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Matt Richards

Islamic Contracts of Finance in Malaysia*

Introducing Islamic Financing

The principal feature that distinguishes "Islamic" from "conventional" or "modern" forms of banking and finance is that interest, or more properly *ribâ*'[1] is proscribed in Islamic law. The Islamic alternative to the payment of pre-determined interest, so pivotal to the practices of conventional financing, is a sharing of risks and rewards between the parties involved in a financial transaction.

Whether this Islamic alternative has in fact been translated from its classical ideal into contemporary practice remains contested. In the case of Malaysia, government and industry leaders have proudly proclaimed that their innovations in Islamic banking are "recognised by many Islamic countries as the model of the future" (Bank Negara Malaysia, 1994: 338). Yet these same developments have alternatively been derided by various Muslim critics as being "far removed from the teachings of Islam" (Lubis, 1996: 9) such that "the Islamic Bank is but another bank" capitalist in all but name only (Muzaffar, 1987: 82).

Set against this debate, this paper explores the legal issues that arise in several of the principal instruments currently used in Islamic financing in Malaysia. Through the document review, it is submitted that these financial instruments consist of English-Malaysian commercial law, albeit set within an Islamic periphery. A consideration of how Islamic law could affect the litigation of these instruments is also undertaken and it is further submitted that given the current statutory and judicial framework of Islamic banking in Malaysia, the effect of Islamic commercial law upon these contracts appears to be morally exhortative, rather than legally enforceable. Finally, it is concluded that Islamic law is presently consigned to the margins of these financial contracts, and the consequences that arise from this conclusion are discussed.

Before proceeding to survey the leading Islamic financial instruments in use in Malaysia, an introduction must firstly be made to nature of Islamic law (referred to as *sharî'ah*), and the limits on commercial activity that it imposes. The politics of law shaping the development of Islamic banking and finance will also be raised, particularly in light of the conflicting desire of the proponents of Islamic banking to integrate their financial products within the globalised finance industry, yet nevertheless to continue differentiate Islamic products from their conventional, secular counterparts.

The *Sharî'ah* and Its Injunctions

The prohibition against *ribâ'* is categorical in the Qur'an. For example:

> "O you who believe! Devour not *ribâ'*, doubled and multiplied;
> But fear God, that you may prosper".[2]
> **And:**
> "O you who believe! Fear God and give up what remains of your demand for *ribâ'*, If you are indeed believers".[3]

The explicitness of the *ribâ'* injunction, however, belies its unsettled interpretation. This is because *ribâ'* is not exhaustively defined in either the Qur'an or the Yadîth,[44] The Hadith is a narrated record of the Sunnah, telling of the habits and customs of the Prophet's life that have become the rules of Muslim faith and practice: see Haron, (1991: 31-48) the two primary and immutable sources of the *sharî'ah*. Instead, the explication and application of this Qur'anic principle is left to the secondary and interpretative sources of Islamic law; namely, judicial consensus (*ijmâ'*) and reasoning through analogy (*qiyâs*). These four sources of the *sharî'ah* find their practical expression in a complex and ever-developing body of jurisprudence, known as the *fiqh*. But within the *fiqh*, ample room remains for scholarly dissension over how to correctly implement the holy edicts of Islam. The varying schools of law to which individual jurists subscribe,[5] the specific social and political context being addressed, and the jurisprudential method employed in resolving legal problems[6] all bear upon the probability of divergent interpretations. What fundamentally underlies such diversity, however, can be summarised as the attempt of each jurist to rightly identify the obscured line that divides "what is Revealed (and therefore Divine and Infallible) and what is human interpretation (and therefore fallible and changeable) (Anwar, 1997: capital added).

Understood literally, *ribâ'* means an "increase in" or "addition to" anything (Rayner, 1991: 267). Yet jurists are divided on their reading of the term, and thus the ambit of the prohibition.[7] According to the legalist approach of the traditionalists, *ribâ'* refers to interest as generally understood. All claims in excess of the sum lent are prohibited under this literalist interpretation, and thus the loan transactions of the modern commercial banking system are deemed illegal (*ḥarâm*) under Islamic law. According to the more contextual readings of the modernists, on the other hand, this Qur'anic injunction was intended to be directed against the exploitation of the economically disadvantaged in pre-Islamic Arab society. *Ribâ'* should thus now more narrowly denote usury, or interest in excess. As such, transactions involving additional gains or profits may in fact be legal (*ḥalâl*) within a contemporary commercial setting, provided those gains are not unearned or unjustified in the context of each contract.

Leaving such deliberations to the jurists, this paper adopts the same expansive definition as that accepted by the "overwhelming majority" (Angell, 1995: 16/12) of the proponents of Islamic banking; namely, that *ribâ'* concerns all forms of interest. As such, the prohibition on *ribâ'* can be understood in the context of Islamic finance as enjoining any "positive pre-determined return on capital" (Soe, 1997: 383; Neinhaus, 1986: 3).

But contrary to Western misperceptions, disallowing interest in lending arrangements does not therefore mean that Islamic money is free (Carlson, 1986: 69-70; Arif, 1988: 2). Alternative techniques are available under Islam by which financiers can legitimately seek to profit. For as stated in the Qur'an:

> "Allah has permitted trade and forbidden *ribâ'*".[8]

Thus, the profit that results from sales and trading is generally permitted (Siddiqi, 1998: 3). In the archetypal form of Islamic investment, namely, via equity interests, providers of capital are encouraged to "participate in the financial results of a venture financed by them, as long as the returns are not pre-determined in positive and fixed amounts" (Soe, 1997: 383). Interest is accordingly replaced by profit-and-loss sharing schemes, with the financier said to be directly engaging in the trade that results from the joint venture. This practical and personal economic involvement of the Islamic financier can occur in a number of ways: for example, by acquiring an equity stake in a business venture (equity financing); by participating in commerce through the trading of goods (trade and debt financing); or alternatively by participating in the production of goods through the leasing of capital equipment (lease financing). These techniques and the instruments that facilitate them are considered below.

It is often thought that because of this "direct and active" involvement, "Islamic banking is a risky business" in sharp contrast to conventional banking, and as such "it is this risk-sharing that justifies profit-sharing and hence the return to capital in an Islamic system" (Arif, 1988: 3; Carlson, 1986: 69). Yet, as will be seen, the dictates of global economic practices are such that this risk-sharing, in the absence of pre-determined gains, features only to a limited extent in Islamic instruments.

Overviews of the concept of Islamic banking tend to stop at this point, leaving "Islamic" to become misleadingly synonymous with "interest-free". However, there are further prohibitions on the commercial pursuit of profit within Islamic precepts, the aggregation of which need to be understood in the context of their Divine nature. Ancillary to the *ribâ'* injunction are further proscriptions relating to *garâr* (undue risk of speculation) and *masîr* (gambling or chance (Rayner, 1991: 141; Saleh, 1992: 62-66). These two concepts are closely related and, like *ribâ'*, are inadequately defined in the classical Islamic law texts. *Garâr* and *masîr* operate to void a contract for lack of certainty, especially where the anticipated (but not pre-determined!) gain of each party cannot be clearly devined at the time the contact is made. As a result, the contract price must not be left subject to determination at a later date by reference to future market value, nor should it be set later by a third party (Rayner, 1991: 144). On this basis, a joint-venture contract of investment (a *muḍârabah* or *mushârakah* arrangement) might seem illegal, given that the return on one's capital and labour cannot be predicted with certainty. But a "reasonable" amount of this type of commercial risk (*mukhatara*) is acceptable (Rayner, 1991: 241; Saleh 1992: 145), and is in fact what is encouraged by the heavy emphasis placed on participation within Islamic economics. Risk-sharing should thus be differentiated from the improper risk of *garâr*.

If a "bottom line" of Islamic banking and finance is to be sought, it could be summed up as follows:

> In Islam, there can be no guaranteed pre-determined return, and variable returns are to be calculated on the basis of shared risk (Suratgar, 1984: 10-2).

Yet as with all "bottom lines", the definitiveness of such a statement is misleadingly simplistic. This is because the restrictions of *ribâ'*, *garâr* and *masîr* upon Muslim commercial activity are most properly understood and construed within their broader context; namely, the moral and ethical framework of Islam. Unlike the secular polities and legal systems borne out of the West's "Age of Reason", there is no separation of law from religion and morality under Islam. The central concept of *ribâ'*, for example, "is condemned on the ground that receiving something in exchange for nothing is immoral" (Sloane, 1988: 145). Such morality in law arises because in representing the totality of God's commands, Islamic law governs the life of all Muslims (the ummah) in every respect (Angell, 1995: 16/03; Ariff, 1988: 194-5). The *sharî'ah* therefore necessarily entails both prescriptive and prescriptive dimensions. As will be seen, however, in implementing the *sharî'ah* in the field of Islamic banking and finance, it is the proscriptive elements which have been emphasised, such that a negative definition has prevailed: "conformity with the *sharî'ah*" is taken to mean "not contravening the Islamic prohibitions", with only peripheral concern given to the Qur'anic norms of social and economic justice.

Islamic banking and finance can thus be understood, in short, as being informed by immutable injunctions, the interpretation and application of which remain inherently unsettled. It is within this setting that Islamic banking and finance has grown exponentially in the latter quarter of this century.

A Growing Investment in Islamic Financing

The *modern* Islamic banking and finance sector began in Malaysia with the passing of the Islamic Banking Act in 1983.[9] The industry flagship. Bank Islam Malaysia Bernad, also began operating in that year, and it remains the only bank to have since been licensed under this Act. From RM41 million in 1983, Bank Islam's total financing to customers had grown to RM1.1 billion in 1993, and continued to balloon to RM2.5 billion by 1997 (Bank Negara Malaysia, 1994: 328; Bank Islam Malaysia, 1997: 22).[10] This rapid expansion in the demand for Islamic financing led to the introduction of the Interest-Free Banking Scheme in 1993, the effect of which has been to open up the Islamic financial market to conventional, secular bankers who, like Bank Islam, are authorised to market products that "do not involve any element which is not approved by the Religion of Islam".[11] In 1997, it was reported that 52 financial institutions are offering Islamic banking products and services in Malaysia, with an annual growth rate in that year of over 75 percent across the industry.[12]

The Malaysian experience is a reflection of trends throughout the Islamic world.[13] Such exceptional growth globally has been primarily attributed to Islamic revivalism as a reaction to the crisis of modernity,[14] and the political harnessing of such revivalism by the Muslim leadership (Saeed, 1996: 5-16). In the context of Arab Islamic banking, one author has contended:

> "The Islamic banking movement is proceeding with powerful backing, both financial and intellectual... the stakes are high enough that those in charge of the movement would not allow an overly restrictive interpretation of Islamic law to jeopardise economic efficiency" (Ray, 1995: 24).

To this insight, a further element of this "powerful backing" can be added; that is, the political. Under the direction of Prime Minister Mahathir, for example, the Malaysian government has given "cautious support" to the Faith (Mutalib, 1990: 127) implementing a policy medley of patronage and control. Given that contemporary Malaysia is a secular polity, whose formal identification with Islam remains largely ceremonial (Ibrahim, 1978: 49), the government has guarded against any form of revivalism that challenges the country's pragmatic practice of "Islam in moderation".[15] It is not inconceivable, therefore, that the introduction, promotion and declaration of success of Islamic banking and finance in Malaysia constitutes one strand in the government's strategy to pre-empt and counter Islamic opposition to the secular state.[16]

That the Malaysian leadership can indeed be said to have "invested in cultivating the Islamic banking sector (Blass, 1997: 62) is attested to by the increasing use of Islamic financing techniques in government sponsored projects. For example: a RM2.2 billion syndicated facility of government guaranteed notes issued under the principle of *bai' bi thaman 'âjil* (that is, deferred payment sales) for Kuala Lumpur's new international airport; the issuing of *bai' bi thaman 'âjil* bonds worth RM1 billion by Tenaga Nasional Berhad, the national electricity company; and the issuing of RM1 billion per quarter benchmark bonds under the *murâbaḥah* principle (that is, cost-plus financing) by the government's investment arm, Khazanah Nasional Berhad.[17] The prevalence of government endorsed think-tanks and the application of "Islamic ways of thinking" to all aspects of social science (Arif, 1998: 197)[18] also indicates in more general terms the government's investment, both pecuniary and political, in Islamic banking and finance. The condition denoted by this term, "Islamic banking and finance", has thus not only become increasingly valued in monetary terms, but has also become loaded with political appeal. This is because by being named "Islamic", certain characteristics are invoked. In the identity politics of pluralist Malaysia, Islam is arguably the most prominent focal point in the inter-ethnic balance between Malays and non-Malays.[19] This relationship has traditionally been marked by economic inequality, prompting the government to promote the position of the former relative to the latter. Islamic banking and finance is thus integral to its plans for inter-ethnic redistribution, through a strengthening of the Muslim-Malays' collective self-identification and participation within the commercial arena. From the Malaysian government's perspective, therefore, Islam is politically volatile: oppositional, yet also exploitable. It is this tension which underlies the government's qualified support for Islam and its promotion of Islamic banking upon wholly modernist terms, and it is a tension that remains firmly grounded in a secularist (ir)rationale.

Given that this paper is ultimately concerned with deconstructing this Islamic identity of certain contracts of finance within the Islamic banking industry of Malaysia, the spectre of legal orientalism is necessarily raised.

On Understanding Foreign Law

Orientalism, the richly critical discourse opened up by Edward Said (1978) refers to the condition of superiority that comes from the West's imagined knowledge of Asia, or the Orient. Throughout European imperial history, perceptions of supremacy by western "selves" became crystallised in the practices of dominance over Eastern "others". This imagined superiority has been (and indeed continues to be) reified by (neo)colonial projects, in turn confirming the West's exclusive possession over rationality, knowledge and civil society (Turner, 1994: 20-35; Gellner, 1994: 15-2a). And it is this issue of possession which bridges the discourse of orientalism with the politics of identity.

In this paper, the act of exposing the identity of these contracts simultaneously takes what was once foreign and turns it into the familiar: "theirs" will in the process become as much "ours". If the power relations implicit in Said's Orientalism teach that "to know is to subordinate" (Roushan, 1996) then in the context of law it can be said that "to know is to appropriate". For this is the creed of the private international lawyer, whose multi-jurisdictional practice is premised on the tenet that "if I can understand it, I can sell it". In a globalised marketplace, the indigenous is thus open for anybody's sale.

"Legal orientalism", by extrapolation,[20] is most compelling in its reminder that how we perceive and understand law is intimately related to how we view, and thereby judge, the culture from which that law derives. It should be clarified, therefore, that the purpose of this paper is not to infer the ultimate superiority of "conventional" (read: Western) legal approaches to financial transactions, from which so-called "Islamic" contracts can only borrow. Such an inference would conform to an orientalist project of delegitimising the *sharî'ah* and its efficacy within the commercial domain. Rather, in highlighting the minimal degree of difference between these Islamic instruments and their conventional counterparts, this paper aims to raise several of the issues that confront the protagonists of Islamic financing, as they work towards reconciling the sacred with the secular.

Instruments of Islamic Finance

In order for the Islamic banking and finance industry to operate competitively alongside conventional markets, several of the medieval modes of commerce that were sanctioned in the Islamic law texts have been revised and updated so as to achieve, at the very least, *modern* banking without interest.[21] But in their contemporary reformulation, important principles contained within these nominate contracts of the classical *sharî'ah* appear to have been downplayed in the interests of economic pragmatism. Thus, as the following survey reveals, it is by structuring the form of the financial arrangements so as to give putative effect to the prohibitions on interest in capital investment (*ribâ'*) and speculative transactions of risk (*garâr*) that what would otherwise remain conventional financing instruments have instead been branded with a peculiarly Islamic identity.

Of the over twenty differing Islamic financial concepts currently in use in Malaysia,[22] with more in development, six are reviewed here. Where clauses from these finance contracts have been excerpted and italicised in the text of the survey that follows, no acknowledgement of the contract's source has been made, primarily for reasons of confidentiality. It seems that Islamic contracts are perceived to be valuable commodities in themselves, with consultant lawyers and financiers being retained to devise these often commercial-in-confidence agreements.[23] As such, a secondary market within the Islamic finance industry is becoming apparent, wherein the protagonists of Islamic banking can themselves directly engage in the sale of their advice, either as practitioners or as members of the *sharî'ah* Advisory Councils that all Islamic financial providers are required to maintain.[24]

In approaching the following selection of instruments, it is important to note the altering of certain aspects of the legal terminology familiar to interest-based transactions. For example, 'borrower' and 'lender' becomes 'customer' and 'financier', and often 'debtor' and 'creditor' will read instead as 'purchaser' and 'seller'. 'Loan' necessarily becomes 'facility', and 'repayment' should be just 'payment'. That Malaysian Judicial Commissioners are continuing to use the "inaccurate" terms of conventional financing in their judgements concerning Islamic transactions has not escaped the critical attention of some Muslim commentators;[25] the implication being that the use of incorrect terminology indicates an inadequate understanding of the differences between conventional and Islamic financing techniques.

Critical Legal Scholars have demonstrated the power of language to shape one's understanding of the subject matter involved; here, the anointing of these transactions with an Islamic identity is aided by the selective use of non-conventional, non-Western, and hence "othered", terminology. As such, that the Muslim commentators would insist upon the correctness of the discourse from an Islamic point of view can be appreciated, given the formulaic nature of the transactions themselves. Western economists have noted that there is little substantive economic difference between the instruments used in Islamic and conventional financing techniques.[26] On this basis, the phrase "formulaic" seems apt, particularly since the Islamic credentials of the financing instruments considered below are to be found more in the legal form, rather than the economic substance, of the transactions that they facilitate. For these reasons, an altered discourse has understandably become one of the key markers of distinctiveness for financing arrangements based on Islamic principles. Malaysia is, in addition, reported to be the only country to have used Arabic names for every one of its interest-free financial instruments,[27] thereby adding a further air of authenticity. The inclusion of the customary prayer, "Bismillah Hirrahman-Nirraheem",[28] at the beginning of an agreement also further Islamises the transaction.

The practice of the drafters of these Islamic financial instruments appears to involve taking a financial agreement that is based upon English law, and then modifying it for *sharî`ah* principles. Yet in doing so, however, compromise and contradiction remains evident. For although the terminology may have changed, it is imperative - politically and economically - that the instruments remain familiar to the English-Malaysian common law legal system. It is therefore standard practice in each contract to specifically define "months", for example, as being "a Gregorian calendar month", meaning that the Muslim calendar has been displaced in favour of the calendar of the West, and of international commerce. Another example that, although minor in itself, tells of the concessions that occur is the retention of the standard English contractual clause on gender:

> "Words importing the masculine gender include the feminine gender and neuter gender and vice versa. Yet such convergence of gender is not known in Islam, which instead generally "ranks the female at half the tariff of the male".[29]

An indication that the contracting parties have anticipated that such discrepancies between the terms of the contract and Qur'ânic' principles may indeed arise can be found in the recitals section of each contract. It is expressly stated here within every instrument that the facility provided is in conformity with its respective "Islamic principle". For example:

> "The financier has agreed to make available the facility to the customer in accordance with the *sharî'ah* principle of *al-mushârakah* upon the terms and subject to the conditions hereinafter contained."

The use of a recital in this way allows to the parties to express a mutual understanding that their arrangement is purportedly pursuant to Islamic principles, yet still concede that for the sake of contractual certainty and economic expediency, the provision of the facility is necessarily and conclusively "upon the terms and subject to the conditions hereinafter contained". This paper now proceeds to consider the degree of incongruity between these terms and conditions within the Malaysian instruments from the classical principles from which their names derive.

Equity Financing

The principle held out as the epitome of Islamic financing is that of *muḍârabah*. This represents a "sleeping partnership" arrangement,[30] wherein the financier (*rabb al-mâl*) contributes capital, whilst the customer as project manager (*muḍârib*) contributes entrepreneurial effort and expertise. The profit that results from this joint venture is apportioned between the parties according to a predetermined percentage. Losses, conversely, are borne solely by the financier, except where the customer has been negligent or in breach of the terms of the *muḍârabah* agreement.

The parties to a *muḍârabah* arrangement can be understood, in theory, as not being tainted by *ribâ* due to the nature of their respective contributions to the partnership. On the financier's side, it is the element of commercial risk that it accepts when providing venture capital that justifies a return on its investment. If the venture is successful, the capital will be returned with a proportional profit, but if unsuccessful, the capital investment will be lost (Haron, 1997: 74). As for the customer, it is the contribution of management expertise that is central, since by definition, the "capital" that the entrepreneur provides to the venture is in fact in the form of its labour.[31] Therefore, the assumption of risk by the financier on the one hand, and the independent right of management by the entrepreneur on the other, represent two of the defining elements of the classical *muḍârabah* arrangement.

Yet in practice, these elements appear watered down, so as to allocate risk away from the financier towards the customer. According to the *fiqh* literature, "the investor cannot demand any guarantee from the *muḍârib* to return the capital, or the capital with a profit"; such a provision would invalidate the contract (Saeed, 1996: 54). In consequence, the financier relies instead upon other forms of indemnification that, whilst appearing to cover other areas, nevertheless achieve the same result. For example, jurists have declared that "guarantees against negligence, contract violations, and the inability to meet one's obligations are permissible (Al-Karran, 1993: 63-4). Guarantees such as these are accordingly expressly required of the customer within the modern *Muḍârabah* contract in use in Malaysia. The customer is also required to take out an insurance policy of *takâful*,[32] covering "any negligence and mishandling caused by the customer". A further means of limiting liability is the express declaration within the contract that the signatories have not entered into a partnership, so as to lessen the possibility that the financier will be held jointly and severally liable for the customer's actions. The overall effect of such precautionary clauses is to ensure that the financier is indemnified as much as possible, whilst nevertheless stopping short of contravening one of the fundamental legal principles of *muḍârabah*, namely, that loss will be carried by the financier alone.

The independent management of the project by the customer represents one such form of significant risk that the financier in practice seeks to mitigate. The entrepreneur's right of independent management was bestowed by the classical *fiqh*, on the ground that the entrepreneur requires as much latitude as possible so as to ensure the success of the venture (Saeed, 1996: 53-4; Saleh, 1992: 141-3). But this traditional managerial discretion is absent in the modern *muḍârabah* instrument. Whilst Bank Islam, for example, does acknowledge that it cannot "interfere" in the management of the venture, it nevertheless declares that it may "supervise" and "follow-up".[33] Such rights of supervision are actualised by contractual terms requiring the customer to submit periodic (sometimes daily) progress reports, to allow the financier to examine and audit its financial reports, and to permit the financier to stock-take the customer's stores without objection at any time. Yet whatever fine line may be drawn between oversight and management is rendered academic by the ultimate right of managerial veto that the financier retains by way of its unilateral right of revocation:

> "The banking facility herein granted shall be subject to annual review, and the financier may in its absolute discretion terminate the same at any time without assigning any reason thereto."

The *muḍârabah* in practice thus seems to deny the customer the opportunity to conduct business freely, as the contract stipulates in detail how the financier's capital is to be utilised. Any contravention of these terms makes the customer directly liable for the financier's losses. Guarantees against negligence, the level of scrutiny to which the customer's performance is subject, and the abiding threat of termination of the facility, all significantly detract from the customer's management rights. The balance of supervisory/managerial rights are thus determined by the contract in favour of the financier.

Closely related to the *muḍârabah* principle is *mushârakah*, which is another form of "partnership" (Haron, 1997: 74) or "joint-venture financing" (Bank Negara Malaysia, 1994: 331). This differs from *muḍârabah* in that capital is contributed by both parties, and consequently losses as well as profits are apportioned The ratio of the parties' participation in the financing activity determines the ratio that profits and losses are to be shared.[34] One or both of the parties may manage the affairs of the partnership (Saeed, 1996: 60-1) although in contemporary practice the institutional financier typically leaves management responsibilities (albeit with significant qualifications) to the customer.

Similar risk minimisation devices to those found in the *murâbaḥah* instruments also occur in the Malaysian practice of *mushârakah*. For example, in one housing construction joint venture agreement, the property developer (as customer) contracted to "bear all cost overruns whatsoever on the project". Such a clause devalues the principle of loss sharing, by shifting to the customer the commercial risk that the project might not eventuate as anticipated. That this was the intention within the agreement is clearly evidenced from the clause which stipulated that if the housing project is not completed within the specified time, or if any of the properties remain unsold, then "the financier may choose to be compensated in the form of cash or actual assets of adequate value". In combination with the additional requirement of insurance, the effect of such contractual terms is that the financier is able to ensure that whilst it might not be able to guarantee a profit, it nevertheless can ensure that, from the customer's own account, its capital is returned intact. Indeed, in the words of one Muslim critic:

> "One wonders, if it were a real partnership, as discussed in [the] *fiqh*, whether the bank has any moral right to throw all such responsibilities [for possible losses] onto the shoulders of its partner." (Saeed, 1996: 61)

Trade Financing

The financing of working capital under Islamic principles can occur via *murâbaḥah*, which is a "cost-plus-profit" arrangement.[35] This transaction takes the form of a contract of sale between the financier and customer at a price that covers the financier's capital outlay plus a pre-agreed mark-up, with the customer commonly paying the financier by instalments. Whilst in theory the financier is earning its profit through active trade with the customer, the nature of the transaction in practice means that the Islamic financiers that use this technique are beginning to move away from the profit-and-loss sharing principles of the *muḍârabah* and *mushârakah* partnerships, and are instead assuming the role of a "classic financial intermediary". (Saleh, 1992: 117)

To operate as a credit facility, the customer acts as the financier's agent and arranges to buy certain goods, for which the financier initially pays, most commonly via a letter of credit or a revolving credit facility. The customer then repays the financier an increased amount at a specified future date (Bank Islam Malaysia, 1994: 32-3). Due to the close proximity between this arrangement and conventional short-term financing, *murâbaḥah* has been derided by some Muslim commentators who perceive the financier as being able to illegitimately earn "a predetermined profit without bearing any risk.[36] Whilst it is true that the classical *sharî'ah* validates the *murâbaḥah* contractual form (Man, 1988: 92), it is the contemporary use of this arrangement that these commentators are questioning. This is because what in medieval times was sanctioned as a mode of *trading* is now being applied as a mode of *financing*. In common with *murâbaḥah*, the other Islamic techniques considered in this paper have also been similarly transposed to a new, and sometimes inappropriate, financial context.

Support for the criticism levelled by these Muslim commentators can be gained by considering how the following two issues are treated in the contemporary *murâbaḥah* instrument; namely, determining the amount of the mark-up, and the customer's subsequent right to dispute that amount. Detailed rules concerning these two points are contained within the *fiqh*, the effect of which has been to impose limitations upon the extent of profit that a financier could legitimately seek through *murâbaḥah* (Saeed, 1996: 76-82). According to the adherents of the Shafi'i school of law (predominant in Malaysia), all of the financier's expenses incurred in connection with the commodity or stock, being the object of the *murâbaḥah*, may be included in the amount of the mark-up, provided that the details and origins of these expenses are not only made known to, but are also approved by, the purchasing customer (Haron, 1997: 77-78; Saleh, 1992: 118-9). Consequently, if the customer believes the marked-up price to be unduly inflated, and the object is still in the customer's possession, the customer has the option of either returning the object for a full refund, or alternatively keeping the object and claiming the undue increase (Haron, 1997: 78; Saleh, 1992: 118-9; Yackop, 1996: 80).

However, these *sharî'ah* rules appear to be poorly reflected in the *modern* formulation of the *murâbaḥah* instrument in Malaysian use. Regarding the quantum of mark-up, for example, one contract for the purchase of raw materials stipulated that the mark-up shall be 1.2% of the purchase price of the commodity, plus an additional "service fee" of 1% of all sums released under the facility. No details were given in the contract as to the breakdown of these fees, leaving one to presume these amounts were intended to cover such items as the financier's handling charges, transaction costs and risk premium. Having stipulated the amount of the mark-up, the contract then included the following clause:

> "Notwithstanding anything herein contained, the financier reserves the right to vary and/or adjust the financier's profit margins, charges, costs and other monies whatsoever in respect of the financing facilities at the absolute discretion of the financier without assigning any reason therefor.

The sheer breadth of this clause surely derogates from the options conferred upon the *murâbaḥah* customer by the *fiqh*, let alone from the *sharî'ah* principle of certainty of obligations. If the customer wishes to subsequently dispute the amount of increase, the contract provides no recourse.

Clearly evident in the *murâbaḥah* instrument is the central design of modern financial practice; namely, the minimisation, if not altogether exclusion, of the investor's risk. Strict contractual terms achieve this goal, with numerous affirmative and restrictive covenants being agreed to by the customer. Negative pledges restrict, in the absence of the financier's prior written consent, any disposal of corporate assets, any variation in corporate structure, constitution, and management, and any subsequent issue of security to other financiers. Positive pledges, on the other hand, demand inter alia that the customer conduct its business "with due diligence and efficiency and in accordance with sound financial and industrial standards and practices", and furnish the financier with all business records and reports concerning the use of the *murâbaḥah* facility. The facility is furthermore secured in full by a third-party guarantee, promissory notes, 'and a covenant by the customer to provide any additional security "if and when required by the financier". Although nominally available for an extended period of time (for example, five years), the financier may unconditionally amend or revoke the facility at any time.[37]

Thus, despite the theory that the financier earns and bears the risks of loss and damage to the goods under *murâbaḥah* (Yong, 1993: 296) the risks inherent in this commercial arrangement are in fact allocated away from the financier. As such, *murâbaḥah* illustrates well "the sometimes thin line that separates legitimate trade from illegal *ribâ*' (Saleh, 1992: 117).

Debt Financing

Debt financing for the acquisition of assets or an increase in trading stock can be achieved under the Islamic principles of *bai' bi thaman 'âjil* and *bai' inah*, being "deferred payment sales" (Bank Negara Malaysia, 1999: 331). Both of these techniques are structured around a set of double sale agreements, with an asset being sold and then directly re-purchased by its original owner, but at a different price and with delayed payment. The underlying scheme common to these two transactions is that the financier receives more than the principal sum lent.[38] For both of these techniques, therefore, the legal fiction that the arrangement involves two discrete contracts of sale needs to be preserved: an interest-bearing loan would otherwise clearly contravene the *sharî'ah* proscription on *ribâ'*.

Bai' bi thaman 'âjil remains Bank Islam's most prevalent method of financing, accounting for over 70 percent of the total financing capital that it extended to customers in 1997 (Bank Negara Malaysia, 1994: 82). After negotiating with the customer as to the period and manner of (re)payment, the financier purchases the asset concerned, either from a third-party supplier or, more commonly, from the customer itself. The financier then immediately sells the same asset (back) to the customer upon deferred payment terms, and in so doing creates a credit facility that is secured by a charge over the asset concerned. The sale price for this second transaction is necessarily higher than the first, as it consists of the actual capital cost of the asset to the financier (being the first transaction price), plus the financier's margin of profits/it (Bank Negara Malaysia, 1994: 46-8).

Closely related in practice to the *bai' bi thaman 'âjil* arrangement is *bai' inah*, which is also the provision of credit masked by a sale with deferred payment. These two principles differ in that the initial ownership of the asset, and thus the capacities of vendor and purchaser, are reversed. Under *bai' bi thaman 'âjil*, it is the customer's asset which is initially sold to the financier, and then re-sold to the customer. Under *bai' inah*, conversely, it is the financier's asset which is sold to the customer, and then returned to the financier, with the security for the customer's obligation to pay the outstanding purchase price thus being wholly divorced from the asset traded. Under both arrangements, however, the selling and purchase price differential accounts for the financier's profit on the credit transaction.

Subject to minor limitations of the *sharî'ah* regarding certainty of object within a sale (Rayner, 1991: 131-4), does not seem to matter what the asset at the centre of either arrangement actually is. It is a condition precedent to the disbursement of, for example, the *bai' bi thaman 'âjil* facility under the initial asset purchase agreement that the attendant asset sale agreement be executed, and where necessary registered, "on even date". The effect of this contiguity is that the proprietary title to the asset will only have momentarily passed from the customer to the financier and back again. Whilst perhaps seeming to be of little practical concern, this transfer of proprietary title is crucially important from the perspective of Islamic law.[39] This is because it is the technique of a double sale which allows the provision of credit for a fee to conform legally, if not morally, to the *ribâ'* prohibition. As such, the techniques *bai' bi thaman 'âjil* and *bai' inah* offer one example of the legal stratagems (*hiyâl*) developed by Islamic jurists to circumvent the prohibitions of the *sharî'ah* that prove too ideal to be practicable.[40]

The use of a double sale serves the ulterior purpose well here, for the customer is said to be merely exercising its right to sell the asset at a lower price than that which it was acquired for (Rayner, 1991: 118). Furthermore, the nominate contract of sale, or *bai'*, is in its classical form considered to be the ideal contract in Islamic law (Coulson, 1984: 19-20, 97)[41], owing to the fact that it creates the least amount of concern over *garâr*; with a fixed price and immediate delivery of the specified goods, there is little scope for contractual uncertainty. The principal characteristic of this contract of sale is that the right of ownership passes for consideration (Rayner, 1991: 101, 103-5). Lest the form of the transaction be ignored in recognition of its substance, this defining feature of the *bai'* contract is specifically recited into the *bai' bi thaman 'âjil* and *bai' inah* agreements. For example, the first contract in the *bai' bi thaman 'âjil* transaction expressly provides:

> "Ownership of the asset shall pass to the Bank upon the execution of this Asset Purchase Agreement."

The asset appears to serve even less of a function under the *bai' inah* principle than under *bai' bi thaman 'âjil* since possession of the asset returns to the financier, it cannot be used to secure the customer's indebtedness. Its only identifiable purpose, therefore, is to facilitate the fiction of a sale. For this reason, it is submitted that of the several instruments canvassed in this paper. *Bai' inah* is the instrument most open to critique by the detractors of Islamic financing arrangements. Yet despite the fact that this transaction "represents the clearest case of legal subterfuge" to avoid the constraints of *ribâ'* the Shafi'i jurists have expressly allowed it.[42] Most other schools of law, however, regard the hollowness of the *bai' inah* transaction to be anathema (Rayner, 1991: 118-9).

In its classical form, the credit, or *inah*, sale was recognised by the jurists as amounting to an unsecured loan (Rayner, 1991: 276). Given that security is ingrained in the practice of conventional financing, however, the contemporary revision of the *bai' inah* contract as used in Malaysia is unequivocally secured in favour of the financier, with numerous contingencies included in the arrangement to guarantee the return of money, inclusive of the financier's profit on the transaction. For example, consider the breadth of the following clause in one *bai' inah* contract, entitled "Duration":

> "The Selling Price shall be paid in full by the Customer to the Bank in the manner provided above [for example, twenty-four monthly instalments of equal amounts]. Notwithstanding the foregoing, the Bank reserves the right to review at any time and from time to time the utilisation of the Facility by the Customer and the Facility shall be subject to recall or cancellation at any time if the Bank in its sole discretion considers it necessary to do so, and nothing in these presets contained shall be deemed to render it obligatory upon the Bank either at law or in equity to continue to make available the Facility or to afford any other accommodation or facility whatsoever to the Customer, and the Customer understands and agrees that the effect of such recall or cancellation would be to require the Customer to immediately upon such recall or cancellation pay the Selling Price to the Bank."

This represents a substantive "out" clause, conferring upon the financier an absolute discretion to oversee the customer's utilisation of the facility and withdraw the credit facility before the expiration of the contractual term. This clause is in addition to the customary "change in circumstances", "breach of representation or warranty" or "event of default" clauses included in all of the contracts surveyed in this paper; although, given the extent of the clause above, these more specific terms for repudiation would appear superfluous in this *Bai' inah* agreement. On its face, the agreement between customer and financier is the provision of credit for a fee over a specified duration.[43] However, by operation of the above clause the financier reserves an unconditional right to effectively rewrite an essential element of the contractual bargain; namely, the period of time that credit is available to the customer. This is indeed a critical aspect of the bargain, for it is according to the duration of the facility that the fee charged has already been calculated. In emphasising the inequality inherent in interest-based transactions, one Muslim economist from Malaysia has observed:

> "The creditor gets for himself a definitive amount of money for his loan, but all that the debtor is certain of is the time to use the money" (Harran, 1993: 19).

However, by the inclusion of such broad discretionary clauses as the one excerpted above, it is evident that this certainty of duration may not even be offered to the Islamic customer-debtor.

In similar measure to the instruments of *muḍârabah, mushârakah* and *murâbaḥah*, the financier ensures that it is indemnified against loss. If there are any cost increases incurred throughout the duration of the credit facility, or in the words of the *bai' inah* agreement, "the net value receivable by the financier be diminished", the customer is contracted to compensate the financier for the full amount. Mohd Illiayas has argued in the context of *bai' bi thaman 'âjil* that similar provisions requiring further payment by the customer on account of an increase in the financier's "cost of funds" renders the agreement void under the *sharî'ah* presumably due to *garâr*. This is because to enforce such a provision is to effectively compel the customer to pay an amount more than the sale price as that stipulated at the time the bargain was struck (Illiayas, 1995: clxi). Whether the inclusion of such a clause could in practice affect the validity of the contract is discussed in below.

In sum, it is evident that the credit sale of *bai' bi thaman 'âjil* and *bai' inah* perform the same economic function as an interest-bearing loan. The legal fiction offered by the double sale arrangement means that the parties can observe the letter of the Qur'anic proscriptions, whilst still effecting a conventional transaction.

Lease Financing

Another of nominate contracts known to Islamic law is that of leasing, or *ijârah*, the defining characteristic of which is that possession rather than title is transferred for consideration (Rayner, 1991: 101; Coulson, 1984: 19). Because the transaction is conceivable in Islamic terms as the sale of the benefit of an asset, this financing principle avoids *ribâ'* in a similar way to the *bai'* contracts considered above (Saleh, 1992: 121). The theme of risk-and-reward sharing that runs through Islamic economic theory also arises in this context, in the form of the mutual benefit ascribed to the contracting parties. On the one hand, the financier-lessor benefits under *ijârah* by retaining ownership of the asset, whilst still receiving a return from the sale of its usufruct. On the other hand, the customer-lessee also benefits by being able to utilise additional equipment to cover its present needs, despite the limits of a small capital base (Al-Harran, 1993: 95-7; Yakcop, 1996: 89). Yet despite this purported balance of benefit, finance leasing in practice typically ensures that as many of the transactional risks as possible are transferred to the lessee.

The *ijârah* instruments used by Islamic financiers in Malaysia are largely modelled upon the finance leases found in conventional English practice, in which the residual value of the asset is guaranteed.[44] This is done by calculating the total rental payable so as to fully amortise the capital outlay of the lessor, with an additional profit. When the asset is sold at the end of the lease, a substantial proportion of the proceeds are returned to the lessee (for example, a division of residual profits of 95% for the lessee and 5% for the lessor). Where the stipulated residual value is not realised in this post-lease sale, however, the lessee is required to compensate the lessor for the shortfall. In this way, the lessee bears what is referred to as the "residual risk"; namely, that the asset might fail to realise whatever price it was initially anticipated as being capable of producing at the end of the term.[45]

A further similarity between *ijârah* and conventional leasing is that the "operational risks" associated with the asset are also borne by the lessee alone. Given that the lessee has chosen the asset, the lessor assumes no responsibility for any shortfalls in the asset's quality or fitness, nor for any liability in tort or contract arising from the asset's use. Replacement and maintenance costs are also contracted as being borne solely by the lessee.[46] So as to indemnify the lessor against possible damage to the equipment, the lessee is also required to take out an insurance policy, albeit in the *takâful*, that is, Islamised, form.

From the foregoing, it is evident that the lessor's role in the *ijârah* arrangement is that of a mere financier. Yet even the "financial" or "credit risk" that the lessee may default in its rental payments has been mitigated by clauses similar to those contained in the other financing instruments discussed herein. Attendant with the clauses requiring a security deposit, third-party guarantees and the payment of a stipulated loss value to penalise the early termination of the lease, numerous performance covenants paralleling those found in the *murâbaḥah* instrument are required of the lessee.[47] Not only is repossession immediately effected upon breach of these covenants, but the lessee is also contracted to pay out the full amount of the rental if the asset cannot be sold within a stipulated period of time (for example, within one month). It is a requirement under Islamic principles of leasing that "the lessee have full power to derive benefit" from the asset (Yakcop, 1996: 89), a concept analogous to the common law's recognition of the lessee's right to enjoy "quiet possession and use (Wainman, 1995: 325). However, it is evident that the breadth of the modern *ijârah* instrument's terms and conditions has the potential to restrict the corporate power of the lessee, thereby substantially qualifying the right to enjoyment by the lessee.

One risk that cannot be shifted to the lessee under Islamic law is that of "interest-rate" risk. This is because unlike conventional leasing arrangements, the amount of rental due under an Islamic lease cannot be varied mid-term. As raised in above, the restriction on *garâr* would appear to prohibit any arrangement in which the consideration passing between the parties is not fixed at the time of contracting. Clauses in which the lessor is entitled to alter the rental payments upon the requisite notice being given would thus be disallowed under Islamic law. It has been suggested, to the contrary, that *ijârah* is more suited to long-term financing than *murâbaḥah*, for the reason that the lease rate can be varied to reflect the price changes of LIBOR, in contrast to the cost of a credit facility which cannot be subsequently reprised or linked to a floating exchange rate (Blass, 1997: 60). However, this proposal fails to contemplate *garâr*; perhaps indicative of the simplistic tendency referred above that reads "Islamic" as denoting "interest-free" only.

In sum, in conferring upon the lessee "the right to use the services of a given asset (Bank Islam Malaysia, 1994, 19), the *modern* Malaysian instrument of *ijârah* does retain the defining feature of its classical namesake. However, this right of use has been qualified so as to reflect conventional finance leasing arrangements, wherein "the risks and rewards of ownership of the asset" are substantially transferred to the lessee, despite a lack of legal ownership (Wainman, 1995: 135). For this reason, it has been commented that *ijârah* is rather "similar to conventional leasing facilities (Blass, 1997: 60). And thus, given that conventional leasing documents appear to be "frequently drawn up in a very one-sided way, keeping total control and all benefits firmly in the lessor's hands, and leaving the lessee holding a very short end of the stick (Wainman, 1995: 311) the same could also be said of leasing instruments drafted in purported conformity to Islamic principles.

The six techniques surveyed above illustrate a spectrum upon which the broader range of Islamic financing principles can be placed, ranging from the "strongly" to the "weakly" Islamic. The equity participation of *muḍârabah* and *mushârakah* typify that which is "strongly Islamic", whilst the finance leasing of *ijârah*, the double sales of *bai' bi thaman 'âjil* and *bai' inah*, and the cost-plus pricing of *murâbaḥah* illustrate that which Haron would term as "weakly Islamic" financial products, due to their "conformity to Islamic norms in form but not in substance (Haron, 1997, 80-1).[48] Yet despite this diminishing Islamic ethos as one moves further away from the archetypal sharing of risks and rewards between the providers and users of funds, the fact that all of these financing techniques remain able to claim a heritage in, and hence derive authenticity from, the nominate contracts of the classical *sharî'ah* means that they nevertheless retain their title (in theory at least) of being "Islamic principles".

But the theory behind these financing principles must be distinguished from their practical expression; namely, the instruments that facilitate them. And it is here that the Islamic nature of these financing techniques is at issue in this paper. Indeed, whilst notionally abiding by the Qur'ânic prohibitions on interest and speculative transactions, the incorporation of various legal devices within the instruments has nevertheless served to dilute the purported equality of the parties' sharing of losses. It is evident that the risks of the transaction are actually allocated to the customer, whilst the financier is effectively guaranteed against loss. And because the legal devices that achieve this risk allocation are taken directly from common law principles and practices on debt, security and suretyship, it is contended that these instruments are informed by English-Malaysian commercial law; albeit set within a *sharî'ah* mould. As such, these instruments mark a confluence of two distinct sources of law; a fact that is easily lost within their exclusive label of "Islamic contracts". What happens at the intersection of these two legal traditions, and the compromises that occur, is the focus of the next part.

Litigating these Instruments

Although the economic operation of these instruments is remarkably similar to those offered by conventional financiers, the peculiar structure of the transactions that results from the Islamic prohibitions do give rise to particular legal issues. Considered below is how such issues could arise in litigation, in which the validity and enforceability of these instruments are being contested. A preliminary question concerns an internal conflict of laws: in which court and under what law are these instruments to be litigated? If it is accepted that these instruments are to be governed by English-Malaysian common law principles rather than those of the *sharî'ah*, then it is worth considering how a party to the transaction could nevertheless seek to contend that Islamic law should still be operative.

A Possible Conflict of Laws

Within Malaysia's bifurcated legal system, the civil and religious courts exist in parallel.[49] Following the 1988 amendment of Article 121(1A) of the Federal Constitution, the jurisdictions of these courts became mutually exclusive: a narrow class of Islamic personal and family laws having been specifically reserved to the *sharî'ah* courts, leaving the hierarchy of civil courts to exercise jurisdiction over the remaining laws of the land.[50] Matters involving Islamic contracts, however, could conceivably straddle this jurisdictional divide. This is because the *sharî'ah* courts, on the one side, have been conferred jurisdiction in general terms over "the determination of matters of Islamic law and doctrine",[51] whilst the civil courts, on the other side, preside over contractual, commercial and financial matters.[52] If Islamic contracts are held as being within the *sharî'ah* courts' jurisdiction, owing to the fact that these instruments facilitate transactions that are explicitly premised on Islamic principles, then Article 121(1 A) would operate to constitutionally exclude such matters of Islamic commerce from the civil courts' jurisdiction.

Such an outcome appears to not be favoured by the proponents of Islamic banking, whose assessment of the competency of the religious court system remains less than complimentary. It is thought, for example, that the officers of the *sharî'ah* courts are not "equipped to deal with commercial transactions" (Shariff, 1997: 21), in the sense that "some cases may be intricate enough to require the intellectual and legal training of a High Court [that is, civil] judge (Soe, 1997: 396). Tied to this perception is a desire within the wider Islamic finance industry that the practical operation of their instruments be kept sufficiently analogous to those of their conventional counterparts (Kultgen, 1995: 15/10). For these reasons, the primary characterisa-tion given to these transactions is that of being "commercial", ahead of being "Islamic", so as to bring the instruments before the civil courts. A statement of the current convention as to this choice of forum for litigating these instruments is given by Bank Islam is the following terms:

> "The granting of financing facilities by the Bank, though based on principles of *sharî'ah*, are nonetheless commercial transactions and therefore come within the jurisdiction of the civil courts."[53]

That the proponents of Islamic financing have sought to avoid a possible conflict of laws in this pragmatic manner is apparent from the case of Bank Islam Malaysia Berhad v Adnan bin Omar.[54] At an interlocutory stage. Bank Islam successfully opposed an objection by the defendant that the Bank's claim for the recovery of money in default under a *bai' bi thaman 'âjil* facility ought to be most properly litigated in the *sharî'ah* court. Presumably, the defendant had hoped that a *sharî'ah* court would look behind the

Islamic form of the facility, and find that the substance of the transaction was interest-bearing, hence voiding the contract for contravening the prohibition on *ribâ'*. The civil court accepted the Bank's arguments that, firstly, financial matters fall constitutionally within its jurisdiction and that, secondly, due to its status as a body corporate. Bank Islam could not profess a religion, Muslim or otherwise, and thus it would not be subject to the jurisdiction of the *sharî'ah* Courts.[55]

Similarly, regarding the applicable law of these instruments, it is English law as received within the Malaysian legal system, rather than the *sharî'ah*. which is the preferred governing law. Where the governing law is stipulated in an Islamic contract, it is typically expressed only in very general, sometimes even ambiguous, terms. For example:

> "This *mushârakah* Agreement shall be governed by and construed in accordance with the laws for the time being in force in Malaysia."

As to the determination of what these general "laws in force" are, guidance can be had from an observation by Ahmad Ibrahim:

> "While in theory it may be claimed that Islamic law is the law of the land in the Malay States, in practice and in actual fact it is the English law which has become the basic law and the law of the land in Malaysia". (Ibrahim, 1993: 42)

And indeed, the Companies, Contracts and Evidence Acts that constitute the general Malaysian law in this context are copies of, or are largely based upon, English legal principles (Ibrahim, 1993: 41)

A construction of the terms of these contracts supports this finding that it is English rather than Islamic law that applies. It has already been noted that all of the instruments recite their conformity with Islamic principles, yet nevertheless then declare that it is the subsequent terms and conditions that constitute the agreement. The instruments also often briefly define their relevant Islamic principle, as the following recital illustrates:

> "The financier has agreed the provide the facility on the Islamic financing principle known as *murâbaḥah* pursuant to which a financier will purchase a commodity that a customer requires and will then sell it to the customer at a price that will represent its capital outlay and profit margin."

This apparent exclusivity, by way of both definition of principle and of strict contractual terms, obviates the need for the parties to have any further reference to Islamic law. Thus, as long as the instrument is valid under general Malaysian law, it remains effective, despite however cogently it may be argued that these contracts have been named "Islamic" for good reason.

Only a small number of cases involving Islamic contracts have been litigated to date,[56] although the incidence of contractual default can be expected to markedly increase due to the country's current economic downturn. In the two cases most recently litigated through to judgement,[57] the courts observed that the transactions were executed under Islamic principles, yet nevertheless based their decisions entirely upon civil, not Islamic, law. The recent case of Dato' Haji Nik Mahmud bin Daud v Bank Islam Malayia Bhd[58] is illustrative of how the courts have mere reference to, without undertaking due analysis of, the operation of these Islamic concepts (Ibrahim, 1993: 41). At issue in that case was the enforceability of a charge arising under a *bai' bi thaman 'âjil* sale and repurchase arrangement. Like the earlier case of Adnan bin Omar,[59] the court did not discuss the concept of *bai' bi thaman 'âjil* from the perspective of Islamic law. If it had done so, it would have noted that the legitimacy of the "fee" charged for the provision of credit via *bai' bi thaman 'âjil* is premised on the fact (or fiction?) of a sale in which physical possession of the goods passes from seller to purchaser, and back again. As explained above, without the transfer of possession that characterises a sale, the transaction seems otherwise tainted by *ribâ'* (Sloane, 1988: 748-9).

However, to hold that the certificate of title to land had indeed passed would have meant that, on the specific facts of the case, the transaction (including the charge) was void, on the basis that it had contravened a statute prohibiting the "transfer, transmission or vesting" of rights in certain Malay lands.[60] In avoiding such an outcome, the court misread the contemporaneous nature of the double sale transaction as involving no transfer of title at all. Yet if no transfer occurred, then would not then transaction appear to be left open to a charge of *ribâ'*? In this case, therefore, validity in English terms was necessarily premised upon invalidity in Islamic terms.

Thus, "although the civil courts have the power to administer and enforce the Islamic law in such cases", it is evident that they have not attempted to do so (Ibrahim, 1992: 13). How, then, could the litigants entreat a civil court to properly heed the relevance and application of Islamic law, whilst still containing their litigation within the current common law framework?

Invoking the *Sharî'ah*'s Effect on these Instruments

The financier, on the one hand, would generally have little concern for this issue, given that the contracts have been drafted in such a way that the financier's rights and remedies exist wholly independently of Islamic law. The enumeration of the customer's obligations as express contractual terms means that the contract can be performed and enforced without reference to the *sharî'ah*. Given the wide discretions reserved to the financier, in the rare case that a financier may wish to justify an exercise of its rights under the contract by reference to Islamic law, it would only be for a supra-legal legitimating effect.

Consider, for example, where a financier wishes to terminate a facility. In addition to the clauses that allow discretionary revocation, the financier could justify its action on the basis that the customer had used the credit facility for a non-Islamic, that is, prohibited (*ḥaram*) purpose; such as trading in alcohol or pork products, or using leased premises as a night-club.[61] Where the contract expressly provided that the facility could only be utilised for a permitted (*ḥalâl*) purpose, the financier's cause of action would proceed as for an ordinary breach of contract. For example, in one *muḍârabah* agreement the customer expressly covenanted that it would:

> "Ensure that its business is conducted in conformity with the *sharî'ah* and all other laws and regulations governing the same."

Alternatively, where no such term is included in the instrument, the requirement of the customer's conformity with the *sharî'ah* would need to arise by implication. The foregoing discussion on the applicable law notwithstanding, the financier could contend that given the contract was expressly executed in conformity with its respective "Islamic principle", it is a necessary implication that the dictates of Islamic law be imported into the contract.

Of greater intrigue is how the customer-debtor, on the other hand, could seek to make reference to the *sharî'ah* in its claim before a civil court that the instrument is, in both fact and law, not "Islamic". Remembering that it is the equitable division of risk implicit in the device of profit and loss sharing that defines Islamic financing, the customer-debtor could seek to highlight the marked absence of this defining feature in the facility instrument at issue. More specifically, any of the discrepancies between the classical *sharî'ah* and the contractual terms raised above could support the customer's claim: for example, the derogation of the customer's right to independent management under *muḍârabah*; a unilateral increase in the amount of mark-up under *murâbaḥah*; the uncertainty allowed for in the duration of the credit facilities of *bai' inah* and *bai' bi thaman 'âjil*: and so on. All of these provisions within the contemporary instruments tell of a disproportionate assumption of risk by the customer-debtor, that would arguably not be sanctioned under Islamic law.

There are a number of ways in which these claims of the customer-debtor regarding illegality in Islamic terms might be argued before a civil court applying English-Malaysian law. Firstly, the execution of a usurious or speculative transaction could be said to be ultra vires the Islamic financier's corporate constitution[62] and statutory fiat, both of which limit its financial activities to those that do not contravene Islam. In consequence, it could be contended that the Islamic financier should be prohibited from enforcing the charges that securities such un-Islamic transactions. This issue was initially raised in the case of Dato' Haji Nik Mahmud[63] in support of the plaintiffs motion that the charges executed in favour of Bank Islam under a *bai' bi thaman 'âjil* facility were in fact usurious, and thus should be declared null and void. However, this point "was abandoned at the outset of the hearing";[64] the reason for which is unreported. It is probable that a reason for this abandonment was a realisation of the effect of the statutory limitation in Malaysia of the common law ultra vires doctrine vis-a-vis a corporate constitution.[65] The consequence of this limitation is that the mere fact that an Islamic financier, as a body corporate, does not have the legal capacity to enter into the transaction at issue is insufficient to void the contract, however flagrantly *ribâ'* or *garâr* may appear to be infringed. A parallel argument could, however, be conceivably mounted in terms of statutory illegality; namely, that the interest-bearing object of an Islamic transaction is ultra vires the financier's statutory licence. Section 24 of the Contracts Act, in either of its "forbidden by law" or "opposed to public policy" limbs, would thus operate to void the contract.

Alternatively, the customer-debtor could seek to establish the voidability of the contract on the grounds that the financier fraudulently misrepresented to the customer as to the instrument's conformity to the *sharî'ah*.[66] In anticipation of such a claim, however, clauses have begun to appear in the instruments that effectively put the customer on notice so as to inquire into the true details of the transaction. For example, is recited into *bai' inah* contract that:

> "The Customer fully understands the nature and the mechanics of operation of the *bai' inah* principle and the Facility, and has with full knowledge of the same agreed to enter into the transaction and execute this Asset Sale Agreement, the Asset Purchase Agreement, the Charge and the Debenture."

Given that these transactions are also invariably set within a commercial context, in which the parties contract at arms' length, it seems furthermore improbable that a claim based in misrepresentation would, in the absence of extraordinary factors, be persuasive.

A third approach open to the customer-debtor involves seeking the court's intervention via equity. Such an approach has the added appeal of being consonant with Islamic principles, in that the *sharî'ah* provides for "considerable intervention by a judge to reconstruct or readjust an existing contractual obligation (Rayner, 1991: 93). Where a disproportion of obligation exists between the contracting parties, an Islamic court may step in on the grounds of unfair advantage (*istiglâl*), to redistribute those obligations in a more "equitable" manner (Rayner, 1991: 94). In this way, a rough parallel can be drawn between the doctrine of *istiḥsân* in Islamic law and equity in English law, in that "both authorise departure from a rule of positive law when its enforcement leads to unfair results (Kamali, 1991: 245). Here, by appealing to the equitable notions of fairness and good conscience, the customer could seek to limit the exercise of the financier's strict legal rights to terminate the facility at will, and without justification. It should be noted, however, that the customer-debtor's appeal in Dato' Haji Nik Mahmud[67] that the court in its equitable jurisdiction look to the usurious intent, rather than the legal form, of the *bai' bi thaman 'âjil* transaction was summarily dismissed by the court.

In the absence of legislative reform or judicial activism, in sum, Malaysian courts appear likely to continue to resolve commercial disputes involving the forms of contract discussed above by a contractual analysis that is without regard to the restrictions of the *sharî'ah*. The Islamic edging that circumscribes the common law of these contracts appears, therefore, only exhortative at best, and would not be directly enforced in a Malaysian civil court. Respect for the *sharî'ah* mould, let alone the ethics that underpin it, remains largely dependent upon the ideological convictions, or piety, of the parties concerned.

Conclusion: Seeking the Authentic

Outsiders who criticise the "huge discrepancy between the neology and the practice of Islamic banking" mistakenly take "the former as a projection of the latter (Neinhaus, 1986: 10). In levelling such criticism it is easy to forget that Islamic banking and finance is still in a transitional state in Malaysia, as elsewhere. A *modern* "Islamic banking" idiom has only been realised within the past two decades, in which time it has grown rapidly in both volume and sophistication, despite, or indeed because of, the prevailing economic and legal practices of the West. In the same way as its Islamic brethren of South and West Asia are grappling with the problem of "balancing reliance on concepts from European law with adherence to *sharî'ah* law (Sloane, 1998: 764). Malaysia too is needing to work through the tensions caused by competing legal traditions. These tensions are being perpetuated by the interdependent strands of globalisation; namely, the global and the local. The dictates of global economic trade, on one level, demand a continuation of this reliance upon and conformity with Western legal concepts and practices. Yet on another level, a reasserted Islamic consciousness and increasing alienation is leading towards a revival and reformulation of the *sharî'ah*.

Put briefly, the choice offered by Islamic finance is the acquisition of profit from risk-sharing, rather than by way of a fixed return. However, at the current stage in the development of these

Islamic instruments and the legal framework in which they operate, this choice is more apparent than real. The Islamic identity of these instruments is shored up by their Arabic titles and altered terminology, their recited conformity with Islamic principles, and the peculiar structure of the transactions. But yet all of these represent formulaic features, which do little to remedy the fact that the underlying ethics of Islam have been sidelined in favour of risk minimisation. And indeed, as Malaysia's central bank has recognised:

> "An Islamic banking system must also reflect the socio-economic values of Islam. In other words, it must be Islamic in substance and not merely in label" Bank Negara Malaysia, 1994: 324).

Given this paper's review of the instruments and their framework for litigation, it would seem that legislative and judicial reform is still needed,[68] in order to further develop the spiritual ethos that is implicit within an Islamic financial system. Until such developments occur, however, several consequences that follow from this paper's assessment of the current state of Islamic financing in Malaysia can be identified.

Firstly, for foreign legal practitioners, the "Islamic" tag need not daunt. For whilst appearing slightly different in terminology and form, these financial instruments are overwhelmingly familiar in content. This is because aside from reciting into the contract its purported conformity with Islamic principles, there is nothing non-English in the legal expression or reasoning contained within these documents. As such, a lawyer trained only in the common law could read, interpret and thus litigate these instruments.

Secondly, for the participants in Islamic financing arrangements, the absorption of the Islamic prohibitions within the broader body of English-Malaysian law offers a pragmatic outcome: whilst still fulfilling the traditional obligations of Islam, the contracting parties nevertheless remain able to engage in modern, conventional business practices. That these practices continue to be defined and litigated in secular rather than Islamic terms means that the traditional *sharî'ah* obligations are inevitably being recast into a wholly new form. Therefore, in accepting the invitation to participate in "the authentic", the contracting parties should be aware that underlying the Islamic formulation of their financial contracts is, in short, a paradigm that is recognisably English.

Thirdly, and by extension, for the proponents of Islamic financing, the challenge faced at present is how to most effectively move beyond the "mere sacralisation of normal banking (Ray, 1995: 3). To do so requires no longer defining Islamic law in a largely negative way. Currently, the "Islamic alternative" espoused within the Islamic banking and finance industry is being conceived in "simplistic formal legal terms"; namely, the elimination of interest-bearing and speculative transactions (Jomo & Check, 1992: 103-4). Countering this legalistic approach, however, is the fact that "capitalism cannot be Islamised simply by abolishing interest and aleatory transactions (Saleh, 1992: 108). As such, the development of transactional structures and commercial instruments that eliminate *ribâ'* and *garâr* on their face can only partly succeed in promoting the more holistic socio-economic relations prescribed within Islam. On the topic of legal change and development, Horowitz has theorised:

> "The possibilities of legal change the directions, the methods, and the context of the change are simultaneously limited and liberated by what the proponents of change know and know about, by what they are reacting against and what they are aspiring towards" (Horowitz, 1994: 242).

In the context of Islamic financing in Malaysia, the frame of reference for these proponents' knowledge is largely determined by the country's absorption within the economic and legal systems of West. The prevailing desire within Islamic financial markets is that the issuers and users of Islamic funds "maintain commercial standing and business reputation", on par with their conventional competitors. It is feared that radical reforms or a restrictive interpretation of the *sharî'ah*'s requirements could undermine this competitiveness. A wariness of economic and ideological obscurity is thus discernible, and it is this wariness that is currently driving, or indeed curbing, further developments in Islamic banking and finance in Malaysia.

Endnotes

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1. *Ribâ* is an Arabic word that has also been incorporated into the Malay language. The interpretation of the term, beyond being a mere synonym for interest or usury, is discussed below. For further definitions of the Islamic terms and concepts used in this paper, see Gibb and Kramers (1953), or Glasse, (1989).
2. Qur'ân, III: 130.
3. Qur'ân, II: 278. There are four direct refernces to *ribâ* in the Qur'ân, excepted in full in the following works: saleh, (1992: 42-43); Abdur-Shahid, (1984: 1100-1101); Haron, (1997: 53-56); Yakcop, (1996: 16-21).
5. The four schools of law (or *maktab*) within the *Sunni* (as distinct from the *Shi'ite*) brand of Islam are the Hanbalî, the Ḥanafî, the Mâlikî and the Shâfi'î. In Malaysia, like the rest of Southeast Asia, the Shâfi'î school is predominant: Tan, (1997: 276).
6. Two prominent jurisprudential methods are merely following the established opinions of earlier jurists (*taqlîd*), or instead exercising independent legal reasoning in reaching one's own findings (*ijtihâd*).
7. The Breadth of differing views by the traditionalists and the modernists on the interpretation of *ribâ* in canvassed in detail in Saeed, (1996: 41-50); and Saleh, (1992: 11-41).
8. Qur'ân, II: 275.
9. For Details of the pre-history of Islamic banking in Malaysia, such as the establishment of the pilgrims' Management Fund Board in 1969 and the formation of the National Steering Committee of Islamic Banks in 1981, see Man, (1988: 68-71).
10. "RM" denotes the national currency of Malaysia, the Ringgit.
11. For Bank Islam, see the Islamic Banking Act 1983, s 2, and for the conventional institutions participating in the Interest-Free Banking Scheme)Skim Perbankan Tanpa Faedah), see Banking and Financial Institutions Act 1989, s 124.
12. In 1997, total assets held across Malaysian Islamic financial markets amounted to RM17.9 billion (up 76.5 percent from RM10.1 billion in 1996), and total financing amounted to RM10.8 billion (growing similarly by 75 percent from RM6.1 billion in 1996). Statistics taken from Bank Negara's Annual Report for 1997, reported in "Islamic Banking Continues to Record Progress", Bernama 25 March 1998.
13. According to the International Association of Islamic Banks, there were 186 registered Islamic banks and financial institutions globally as of 1995, with total assets of US$166 billion, and net profits of US$1.27 billion: reported in "Islamic Banking Facing Challenge of Global Integration", The Star 18 August 1998.

14. Angell, (1995:16/14), for example, writes of the rootlessless experienced in urban migration and of a "reation against an essentially materially capitalist ideology".
15. Dr Mahatir Mohamad used this phrase, quoted in Mitton, (1997).
16. See, for example, Means' discussion of the political agenda surrounding the establishment of Bank Islam in 1983: Means, (1991: esp. 101).
17. Data drawn from "Banking & Structured Finance", <_HYPERLINK "http://www.zaidibrahim.com/banking&.htm", _http://www.zaidibrahim.com/banking&.htm_> on 21 July 1998; and "US$100b looks for Islamic Home", South China Morning Post 11 February 1998.
18. For specific examples of the islamisation policies of the Malaysian government, see Means, (1991: 99-105).
19. See generally, Crouch, (1996).
20. Said did not directly apply his theory of orientalism to a legal context, although others have done so: see, for example, Veronica Taylor, (1997: 47-62); and Strawson, (1995: 21-38).
21. The Foreword by Frank Vogel to Saleh, (1992: ix).
22. For an overview of the broader range of Islamic products available, see Bank Negara Malaysia, (1994: 329-33); Haron, (1997: 71-90); Nor Mohamed Yackop, (1996: 74-94); Yong, (1993: 301-306).
23. Indeed, I am unaware of any collections of forms and precedents of Malaysian Islamic contracts being published to date.
24. For Bank Islam, this requirement is found in the Islamic Banking Act 1983, s 3(5)(b), and for conventional financiers, it is found in the Banking and Financial Institutions Act 1989, s 124(7).
25. Note 10 in Illiayas, (1995: clv), referring to Bank Islam Malaysia Bhd v Adnan bin Omar [1994] 3 CLJ 735. Conventional terms were also used in the more recent judgements of Dato' Haji Nik Mahmud bin Daud v Bank Islam Malaysia Bhd [1996] 4 MLJ 295; upheld on appeal, [1998] 3 MLJ 393. See also Ibrahim, (1998: 8).
26. See, for example, Neinhaus, (1986: 10).
27. Haron, (1997: 80).
28. "In the Name of Allah, the Most Compassionate, the Most Merciful".
29. Coulson, (1969: 61).
30. Mudarabah can also be understood in English as "trust finacing", "trustee profit-sharing" and "commenda": Haron, (1997: 72)
31. Saeed's work is a detailed and provocative modernist critique of the discrepancies between the *sharî'ah* theory and Arab contractual practice.
32. *Takâful* is the Islamic method of insurance that seeks to comply with the prohibitions on *garâr* and *maysir* by structuring insurance into "a cooperative venture, in which groups pool their resources and provide payment to group members who suffer a loss": Horowitz, (1994: 290); see also Saleh, (1992: 123-126) .
33. Bank Islam Malaysia, (1994: 44).
34. Abdullah Saeed, (1996: 61); Haron, (1997: 75), however states generally that unlike the ratio of loss sharing, the ratio of profit sharing need not coincide with the ratio of participation.
35. Saleh, (1992: 117); Bank Negara Malaysia, (1994: 331). Working capital can be also acquired via the double sales of Bai` bi Thaman `Âjil and Bai` `Inah.

36. Nabil Saleh, (1992: 117); citing Muhammad Nejatullah Siddiqi; al-Harran, (1993: 98). For other endorsements of this criticism, see also Saeed, (1992: 93-5), referring to The Council of Islamic Ideology , Muhammad Nejatullah Siddiqi, and Ziauddin Ahmad. This level of profit is, moreover, often perceived as being commensurate to conventional rates of interest (Man, at 91), and, at least in the context of Arab Islamic banking, is "in almost every case" determined by reference to LIBOR, Blass, (1997: 60).
37. The legal devices described here are also very prevalent in the other forms of Islamic financial contracts considered in this paper.
38. The coupling of two such contracts together into a sale and repurchase agreement is not unknown in conventional financing. In the United States, for example, sale and repurchase agreements have frequently been used to evade curbs on direct lending occasionally imposed by the federal authorities: Burgess, (1992: 99)
39. The case of Dato' Haji Nik Mahmud v Bank Islam Malaysia Berhad [1996] 4 MLJ 295, upheld on appeal [1998] 3 MLJ 393, discussed below, illustrates this point.
40. Rayner, (1991: 23-24), citing Schacht's reference to hiyal as being the "modus vivendi" between theory and practice.
41. The Qur'ânic text excerpted earlier in this paper stating that "Allah has permitted trade" has also been transliterated as "Allah has permitted sale." Saleh, (1992: 42-3).
42. Mallat, (1988: 87), referring to Badawi.
43. Sudin Haron categorises Bai` bi Thaman `Âjil as a "fee—or charged-based service." By analogy, Bai` `Inah would be similarly characterised.
44. The absence of a guarantee of residual value is one element that turns a finance lease into an operating lease: Wainman, (1995: 136-137). Islamic financiers do not generally adopt the operating lease, "because it involves so much work and responsibility", in terms of maintaining the equipment necessary for recurrent hiring: Attia, (1986: 107-108).
45. A variation upon *ijârah* that is also used in Malaysia is *ijârah thuma bai`*, which confers upon the lessee the option of purchasing the asset at the end of the lease. This arrangement consists of an *ijârah* and Bai` contract signed consecutively: Yakcop, (1996: 89-90)
46. As to how the operating risks are allocated in conventional financing, see the draft finance lease and preceding explanatory notes in Wainman, (1995: at 3ll-341). The elements discussed therein are invariably evident in the *ijarâh* instruments also.
47. One Malaysian *ijârah* instrument seen enumerated over forty express covenants for performance by the lessee, any of which if infringed is deemed to constitute an event of default, and hence material breach of contract.
48. What Sudin Haron differentiates as "strongly and weakly Islamic", Zakariya Man categories as "first-line and second-line techniques" respectively: Man, (1988: 91-93).
49. For an introduction to Malaysia's pluralist legal system, see Tan, (1997: 287-292).
50. Marican, (1998: 1xxvii-lxxxviii); see generally Ibrahim, (1992: 295-317).
51. Item 1 of the State List of the Ninth Schedule of the Malaysian Constitution.
52. Items 4, 7 and 8 of the Federal List of the Ninth Schedule of the Malaysian Constitution.

53. Bank Islam Malaysia, (1994: 159); Ibrahim agrees.
54. Kuala Lumpur High Court, Civil Suit No. S3-22-101-91, unreported: Mohd Illiayas, above n 50 at clii-cliii; Ahmad Ibrahim, (1998: 4).
55. 'It is stated in item 1 of the State List of the Federal Constitution that the *sharî'ah* courts "shall have jurisdiction only over persons profession the religion of Islam". Given the politics of law in Malaysia, it would not be surprising to learn of a corporation being deemed as having a religion, particularly if Islam was the religion at issue. The reasons for this supposition are, however, beyond the scope of this paper.
56. The three reported cases in which Bank Islam has featured as a party are: Tinta Press Sdn Bhd v. Bank Islam Malaysia Bhd [1984] 2 MLJ 192; Bank Islam Malaysia Bhd v Adnan bin Omar [1994] 3 CLJ 735; and Dato' Haji Nik Mahmud bin Daud v Bank Islam Malayia Bhd [1996] 4 MLJ 295, upheld on appeal [1998] 3 MLJ 393.
57. Adnan bin Omar [1994] 3 CLJ 735 and Dato' Haji Nik Mahmud [1996] 4 MLJ 295.
58. [1996] 4 MLJ 295, upheld on appeal [1998] 3 MLJ 393.
59. [1994] 3 CLJ 735.
60. The Malay Reservations Enactment 1930 of Kelantan, ss 7(i) and 12.
61. Under the *sharî'ah*, as for English law, the object of the contract must be licit (*mubâḥ*): Comair-Obeid, (1996: 24-25).
62. Bank Islam's Memorandum of Association, for example, states that "all businesses of the company will be transacted in accordance with Islamic principles, rules and practices": excerpted in Ibrahim, (1992:3). See also Haron, (1997: 9).
63. [1996] 4 MLJ 295, [1998] 3 MLJ 393.
64. [1998] 3 MLJ 393 at 396.
65. The Companies Act 1965, s 20(1). See, for example, Arjunan and Low, Lipton & Herzberg (1995: 48-51); and CCH, (1995: 104-107).
66. Applying the Contracts Act 1950, ss 14, 18 and 19. As to the specific application of these general principles of contract law, see, for example, Sinnadurai (1987).
67. [1996] 4 MLJ 295, [1998] 3 MLJ 393.
68. See, for example, Jamaluddin, (1996: 13-20).

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