SOME ISSUES OF BAY’ AL-‘INAH IN MALAYSIAN ISLAMIC FINANCIAL MARKETS

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PROBLEM STATEMENT

The contract of bay’ al-‘inah normally involves a sale of an asset or property by a first party to a second party for immediate or spot payments followed by an immediate sale of the same asset by the second party to the first party for a higher amount on deferred payments. The asset is by no means useful to both parties either for consumption purposes or derivation of usufruct (manfaah). Apparently this device is used to bypass the Quranic prohibition of interest as riba since the main objective of the contract involves two consenting parties both of whom are willing to pay and receive a contractual rate of return on a loan. Even though bay’ al-‘inah is not a loan, it resembles one when both parties ignore the real intent of buying the said property. For example, the purchase of consumer goods is for the purpose of consumption. Likewise, a trader who purchases an asset will later sell it with an intention of making a profit. In other words, the object of sale (Mal Mutaqawwim) must offer benefits (manfaah) to the buyer.1 However, in an ‘inah sale this condition is not met by both contracting parties.

Based on the above, the application of bay’ al-‘inah in Malaysian Islamic financial markets today is a cause for concern to many observers since the contract allows the contracting parties to observe and execute identical conditions set by any existing interest-based financial agreement. The implication in using an al-‘inah sale is serious as participants as buyers will be subject to similar legal measures as debtors who enter into the contract of interest bearing debts. In the event of a banking crisis, one who defaults on the ‘inah sale will face similar consequences as most loan defaulters. As bad debts will deplete capital, the same applies to Islamic banks and similar financial institutions using al-‘inah

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1 As the law of contract revolves around the concept of property (al-Mal), the four conditions concerning the object of sale are: (1) legality; (2) existence; (3) deliverable; and (4) precise determination. As stated by Rayner, on the legality aspect, the object of sale must be something of use, i.e. the contract must contain lawful benefit to both contracting parties. Otherwise the contract is invalid (batal). See Rayner, The Theory of Contracts in Islamic Law, pp. 131–132 and 154.

Arab Law Quarterly, [2001]

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instruments. This article will argue that bay’ al-‘inah is unanimously rejected by most Muslim jurists. Although the contract is valid by al-Shafi‘i’s legal theory, the difference in opinion is only methodological in nature. One can say that al-Shafi‘i’s teaching has reached a level, which is similar to the other Muslim schools, although the methodology which he adopted appears to be different. The Shafi‘i may thus permit the contract because its legal preconditions are fulfilled, but forbids the transacting act of the parties when it conflicts with Shari‘a principles. It follows that when al-‘inah sales are applied in the Islamic banks and the capital market it will put the system back into the culture of debt financing. It readily supports the wealthy and large corporations, but is incapable of helping the start-ups, who usually have less than sufficient assets or collateral to support their demand for funding.

RIBA AND THE DEBT DEPENDENT ECONOMY

The developmental role of Islamic banking and finance is not significantly different from its conventional counterparts. Both are financial intermediaries serving to mobilise savings from the surplus sector and performing a credit allocation function to the deficit sector. The main difference being in the nature of financial contracts applied in these markets. For example, in Islamic banking, the contract of al-bay‘ replaces the contract of loans. The main issue for this replacement is the prohibition of interest as riba. As such deposit taking and financing activities must avoid the payments and receipts of interest.

The distributational issue has often been used to explain the evils of riba. Since profits from riba are created without the existence of ‘tiwad, namely an equivalent countervalue, riba constitutes an unlawful gain as it is created without risk-taking and value-addition activities. Literature on Islamic banking often said that people who benefit from riba do so without putting work and effort into the business transaction. These returns are contractual in nature, in which lenders hold a legal claim. Failing to make full repayments of capital and interest allows lenders to take legal action against borrowers. Bankruptcies and business closure are common examples of punitive damages of the interest system. When capital owners are allowed to create wealth in this way they become richer by virtue of the capital accumulation in which the de facto machine is interest. On the contrary, people who contribute to risk-taking and value addition, namely the borrowers, are bound by the law to repay both capital and interest even if the business fails to earn profits. It follows that in the long-run the distribution of income will work in favour of the lending sector.

The Asian economic crisis bears testimony to this. Debt ridden companies find no protection under a régime where defaulters are punished discreetly even if they can still play a positive role in economic development. For example, it is common

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practice among banks to accept stocks as collaterals on loans. The stock market meltdown across the emerging market countries in 1997 saw banks recalling loans when the value of collaterals depreciated. It halted factory operations leading to colossal layoffs and loss of income. Borrowing via the bond market too suffers acutely under a collapsing currency system. Depreciation of currencies arising from panic selling of stocks followed by short-selling of affected currencies impact on borrowers in a big way as they must continue to pay debt in hard currencies.3

Our main contention in this article is to argue that in the event of an economic and banking crisis, bay’ al-‘inah oriented financial instruments can do less to help economic recovery, which traditional instruments are also incapable of. It therefore fails to project the conception of justice that Islam desires man to pursue by using al-bay’ instead of riba. We will argue that the bay’ al-‘inah contract must be used discretely for it does not serve to be applied wholesale as evident in the Malaysian case.

BAY’ AL-‘INAH IN MALAYSIAN FINANCIAL INSTITUTIONS

The Malaysian financial markets can be divided into two main parts, namely the direct and indirect financial markets. The former shall consist of the capital and money market, while the latter includes the financial intermediaries, namely the banking sector, unit trusts, insurance companies and pension funds. In the capital market funds are mobilised via the bond and stock market. In 1997, the trading volume of equities listed on the Kuala Lumpur Stock Exchange (KLSE) was RM221.4 billion, while total trading of debt securities was RM64.5 billion.4 The money market mainly functions to serve liquidity needs via the discount houses and inter bank money market.

At present, Malaysia contributed about 10 per cent of the total US100 billion global Islamic funds, in which RM7.3 billion (US$1.92 billion) consists of Islamic bonds. But the size of Islamic banking assets relative to that of conventional banking in Malaysia has remained low, estimated at RM34 billion with a market share of only 5.4 per cent in 1999.5 About half are allocated to finance housing and property, which will make it relatively easier to apply the bay’ al-‘inah contract. The Islamic insurance (takaful) sector is much smaller by size with a market share of only 1.4 per cent. In the equity market, 544 out of 745 or 73 per cent of equity stocks traded in the KLSE are Syariah compliant.6 In 1999 there

were 13 Islamic unit trust companies with a net asset value of RM1.4 billion (US$363 million).\(^7\)

The application of bay’ al-'inha in the Malaysian financial market is by no means small since it is operative in almost all Islamic bonds. It also constitutes a significant amount in Islamic banking products and may be further applied whenever the need arises to adopt traditional interest-bearing instruments.

**Bay’ al-'inha in the banking sector**

This part of the article will discuss the existing interest-free banking products in the Malaysian market where the contract of bay' al-'inha is applied. It is worth noting that the contract of bay' bithaman ajil or al-murabahah is instrumental in making the bay' al-'inha transaction possible in the banking business. Before we look in greater detail about how bay' al-'inha works in banking, it is important to see that this contract is made up of two basic commercial transactions, namely: (i) al-bay' al-mutlak (cash sale); and (ii) al-bay' al-bai-bithaman ajil (deferred sale), both of which are applied in sequences. Sometimes the deferred sale is preceded by a spot sale and vice versa but both ways each party gets what it wants.

For example, when sale by deferred payments is preceded by a spot sale, it is a case where the bank sells an asset to the customer with payments made in equal installments, say for RM12,000 payable in ten months. The installment sale saw the customer executing his right to sell back the asset to the bank on a cash basis, say at RM10,000. The installment price has to be higher than the cash price if the bank wants to profit from the sale. In essence, the bank and customer have both achieved what both wanted. The customer gets the RM10,000 cash he wanted and the bank makes the RM2,000 profit from the RM10,000 invested fund. The object of sale comes into play by virtue of a trick to get away with interest payments and receipts.

The same applies when the bay’ al-mutlak preceded al-bay’ bithaman ajil. Here the customer sells his asset to the bank for cash, say RM10,000, after which he will purchase it back from the bank on a deferred payment basis, say at RM12,000. Again both parties get what each desires, while the asset took a fictitious character. It is not utilised in the same way that a genuine buyer would use it.

**Bay' al-'inha personal financing**

Conventional banks provide a number of products for personal finance such as personal loans and overdrafts. In a personal loan, the bank normally charges a higher spread since the loan is not collateralised. The interest rate is therefore higher than interest rates on housing and car loans. Normally, consumers apply for a personal loan for the sole reason that they can spend the money any way they like.

If the principle loan is RM10,000 and interest per annum is 15 per cent, a five year repayment period will require the customer to pay the bank RM291.70 per month. The customer is contractually required to pay the bank a total sum of RM17,500. In other words, the loan contract guarantees the bank the principle loan and interest.

As Islam prohibits interest as riba, a customer who is looking for a personal loan cannot utilise the above facilities. But he is willing to pay the necessary charges required by the bank as long as the contract is free from riba. The bank too wants to generate income for every dollar it gives away for financing. But the essence of the story is still the fact that the customer wants a loan and the bank is willing to lend but at a price.

One way out is to use the contract of sale since the Quran says: “Allah has allowed trade (al-bay') but prohibits riba”. To do so, the bank sells goods X to the customer for RM17,500 via the bai-bithaman ajil system in which it receives RM291.70 in monthly repayments for five years. The customer will then sell back the asset to the bank on a cash basis for RM10,000. Both ways the customer gets his cash while the bank earns RM7,500 in profit. This form of sale clearly indicates that both parties are not interested to perform al-bay' in its true sense but rather to reap the benefits of loan financing. In Malaysia, bay' al-'inah personal financing is presently practised by Bank Kerjasama Rakyat Malaysia and Mayban Finance. Banks choose a specific asset as the object of sale (mahallul aqdi) to cater for the hundreds or thousands of personal financing transactions. Certainly, this shows that the mahallul 'aqdi is only fictitious, that it is not intended to serve its function. Bay' al-'inah is used here as a legal device (hiyal) to legitimise the payments and receipts of interests.

_**Al-Naqad financing**_

_Al-Naqad_ as a mode of financing is a product of Bank Islam Malaysia Berhad (BIMB). It differs from Bank Rakyat's bay' al-'inah financing by virtue of using a genuine asset rather than a fictitious one. In _al-Naqad_, a spot sale is first executed followed by a deferred sale. This time, the customer sells his asset to the bank for cash payments after which the latter will sell it back to the customer at a mark-up price. For example, Mr Ali owns a piece of land valued at RM100,000. He needs a RM50,000 loan but he wants to get one without riba. He can sell his land to the Islamic bank for RM50,000 on a cash basis after which the bank sells it back to Mr Ali on deferred payments. The bank sets the annual profit rate, say 10 per cent. If Mr Ali needs five years to make full repayment, the mark-up is RM25,000. This follows that the selling price is RM75,000 where Mr Ali pays a RM1,250 monthly installment payment. Again, the land is not meant for genuine use as both parties have no intention of doing so in the first place. It only serves as an object of sale to legitimise the profit made from the transaction.\(^8\)

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\(^8\) Maybank offers _At-Tawuell_ overdraft using similar apparatus. See Solehah Omar, “_At-Tawuell and Overdraft Facility in Maybank_”, project paper for the partial fulfillment of Bachelor in Shariah, Islamic Academy, University Malaya, 1996.
Negotiable Islamic Certificate of Deposit (NICD)

The Negotiable Islamic Certificate of Deposit (NICD) is a deposit product that operates on similar lines as the conventional Negotiable Certificate of Deposit (NCD). The NCD, or as it is often known the Certificate of Deposit (CD), is a debt certificate or security issued by the bank, who now acts as a debtor to the public. Let’s say a one year RM10,000 CD pays five per cent interest. At the end of the year, the CD holder is guaranteed RM10,000 plus RM500 in interest. Certificates of Deposit are popular because they can be traded in the secondary market. This special liquidity attribute makes it an attractive deposit product compared with fixed and saving deposits, both of which are not tradable. In 1996, NCDs issued accounted for 11.8 per cent of total deposits.

The NCD to some extent is a fixed rate liability which can be useful to help dilute the predominantly variable rate Islamic deposits, such as Wadiah Yad Dhamanah and Al-Mudarabah investment deposits. The former guarantees only the principle while the bank holds the option to give profits on deposits, while the latter guarantees none. This makes it relatively difficult for Islamic banks to contain the asset-liability mismatch problem. In other words, besides the problem of matching short-term deposits to long-term financing, Islamic banks are also exposed to the problem of holding predominantly variable rate deposits as opposed to fixed rate assets such as al-murabahah and al-bai-bithaman ajil financing.

The application of Shari’a principles to CDs is therefore crucial to reduce dependency on variable rate deposits. To do so Islamic banks, such as Bank Islam Malaysia Berhad, has applied bay’ al-‘inah to produce the Islamic version of the NCD. Known as the Negotiable Islamic Certificate of Deposit (NICD), the procedure remains similar to the ones applied in bay’ al-‘inah personal financing and al-Naqad. For example, Company A wishes to put RM1 million in NICD with Bank Islam Malaysia. Here, the bank sells a specific asset worth RM1 million such as share certificates to Company A. The bank now secures a RM1 million new deposit. Now, Company A sells back the share certificates to the bank at a deferred price, which is based on a profit rate, say 7.5 per cent for a duration of six months. The selling price was at RM1,037,500 where Company A earns RM37,500 in profits. The bank pays Company A by issuing NICDs worth RM1,037,500. The issuance of the NICD is undertaken as evidence of the RM1,037,500 debt that the bank owes Company A. Upon maturity, the NICDs are redeemable at par value where Company A gets back the RM1 million deposit plus RM37,500 profit.9

Based on the three banking bay’ al-‘inah products described above, it is worth concluding that all bay’ al-‘inah sales primarily consist of two components, namely:

1. Spot sale (al-bay’);
2. Sale by deferred payments (Al-Bai-Bithaman ajil).

9 For more information see Bank Negara Malaysia circular on Guidelines on Islamic Negotiable Instruments, Kuala Lumpur, 8 December 1998.
In the Bank Rakyat model, the personal financing transaction is initiated by a deferred sale followed by a spot sale. In this case, the bank acts as the first seller of the fictitious asset in which payments are paid by installments. The same applies in the issuance of NICDs. The bank assumes the role of the first seller. However, in the al-Naqad model, a spot sale is initiated by the customer followed by the bank resale based on installment payments. Here the customer and bank acted as the first seller and second seller respectively.

What we see in the above is a deliberate attempt to bypass interest by virtue of using al-bay’ as an insurance against violating Shari’a principles. The easy application of BBA has made the use of the al-‘inah sale even comforting. Customers virtually see that the intention to use the object of sale is non-existent. For example, when a computer is used to execute an al-‘inah sale, it is never intended to be used by the customer either for personal, business, or trading purposes. The same computer is used to execute new al-‘inah financing involving new customers. In the al-Naqad model, apparently the bank has no intention of using the asset it purchases as a mode of finance or investment but only to execute a resale transaction with the original owner.

The same applies to the NICD where shares are sold and purchased at a profit without there being any investigation as to whether the company is performing up to standard. These illogical decisions seem to run against any form of rational thinking. How the al-‘inah sale is approved by the Shari’a panels at the respective banks is perplexing as they seem to pay more attention to the technicalities of fiqh by downplaying ethics and morality (akhlak) or the sense of justice the Quran intends to project by way of declaring riba unlawful.

Bay’ al-‘inah in the capital market

So far, the application of bay’ al-‘inah in the capital market only took place in the Islamic bond market while Islamic stocks are sometimes used as the object of sale (mahallul ‘aqdi) to facilitate the ‘inah sale. In this part of the article we will highlight the process by which the bay’ al-‘inah contract is used in the Islamic bond market.

Al-Murabahah Notes issuance Facility (MuNif)

Both MuNif and BAIDS (Al-Bai-bithaman Ajil Islamic Debt Securities) hold a similar structure, except the latter is a long-term bond with maturities exceeding 10 years. To issue MuNif, the issuer sells some underlying assets to investors in return for cash payments. These assets must be of equal value to the amount of funds required and normally comprise fixed assets and stocks of the issuing companies. Sometimes, expected cash flow from a non-existent project is used to securitise the bonds.10 Once the cash payments are made, the investors sell the

10 Securitisation in traditional finance generally implies pooling assets with future cash flows such as housing and vehicle loans or credit card receivables and selling securities or bonds back by these pool of assets to investors. See Frank Fabozzi and Franco Modigliani, Capital Markets: Institutions and
asset again to the issuer with payment made by way of installment in which the principle amount is paid in bullet form at the end of maturity, by way of issuing primary notes while the profit component is paid every six months. Here the realisation of profits is made possible through issuing secondary notes each maturing every six months. Issuance of bond or debt certificates is similar to the sale of an asset or property (al-mal) since the newly issued bonds are now supported by a package of underlying assets agreed upon by both parties.

In essence, MuNif and BAIDS are coupon bonds with contractual coupons payments, which make them similar to conventional interest-bearing bonds. In this way, both issuing and investing party will be able to obtain what they actually want, namely the payments and receipts of a contractual rate of return with guaranteed repayment of capital. It follows that the ‘inah contract when applied in this context will make it possible for participants to bypass the Quranic ban of riba. This is because in all forms of riba based debt, the borrower holds the legal or contractual obligation to pay interest while providing a legal guarantee on capital payment. To date, Islamic bond issues are worth more than RM10.2 billion, among which include funding KL International Airport at Sepang.

Khazanah Zero Coupon Islamic Benchmark Bonds

The Khazanah Benchmark Islamic Bonds bear similar features as MuNif when the ‘inah sale is implicated. However, it is generally described as a bond that operates based on the asset backed al-murabahah concept minus the bay’ al-inah element. But on closer examination, it is found that Khazanah as the issuing party sells a pool of assets equivalent to the amount of financing to the Private Debt Securities (PDS) investors for immediate payments. These assets shall comprise of Khazanah’s holdings of property, shares, etc. A resale of the same assets via an al-murabahah contract (mark-up sale) by the investors to Khazanah follows with cont.

Instruments, Prentice Hall, New Jersey, 1992, pp. 655-659. However, it is different from Islamic asset securitisation as the latter places no pool of assets with future cash flows to back the issuance of Islamic securities. Instead, Islamic asset securitisation is in essence a bay’ al-inah transaction in which certain selected fixed assets of the issuing companies is used to support the issuance of Shahadah al-days such that the latter qualify as al-mal mutaqawim. Doing so will legitimise new bond issuance which are either sold at a discount in the primary market to dealers and underwriters or traders in the secondary market. For more details on Islamic asset securitisation, see Majid Bader AH Al-Refai, “Manifestation of Islamic Banking in the 21st Century”, Fourth Annual Meeting of Islamic Banking and Finance Forum, Bahrain, 8–10 December 1977, pp. 52–56.

11 In the case of Al-Bat-Bithaman Aji Notes Issuance Facility, the asset used in the al-inah transaction is also used as collateral to the facility given. Normally, the total market value of the shares pledged is not less than 130 per cent of the total amount outstanding under the facility at all times. For more details see Bank Islam Malaysia, “Syndication and Securitisation”, Seminar on Islamic Banking Practice, Holiday Inn City Centre, Kuala Lumpur, 4 May 1995, pp. 26–32.

12 There are a number of Islamic bonds in Malaysia which are free from al-inah. These include Subuh Al-Ijarah worth RM521.5 million (US$208.6 million) issued by Segari Energy Ventures, Ijarah Wa Iqtina bonds issued by Telekom Malaysia in 1998 worth RM2.2 billion (US$88 billion).

payments made at a future date. As a zero-coupon bond no secondary notes are issued. The bonds are sold at a discount and traded in the secondary market using the contract of bay’ al-dayn.\textsuperscript{14}

\textit{Bank Negara Negotiable Notes (BNNN)}

The most recent public sector Islamic bond issue has been the Bank Negara Negotiable Notes (BNNN). Using the contract of bay’ al-‘inah, the Central Bank of Malaysia (BNM) will identify and sell certificates of BNM assets on a tender basis at a discount to Islamic banking institutions. BNM will then buy back the certificate of assets at par value to be paid on credit terms, i.e. 91, 182 or 364 days. BNNN is similar to Khazanah Benchmark Bonds where both bay’ al-‘inah and bay’ al-dayn are implicated. On tendering, only Islamic banks are allowed to tender for the BNNN, with minimum bidding denomination being RM 5 million (US$1.3 million). However, both conventional and Islamic banking institutions are allowed to trade BNNN in the secondary market.\textsuperscript{15}

\textit{Labuan Off-Shore Islamic Money Market}

The establishment of the Labuan Off-Shore Islamic Money Market involved three main parties, namely the LOFSA, the Islamic Development Bank, and the Bahrain Monetary Agency. It is a co-operation among Muslim countries in the field of Islamic finance.\textsuperscript{16} The first meeting on 7 December 1999 was held in Bahrain, followed by several others in Labuan, Jeddah and Brunei. Among others LOFSA serves to provide Islamic facilities for liquidity management in which main participants shall consist of Malaysian and foreign banks in Labuan as well as Islamic banks from Muslim countries.\textsuperscript{17} As a mode of financing, Islamic finance via asset securitisation will be offered by the surplus financial institution to the deficit ones. As the term “securitisation” normally implies the application of bay’ al-‘inah, the Labuan Off-Shore Money Market has now introduced bay’ al-‘inah into international finance. The ‘inah sale can either originate from the surplus or deficit sector. For example, bank A has a USD200 million asset, which it will use to securitise a money market instrument it is planning to sell in order to raise short-term funds. The asset will be sold to the surplus bank in return for cash payments. It, i.e. the surplus bank, will sell the same asset to the deficit bank but at a mark-up price. The difference constitutes the return on the investment by the

\textsuperscript{15} For more details see Bank Negara Malaysia Guidelines on Bank Negara Negotiable Notes, 2000.
\textsuperscript{16} Mohd Razif Abdul Kadir, “Development of LOFSA IOFC as an Offshore Centre for Islamic Banking and Finance”, World Class Islamic Finance Conference, organised by Marcus Evans, 31 October–1 November 2000, Sheraton Hotel, Kuala Lumpur, Malaysia.
surplus bank, which is now legitimate since the ‘inah sale is in essence a contract of sale and not a loan.\textsuperscript{18}

\textbf{THE REQUIREMENT OF ‘IWAD (EQUAL COUNTERVALUE)}

Even if an al-‘inah sale is considered legitimate by Malaysian \textit{Shar\'a} standards, it is not well accepted in the Middle East. The juristic views will be discussed in detail in the next part of this article but there is one main issue upon which the \textit{bay‘} al-‘inah sale must provide clear explanation if it wishes to claim Islamic legitimacy. There is the question of lawful profits, which logically are derived from a lawful sale. As stated by Ibn ‘Arabi, “every increase which is without an ‘iwad or equal countervalue is riba. ‘Iwad therefore is the basic trait or the \textit{conditio sine quo non} of a halal or legal sale, because a sale is necessarily an exchange of value against an equivalent value; an equitable return and compensation for the goods or services exchanged.\textsuperscript{19} Based on this principle of legal exchange, profits created from an al-‘inah sale are not able to fulfil this requirement.

For example, from the ‘inah sale, the bank realises a RM1,000 profit from a RM10,000 sale, which initially cost RM9,000. What this exactly means is that the ‘inah asset costing RM9,000 was sold for RM10,000, with the elements of risk and value-addition non-existent which also means the ‘iwad factor is absent. The seller, namely the bank, profited from the sale by virtue of time preference and compensation for waiting which represents a basic rationale for the payments and receipts of interest. This is the nature of riba in the ‘inah sale.\textsuperscript{20} The buyer does not receive an equivalent countervalue from the exchange. If the asset is sold for RM10,000 at RM9,000 cost price, the additional RM1,000 value he is paying the bank does not constitute compensation for the risk and value-addition imputed in the sale which the bank must hold if Islamic legitimacy is desired. This is because the bank holds practically no market risk in this transaction. Likewise, it does not introduce any form of value-adding component to the asset on sale. Rather, it is a payment for waiting. Risk-taking is negligence, as the bank does not assume some degree of default and inflation risk since the financing is collateralised and shielded against both risks by virtue of imposing an inflation and risk premium on the rate of profit.

In another example, suppose RM1,000 is invested in a fish business. Let us assume that one kilogram cost the trader RM10, which he bought fresh at the dock. He then sells the fish at the market for RM18 per kilogram. He profited by RM8 per kilogram, an “excess” which is equivalent to RM800. In Islam this is a

\textsuperscript{18} The first offshore Islamic bond worth RM100 million (US$2.5) will be issued by Kumpulan Guthrie Pte in the first quarter of 2001. See \textit{The Sun}, “Guthrie scores a first with offshore Islamic bond”, Thursday, November 2000, p. 1.


\textsuperscript{20} In this context Rayner asserted that “although all transactions forming the ‘inah contract are correct in themselves, when put together they merely mask a loan with interest which is prohibited in Islamic law according to the rules of Riba”, see p. 118 in \textit{The Theory of Contracts in Islamic Law}, 1991.
legitimate business since the contract of sale allows profit-taking. What is taking place here is an exchange of goods, namely the fish for currency. Customers pay RM1,800 for the fish even though it costs the seller RM1,000. Customers do not mind paying RM800 more since they know that the seller has put himself at risk of losing his investment to create the “excess”. For example, he will suffer deep losses if he could not find the market. The same thing could happen if the price of fish suddenly declined at the market-place. Customers are willing to pay the “excess” since a lot of hard work and effort has taken place. These are the value-adding components of fish trading. So what we see is an exchange of fish valued at the market price for currency. ‘Iwad exists in this case since the “excess”, namely RM800 in profit, is created involving risk (ghurmi) and work (ikhhtiyar). Any contract of sale must also provide a warranty agreement that favours the customer when the goods sold are proven defective. The seller must be made responsible for assuming this type of liability. The legal maxim “al-kharaj bil daman” is therefore instrumental in determining the nature of ‘iwad in sales since it says that any benefits (i.e. profit) derived from a transaction must be accompanied by the liability to absorb any arising potential loss.

However, in the contract of bay’ al-‘inah, valuation of selling prices is made without involving risk, liability and value-addition. For example, a portfolio of assets are sold for RM200 million and resold at RM250 million. The “excess” RM50 million in profit arising from this double-sale came into being by means of time value with a contractual premium and not risk-taking and value-addition activities. Even though an equivalent counter value is detected at face value, i.e. exchanging an asset for currency, the valuation or pricing of the asset is devoid of components that represent risk-taking and value-addition. What this means is simply that people are buying a piece of an asset at a price equivalent to the market value but only getting to enjoy a utility equivalent to the cost price.

The Meaning of Bay’ Al-‘Inah

It is now worth taking an in-depth look at the contract of bay’ al-‘inah and the various juristic views on its prohibition. Bay’ al-‘inah is generally known as a sale based on the transaction of Nasi’ah (delay). The (prospective) creditor sells to the (prospective) debtor some object for cash which is payable immediately; the debtor simultaneously immediately buys the same object for a greater amount at a future date.21 Thus, the transaction amounts to a loan. The difference between the two prices represents the interest. Such a contract was evolved in the early period of Islam and it exists for the fundamental reason that a loan for interest is forbidden because it is equivalent to usury (riba).22 In this contract there is an

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22 Careful type of legal devices (hiyal) under which usurious transactions can take place in developed countries where the Hanafi and Shafi’i schools practised. These legal devices are not acceptable to other schools of law.
economic interest for both the borrower and the lender, which at the same time circumvents the prohibition of usury.

The issue which concerns us here, is how does Islamic law view such a contract: should the sale be allowed *prima facie*, or disallowed because the motive behind the sale is to legalise that which is illegal or usurious?

**The Shafi‘i opinion**

According to the Shafi‘i school such sales are to be allowed because in the words of Imam Shafi‘i contracts are valid (*Sahih*) by the external evidence that they were properly concluded: the unlawful intention (niyya or qasd) of the parties is immaterial, it does not invalidate their act, unless expressed in that act. Al-Shafi‘i illustrated his teachings with the following example which concerns the marriage of a man who intends to keep his wife for only a short period of time. That marriage is reprehensible (*makruh*) but valid, whereas a *mut‘a* marriage is invalid (*Batil*).

The foregoing example illustrates that Shafi‘i’s considered the intention of the parties is only taken into account when the invalid intention is explicitly mentioned in the contract.

**The Maliki and Hanbali opinions**

The Maliki and Hanbali jurists hold that the contract of *bay‘ al-inah* is not valid because according to them the motive of the parties to the contract determines the legality or illegality of the contract, and in the sale under consideration the motive of the parties is illegal and, therefore, the sale is not valid because it constitutes a legal device (*Hiyal*) to obtain a loan with interest which should be averted at all

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23 Intention is generally understood as a mental formulation involving foresight of some possible end and the desire to seek to attain that end. Intention is rarely expressed or admitted and usually has to be inferred from circumstances and conduct which are put into action by the will. See *Oxford Companion to Law, Verbo Intention*, 1980.

24 The words (niyya or qasd), are generally found in the classical *fiqh* treatises, that is, the intention of the contracting parties in bilateral contracts and of the one party in a unilateral undertaking.


26 *Mut‘a* is a temporary marriage where precariousness is the inherent rule. *Mut‘a* is allowed for the Shi‘a but is void (*Batil*) for the Sunnis Muslims.


28 Al-Sanjur holds that the Maliki teaching is like the Hanbalis when it comes to the significance of the intention of the contracting parties and the effect of such intention on the validity of the contract (*masadr al-haqiq* Vol. 4, p. 72). This kind of transaction is also considered by Abu Hanifa as *haram*. See *Al-Musatta* (*Kitab al-Buyu‘*), pp. 295–296.

29 Ibn Rushd, *Bidayat al-Mujtahid*, Beirut, 1981, Vol. 2, p. 58; see Mawla al-Aham al Adliyyah, Article 3, which states that “the intentions and meanings and not the wording or the construction of the contract must be considered”.

30 *Hiyal* an act may seemingly be lawful in accordance with the literal meaning of the law but could hardly be in conformity with the spirit or the general purposes of *Shari‘a* law.
costs according to the Shari’ā.31 Abn Qayyim,32 a Hanbali author, states that “Islamic law and its rules specify that intention influences legal acts: the formality of a legal act can be the same but the end result depends on the intention”, and after he had mentioned 99 proofs of preventing what is conclusive to unlawfulness even if it is permitted he said: “All these examples show that contracts are not regarded as valid if the contracting party harbours ill intention”.

Another Hanbali author33 noted that if the vendor of a quantity of grape juice knew, either directly or owing to circumstantial evidence, that the buyer intended to use the juice in order to make wine, then the contract is void. According to the Maliki, Ibn Rushd, the marriage of a muhalil (a man who marries a woman divorced three times by her husband only with the intention to divorce her afterwards and make lawful her remarriage to her previous husband) is to be cancelled (Bati‘).34

In the Maliki Fiqh book “Al-Muwatta”, which was written by Imam Malik at the beginning of the second century Hijra, we find countless examples of contracts and transactions that were considered as invalid by Muslim scholars because the intentions of the contracting parties were bad and unlawful. Malik35 is also of the opinion to cancel the sale of any article when the contracting parties intend to use that article for an unlawful purpose, such as the sale of arms to people already at war or to bandits. Imam Sahnoon states in his book “Al-Mudawwana” that it is invalid and haram to lease a shop to someone who intends to sell alcohol therein. It is explicit in the opinions of the above noted jurists that intentions are to be taken into account in relation to legal acts just as they are in matters of faith: Islam does not tell Muslims to define an objective, and then use what means they observe fit in order to attain it. Instead, it tells them that if the means are correct, the ends will look after themselves. Islam does not teach us to overcome usury by competing with the usurer at his own game.

Analysis based on the comparative Fiqh

From the foregoing discussion, we may draw the following conclusions. It is obvious that bay‘ al-‘mā’ah is a legal device in order to overcome the prohibition of riba (no person would effect such sale if he cannot realise profit without ‘īwād), and is not deemed to be an act of sale as there is clear evidence that such act amounts, in effect, to a contract of loan; thus it is forbidden as it is based on unjustified enrichment (fadd mal bila ‘īwād) or “receiving a monetary advantage without giving a countervalue”.

32 Ibn Qayyim al-Jawziyya-Flam al-muwaqqi‘in, Cairo, 1971, Vol. 3, pp 98–99; and see for example the saying of the Prophet (S.A.W.) “deeds are judged according to intentions and every human being will have to take responsibility for what he intended”, Sahih al-Bukhari.
34 This marriage was meant by the law to be real, but hīyal were developed by which the woman signed a marriage contract with a man paid for the purpose, who then immediately divorced her so that she could remarry her first husband. The end result is clearly against Shari’ā principles.
The second point is that behind al-Shafi‘i’s recognition of the validity (sahih) of bay‘ al-‘inah is his personal opinion (Ra‘y) not based on interpretation of any authentic Islamic authority. However, according to other schools the prohibition of such sale was based on the consensus of the jurists (IJma‘ al-ulama’) on the authority of Islamic law sources. Ibn Qayyim36 prohibited bay‘ al-‘inah quoting the following Hadith that Allah’s messenger says: “A time is certainly coming to mankind when they legalise (Yastahillun) the Riba under the name of Bay’” 37 (trade concerning that intending usury by words of a sale).

Ibn Umar said:38 “I heard the Prophet of Allah (S.A.W) say when you enter into the ‘inah transaction, hold the tails of oxen, are pleased with agriculture, and give up conducting jihad, Allah will make disgrace prevail over you, and will not withdraw it until you return to your original religion”.

Wasili b. ‘Ata39 is reported to have said that a right judgment can be arrived at through four sources: the express word of the Book, authentic Hadith, Qiyas and consensus of the ulama community. Bay‘ al-‘inah, is a violation of the established consensus, since this sort of sale agreement constitutes the taking of usurious interest as most jurists hold that such transaction should be forbidden.

Furthermore, Ibn Taimiyah divides sales into three groups according to the buyer’s intentions, namely:

... that he purchases the goods in order to use or consume them such as food, drink and the like, in which case this is a sale, which God has permitted.

... that he purchases the goods in order to trade with them; then this is trade, which God has permitted that the cause for purchasing the goods is neither the first nor the second, then the cause must be dirhams (money) which he needs, and it was difficult for them to borrow, so he purchases the good on credit (with increased dirhams) in order to sell it and takes its price. This, then, is ‘inah which is Haram according to the most eminent of the jurists.40

The third point is that there is hardly any satisfactory evidence which enables one to say that al-Shafi‘i has expressly declared that bay‘ al-‘inah is Halal. It should be pointed out that al-Shafi‘i’s method of determining the validity of any contract by its formal evidence that it is legally concluded cannot be cancelled on account of the intention of the parties, although he had to recognise such intention as forbidden (Haram), but the contract remains valid unless the intention is expressed in the contract as not every valid contract is a Halal contract. The Shafi‘i may thus permit a contract because its legal preconditions are fulfilled, but forbids the transacting act of the parties when it conflicts with Shari‘a principles. The following example can illustrate his teaching. Al-Shafi‘i states41 that it is not disallowed to sell a sword to a person who could use it to commit an unjust killing,

39 Abu Hilal al-‘Askari, Kitab al-awa’il, Cairo, 1985, p. 278.
40 Ibn Taimiyah, Ma‘mu‘at al-Fatawa, Vol. 29, p. 431.
41 Al-Umm, Vol. 3, p. 74.
however, that sort of sale is valid (Sahih), for that person might not use the sword for that purpose, but at the same time Shafi'i recognises such an act as forbidden (Haram) if that person is under suspicion of using it unlawfully. He is not allowed to take possession of the sword (Tamlık), thus preventing the contract from producing its effects. The above classical example leaves no doubt about where the Shafi'i’s stand in regard to unlawful intention of the contracting parties. Conclusively speaking, one can say that al-Shafi’i’s teaching has reached a level, which is similar to the other Muslim schools, although the methodology which he adopted appears to be different. Al-Qaradawi states, in relation to this question of bayt al-‘inah, that it is a clear case of usury, and the device why should we practice a transaction which contains elements of devices while we are in a position to have a clear and apparent alternative transaction? Furthermore, mī‘āmalāt which contains elements of device deviates from the true objective of Shari'a.

The use of legal device is therefore evidence that the niyyah or qasd factor is undermined or made secondary in the application of an al-‘inah sale in the Malaysian Islamic financial system. It is apparently clear that most underlying assets used in these banks have no direct relation with its actual use. These assets were simply used as Mal-Mutaqawwim serving as an object of sale (Mahallul ‘aqdi) in order to claim validity of the al-‘inah sale.

The fourth point is that the scholars of the Shafi'i school consider that an illegal motive does not lead to the invalidity of a contract, unless the motive is clearly indicated or understated. They upheld this condition so as to preserve the stability of transactions which means that the contracting party cannot be absolved from his legal obligations on the grounds that the motive that lead him to enter into the contract was unlawful and to safeguard the self-interests of the other contracting party who was not driven by an illegal motive. However, in the contract of bayt al-‘inah it is clearly indicated that the contracting parties concerned do not intend to fulfil the objective for which the Shari'a has initiated legitimate sale (bay') in the first place, but they intended to achieve an illegal objective which is against Islamic principles, namely Ribā by getting an increase on the lending of money. It is to be noted that according to the Islamic concept bayt (sale) does not mean selling out thing for getting money. But it also implicates the sense of buying other necessities with that money. Allah S.W.T. has used bayt in the sense of Shira (purchase) and vice versa in the Holy Quran. It is the display of grand wisdom and knowledge of Allah S.W.T. as evidenced in the following verses: “Allah has permitted trade (bay') and forbidden usury”, “There are men, whom neither traffic nor merchandize can divert from the remembrance of Allah”.

In the above quoted Quranic verses, sale implicates the sense of Shira. While defining the quantities of Muslims, Allah S.W.T. says that these are the people to

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44 Surah Al Baqarah: 275.
45 These verses are selected from among many other similar verses mentioned in the Holy Quran in Surah Al Noor: 37.
whom traffic and sale do not make negligence of remembrance of Allah S.W.T. He means that both the sale and purchase do not make them negligent. In this sense, sale and purchase are the two terms of one’s affair, whereby separation between them is incorrect. Commenting on the above Quranic verses, the leading jurists held that bay al-‘inah is not among the list of sale which can be considered as a lawful act. It must be considered unlawful *ab initio* (*Haram*).

THE ROLE OF NIYYAH OR QÂSD (INTENTION) IN CONTRACTS: A COMPARISON BETWEEN THE ISLAMIC AND WESTERN LEGAL SYSTEM

Any study is incomplete without making a comparison between the Islamic and Western legal system. We shall review the position of the positive laws, particularly on the impact of the contracting parties’ intention on the validity of transactions so that we may draw a comparison between the conclusion reached by these laws in modern times and the rules laid down by the Muslim jurists (*fuqaha*) centuries ago.

Briefly, we may say that the ancient Roman law gave no importance to intention because it relied on the formality of the contract, which stipulated that for transactions to be valid they had to be drafted in the required form. It did not seek to ascertain whether the intention of the parties to the transaction was good or bad.

The above attitude was also adopted by French legal system scholars for many centuries. All they did was to explain Roman law. However, in the seventeenth century, the famous legal scholar Dumat highlighted in his book *Civil Laws in Accordance with Natural Law* the concept of “cause” and arranged it in a manner that was not familiar. This had a tremendous influence on legal scholars who publicised his theory and introduced it into the civil law at the beginning of the nineteenth century.

This enabled the French legal scholars early in the twentieth century to come up with what is now known as “the modern theory of cause”. The proponents of the theory argued that it was necessary to extend the concept of cause from the legal point of view to cover the intention that induces a person to enter into a contract with another person as well as the motive for contracting or the motive that has led to an act. In other words, all intentions have to be accounted for because this would give the legal system the opportunity to look into contracts, and to protect society

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46 Cause is defined as being the sum of all external and internal motives which induce a party to conclude a legal act as well as the aim which is intended to be achieved through the legal act. See Ernest G Lorenzen, “Cause and Consideration in the Law of Contracts”, in *Yale Law Journal*, Vol. xxviii, May 1919, pp. 621–46.

and people from bad intentions. Therefore, the modern theory of cause lays down as a condition for a contract to be valid that both the intention and the motive need to be lawful, i.e. all intentions that trigger the act ought to be good. In Islamic law with regard to the principle of the intentions and motives of the contracting parties, it is to be noted that the majority of the Muslim schools of thought (Mazahib) have agreed on the invalidity of contracts wherein the direct cause is unlawful. They call this cause the initial motive, i.e. the aim sought by the contracting party. They argue that the Divine Legislator has laid down contracts for people to achieve their aims through them and stipulates that each contract needs to have an objective to be achieved by the contracting parties. However, even the Muslim jurists agreed on the impact of the intention on the validity or invalidity of an act from the legal point of view. It seems that they differ only on the methodological application. In reality, none of them uphold the validity of a contract when the intention or motive is unlawful. Disagreement lies in what is acceptable and what is not.

**Securities and Guarantees in Avoiding Risk of Default**

It is apparent that the strict requirement of securities and collaterals in all *bay' al-‘inah* contracts signifies the fear of default risk in an event of failure to pay. This allows *al-‘inah* financing to bear relatively similar features to interest bearing instruments. For example, in a crisis involving depletion of asset values, the amount of *al-‘inah* financing may exceed the value of collaterals used to support it and therefore put an Islamic bank’s capital at high risk. When this is true, it follows that *al-‘inah* intensive financial institutions will suffer similar consequences as their conventional counterparts. A good example concerns Islamic banking. It is expected to behave in a procyclical manner during both economic slowdown and inflationary pressure similar to that evident in conventional banking. During a recession, the supply of funds will fall as banks are afraid to

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48 French courts require that the motive ought to be lawful. Obviously only the motive which is known or expected to be known to all the parties is retained, otherwise it will be easy for any party willing to liberate himself from his obligations to allege the motive which lead him to contract is unlawful. Accordingly, French courts cancel a sale or lease contract if the buyer or lessee intended to use the premises for prostitution provided the vendor or lessor knew the intention of the buyer or lessee. Also cancelled was a loan intended for gambling when the lender knew the purpose of the loan, see A F Al Sahdah, *Masadir al-Itizam*, Cairo, 1969, pp. 249–264.

49 That is not the civil and common law’s concept of contracts in *British Movietonees Ltd v London and District Cinemas* [1951] 1 KB 190, were the House of Lords upheld “… it was the duty of the courts to ascertain the intention of the parties from the document itself, and not to rewrite it in the light of what the parties might (or might not) have in mind at the time they made the contract”, see Anson’s, *Law of Contract*, edited by AG Guest, Britain, 1979, p. 149.

50 In Bank Kerjasama *al-‘inah* personal financing, customers are required to provide two guarantors as well as three prepaid installments in *Al-Wadiah* savings accounts.

inject funds for fear of default. This safety objective can further dampen aggregate demand and makes the recession even deeper. Likewise, when the economy is booming and the price-level is on the increase, banks will push the inflationary pressure even higher when they inject more funds with the hope of making profits. This will frustrate attempts by the government to reduce inflation by reducing the money supply. Thus, when al-‘inah financing is rampantly practised in Islamic banks the economy will move according to the mainstream cycle and leave less for the public to appreciate the benefits an Islamic system can bring to the business community.

CONCLUSION

This article has attempted to argue that Islamic banking that thrives on bay’ al-‘inah has put Islam in a discomforting position as it fails to exemplify the sense of justice and fairness the Quran desires. To some extent, the ‘inah sale is able to draw a considerable amount of activity in the Islamic financial market, but the real test will come when the system comes under shock. In a banking crisis, involving bad loans, Islamic banking driven by the ‘inah sale will find no assets available at her disposal for cash recovery. This is because in banking the same single assets acting as a dummy are used over and over again when executing new transactions. This is true in all bay’ al-‘inah personal financing schemes. At this juncture, the role of guarantors is crucially important, but if this is the case bay’ al-‘inah personal financing is similar to personal loans, as the latter also place no importance on collateral, but mainly on a system of guarantors and securities. In the event of default, the Islamic bank will pursue the guarantors even if they play no major role in the ‘inah sale. Logically, it does not make sense for any seller to demand some form of guarantee from a third party for payments. The same applies to the Islamic bond market. Defaulting in payments, say via secondary notes, is expected to produce the same consequences seen in traditional bonds. Even if the Islamic bonds are securitised to some underlying assets, they are subject to similar debt covenants and requirements such as collaterals, securities and sinking funds. Concerning this aspect bay’ al-‘inah Islamic bonds have done less to project the dynamism of the Islamic law of contracts where in the former elements of profit and risk-sharing have been undermined in the interest of preserving the neoclassical economic thinking.