thumma Al-Bai' (AITAB): The Handbook. Late Charges.* p.129

realised and until payment of such differential amount, the Customer pay late payment compensation charges on the differential sum until the date of actual payment made²².

All *Shariah* bodies like the International Islamic *Fiqh* Academy, the AAOIFI, and so forth have approved the provision of penalty clauses embedded in contractual agreements that keep a balance between the requirement in view of the severity of the problem and that of the *Shariah* conditions or principles to keep the fine difference between interest and a e.g *Murabahah* profit unharmed. The penalty thus received has to be given to charity. The penalty proceeds should be given to charity because penalties on default in repayment cannot become a source of income for the creditor, if not it is considered as prohibited *riba* and makes the contract by design against the *Shariah*.

6.0 Resolution of dispute over legal documentation of Islamic financial transaction

It is important to include this as a sub-topic to be address too since the legal documentation as we discussed earlier must able to enforce in court. But in case of Malaysia that has a dual-system of courts-the civil system and the *Shariah* court system. Nik Norzzrul *et. al.* (2003) state that the jurisdiction of the *Shariah* courts is laid down in paragraph 1 of the State List in the Ninth Schedule of the Federal Constitution. On the other hand, the Federal List in the Ninth Schedule of the Federal Constitution include *inter alia* Item 7 which includes “ banking, money lending, pawnbrokers, control of credit, bills of exchange, cheques, promissory notes and other similar instruments”.

Although the law clearly state that the civil law have power to administer and enforce Islamic law in cases occurred, they did not attempt to do so. It is not feasible to transfer such cases to the *Shariah* court, as this will require legislative amendments and the elevation in the status of *Shariah* court (Nik Norzzrul *et. al.*, 2003, p. 93).

Nik Norzzrul *et. al.* (2003) quoting the ideas of Mohamed Ismail Shariff and Professor Tan Sri Ahmad Ibrahim regarding this issue, both of them suggesting something to be establish in the Federal and High court respectively. Mohamed Ismail Shariff argues that the setting up of the Islamic Bench would entail that gradual integration of the two systems of

²² Sample of clause in an agreement with some modification.

law in one, evolving in the process of a system of court structure and court procedure that would have incorporated and integrated elements from both of the systems and one that apply to both systems. This will give a rise to the court system and procedure of handling all type of cases both under Islamic law, other than that come within the jurisdiction of the Shariah courts, as well as common law that would be unique in this country and which serve as a model for other countries to follow (Nik Norzzrul *et. al.* 2003 p. 94).

Professor Tan Sri Ahmad Ibrahim also suggested that appointment of some Muslim scholars skilled in the Islamic law under the advocated of setting up a *Shariah* Bench in the Federal Court. Interesting to note that in the Bank Negara Malaysia's Financial Sector Master Plan under chapter of Islamic banking and *takaful* stated gives more or less the same in establishing an effective legal structure via:

One of the pre-conditions to sustain the continuous growth of Islamic banking and *takaful* is a comprehensive legal infrastructure to seek any legal redress arising from Islamic financial transactions. A sufficient number of competent lawyers and judges equipped with sound knowledge and expertise in both *Syariah* and civil laws is needed to handle legal matters on Islamic financial contracts to promote confidence amongst the industry practitioners and customers. In this regard, steps will be taken to:

- Form a committee to establish a *Syariah* commercial court dedicated to deal with legal matters on Islamic banking and *takaful*. In the interim, an Islamic banking tribunal will be formed to serve as a foundation for the ultimate establishment of the proposed court; and
- Design dedicated awareness and training programmes for judges and lawyers on Islamic banking and *takaful*, to be conducted by the industry-owned research and training institute in consultation with the Judiciary and Bar Council.²³

Therefore, it is clearly shown that legislative and judicial reforms are still needed in order to further develop the spiritual ethos implicit within an Islamic financial system.

7.0 Conclusion

²³ Bank Negara Malaysia. *The Financial Sector Masterplan: Islamic banking and takaful*. Chapter 5 p. 83.

Islamic banking law provides a level playing field, and gives Islamic banks the opportunity to coexist with conventional banks on an equal footing, subject to a prudent regulatory and supervisory regime. This is important for both the Islamic banks, as it inspires public confidence in their operations, and to ensure the soundness of the banking system. Compared with conventional banks, Islamic banks bear certain additional risks associated with ownership of assets if underlying some Islamic modes of operation and transactions. This requires greater attention to supervisory policies and tools. Moreover, Islamic banking is highly innovative; thus supervisory authorities will be hard pressed to continually develop their policies and tools to proactively respond to market dynamics and developments.

Therefore, the Islamic banks need a comprehensive legal infrastructure that provides legal redress for disputes arising from Islamic financial transactions. Thus according to Nik Norzrul *et al.* (2003):

A sufficient number of competent lawyers and judges equipped with sound knowledge and expertise in both *Shariah* and civil laws is needed to handle legal matters on Islamic financial contracts and to promote confidence amongst the industry practitioners and the customers (p.104).

According to what clearly stated in the holy Quran:

“O you who have attained to faith! Whenever you give or take credit for a stated term, set it down in writing. And let a scribe write it down equitably between you; and no scribe shall refuse to write as God has taught him: thus shall he write. And let him who contracts the debt dictate; and let him be conscious of God, his Sustainer, and not weaken anything of his undertaking...”²⁴

The verse shows that the debtor is the one who shall write the agreement so that he or she who involve in a contract of debt could understand the liability that he or she bear with. But nowadays, since it is according to the *maslahah* and *'urf* that the financier who the one that prepared all the agreement or legal documentation. What the client or customer do is just sign the agreement. There is no problem occur until the

²⁴ Al-Baqarah Chapter 2 Verse 282.

customer sign the legal documentation without knowing and understand the contract fully.

The bombastic words and terminologies used by the lawyers who drafted the legal documentation using legal terms may confuse even both parties. It is the customer rights to ask for financier assistance to understand the whole agreement before signing it, this is important to avoid any possibility of dispute in the future between the both contracting parties. Therefore the client or customer should be given ample time to understand the legal documentation first before the make any decision either to continue the transaction or otherwise. It is important to note this down since it is such a procedure of a bank whereby the contract is not given to the customer to take home and revise or study on it before understand its serious implication. All these need to be taken into consideration when we discuss on the transparency of exercising legal documentation in line with to the *Shariah*.

However, Ng Boon Ka (2009) believes that,

In the context of *Shariah* harmonisation and product innovation, BNM is developing the so-called '*Shariah* parameters' to provide a standard guidance on applying and operating the *Shariah* contracts in Islamic finance. This may minimise the possibility of *Shariah* arbitrage and may promote more consistent application of Islamic financial contracts, both locally and abroad.

It is also our hope that a holistic application of the *Shariah*, both ex-ante and ex-post, shall warrant Islamic banks to ensure the use of property is Shari'ah-compliant particularly in view of the inherent reputational risk in Islamic transactions and governance. The Islamic legal documentation should portray the Islamic commercial law and reflects its maqasid *al-Shariah* (objective of *Shariah*).

References

- AAOIFI Shari'a Standard. (2008). Shari'a Standard No.4, Settlement of Debts by Set-off. p.49
- Bank Negara Malaysia. *The Financial Sector Masterplan: Islamic banking and takaful*. Chapter 5 p. 83. Reterived 13 September 2009, at <http://www.bnm.gov.my>.
- Bank Negara Malaysia. (2009), Murabaha Paramater of BNM. Reterived 23 October 2009, at <http://www.bnm.gov.my>.
- El-Gamal. M. (2008). Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering. *Wisconsin International Law Journal*. 25(4).
- Iraj. Toutochian. (2009). *Islamic Money & Banking; Integrating Money in Capital Theory*. Singapore: John Wiley & Sons (Asia) Pte. Ltd.
- Mohd Daud Bakar. (2008). *Contracts in Islamic Commercial Law and Their Application in Modern Islamic*.
- Muhammad Ayub. (2007). *Understanding Islamic Finance*, Singapore; John Wiley and Sons (Asia) Pte Ltd.
- Nabil Saleh. (1990). Definition and Formation of Contract under Islamic and Arab Laws. *Arab Law Quarterly*. 5(2) p. 101-116.
- Ng Boon Ka et al. (2009) *Selected Shariah Committee Reports in Malaysia: A Critical Appraisal*. INCEIF Working Paper. (Unpublished)
- Nik Norzzrul et. al. (2003). *Law and Practice of Islamic Banking and Finance*. Malaysia: Sweet & Maxwell Asia.

Razli and Hasleeza (2007), *Islamic Hire Purchase-Ijarah Thumma Al-Bai' (AITAB):The Handbook*. Late Charges. p.129

Saiful Azhar Rosly. (2005); *Critical Issues on Islamic Banking & Financial Markets* Malaysia; Dinamas Publishing.

Usmani, Muhammad Taqi. (2005). *An introduction to Islamic finance*. (Special ed.). Karachi, Pakistan: Maktaba Ma'ariful Qur'an.

Wahabah Al-Zuhaily. (2003). *Financial Transactions In Islamic Jurisprudence* (Mamoud A. Al-Gamal, trans.) Damascus: Dar al-Fikr.

Zaharuddin Abd Rahman. (2009). *Money, You and Islam*. Kuala Lumpur;True Wealth Sdn Bhd.