



***Musharakah* and Its Compatibility with the
Malaysian Legal and Regulatory Framework:
An Examination on the Implementation of
Risk Sharing**

by

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*A thesis submitted for the Degree of Doctor of Philosophy in Law at Newcastle Law School,
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September 2019

Abstract

Undoubtedly, justice forms an integral part of *Shariah* (Islamic law) and shall be observed in each of its domain including the commercial segment. This position, therefore, sets the idea of risk sharing at the heart of any business dealing with the profit motive since it manifests the notion of justice; the idea that is propagated by *Shariah* through the discourse of *Maqasid Al-Shariah* (the higher objectives of *Shariah*). In addition, the existence of the element of risk sharing is also essential in determining the validity of such a dealing and to justify the enrichment derived from it.

In the Malaysian context, the initiative for strengthening the implementation of the idea of risk sharing has been demonstrated in various ways. One of these initiatives is the introduction of the *Musharakah Mutanaqisah* home financing as an alternative to the *Bai Bi Thaman 'Ajil* (BBA) home financing. As an equity financing, it is expected that the product would be able to demonstrate such idea as opposed to what is entailed by the BBA home financing which rides on the concept of debt-based financing.

This study examines the extent to which the existing legal and regulatory framework in Malaysia supports the implementation of risk sharing thus upholding the notion of justice by referring mainly to the *Musharakah Mutanaqisah* home financing. It argues that the said framework is not consistent with the purpose of the introduction of the *Musharakah Mutanaqisah* home financing as mentioned above ie to implement risk sharing as it identifies three main issues. The first issue is the characterisation given by the *Musharakah* Regulatory Policy of the Central Bank of Malaysia (BNM) to the product as *Shirkah Al-Milk* which inflicts two major problems ie inaccurate definition which leads to different consequences pertaining to the risk sharing requirement and negating the implementation of risk sharing. The second issue is the discrepancies between equity and debt financings as demonstrated by the Islamic Financial Services Act 2013 (IFSA 2013) and the *Musharakah* Regulatory Policy; debt financing defeats the idea of risk sharing and serves as a major setback to its advocacy. The third issue is the inability of the product to be recognised as a partnership from the legal standpoint (by virtue of the Partnership Act 1960, PA 1960) which infers the product is not an equity financing but a debt financing instead. The study proposes several further steps to be undertaken in the future to address these three issues as the way to move forward in order to ensure that *Musharakah* is able to demonstrate the idea of risk sharing and eventually upholding the justice as required by the *Shariah*.

Dedication

I dedicate this doctoral thesis to my parents, my wife and also the Islamic finance industry.

Mama, words cannot describe how grateful I am to you. I hope the end of my research journey may wipe off your tears and bring the light of joy into your heart.

Abah, you have influenced the directions I have taken in my life. Your unwavering belief, wise words and encouragement have carried me throughout my life. I hope I would be able to raise my children the same way you have raised me.

My love Marhamah, I treasure all the moments we spent together and this thesis shall always remind me about one thing; when the world turns against me, I know I shall always have one person stand next to me and the person is you. My darling, with your presence I never feel afraid to face the world and I am looking forward to starting our next adventure.

To the Islamic finance industry, please accept this little contribution from your humble servant. I have decided to devote my life to serve you and I shall do my best for you.

Acknowledgements

In the name of Allah, the most gracious, the most merciful. All praises to the Almighty for giving me the strength and determination to complete this study. I feel so blessed.

After an intensive period of three years, today is the day; writing this note of appreciation is the finishing touch on my doctoral thesis. It has been a period of intense learning for me, not only in the law and Islamic finance arena, but also on a personal level. Writing this thesis has had a big impact on me. I would like to reflect on the people who have supported and helped me so much throughout this period.

First of all, I would like to express my sincere gratitude and deepest appreciation to my main supervisor Dr. Abdul Karim Aldohni for his tireless help, advice, guidance, patience and wisdom, invaluable comments and criticism, encouragement and personal support, all which have helped me to achieve this research degree. He consistently allowed this paper to be my own work but steered me in the right direction whenever he thought I needed it. I am forever grateful for his meticulous comments and suggestions throughout the course of my Ph.D. Indeed, it has been a real privilege and honour for me to have Dr. Abdul Karim as the main supervisor.

I would also like to acknowledge Professor Andrew Griffith, the second supervisor of this thesis, for his contribution. I am gratefully indebted to him for his insightful comments and guidance on this research.

In addition, I would also like to thank the experts who had contributed their ideas and suggestions to this research project: Associate Professor Dr. Azman bin Mohd Noor from IIUM Institute of Islamic Banking and Finance (IIiBF), International Islamic University of Malaysia (IIUM) and Mohd Faizal bin Baharom from CIMB Islamic Bank Berhad. Without their passionate participations and inputs, the research could not have been successfully conducted.

This Ph.D study could not have been completed without the kind support I have received throughout my research. In particular, I am grateful for the funding provided for this study by Jabatan Kemajuan Islam Malaysia (JAKIM) under the Prime Minister Department of Malaysia. I am also thankful to the Newcastle Law School and Law Library staff for assisting me in many different ways during my academic study.

My acknowledgement also goes to the love of my life, Marhamah binti Jailani, and my four beautiful angels: Tuan Ilham, Tuan Arwa, Tuan Ahla and Tuan Areej for providing me with

such unfailing moral and emotional support, and continuous encouragement throughout my years of study and through the process of researching and writing this thesis. Thank you for your sacrifice, patience, tolerance and cooperation, for which I hope I will have the pleasure of repaying all of you over the rest of our lives together.

Finally, my sincere appreciation goes to my closest friend throughout my tenure at Newcastle University: Halim, Faizal, and Akmal. For all discussions, quarrels and jokes over hundreds, if not thousands, cups of coffee, please accept my gratitude to all of you from the bottom of my heart.

This accomplishment would not have been possible without all of those mentioned above. Thank you for everything.

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List of Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BBA	<i>Bai Bi Thaman 'Ajil</i>
BNM	Bank Negara Malaysia
BAFIA	Banking and Financial Institutions Act
BP	Beximco Pharmaceuticals Ltd
CBMA	Central Bank of Malaysia Act
CLA	Civil Law Act
CA	Contract Act
CDS	Credit Default Swap
CASA	Current Account or Saving Account
FC	Federal Constitution
FMS	Federated Malay States
FSA	Financial Services Act
HPA	Hire Purchase Act
ISRA	International Shariah Research Academy for Islamic Finance
IAP	Investment Account Platform
IBA	Islamic Banking Act
IsDB	Islamic Development Bank
IFIs	Islamic Financial Institutions
IFSA	Islamic Financial Services Act
IRTI	Islamic Research and Training Institute
KLSBB	Kuala Lumpur Sentral Berhad
MYR	Malaysian Ringgit

NLC	National Land Code
OIC	Organisation of the Islamic Conference
PA	Partnership Act
PTC	Principle Terms and Conditions
PER	Profit Equalization Reserve
PPA	Property Purchase Agreement
PSA	Property Sale Agreement
PjH	Putrajaya Holdings Sendirian Berhad
S&P	Sale & Purchase
SB	Shamil Bank of Bahrain
SAC	Shariah Advisory Council
SMEs	Small and Medium Enterprises
SPV	Special Purpose Vehicle
SOPs	Standard Operational Procedures
SRD	Strategic Roundtable Discussion
UFMS	Unfederated Malay States
USD	United State Dollar
VBI	Value-Based Intermediaries

For legal journal abbreviations, refer to Cardiff Index to Legal Abbreviations:

<http://legalabbrevs.cardiff.ac.uk/>

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- s.51
- s.52(1)
- s.57
- s.59

Civil Law Act 1956

- s.3
- s.5

Contract Act 1950

- s.66

Federal Constitution

- Art. 4(1)
- Art. 10(1)(c)
- Art.121(1)
- Ninth Schedule, First List, para. 4(a)
- Ninth Schedule, First List, para. 4(b)
- Ninth Schedule, First List, para. 4(e)(i)
- Ninth Schedule, First List, para. 7(j)
- Ninth Schedule, Second List, para. 1

Islamic Banking Act 1983

- s.2

Islamic Financial Services Act 2013

- s.2
- s.27
- s.28
- s.29(1)

s.29(2)

s.30

s.32

s.60

s.65

s.66

s.67

s.68

s.135(1)

s.135(2)

s.277

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Art. XXXIA

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s.241

s.344

Partnership Act 1961

s.3

s.4

s.4(a)

s.4(c)

s.6

s.47(1)

s.47(2)

List of Quranic Verses

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Quran [Al-Baqarah 2:219]
Quran [Al-Baqarah 2:275]
Quran [An-Nisa' 4:29]
Quran [An-Nisa 4:115]
Quran [An-Nisa' 4:135]
Quran [Al-Maidah 5:48]
Quran [Al-Maidah 5:90]
Quran [Al-Maidah 5:91]
Quran [Al-A'raaf 7:158]
Quran [Yunus 10:57]
Quran [Al-Hijr 15:9]
Quran [An-Nuur 24:37]
Quran [Al-Najm 53:3-4]
Quran [Al-Hadid 57:25]
Quran [Al-Mumtahanah 60:8]

In translating the verses of the Quran, this study relies on Aminah Assami (tr), *The Quran: English Meanings and Notes* (Al-Muntada Al-Islami 2013)

Chapter 1. Introduction

1.1 Introduction

This initial chapter consists of eight subsections which provide the general overview of this study. The first subsection 'Background of the Study' addresses the central theme of this study namely risk sharing. The discussion begins with the deliberation of *Maqasid Al-Shariah* and the correlation between justice and risk sharing. Subsequently, the discussion is on the position of risk and risk sharing as well as their significance in the landscape of Islamic finance, subject of risk and the forms in which risk sharing may take place. As shall be explained further later, *Shariah* has put a great emphasise on the existence of risk sharing in a dealing with the motive of generating profit. Therefore, this discussion prepares the readers with the necessary understanding of such key concept and its significance in Islamic finance and helps them to follow the lines of argument that this study shall proceed with. Following this subsection is the 'Problem Statement'. The duality of the governance framework in the case of Islamic finance in Malaysia (*Shariah* and common law) implicates a certain level of complexity as both are not always consistent with each other. Furthermore, the inconsistency between the theoretical discussion in Islamic finance which construes risk sharing as its cornerstone and the practice of the Islamic finance industry which inclines towards the application of debt-based financing products is also observed. As such, the extent of which the current legal and regulatory framework in Malaysia consistent with the implementation of risk sharing becomes a point of concern in this regard. The detail deliberation on this said issue is dealt in this subsection.

Against the backdrop as set in the subsections as mentioned above, the subsequent subsections lay down the aim and objectives of this study, its research questions, the methodology it employed, the scope and limitation it faced, its potential contribution and its organisational structure and chapters outline.

This study is closely related to the Islamic commercial law; hence this would render necessary for the reference and usage of a significant number of Arabic terms. For the purpose of clarity, the translations of these terms are provided in brackets and further elaboration on the understanding of some of them will be provided where it is relevant.

1.2 Background of the Study

To contextualising this study in a clear manner, it is important for the discussion at this juncture to address an important component of *Shariah* namely the *Maqasid Al-Shariah* (the objectives of *Shariah*). This is because by having a firm grasp of this particular subject, one should be able to understand the correlation between risk sharing and Islamic finance and find the answer to the question of why Islamic finance pays very much attention to the propagation of the idea of risk sharing in the commercial activities.

1.2.1 *Maqasid Al-Shariah*

Islamic finance finds its origin from a divine code of practice called *Shariah*. Through *Shariah*, the instructions, restrictions and prohibitions are laid down and shall be observed by its believers. In the context of Islamic finance, *Shariah* prescribes, among others, what are the mode of businesses that are permissible (hence *Shariah*-compliant) and what are the mode that shall not be undertaken (further deliberation on *Shariah* shall be made later).

Not only that, *Shariah* has also prescribed specific objectives that are sought to be attained through its operation and implementation. These objectives are termed as *Maqasid Al-Shariah*. The Quran, as the highest authority of *Shariah*, is expressive in describing the overarch concept under which all the said objectives reside when it mentions, “O mankind, there has come to you instruction from your Lord and healing for what is in the breast and guidance and mercy for the believers”.¹

It is the objective of *Shariah* to be as a mercy to all humankind by governing the conducts of human life and to protect the interests and benefits (*Maslahah*) of the people. In elaborating this concept of protecting the interests and benefits, the scholars of Islamic jurisprudence have divided the objectives of *Shariah* into two types namely the religious or spiritual objective and the worldly objectives.² The religious objective is the objective pertaining to the Hereafter where the religious faith is sought to be preserved and promoted. It includes facilitating the ritual worship of God and demonstrating the pillars of Islam eg prayers, fasting and alms paying (*Zakah*) as well as defending the religion from any element which can lead to the distortion or the destruction of the established pillars of Islam. The worldly objectives, on the

¹ Quran [Yunus 10:57]

² Asyraf Wajdi Dusuki (ed.), *Islamic Financial System: Principles & Operations* (International Shari'ah Research Academy for Islamic Finance (ISRA) 2011) 166

other hand, are related to the preservation of mundane affairs which comprise of human life (*Al-Nafs*), intellect (*Al- 'Aql*) progeny and offspring (*Al-Nasl*) and property (*Al-Mal*).³

Furthermore, there are also another two areas which are identified as the components of the intended mercy. The first area is the individual education. Through the act of worshipping God like prayer, for example, the *Shariah* inspires the believers with faith and instils in them the quality of being trustworthy and righteous since they are expected, inter alia, to perform it even though when there is nobody to monitor them. It aims at purifying the mind and heart from corruption, selfishness and over-indulgence in material pursuits so that the one who performs it will be able to become a good member of the whole society.⁴ Additionally, this action of prayer educates those who want to pray to have discipline by adhering to certain rules imposed. They cannot, for example, perform the prayer at the time suits them. Rather, they have to follow the stipulated time frame of performing it. Instilling quality such as self-discipline indeed is one of the steps taken by the *Shariah* to educate people so that they will be beneficial not only to themselves but also to their surrounding community.

1.2.2 Justice as an Integral Part of Maqasid Al-Shariah

The second area, which holds the direct relevance to this study, is the establishment of justice (*Adl*). In fact, justice is a striking feature of Arab popular culture and politics (the environment in which Islamic system started and developed) that the concept of justice and injustice play such a central role in their everyday life and thought.⁵ This can be seen in their discussions of history where the times may be seen as unjust or otherwise, or their assessment on the qualities of the characters by referring to their just behaviour or in social perception where the appropriate response to another's behaviour may be measured against the justice that flows from the relationship.⁶

Admittedly, justice is a universal value which is commonly shared across the border of places and times, races and religions. Nevertheless, the understanding of justice might be different from one perspective to another. While some might perceive justice as something that necessitates everything to be equal, the *Shariah* holds that justice is more extensive than just equating it to equality. Instead, *Adl* means placing things in their right places where they

³ *ibid*

⁴ Mohammad Hashim Kamali, *An Introduction to Shariah* (Ilmiah Publishers 2006) 25

⁵ Lawrence Rosen, *The Justice of Islam* (Oxford University Press 2000) 154

⁶ *ibid*

belong.⁷ In other words, justice does not always necessarily mean to treat everything equally but instead to handle them in the right manner which suits best them based on their nature and behaviour. Justice is to establish the equilibrium by way of fulfilling rights and obligations and by eliminating excess and disparity in all spheres of life.⁸ This includes the right and obligation between man and his Creator and man with his community. As such, it can be observed that the Quran has frequent recourse to a vocabulary of justice which is grounded on the proposition that humankind is responsible for all those actions that lie within exterior bounds set down by God.⁹

The significance position of justice in the landscape of *Shariah* is also among the subjects that have been discussed frequently by the scholars in the Islamic jurisprudence. For instance, Ibn Qayyim Al-Jauzi, a prominent scholar of the 14th century is reported to say, “Allah the Exalted has made clear in His law [*Shariah*] that the objective is the establishment of justice between His servants and fairness among the people, so whichever path leads to justice and fairness is part of the religion and can never oppose it”.¹⁰

With regard to the flexibility of *Shariah* to adapt to the changes of time and place, he further emphasised the position of justice in *Shariah* by saying:

Verily, the *Shariah* is founded upon wisdom and welfare for the servants in this life and the afterlife. In its entirety, it is justice, mercy, benefit, and wisdom. Every matter which abandons justice for tyranny, mercy for cruelty, benefit for corruption, and wisdom for foolishness would not be a part of the *Shariah* even if they were introduced therein by an interpretation.¹¹

In all its flexibility, *Shariah*, therefore, must serve the justice and its value and continuously in line with the benefits of humankind. Furthermore, since justice is also a universal value shared across the border of races and religions, it is an obligation for its believers to uphold it and adhere to its value wherever it is found; within or outside the declared provisions of law.¹²

⁷ Kamali, *An Introduction to Shariah* (n 4) 26

⁸ *ibid*

⁹ Rosen (n 5)

¹⁰ Muhammad bin Abu Bakar bin Ayub Ibnu Qayyim Al-Jauziyyah, *At-Turuq Al-Hukmiyyah fi As-Siyasah Asy-Syar'iyah* (Vol 1, Nayef bin Ahmad Al-Hamad ed, Dar Alam al-Fawaid lin-Nasri wat-Tauzi' 2007) 31

¹¹ Muhammad bin Abu Bakar bin Ayub Ibnu Qayyim Al-Jauziyyah, *I'lam Al-Muwaqqi'in 'An Rabbil 'Alamin* (Vol 1, Abi Ubaidah Masyhur bin Hasan Aal Salman ed, Dar Ibnu Al-Jauzi 2002) 41

¹² Mohammad Hashim Kamali, *An Introduction to Shariah* (Ilmiah Publishers 2006) 28

As justice is one of the objectives to be achieved through *Shariah*, it can be observed that this particular subject is among the central themes of the Quran. In many places, the Quran emphasises the obligation of justice. In fact, justice is the standard message brought by all the Messengers of God including the Prophet Muhammad. In this respect the Quran explicitly mentions, “We have already sent Our messengers with clear evidences and sent down with them the Scripture and the balance that the people may maintain [their affairs] in justice ...”.¹³

In the social aspect, *Shariah* urges people to be just in words and actions when dealing with the others at all levels whether personal or public, with friends or foes. The Quran mentions in this respect, “O you who have believed, be persistently standing firm in justice, witnesses for Allah, even if it be against yourselves or parents and relatives. Whether one is rich or poor ...”.¹⁴ It also instructs the Muslims to be just not only with their fellow Muslims but also with the non-Muslims by saying, “Allah does not forbid you from those who do not fight you because of your religion and do not expel you from your home—from being righteous towards them and acting justly towards them. Indeed, Allah loves those who act justly”.¹⁵

Further, justice also becomes the objective to be achieved in the segment of economy and finance. In this regard, a fundamental principle of dealing with property and the way for its acquisition has been laid down by the Quran, “O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful”.¹⁶

Once again, justice has been put at the core; the value and spirit in every economy and financial activities that must be observed. As much as the *Shariah* aims for the preservation of wealth and promotes commercial activities, it emphasises that any action to acquire wealth should not be done except within the framework of justice and does not jeopardise the interest of the public. Based on this proposition, Islamic finance is very keen on promoting justice through the idea of risk sharing instead of risk transferring.

From the *Shariah*'s point of view, risk sharing serves the notion of justice better since it requires one to expose himself to the business risk in order for him to be entitled to the expected profit. Neither he may secure his profit regardless of the performance of the business venture that he participates in (by extending the fund) nor he may manipulate the need for money that arises among the entrepreneurs by inviting them to receive the fund which

¹³ Quran [Al-Hadid 57:25]

¹⁴ Quran [An-Nisa' 4:135]

¹⁵ Quran [Al-Mumtahanah 60:8]

¹⁶ Quran [An-Nisa' 4:29]

subsequently creates the commitment of repayment (that shall comprise the principal amount plus interest) although their businesses are experiencing losses. In other words, by switching from risk transferring to risk sharing in the business operation, it shall eradicate the oppression of the 'upper hands' by preventing them from taking advantage out of the difficulties faced by the needy thus serving justice and fairness in doing business.

On the same basis ie propagating risk sharing instead of risk transferring in pursuit of justice and fairness, three modes of transaction are declared as prohibited in the eyes of Islamic finance, namely *Riba*, *Gharar* and gambling. This is because all of these three modes of transactions are working in such a way where the risks are not fairly distributed (shared) thus contravenes with the principle of justice as explained earlier (further discussion on these three modes of transactions shall take place later in this study).

1.2.3 The Global Financial Crisis as a Result of the Absence of Risk Sharing

The global financial crisis which took place circa 2007-2009 had once shaken the world community. Since then, numerous opinions from both Western and Islamic perspectives have been offered as to the factors that contributed to the occurrence of such a financial catastrophe. On the one hand, both Western and Islamic perspectives appear to acknowledge that the event started with the offering of subprime mortgage in the USA. On the other hand, some of the Western critics did not see the financial instruments such as Collateralised Debt Obligation (CDO) and Credit Default Swap (CDS) per se as the reason behind the crisis.¹⁷ In addition, they refuse to associate the moral judgement to these products; subprime mortgages are not the sort of things than can themselves have a moral status. Rather, the proper objects of judgement are people and their actions.¹⁸

This approach of assessment is significantly different as compared to what has been said in the perspective of an Islamic economist where the criticism is directed to the nature of the product itself. To the Islamic economist's mind, the reasons behind the global financial crisis can be encapsulated under one common theme; lack of risk sharing in the global financial market. In this regard, a prominent Islamic economist by the name of Nejatullah Siddiqi argued that the crisis, which started as a credit crunch resulting from the highly over-stretched leverage, was aggravated by the complexity of the derivative product such as Credit Default Swap (CDS). To him, CDS is a gambling-infested product which operates based on the idea

¹⁷ Elaine Sternberg, 'Ethical Misconduct and the Global Financial Crisis' (2013) 33(1) Economic Affairs 18

¹⁸ *ibid*

of risk shifting.¹⁹ In gambling, one who buys risk exchanges an exact amount of money for an uncertain amount of money whose delivery itself is uncertain.²⁰ It is a zero-sum game in which one gains at the expense of the other without the creation of real wealth but merely transferring it from the loser to the winner (hence ‘risk shifting’).²¹ Such a situation is exemplified in CDS. By relying on the risk of default (credit risk) in various degrees, the CDS-offering institution (risk buyer) undertakes to pay all defaulters without having a scientific basis for measuring the risk assumed nor a long history to fall back on but merely taking chances, ie gambling.²² As a result, its customers were sent on a buying spree which encouraged an expansion that had an insignificant basis in earning powers, disposable incomes and savings and investments (real wealth).²³ This situation, therefore, illustrates the injustice and manipulation culture as mentioned earlier.

A similar reason is also suggested by Chapra, another prominent Islamic economist. By describing the crisis as an ‘inadequate market discipline’ in the conventional financial system, he attributed the event to the absence of explicit risk sharing and the mind-boggling expansion of derivative products (such as CDO and CDS), as well as the policy of ‘too big to fail’ which gives big banks some sort of assurance that the central bank would not allow them to fail.²⁴ On the point of risk sharing, he explained that, since the bank and the depositor are guaranteed with the repayment of the deposit or the loan with interest, the depositor took little interest in the soundness of financial system and the bank, with the reliance on collateral, was ready to extend credit facility for any purpose, including speculation.²⁵ Pursuant to such, the proponents of Islamic finance have asserted that the crisis could have been avoided had the Islamic principles related to economics and finance been applied since both risk shifting and gambling are among the things that are incompatible with Islamic finance (because they are inherently unjust) and have no place in any of its product.²⁶

The same message is reaffirmed in the Kuala Lumpur Declaration pursuant to the Second Strategic Roundtable Discussion (SRD) by the International *Shariah* Research Academy for Islamic Finance (ISRA), Islamic Research and Training Institute (IRTI) of Islamic

¹⁹ Mohammad Nejatullah Siddiqi, ‘Current Financial Crisis and Islamic Economics’ (2009) 1(3) Insights 141

²⁰ *ibid*

²¹ *ibid*

²² *ibid*

²³ *ibid*

²⁴ Muhammad Umer Chapra, ‘The Global Financial Crisis Can Islamic Finance Help’ (2009) 1(4) Insights 27

²⁵ Muhammad Umer Chapra, *Morality and Justice in Islamic Economics and Finance* (Edward Elgar Publishing 2014) 140

²⁶ Habib Ahmed, ‘Financial Crisis: Risks and Lessons for Islamic Finance’ (2009) 1(1) ISRA International Journal of Islamic Finance 7

Development Bank (IsDB) and Durham University which took place on 20 September 2012. Asserting that the salient feature of the conventional financial system is the transfer of risks away from financial institutions onto customers, governments and the public at large, the discussion agreed on several points which can be summarised as follow:²⁷

- a) By virtue of the *Shariah* (Islamic law), risk sharing is a salient characteristic of Islamic financial transactions.
- b) Risk shifting in exchange contracts (as opposed to charitable contracts) violates the *Shariah* principle as the risk inseparable from the right to profit.
- c) Sales must be genuine transactions in open markets.
- d) Despite its permissibility from the *Shariah*'s point of view, debt has detrimental effects on society when it is used excessively.

Based on these resolutions, the Kuala Lumpur Declaration has proposed some suggestions, all concerning moving from interest-based systems towards risk sharing systems. The suggestions include levelling the playing field between equity and debt, increasing governments' use of fiscal and monetary policies based on risk sharing and broadening the organisational structures of traditional banking models to include models like venture capital with the aim of fulfilling the social needs and risk sharing features of Islamic finance.²⁸ The follow-up event which took place a year later in April 2013 in Jeddah, repeated more or less the same message in its resolutions, the Jeddah Roundtable Declaration. This time, the declaration consists of several suggestions pertaining to three different aspects, namely regulatory, institutional, and product. As for regulatory, it is suggested for the legal, tax and regulatory frameworks to be adjusted in order to create a level playing field for equity vis-à-vis debt and, given the detrimental effect of excessive debt on individuals and the economy, the optimum balance between them is to be sought.²⁹ At the institutional level, the Islamic financial institutions (IFIs) are expected to champion the equity-based financing. Therefore, it is suggested for them to introduce special funds or restricted investment accounts to be used in equity financing for it will enable them to promote such a financing without having to

²⁷ 'Kuala Lumpur Declaration' (The Second Strategic Roundtable Discussion by International Shari'ah Research Academy for Islamic Finance (ISRA), the Islamic Research and Training Institute (IRTI) and Durham University, 20 September 2012)

²⁸ *ibid*

²⁹ 'Jeddah Roundtable Declaration', (The Third Strategic Roundtable Discussion by International Shari'ah Research Academy for Islamic Finance (ISRA), the Islamic Research and Training Institute (IRTI) and Durham University, 1 April 2013)

invoke higher capital requirement (due to relatively higher risk).³⁰ In addition, they also should enhance their risk management infrastructure (risk governance and management process) for mitigating the unique risk characteristics embedded in equity-based financing.³¹ As for the product, resources should be allocated to study and promote innovative equity-based products and developing Islamic financial product should involve more structured and holistic deliberations and debates amongst the major stakeholders like *Shariah* scholars, practitioners, economists and regulators.³²

The point on the ability to avoid the financial crisis should the Islamic principles of economic and finance had been applied as mentioned above might be contentious and need deeper analysis to be proven. Nevertheless, this study shall not engage with such an analysis since it does not fall under its ambit. Rather, the important points that draw this study's attention here are the opinions postulated by the Islamic economists, and the gist of the Kuala Lumpur Declaration and the Jeddah Roundtable Declaration where all have asserted few common points; risk sharing is the cornerstone of the Islamic finance, and equity-based financial product needs to be strengthened as it conforms to the idea of risk sharing. It is this quality that puts Islamic finance at a unique position from its conventional counterpart. Contrary to the former, the latter rides on the interest-based transaction which is built on the idea of risk shifting or risk transferring, further discussion on which shall be engaged after this.

As the main theme of this study shall be centred on risk sharing, it is crucial at this initial stage for this study to provide a good grasp of its fundamental understanding, especially on the importance of risk sharing in the big picture of Islamic finance and its role in determining the permissibility of one particular commercial dealing in the eyes of *Shariah*. As such, the following subtopics shall be dedicated to addressing, inter alia, these points.

1.3 Risk and Islamic Finance

As much as it becomes an integral part of the daily human life, 'risk' is also an essential element in financial activities. It has been defined with a number of definitions by both western as well as Islamic economists. For instance, risk according to Madura is the probability that the result of an event will differ from the expected outcome.³³ According to

³⁰ *ibid*

³¹ *ibid*

³² *ibid*

³³ Jeff Madura and E. Theodore Veit, *Introduction to Financial Management* (West Publishing Company 1988) 110

Al-Suwailim, risk is simply the possibility of loss.³⁴ The understanding of risk is also being discussed by comparing it to another term namely uncertainty. For instance, a renowned economist by the name of Frank Knight had argued that the difference between risk and uncertainty lies in the ability to measure the odds; risk applies to the situation which the outcome of the event is unknown but the odds are possibly measured whereby uncertainty refers to the situation where such measurement of odds is impossible due to the lack of necessary information for such purpose.³⁵ Therefore, risk is easily converted into an effective certainty (as the odds can be measured) while uncertainty (or as he termed it, ‘true uncertainty’) is not susceptible to measurement.³⁶ The difference between risk and uncertainty is also explained by another economist by the name of Thornhill. To him, a risky situation refers to the circumstance where all possible outcomes are listed, and the change caused by their occurrence is foreseen whereby it is uncertainty if an outcome is required and the changes that cause it to occur are met.³⁷ However, what is important in this regard is the fact that the Western and Islamic economists have a common understanding of risk; it is about uncertainty and probability of the occurrence of the undesirable event (loss).

From the *Shariah* standpoint, assuming a certain degree of risk (or simply put, risk taking) is indispensable for the justifiable enrichment. This position can be traced to be deduced from and substantiated by various Islamic legal texts. For instance, an authentic prophetic tradition, termed as *Hadith*, is reported to say in this respect, “It is not lawful to profit from something for which one takes no liability, nor to sell one does not possess”.³⁸ It is, therefore, impermissible in the eyes of *Shariah* for someone to gain profit out of nothing or at the expense of other’s liability or loss (the authority vested in *Hadith* as one of the primary sources for Islamic law shall be discussed further in Chapter 2). There are also a number of legal maxims, termed as *Qawaid Al-Fiqhiyyah* (among the tools that the Muslim jurists rely upon in formulating legal ruling. Further discussion on this point in Chapter 2), in the Islamic commercial law that serves as the substance of this position. The maxim ‘*Al-Ghunm bil Ghurm*’ which means ‘liability accompanies gain’ could be an example of these maxims. According to this maxim, liability is the essential element that must accompany the profit

³⁴ Sami Al-Suwailim, *Hedging in Islamic Finance* (Islamic Development Bank, Islamic Research and Training Institute 2006) 56

³⁵ Peter Dizikes, ‘Explained: Knightian Uncertainty’ (MIT News, 2 June 2010) <<http://news.mit.edu/2010/explained-knightian-0602>> accessed 27 November 2018

³⁶ Frank H. Knight, *Risk, Uncertainty and Profit* (Reprint of Economic Classics 1964)

³⁷ William T. Thornhill, *Effective Risk Management for Financial Organizations* (Bank Administration Institute 1989) 22

³⁸ Abu Dawud Sulaiman bin Ash’ath, *English Translation of Sunan Abu Dawud*, vol 4 (Nasiruddin al-Khattab tr, Dar al-Salam 2008) 140

entitlement. A seller, for instance, is entitled to the profit from the sale of his asset because he is willing to assume all the risks attached to the asset such as the risk of damage or loss.³⁹ This position, therefore, has a strong substance from the sources of Islamic law as shown above. More importantly, it is also consistent with the aspiration of the *Shariah* which aims to promote and uphold justice among the people.

It is interesting to note here that the wisdom behind the Quranic injunction which prohibits the practice of *Riba* (frequently equated to usury) and the suggestion to invoke *Bai* (frequently translated as sale) as the lawful mean to gain profit instead of charging interest. The verse says, "... that is because they [the non-believers] say, 'Bai is just like interest', but Allah has permitted *Bai* and has forbidden interest".⁴⁰ The God Himself falsifies the understanding to equate interest to *Bai* although both can be invoked to generate profit due to the core difference regarding the risk assumption that both would entail.

Bai is an Arabic word, rooted from the word *Ba'* (for arm) because one extends his arm to give or take.⁴¹ In its technical meaning, it is defined as the exchange of the owned commodity for another with the exchange of ownership.⁴² Many references in the literature of Islamic commercial law use *Bai* loosely to refer to the activities of selling and buying. However, in a more detail analysis, it is observed that such activities are also referred to with another term namely *Tijarah*. For instance, Allah says, "[Are] men whom neither commerce [*Tijarah*] nor sale [*Bai*] distracts from the remembrance of Allah and performance of prayer and giving of *Zakah*. They fear a Day in which the hearts and eyes will [fearfully] turnabout".⁴³ Since the principle laid down by the linguistic semantics dictates that there should be no absolute synonymy among words for that will result in a breach of the economy of language,⁴⁴ it is asserted that there is a difference between the term *Bai* and *Tijarah*, especially when both are mentioned in the same verse. Some of the scholars, in explaining the relationship between these two terms, asserts that *Tijarah* is a general term (*'Am*) while *Bai* is a specific term (*Khas*), referring to the specific form of trading. Another group of scholars tend to explain these two terms by looking into the nature of the contract connoted by these words respectively. For them, a *Tijarah* contract is entered into with the expectation of profit

³⁹ Mohamad Akram Laldin and others, *Islamic Legal Maxims & Their Application in Islamic Finance* (International Shari'ah Research Academy for Islamic Finance (ISRA) 161

⁴⁰ Quran [Al-Baqarah 2: 275]

⁴¹ Wahbah Al-Zuhaily, *Financial Transactions in Islamic Jurisprudence* (Vol 1, Mahmoud A. El-Gamal trs, Dar al-Fikr 2003) 5

⁴² Abdullah bin Ahmad, Al-Mughni (Vol 6, 3rd edn, Dar 'Aalam al-Kutub 1997) 5

⁴³ Quran [An-Nuur 24: 37]

⁴⁴ Jamal alQinai, 'Convergence and Divergence in the Quranic Polysemy and Lexical Recurrence' (2011) 19 Studies About Language 28

whereby in the case of *Bai*, the contracting parties entered into the contract with the expectation to gain but are cognisant of the probability of loss.⁴⁵ Hence, it can be understood that even though the understanding of both words might overlap to a certain extent (as both might be used to refer to the act of trading), the term *Bai* gives emphasise to the circumstance where the seller can legally gain profit out of his sale as a result of his willingness to take the risk of loss.

Looking back into the verse as quoted above, the opponent of this prohibition (the non-believers) tried to justify their action of charging the interest by saying that there is nothing wrong with *Riba* as it renders profit to the creditor as much as the sale renders profit to the seller. To rebut this misconception, Quran does not use the term *Tijarah* as it will not suffice to address the real issue. Instead, it uses the term *Bai* to refer to the legitimate means of deriving profit for the term implicates the element of risk taking which is absent in the interest-based loan arrangement. Unlike in the sale arrangement where the seller has to bear the risk of the asset (therefore is entitled to the profit derived from the asset, if any), the creditor in the interest-based loan does not have to bear the similar risk to gain profit. In the case of enterprise financing, for instance, the creditor is guaranteed with the return (principal amount together with interest) regardless of the outcome of the enterprise. This transfers the entire risk of the transaction to the borrower. Arguably, the creditor still bears certain risk like in the case where the debtor might not be able to serve his debt. Nevertheless, this kind of risk which is known as the credit risk is disregarded in the eyes of *Shariah* as it concerns only about the ability of the debtor to pay the debt and his solvency rather than the performance of the business and the transaction it entails (more on this point shall be addressed further in Chapter 2 under the discussion of the prohibition of *Riba*).

1.3.1 Subject of Risk

The discussion pertaining to risk from the perspective of the Islamic commercial law also covers another two issues. The first issue is pertaining to the subject of risk which refers to the origin of the integral risk that is inherent to a financial transaction. It is established by now that risk is an important component of the legitimate profit. Hence, it is important to consider the subject from which the risk may emanate as this risk has to be dealt with in accordance with its subject. In addition, as will be further addressed in Chapter 3–*Musharakah*, the

⁴⁵ Hossein Askari and others, *An Introduction to Islamic Economics: Theory and Application* (John Wiley & Sons Singapore Pte. Ltd. 2015) 86

variety of opinion among the jurists pertaining to the legitimate (and illegitimate) form of partnership is also traced to have originated from this issue, particularly as to the basis of profit entitlement in *Musharakah* (Islamic partnership based on profit-loss sharing).

In general, risk may originate from two things, namely the asset/wealth and the labour. As for the asset risk (*Makhatir Maliyah*), the risk is pertaining to the subject matter (*Al-Maqud Alaih*) of a financial transaction; both transacted asset (*Mal*) and its agreed price. In a sale transaction, for instance, the seller must bear the possibility (risk) of an uncalled circumstance such as damage, loss (due to theft or fire for instance) or value depreciation. Reciprocally, any benefit that arises from this asset such as physical growth, appreciation of value or revenue shall belong to him. This also entails the liability of ownership. In order for the profit to be considered as legitimate, the seller must also acquire the full ownership of the asset for it shall allow him to dispose the asset as he wills. Having said this, the buyer cannot sell the commodity he bought before he has the full possession over the asset (before it is delivered to him, for instance) as it is still under the seller's liability (the issue of ownership of the property will also be re-addressed in the discussion of the prohibition of *Riba* of Chapter 2).

Risk can also emanate from the labour contributed by the involved parties thus provides the basis for the contributor's entitlement to the profit. For instance, the *Mudarib* (entrepreneur) in *Mudharabah* arrangement (Islamic partnership based on profit sharing and loss bearing), despite not contributing capital like the *Rabbul Mal* (capital provider), contributes his skill and labour work in running the business. The business, like any other businesses, may face loss which will cause the *Mudarib* not be able to get the expected portion of return and have to bear the loss in terms of his time and effort. On the contrary, he is then entitled to the profit based on the pre-agreed ratio should the business manages to generate income (since this study, as shall be explained later, put *Musharakah* as its focal point the discussion on the existence of risk taking/risk sharing in it shall be engaged in the later part). At the institutional level, this type of risk can be observed in various forms. These forms include the reputational risk where the institution is liable for the risk which arises from the failures of governance, business strategy and process. Also, the risks that can be classified under this category are the operational risks which arise from the day-to-day activities and legal risk which may arise from a lack of qualified legal personnel, or in the case of Islamic finance, from the special task which is improperly discharged to operationalise Islamic financial products and

services.⁴⁶ By assuming this type of risk, the institution in question, therefore, deserves the profit arising from the business.

It is also worth to mention here that in some circumstances the risk may emanate from different subject risks although the contract used is the same. For instance, in *Ijarah* (lease) the risk may emanate from the leased asset (*Mal*) or the rendered labour (*Amal*), depending on the type of the lease (the former exists in asset leasing, *Ijarah Al-Ain* while the latter exists in the case of hiring the individual, *Ijarah Al-Ashkhas*). Nevertheless, the common practice shows the term frequently refers to the former, especially when it is used in an absolute manner, ie without further specifying the type). It is a contract where the ownership of the asset is maintained under the lessor while the ownership of the specified usufruct of the asset is transferred for a specified consideration. For instance, in the case of *Ijarah/Ijarah Al-Ain*, the ownership of usufruct is being transferred to the lessee while the ownership of the leased asset is maintained under the lessor. As such, the lessor is liable for the loss in case the leased asset is damaged, stolen or has depreciated in value as well as he is to assume the liability for its maintenance to the extent its usufruct can be enjoyed by the lessee.⁴⁷ In return, he is eligible to receive the rental payment.

1.3.2 Form of Risk Taking

The second issue is pertaining to the form that risk taking may be manifested through. The first form is risk sharing. As discussed above, the practice of *Riba* was prohibited due to its inherent risk transferring (from the creditor to the debtor). Alternatively, the sale (*Bai*) has been declared as the legitimate means to achieve the same goal, ie making profit. Based on this dichotomy, it is argued that since the former transfers risk from one party to the other, the alternative does not.⁴⁸ As such, some scholars are of the opinion that risk sharing is an intrinsic nature of all *Shariah*-compliant contract including exchange contract (like sale) and partnership contract (like *Musharakah* and *Mudharabah*).⁴⁹ While risk sharing is obvious in a partnership contract as explained above in the case of *Mudharabah*, parties in the sale contract are sharing risk (and reward as well) of the sale activity in such a way where the benefits of specialisation and cooperation may be pursued, resulting in potential efficiency and

⁴⁶ Mohamed Fairouz Abdul Khir and others, 'Risk Taking in Islamic Commercial Transactions: A Fiqhi Perspective' (2014) ISRA Research Paper 77/2014, 16

⁴⁷ *ibid* 19

⁴⁸ *ibid* 13

⁴⁹ *ibid*

profitability gains as economic agents need not individually produce all things but may specialise and exchange between themselves (hence risk sharing).⁵⁰

However, some others opined otherwise. While admitting that risk sharing illustrates the idea of risk taking, not every *Shariah*-compliant contract necessarily entails risk sharing. Rather, the risk could be mutually borne (risk bearing) by the contracting parties instead of shared in the exchange-based (sale) contract.⁵¹ They argued that unlike in the partnership-based contract such as *Musharakah* and *Mudharabah* where the risk would arise from the same asset that comprises the subject of risk, and the partners shall suffer the loss at the same point of time (hence risk sharing), the parties in the exchange-based contract such as sale have their own, separate risk.⁵² During the negotiation stage that precedes the sale, the seller bears the risk of the asset while the buyer bears the risk of the price.⁵³ Upon the completion of asset delivery and the price payment, each of them transfers the subject of his risk to another party; the seller hence bears the risk of price while the buyer bears the risk of the asset.⁵⁴ The seller might also bear the risk of the option to terminate the contract due to the defect on the asset, termed as *Khiyar Al-Aib*, upon invoking of which shall result in him to refund the money.⁵⁵

As much as this study does not intend to engage deeper with the semantic argument of the terms, the difference in terms of characterising the behaviour of risk taking is insignificant for the purpose of this study. Rather, what does matter at this point is the fact that one can safely claim that these two different views do not deny that risk taking shall exist in every contract that aims to generate profit regardless the branding (risk sharing or risk bearing), the fact of which conforms with the earlier assertion on the cruciality of risk. Furthermore, as mentioned earlier, the focus of this study is on *Musharakah*. Hence, the term risk taking and risk sharing might be used interchangeably (unless mentioned otherwise) since the manifestation of the former through the latter in the case of *Musharakah* is free from contention, dissimilar to what is taking place in another case such as sale.

⁵⁰ Said Bouheraoua and others, 'Implementing the IFSA Investment Account: A Risk Sharing Banking Model' (2016) ISRA Research Paper 87/2016, 5

⁵¹ Khir and others (n 46) 13

⁵² *ibid*

⁵³ *ibid*

⁵⁴ *ibid*

⁵⁵ *ibid*

1.4 Problem Statement

1.4.1 Legal Uncertainty

In *Vallejo v Wheeler*, Lord Mansfield emphasised the importance of legal certainty by saying, “In all mercantile transactions the great object should be certainty; and therefore, it is of more consequence that a rule should be certain than whether the rule is established one way or the other. Because speculators in trade then know what ground to go upon”.⁵⁶ As legal systems are meant to facilitate business activities and promote economic efficiency, certainty in law enables the participants of the market to make a fully-informed decision regarding their business call.⁵⁷ It also has a role to ensure that courts resolve disputes according to established legal norms and act in a legitimate manner by, inter alia, limiting arbitrary judicial decision-making.⁵⁸ On the contrary, uncertainty in law would blur the boundary between what is permitted and what is otherwise which is likely to affect the incidence of unlawful activity and subsequently, might result in higher litigation and judicial system costs.⁵⁹

Islamic finance is no exclusion from the need for legal certainty. As mentioned above, the validity of the financial products offered under Islamic finance is highly depending, inter alia, to the legal and regulatory framework that applies in their case. It is such framework that shall determine, for instance, the true nature of the products in question thus validate which set of rules is to be invoked, especially if the matter is being brought before the court of law for adjudication. As shall be explained later, the uncertainty in this regard has been causing legal complexity and puts the involved parties at certain uncalled situations such as unable to recover the supposedly due debt amount since the financial product used in the financing facility is deemed as ‘unrecognised’. In the case of Malaysia, the question of legal certainty in Islamic finance matters becomes a matter of concern due to the reality of its legal landscape.

Malaysia is a country which runs dual legal systems that work side by side. At one end, there is the Islamic legal system in place which operates *Shariah*-based legal regime through the *Shariah* courts. At the other end, the country is also governed by the legal regime which adopts the English common law system as a result of the long British colonisation history. The civil courts (the *Shariah* courts’ counterpart), therefore, shall try the cases brought upon them according to the relevant Malaysian English-based laws. The Federal Constitution, as

⁵⁶ [1774] 1 Cowp 143

⁵⁷ Iain MacNeil, ‘Uncertainty in Commercial Law’ (2009) 13(1) *Edinburgh Law Review* 68

⁵⁸ *ibid*

⁵⁹ *ibid*

the supreme law of the land, has explicitly allocated each of these courts with their jurisdiction. While the jurisdiction of the *Shariah* courts is relatively limited and can only handle the cases which involve only person who professes the religion of Islam (Muslim), all cases related to banking matters and commercial transactions, including the cases of Islamic banking and finance, fall under the purview of the civil courts. As such, notwithstanding the fact that *Shariah* (particularly Islamic commercial law known as *Fiqh Al-Mualamalat*) is at the heart of Islamic finance, in the Malaysian context, all its dealing shall be governed by the common law framework rather than *Shariah* law framework. (Chapter 4 will engage this point with deeper deliberation).

The reality as mentioned above (Islamic finance dealing is to be governed by the English Law) has been causing legal complexity as what can be observed in a number of cases involving Islamic finance dealings from all around the globe. One of these cases is *Beximco Pharmaceuticals Ltd & Ors v Shamil Bank of Bahrain*.⁶⁰ In this case, which had reached the Court of Appeal, the appellant appealed against the summary judgement of the High Court which was in favour of the plaintiff (Shamil Bank of Bahrain, SB) regarding its debt recovery. In summary, SB had entered into various Islamic financing agreements (they are mainly based on the cost-plus sale, *Murabahah*) with the first defendant (Beximco Pharmaceuticals Ltd, BP) and the second defendant as the principal debtors for the purpose of advancing credit facilities. The financing agreements contained, inter alia, the governing law clause which reads “subject to the principles of Glorious Shari’a [*Shariah*] this agreement shall be governed by and construed in accordance with the laws of England”. As defendants defaulted the payments under the agreements, SB sought to enforce them. Although the amount being claimed is not in dispute, the defendants had advanced several defences including their contest on the availability and the enforceability of the agreement. According to them, by virtue of a true construction of the governing law clause, the agreements were only enforceable in so far as they were valid and enforceable in accordance with the principle of the *Shariah* and accordance with the English Law. They further argued that although the facilities invoked the *Shariah*-compliant contract, they were merely ‘a disguise for an otherwise undocumented interest-bearing loan’. Since the agreements entail the payment of interest (*Riba*) which clearly offended the *Shariah* law, thus they are not enforceable.

The judges of the Court of Appeal, however, had unanimously affirmed that the summary judgement was given by the High Court and thus dismissed the appeal. They held, inter alia,

⁶⁰ [2004] EWCA Civ 19, [2004] 1 CLC 216

that there could not be two governing laws for the agreements and as for the case in question, the governing law was the law of England. The phrase 'subject to the principles of Glorious *Shariah*' should be taken on a basis which was reconcilable with the purpose of having the agreement, not to defeat it. Furthermore, notwithstanding the possibility of incorporating provisions of foreign law as terms of a contract, the general reference to *Shariah*, in this case, did not specify which aspect of it was intended to be incorporated into the contract (since the principles of *Shariah*, generally, are broad). Rather, it should be understood merely as a reference to the fact that SB held itself out as conducting its businesses according to the *Shariah* principles. Hence, such a reference stands unqualified, inevitably repugnant to the choice of the English Law as the law of the contract and render the clause in which the phrase was inserted as meaningless.

What can be observed from this case is that the principles of the English Law are not always consistent with the *Shariah* and the court may not be able to apply both the English Law and the *Shariah* simultaneously. The conflictive situation, either within the same legal system or between different legal systems, renders uncertainties in the application of law.⁶¹

The Malaysian Court of Appeal case, *FLH LCT Services Sdn Bhd & Anor v Malaysian Debt Ventures Bhd*⁶² can also exemplify that there are some serious issues in the way how the common law addresses the Islamic banking cases. In this case, the respondent had granted the first appellant with the credit facility up to RM9.5 million under the *Bai Al-Inah* contract. Via this contract, the respondent agreed to sell its asset to the first appellant at RM14,233,200 the price of which to be paid in stages and it will be repurchased by the respondent for RM9.5 million, subject to the terms and conditions contained in the various documents. As the first appellant defaulted the payment, the respondent (the plaintiff) prayed to the High Court, inter alia, for the recovery of the sum of RM12,139,615.23 which was due and payable. In their defence, the appellants (the defendants) claimed, inter alia, that the transactions entered into between the plaintiff and the defendants were not in line with the *Shariah*, tainted with the element of usury which was clearly prohibited by the *Shariah* law and contrary to the spirit and intent of the financing concept based on *Bai Al-Inah*. In its decision, the High Court allowed the plaintiff's claim against the defendants and therefore ordered the defendants to pay RM12,139,615.23 together with other granted payments. The defendants, being dissatisfied with the decision, appealed to the Court of Appeal against the whole decision.

⁶¹ Syed Adam Alhabshi, 'Introducing the *Shariah* Investment Agreement: Compatibility with Common Law' (Doctoral thesis, The International Centre for Education in Islamic Finance (INCEIF) 2016) 4

⁶² [2016] 1 MLJ 248

After the deliberation, the Court of Appeal found that the failure to mention the asset in the *Bai Al-Inah* transaction had violated its entrenched principles and therefore rendered it *Shariah* non-compliant. According to the Court, as it is not recognised as *Bai Al-Inah* financing contract but something else unknown in the *Shariah* financing system, the remedy sought is also elsewhere and not under the *Bai Al-Inah* financing system. Therefore, the previous order by the High Court which includes the payment of RM12,139,615.23 was hereby set aside.

Without having to go deeper into the factual background of the case, what has been mentioned above would suffice to illustrate the severe risk posed to the financial institution. As the Court in this case failed to recognise the sought-after remedy even though the mode of financing used is well known to both Islamic finance and Malaysian courts (based on the fact that *Bai Al-Inah* was the financing method predominantly used during the inception of Islamic finance in Malaysia in the 1980s and a number of cases involving it had been brought to the court since then), the financial institution was put in a difficult situation where the attempt to collect the principal sum that it had initially disbursed to its customer is interrupted.

1.4.2 Conflictive Nature of Islamic Finance: An Overview of Musharakah as a Risk-Sharing Vehicle in Malaysia

Earlier in this chapter, it is asserted that risk sharing is the cornerstone of Islamic finance and the existence of risk is essential in all Islamic commercial transaction which aims to generate profit. Nevertheless, the reality of the Islamic finance industry in this respect rather illustrates a contrary situation. Some had argued that even though risk sharing is idealised in Islamic finance, in reality, it is seriously marginalised in the IFIs.⁶³ Rather, *Murabahah* (the cost-plus sale) has always been predominantly used as it ensures maximum risk avoidance with a relatively high return.⁶⁴ The IFIs, the argument went on to say, have quietly disengaged from risk sharing modes and embraced the *Murabahah* syndrome; the strong and consistent tendency of Islamic banks and financial institutions to utilise debt-like instrument.⁶⁵ Although *Murabahah*-based financing might still be considered as *Shariah*-compliant, it implies a totally different position in terms of the risk profile which does not conform to the idea of risk sharing. It is because the risk involved in this mode of financing is arguably in existence and

⁶³ Mohammad Omar Farooq, 'Partnership, Equity-Financing and Islamic Finance: Whither Profit-Loss Sharing?' (2007) 11 *Review of Islamic Economics* 67

⁶⁴ *ibid*

⁶⁵ *ibid*

negligible as a result of its documentation construction which eliminates the IFIs from all liabilities.⁶⁶ Therefore, it can be said that the sale executed in *Murabahah* financing is nothing more than creating indebtedness to sugar coat the arrangement whereby in the real sense, it is akin to the *Riba*-based loan with no involvement of risk (in Chapter 3, the steps involved in *Murabahah*-based financing shall be explained).

Such a disengagement is also illustrated by the statistic of Malaysian Islamic financing composition based on the Islamic contract used issued by the Central Bank of Malaysia (Bank Negara Malaysia, BNM) in its 2017 issuance of the Financial Stability and Payment Systems Report.⁶⁷ As shown by the statistic, financing that takes *Musharakah* (equity-based) as its underlying contract was relatively small as compared to the financing that takes the debt-based contract as its underlying contract; the former represented 9.2 per cent of the total financing size whereby the latter represented 78.3 per cent of the total financing.⁶⁸ This further implicates the existence of a serious gap between the theoretical approach which dominates the Islamic finance literature that propagates risk sharing as the backbone of the Islamic finance, and the practice of the Islamic finance institutions which conforms with the status-quo of the conventional banking practice that heavily relies on the debt-based arrangement for the provision of finance.

Looking from the perspective of the Malaysian legal and regulatory framework, a similar dichotomy can be observed as well. At one end, the Islamic Financial Services Act 2013 (IFSA 2013) construes *Musharakah* and *Musharakah Mutanaqisah* as equity or partnership financing. However, the *Musharakah* Regulatory Policy issued by BNM which provides, inter alia, regulatory framework pertaining to the *Musharakah* operation in Malaysia explicitly provides *Musharakah Mutanaqisah*, particularly with the purpose of asset acquisition (as in home financing product), shall reflect a debt-based financing risk profile. Since both equity and debt financing modes connote contradict meanings and render opposite impacts on their risk profile (as shall be further discussed in this study), the contradictory positions held between the IFSA 2013 and the *Musharakah* regulatory policy in this respect, may potentially lead to the uncertainty in law as mentioned above.

⁶⁶ Ahamed Kameel Mydin Meera and Dzuljastri Abdul Razak, 'Islamic Home Financing through *Musharakah Mutanaqisah* and al-Bai Bithaman Ajil Contracts: A Comparative Analysis' (2005) 9(2) Review of Islamic Economics 5

⁶⁷ Bank Negara Malaysia, 'Financial Stability and Payment Systems Report 2016' (March 2017) 91

⁶⁸ As for debt-based financing, the breakdown is as follows; BBA-12 per cent, Bai al-Inah-7.2 per cent, Tawarruq-22.4 per cent, Murabahah-18.7 per cent and Ijarah-18 per cent. The rest 12.5 per cent consist of unspecified Islamic contracts such as *Bai al-Dayn*, *Bai al-Salam*, *Bai al-Sarf*, *Istisna*, *Mudharabah*, *Kafalah*, *Qard*, *Rahn*, *Ujrah* and *Wakalah*.

Also, as shall be explained later in this study, the introduction of *Musharakah Mutanaqisah* in Malaysia as a method of financing, was motivated by the desire to depart from the BBA-based financing (which may also be referred to as the Murabah-based home financing) since the latter resembles the features of debt financing which akin to riba-based financing. As such, the failure to ascertain the true nature of *Musharakah* and *Musharakah Mutanaqisah* may become a major setback to the development of Islamic finance and pose the reputational risk under the impression of misleading. Furthermore, the products might not be correctly recognised by the court of law since its true nature, as far as the current legal and regulatory frameworks are concerned, is yet to have a solid characterisation. Assuming such an event is to take place, the occurrence of problem pertaining to the sought-after remedy as what had been seen in the case of *FLH LCT Services Sdn Bhd & Anor* is not something far-fetched.

Based on the problematic circumstance and its potential effects as mentioned above (the uncertainty of the *Musharakah* product's nature due to the uncertainty within the legal and regulatory framework which is counterproductive to the development of Islamic finance in strengthening risk sharing in Malaysia as well as posing the reputational risk) it is important for a study to be undertaken in this respect to evaluate the current position of the Malaysian legal and regulatory framework vis-à-vis *Musharakah*, particularly on the question of the framework's consistency with the implementation of risk sharing through *Musharakah*.

1.5 Aim and Objectives of the Study

Against the backdrop mentioned above, this study aims to gauge the extent to which the Malaysian current legal and regulatory framework conform and support the implementation of the idea of risk sharing through *Musharakah* on its capacity as one of the equity-based financing modes as declared by the IFSA 2013. This exercise shall be preceded by examining the way *Musharakah* helps to operationalise the idea of risk sharing. Subsequently, this study shall examine the relevant governing laws and regulation for *Musharakah* and how the issue of risk sharing is being addressed through them. The findings from these two steps eventually will be used to examine how far the governing laws and regulation back the implementation of the idea of risk sharing in *Musharakah* through its product.

1.6 Research Questions

For the purpose of gauging the extent to which the Malaysian current legal and regulatory framework consistent with the implementation of the idea of risk sharing through *Musharakah*, three research questions are brought forward, the answers to which will lead to the conclusion sought by this study. These three questions, being the first two serve as the subsidiary questions while the last one is the primary/main question, are as follows:

- a) In which way does *Musharakah* help to operationalise the idea of risk sharing? (first subsidiary question)
- b) What are the governing laws and regulation for *Musharakah* in Malaysia and how the issue of risk sharing is being addressed through them? (second subsidiary question)
- c) To what extent do the governing laws and regulation support the implementation of the idea of risk sharing through *Musharakah* in Malaysia? (primary/main question)

1.7 Research Methodology

In seeking the answers to the questions mentioned above, this study employed the qualitative research methodology by examining the relevant legislations (primary source) as well as the secondary sources such as books, journal, articles or other written commentaries on the case law, hence made this study as a library-based research. In addition, since this study is pertaining to the Islamic finance in the context of the Malaysian legal and regulatory framework, therefore, the sources involved in the research comprise materials from two segments: the Islamic law and the Malaysian law which primarily based on the English law. For both segments, the same method was applied. For Chapter 2 and Chapter 3, the focus was on the *Shariah* as the bedrock of Islamic finance and *Musharakah* as the subject matter of Islamic commercial law respectively. For that, it relied on the analysis of the literature in the original Islamic legal text from the past as well as the present, some of which in the Arabic language. The steps taken here were to provide the understanding on the nature of Islamic law in general, its aspiration and the methodologies used in deducing its legal rulings. Subsequently, the works of literature pertaining to *Musharakah* were examined to gain relevant information for this study. This includes the type of *Musharakah* recognised under the Islamic law and how it is relevant to the discourse of risk sharing.

Furthermore, the *Shariah* requirements on *Musharakah* were also studied to identify the way the idea of risk sharing is sought to be manifested through it. These *Shariah* requirements,

however, were not studied in isolation. Instead, their adoption in various contemporary *Shariah* standards was also examined. In order to have the closest picture possible of the operation of *Musharakah*, reference was also made to the banking documentation such as the *Musharakah* Principle Terms and Conditions (PTC) for *Musharakah Sukuk*. The exercise undertaken in this chapter, hence, answered the first research question (the first subsidiary question).

Chapter 4 and Chapter 5 discussed the legal reality for Islamic finance in Malaysia as well as the legal and regulatory framework for *Musharakah*. Since the discussion of Chapter 4 addressed the historical development of the legal system in Malaysia and its current situation, the chapter relied heavily on the materials from the secondary source. These materials including legal textbooks, legal history book and journals. Nevertheless, the chapter also utilised materials from the primary source such as reported court judgements which can be found in various online legal databases. The analysis of these materials formulates the legal setting in Malaysia particularly pertaining to the matters of Islamic banking and finance. As for Chapter 5 which is meant to answer the second research question (the second subsidiary question), the examination here was on the statutes as well as the regulatory policy.

In Chapter 6, the information gathered and examined previously was used to critically examine the position of risk sharing in the legal and regulatory framework of Malaysia as to provide the answer to the third question (the primary question). One of the aspects in which such examination takes place is pertaining to the legal recognition held by law towards *Musharakah*. Therefore, several cases that had been brought before the court which have relevance were examined in order to determine such legal recognition.

It is also important to note here that the coverage of this study is not strictly confined to the Islamic law and legal propositions. Rather, the aspect of social value like justice and fairness are also within the ambit of this study although no empirical exercises such as interviews, questioners and so forth were involved. This can be noticed upon the reflection on the operation of the *Musharakah Mutanaqisah* home financing as an equity-based or a debt-based financing instrument on the *Shariah*'s pursuit for justice, particularly in 'Second Part–Debt Financing Vis-À-Vis Equity Financing: A Comparative Analysis of the Rendered Effects on Risk Sharing in Light of the IFSA 2013 And the *Musharakah* Regulatory Policy' of Chapter 6.

1.8 Research Scope and Limitation

This study limited its scope by engaging the analysis only on *Musharakah Mutanaqisah*-based product, namely the *Musharakah Mutanaqisah* home financing. Nevertheless, since *Musharakah Mutanaqisah* might also be used as the underlying structure of *Musharakah Sukuk*, the reference to this type of *Sukuk* shall also be made even though it does not fall under the ambit of the *Musharakah* regulatory policy. Furthermore, the study addressed *Musharakah Mutanaqisah* in the light of its understanding and operation in Malaysia only as described by the relevant laws and regulation without engaging in the comparative analysis with the structure of *Musharakah Mutanaqisah* as it might be operated in foreign jurisdictions.

As most of the financing agreements are considered as private and confidential between the financial institution and the customer, the analysis of this study was based on the materials which can be accessed by the public only. Although variation pertaining to the terms might occur based on each customer involved, the basic structure of the products as reflected by these materials remains the same which makes the reliance on them for the purpose of this study suffice.

It is also important to note here that the terms equity financing and equity-based financing (as well as debt financing and debt-based financing) were used interchangeably for the purpose of this study.

1.9 Potential Contribution

The issue of risk, particularly risk sharing has always been among the topics to be discussed in Islamic finance discourse in the past and the present. The strive for strengthening its implementation is indeed a continuous work undertaken by various parties such as the legislatures, the regulators, the industry practitioners as well as the academics. In the case of Malaysia, such a work is evident, inter alia, by the introduction of the IFSA 2013. It is for the first time in Malaysia, the law requires the IFIs to segregate the funds placed by a customer into either a deposit account (current or saving account, CASA) or an investment account. The salient difference between these two types of account is that the former is a risk-free account where the principal fund is guaranteed whereby the latter shall treat its fund as risk

bearing subjecting the principal to potential loss.⁶⁹ BNM has also issued a separate regulatory policy (the Investment Account Regulatory Policy) which aims to outline the regulatory requirements on the conduct of investment accounts. By virtue of this regulatory policy, the IFIs are required to ensure the investment account is structured based on the *Shariah* contract which does not entail the creation of an obligation on the IFIs to repay in full, the money accepted from the account holder (paragraph 8.2) and the structure and terms of investment account provide sufficient legal enforceability to affect the loss bearing or loss transfer to the account holder in *Shariah* compliant manner (paragraph 8.3).⁷⁰ The initiative continues with the introduction of the investment account platform (IAP), a centralised multi-banks platform which offers the opportunity to institutional and individual investors to invest in the Islamic financial market as well as financing the entrepreneurship (viable small and medium enterprises, SMEs). In her keynote speech during the launching of IAP, the then BNM's Governor said that IAP is more than just a new and innovative medium for *Shariah*-compliant investments and fundraising initiatives. Rather, it also signifies a fundamental shift towards providing solutions that address the existing gap in the conventional risk transfer monetary regime to one that allows for financial institutions to include investment intermediation activities that emphasises risk sharing and therefore, contributes a stronger linkage of finance and the real economy.⁷¹ Furthermore, the recent introduction of the Value-Based Intermediaries (VBI) by BNM has also amplified the seriousness from the regulatory end to instigating the total departure from the conventional framework of financing which heavily relies on debt creation to the active participation in the entrepreneurship which conforms with the idea of risk sharing. The initiative aims to create intermediation function with the aspiration to deliver the intended outcome of *Shariah* through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment.⁷² Four key thrusts underpin it; one of which is the entrepreneurial mindset that entails support to the entrepreneurial activities by providing comprehensive and relevant offerings.⁷³ Hence, this study is being timely undertaken as it complements all the initiatives mentioned above. The findings of this study shall provide a clear indication of the current position of Islamic finance industry in Malaysia as well as its inclination pertaining to the issue of risk sharing in its financing segment. Relevant stakeholders such as BNM or the Legislative House (the

⁶⁹ Bouheraoua and others (n 50) 3

⁷⁰ Bank Negara Malaysia, 'Investment Account' (March 2014) para 8.2 and para 8.3

⁷¹ Zeti Akhtar Aziz, 'Governor's Keynote Address at the Launch of the Investment Account Platform (IAP)' (*Bank Negara Malaysia*, 17 February 2016)

<www.bnm.gov.my/index.php?ch=en_speech&pg=en_speech&ac=665&lang=en> accessed 9 August 2018

⁷² Bank Negara Malaysia, 'Financial Stability and Payment Systems Report 2017' (March 2018) 94

⁷³ *ibid*

Parliament) may benefit from the findings of this study should they decide to embark with further research on this topic or if necessary, to revisit the relevant existing laws and regulations for the purpose of revision and amendment by taking into consideration the findings and values as offered in this study.

Besides, since this is an academic research, it enriches the existing literature in this area which beneficial to *Shariah* and legal researcher as well as the academics. Although works of literature in which the issue of risk sharing being discussed are numerous, study with focus on the legal and regulatory aspects and their impact on the implementation of risk sharing, particularly in the case of Malaysia, is relatively small in number. Hence, this study fills such a prevailing gap and offers a fresh perspective in evaluating the performance of the Islamic finance industry.

1.10 Organisational Structure and Chapters Outline

This study is systematically designed with the ambition to provide a comprehensive legal analysis on the current Malaysian legal and regulatory framework and the degree of its compatibility with the propagation of the idea of risk sharing through *Musharakah*. As such, it is divided into seven chapters the outline of each is as follows:

Chapter 1, Introduction (the present chapter) – This chapter serves as the introduction chapter for the whole thesis with the aim to prepare the reader with the general idea of this study before embarking into deeper discussions. The background and problem statement, the aims, the objectives and the questions this study seeks to answer as well as the methodology employed for such a purpose are explained here. The motivation for undertaking this study as well as the scope and limitation of this study which has been set to ensure its feasibility are also included in this chapter.

Chapter 2, The Fundamentals of *Shariah* – Since Islamic finance is, originally and fundamentally, governed by the Islamic Law which is frequently referred to as *Shariah*, this chapter explains the general yet sufficient view on the *Shariah*. This explanation covers the real understanding the term *Shariah* carries and how the components of which it is made of, put the Islamic Law at a different position as compared to the other legal systems. Subsequently, by narrowing the scope of *Shariah* to the aspect of law and regulation (termed as *Fiqh*), the discussion continues to address how the Islamic law, particularly the commercial law (*Fiqh Al-Muamalat*) is being operationalised; the flexibility it enjoys as a result of the

process of legal ruling deduction known as *Ijtihad* as well as the sources of the law and its legal maxims. As the continuity of what was established in Chapter 1 pertaining to justice and risk sharing, this chapter ends with the deliberation on three major prohibitions in Islamic finance, namely *Riba* gambling and *Gharar*. As explained in the discussion of this chapter, the prohibition on these three modes of transaction manifests the proposition of *Shariah* which aspires to uphold justice through risk sharing; these three modes of transaction are banned since they operate on the basis of risk transferring. The information gathered through this chapter would help the readers to understand the *Shariah*'s basis on its assertion of the importance of risk sharing in the commercial transaction. This shall provide the important element to the answer for the research question pertaining to the way *Musharakah* helps to operationalise the idea of risk sharing.

Chapter 3, *Musharakah* – The assertion on the cruciality of risk sharing has taken place earlier in 'Risk and Islamic Finance'. As such, this chapter is dedicated to addressing the first question of the study pertaining to the way *Musharakah* helps to operationalise the idea of risk sharing, the answer of which shall illustrate the degree of relevancy of *Musharakah* with the central theme of this study, ie risk sharing. It begins with the discussion on the general understanding of *Musharakah* (especially its various classifications) and how risk sharing features in the *Musharakah* arrangement; both are purely from the perspective of Islamic commercial law. Subsequently, the discussion shall address the *Musharakah* operational requirements and how such requirements being adopted by the standard-setting body such as BNM and the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). Finally, the discussion shall point out two products, namely Islamic home financing and *Musharakah Sukuk* to illustrate the application of *Musharakah* (*Musharakah Mutanaqisah*) in them.

Chapter 4, The Malaysian Legal System – Chapter 4 and Chapter 5 are meant to set the framework within which the analysis of this study shall be undertaken. As for this chapter (Chapter 4), it identifies the applicable jurisdiction for Islamic finance in the context of Malaysia. It brings the discussion on the construction of the legal landscape in Malaysia, starting from the historical background of the English Law reception in Malaysia as a result of the British colonisation. This discussion holds its significance as it will describe how eventually the matters pertaining to Islamic banking and finance become the subject matter under the purview of the civil court which operates within the legal framework that is based on the English Common Law legal system despite of the existence of the *Shariah* court which also constitutes part of the whole legal system of the country. This would provide the readers

with a clear foundation which is important for answering the research questions, particularly the question pertaining to the applicable governing laws and regulation for *Musharakah* in Malaysia. This chapter ends with the discussion on the attitude the court has shown towards the Islamic finance cases that were being brought before it for the purpose of adjudication. As mentioned above, the discussion in this chapter not only clarifies the juridical boundary within which the core discussion of this study takes place but also illustrates the reality that Islamic finance in Malaysia has to embrace and give a serious consideration to while paving the way forward for the future development and advancement of the industry.

Chapter 5, The Legal and Regulatory Framework for *Musharakah* – This chapter is meant to answer the second question of the study—what are the governing laws and regulation for *Musharakah* and how the issue of risk sharing is being addressed through them? The IFSA 2013, Partnership Act 1960 (PA1960) and *Musharakah* regulatory policy are being identified as the relevant pieces of law and regulation for *Musharakah*. For that, the discussion in this chapter shall address the reasons behind this identification. Furthermore, the relevant provisions of each shall be pointed out to illustrate how the issue of risk sharing being addressed through them which indicates the direction taken by the legislative side pertaining to this issue. The discussion in this chapter is important as it sets the boundaries within which the discussion of the next chapter shall be undertaken.

Chapter 6, The Legal and Regulatory Framework Vis-À-Vis Risk Sharing: An Analysis –This chapter is considered the most important chapter since it answers the primary research question based on the findings (answers to the subsidiary questions) and the information gathered from the previous chapters. The analysis in this chapter takes place from three different aspects: the type of partnership that underlies the *Musharakah* products (*Shirkah Al-Milk* or *Shirkah Al-Aqd*), the inherent behaviour of the *Musharakah* products (debt financing or equity financing) and the legal recognition given by the laws to them. The conclusion drawn from all three aspects would be able to provide the answer to the primary question of this study—does the current legal and regulatory framework support the implementation of risk sharing?

Chapter 7, Conclusion and Recommendation – This is the final chapter where this study offers its overall conclusion based on the discussions undertaken throughout this thesis. Also, several recommendations are brought forward which shall include further possible research area.

Chapter 2. The Fundamentals of *Shariah*

2.1 Introduction

Looking from the perspective of the nature of business, Islamic finance does have some similarity with its conventional counterpart. Both, for instance, are dealing with resource allocation, management, acquisition, investment as well as the fundamental issues in finance such as risk transformation and management.⁷⁴ Nevertheless, the adjective ‘Islamic’ it carries within its brand name implies some differences. For instance, as established in Chapter 1, the conventional finance relies heavily on the interest-based system which entails risk to be transferred. Banks operating under this system (always referred to as the conventional banks) run their businesses in such a way where the charged interest rate could be fixed in advance regardless the actual performance of the business or the rate is a simple linear function of some other benchmark.⁷⁵ The Islamic finance system, however, opposes the idea of risk transfer but makes risk sharing as its cornerstone instead. Banks which operate within this system (the Islamic banks) conduct their businesses with a different approach where the profits and losses on a physical investment are shared between the banks and their customers based on the formula that reflects their respective levels of participation.⁷⁶

Admittedly, the conventional bank is also concerned about the profitability of the business project. However, since such a concern is actually on the potential loan default, it puts the emphasis on receiving the interest payments according to some set time intervals, and so long as this condition is being met, its profitability is not directly affected by whether the project has a particularly high or rather a low rate of return.⁷⁷ This is different in the case of the Islamic bank where it has to focus on the return of the physical investment since its own profitability is directly linked to the real rate of return.⁷⁸ That being said, the equity-based financial instruments such as *Musharakah* and *Mudharabah* are being offered to replace the conventional products since both appear to conform with the idea of risk sharing propagated by the Islamic finance (in Chapter 3, the mechanism used in implementing risk sharing through *Musharakah* and *Mudharabah* shall be explained further).

⁷⁴ Dusuki (n 2) 4-5

⁷⁵ Abbas Mirakhor and Iqbal Zaidi, ‘Profit-and-loss sharing contracts in Islamic Finance’ in Kabir Hassan and Mervyn Lewis (eds), *Handbook of Islamic Banking* (Edward Elgar 2007)

⁷⁶ *ibid*

⁷⁷ *ibid*

⁷⁸ *ibid*

The difference between the conventional and Islamic finance as mentioned above does not take place by chance. Instead, it is rooted from the underlying principles and the philosophy the latter is built upon. In other words, it is a manifestation of Islam and what it entails, hence the term 'Islamic'. The religion of Islam represents a complete code of practice which is made of instruction, restriction and prohibition that should be adhered to by its believers (Muslim).⁷⁹ This code of practice, referred to by the term '*Shariah*', does not only concern the ritual aspect as to the rules of worshipping Allah (the term used to refer to the one and only God), but also includes all types of rules governing the relationship between the creatures being such as marriage, divorce, and in the case here, business and commercial activities. Therefore, it is essential to have a clear picture of the *Shariah* in order to understand the rationale behind all the Islamic finance propagations such as risk sharing. This includes the legal substance which supports it and prohibits its counterpart (risk transferring), as well as its relation to the objectives that *Shariah* aspires to achieve.

This chapter seeks to provide an overview of the *Shariah*. It starts with the explanation of the basic understanding of *Shariah*; its components, the involved process in deriving its positive laws (*Fiqh*) known as '*Ijtihad*', the sources of these laws as well as the legal maxims formulated based on the trends set by the laws which are useful in deriving the legal ruling for an unprecedented case. Following such is the discussion pertaining to the major prohibitions in the Islamic commercial law namely *Riba*, *Gharar* and gambling. These three modes of transaction are banned due to their inherent injustice through the mechanism of risk transferring. As such, they work against the pursuit of justice as propagated by Maqasid Al-Shariah through the operation of risk sharing.

It is important to note here that the discussion in this chapter is essential and links closely to the discussion in the next chapter (Chapter 3); Chapter 2 prepares the readers with the fundamental understanding of the *Shariah* and the way it regards risk sharing before the discussion continues in Chapter 3 on how risk sharing is being operationalised through one of the Islamic business models, namely *Musharakah*.

2.2 *Shariah*: An Introduction

Shariah is an Arabic term which is rooted from *Shin*, *Ra* and '*Ayn* (these three are Arabic letters). Literally, it means the path to the watering place, the clear path to be followed and the

⁷⁹ Abdul Karim Aldohni, *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at The United Kingdom and Malaysia* (Routledge 2011) 6

path which the believer has to tread in order to obtain guidance in this world and deliverance in the next.⁸⁰ This term might be used in, at least, two different senses. Firstly, it can stand for Islamic normativity in the fields of ritual, morality as well as law, hence the *Shariah* in its totality.⁸¹ In this broad sense, the *Shariah* is the sum total of Islamic teaching and system which was revealed to the Prophet Muhammad (the Prophet) recorded in the Quran as well as deducible from the Prophet's divinely guided lifestyle called *Sunnah*.⁸²

Secondly, the *Shariah* is also used in a narrow sense to refer only to the legal normativity of the *Shariah*.⁸³ In this context, the *Shariah* might be used interchangeably with other terms such as the *Shariah* law or Islamic law as generally employed in this study (unless it is mentioned otherwise). There is also another relevant term in this segment, namely '*Fiqh*' which refers to the Islamic positive law. This term is frequently used to distinguish between the divine basic code collected from the legal texts of the Quran and *Sunnah* (*Shariah* as implied in the first concept as mentioned above) and the law as a product of human intelligence in deciding a point of law in the absence of a binding text of the Quran or *Sunnah*.

The *Shariah*, therefore, is not just another legal regime as what is understood in other legal systems. It is rather a religion, morality, etiquette, law in one.⁸⁴ Its theological foundation holds that the *Shariah* is the revelation from Allah to lead the believers on the straight path to salvation.⁸⁵ It contains rules that are primarily concerning the relationship between a believer and his Creator.⁸⁶ These qualities qualify the *Shariah* to be regarded as the religious law.

The *Shariah* is also the moral law. It does not make a distinction between law and morality since both subjects are regarded as part of one single ideational institution and found their basis from the same foundational texts.⁸⁷ Not complying with the legal obligation which also has the moral characteristic such as violating sexual prohibitions or not paying debts will not only make a person liable with the punishment in this world (legal punishment) but also entails sanctions in the hereafter.⁸⁸ This further puts the *Shariah* in a different position as compared to the law as understood in the West; the question of the link between law and morality is something debatable. At one side, the advocates of the theory of natural law held

⁸⁰ Kamali, *An Introduction to Shariah* (n 4) 12

⁸¹ Rudolph Peters and Peri Bearman, 'Introduction: The Nature of the Sharia' in Rudolph Peters and Peri Bearman (eds), *The Ashgate Research Companion to Islamic Law* (Ashgate 2014)

⁸² Mohamad Akram Laldin, *Introduction to Shariah & Islamic Jurisprudence* (3rd edn, CERT Publications 2011) 3

⁸³ Peters and Bearman (n 81)

⁸⁴ *ibid*

⁸⁵ *ibid*

⁸⁶ *ibid*

⁸⁷ *ibid*

⁸⁸ *ibid*

that there is an ideal type of law that is based on reason and morality and the validity of man-made law lies with its conformity with natural law thus morality.⁸⁹ At another side, the legal positivists argued that the connection between the law and morality is loose and accidental and the law can be defined without having a recourse to morality.⁹⁰ In modern history, the separation between law and morality can be observed in many occasions. One of them is the report of the Departmental Committee on Homosexual Offences and Prostitution, better known as the Wolfenden Report. The committee, set up on 24 August 1954, was appointed by the Government of the United Kingdom to consider ‘the law relating to homosexual offences and the treatment of persons convicted of such offences by the court’ and ‘the law and practice relating to offences against the criminal law in connection with prostitution and solicitation for immoral purposes’.⁹¹ Although homosexual might once be considered as immoral in the eyes of the public, the committee is of the opinion that it is not the function of the law to intervene in the private lives of the people nor should it cover all fields of sexual behaviour.⁹² Thus it recommended, inter alia, that the homosexual behaviour between consenting adults in private be no longer a criminal offence.⁹³

The report had drew the attention from Patrick Devlin, a British judge and legal philosopher who rejected the principle of distinguishing public from private morality and advocated criminal legislation against conduct which is commonly regarded as wrong from the moral standpoint such as homosexuality.⁹⁴ For him, the ‘immorality’ of an act is sufficient reason for its legal proscription since the act with such quality is capable of injuring society, and that the law’s tolerance of activities which is wrong from the moral standpoint can lead to the society’s ‘disintegration’.⁹⁵ This position had invited critical responses, among of which from another legal philosopher by the name Herbert Lionel Adolphus (H.L.A) Hart. Unlike Devlin, Hart argued that the law should never prohibit and punish conduct merely because it is thought to be morally wrong by an important segment of society.⁹⁶ According to him, in the absence of demonstrated harm, the law should not interfere with, and is unjustified, in intervening in the private sexual behaviour of consenting adults.⁹⁷ Both had been exchanging criticism ever since then through their lectures and writings, the event of which famously

⁸⁹ *ibid*

⁹⁰ *ibid*

⁹¹ Home Office, *Report of the Committee on Homosexual Offences and Prostitution* (Cmd 247, 1957) para 1

⁹² *ibid* para 14

⁹³ *ibid* para 355

⁹⁴ Peter August Bittlinger, ‘Government Enforcement of Morality: A Critical Analysis of The Devlin-Hart Controversy’ (Doctoral thesis, University of Massachusetts 1975)

⁹⁵ *ibid*

⁹⁶ *ibid*

⁹⁷ *ibid*

known as the ‘Hart-Devlin debate’. Until the present days, researchers on the legal moralism take the debate as one of the primary references in their works as to demonstrate the idea of separation between law and moral as argued by Hart.

2.3 Components of the *Shariah*

As an umbrella body of laws intended to regulate all aspects of a human's life, the *Shariah* covers all three major categories of commandment. The first category is *Al-Ahkam Al-I'tiqadiyyah* which refers to the sanctions related to the system of belief.⁹⁸ This system is based on the six articles known as *Arkan Al-Iman* (pillars of faith). One is required to have faith in the oneness of God, the existence of angels, the revelation books, the messengers, the day of judgement and the predestination. The second category is *Ahkam Al-Akhlaqiyyah* which refers to the sanctions related to moral and ethics.⁹⁹ Under this category, injunctions such as to tell the truth, be just and sincere and so forth are imposed. As much as the believers are expected to believe in the day of judgement (as prescribed under *Ahkam Al-I'tiqadiyyah*), they are expected to conduct their mundane affairs in accordance to such a code of moral and ethics. Failure of which will not only expose them to be held liable in this life but also in the life hereafter.

The last category is *Ahkam Al-Amaliyyah* – the sanctions in relation to the sayings and doings (physical conducts) of the individuals and his relations with others.¹⁰⁰ This last component can be divided further into two main groups, namely *Ibadah* (rituals) and *Muamalah* (interaction).¹⁰¹ As for the former, the rulings are concerning the relationship between God and His servant. Under this category, rules and regulations regarding the prayer, fasting, almsgiving and pilgrimage are spelt out.¹⁰² The latter, on the other hand, provides the rulings that govern the relationship between one man to another.¹⁰³ There are several legal domains under this category such as (Islamic) family law, criminal law and commercial law.¹⁰⁴ For each domain, rules, regulations and, even penalties and punishments for offences are being detailed out through specific mechanisms of deducing the legal rulings.

⁹⁸ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82)

⁹⁹ *ibid* 3-4

¹⁰⁰ *ibid* 4

¹⁰¹ *ibid* 9-10

¹⁰² *ibid*

¹⁰³ *ibid* 10

¹⁰⁴ *ibid*

2.4 Flexibility of Islamic Law

As mentioned earlier, *Shariah* is the divine basic code sent down by Allah as guidance to regulate all life affairs. The believers hold that *Shariah* is universal in such a way where it is neither exclusive to a certain group of people nor its relevancy is bound to certain territorial part or period. Instead, the Prophetic message (*Shariah*) was sent down to the whole mankind as per the verse, “Say [O Muhammad] ‘O mankind! Indeed, I am the Messenger of Allah to you all ...’”.¹⁰⁵ Since its establishment is strictly based on the Quran and *Sunnah*, the *Shariah* is immutable. However, the universal characteristic of the *Shariah* as guaranteed by Allah Himself entails its principles and regulations to be in line with the interest (*Maslahah*) of mankind in all times and all places.¹⁰⁶ In all its components, the *Shariah* is realistic and contemporary. It preaches a realistic system of belief where it could be understood even by a person with an average mind. It also directs towards all good deeds and rejects all bad behaviours which are in the interest of individual and society.

In respect to the law it provides, the *Shariah* (Islamic law or *Fiqh*) is dynamic in the sense that it is flexible and ready to accept changes as the response to the variation of time and place without jeopardising its fundamental principles. The ruling pertaining to the act constituting possession (*Qabdh*) in a sale transaction can be one of the examples to illustrate how accommodative a *Fiqh* ruling can be in addressing the changes of circumstance.

Conceptually, *Qabdh* means taking possession, receipt or control of something that arises from a transaction.¹⁰⁷ It becomes among the important issues to be looked at since, in certain business transactions, the validity of such a transaction depends, *inter alia*, on how the subject matter is transferred to and possessed by the buyer. For instance, in the currency exchange transaction (*Bay Al-Sarf*), the issue of possession becomes crucial as the validity of the contract depends, *inter alia*, on how the possession of each traded currencies being made by the involved parties (the seller and the buyer). In this respect, the ruling of exchange is as mentioned in the *Sunnah* as follows: “Gold for gold, silver for silver wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal, and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to

¹⁰⁵ Quran [Al-A’raaf 7: 158]

¹⁰⁶ Abd al-Karim Zaidan, *Al-Madkhal li Dirasah al-Shariah al-Islamiyyah* (Muassasah al-Risalah 1969) 46

¹⁰⁷ Mohd Bahroddin bin Badri, ‘Qabd (Possession): An Overview’ *ISRA Bloomberg Bulletin* (June 2015) <<http://ifikr.isra.my/documents/10180/16168/FATWA%20IN%20ISLAMIC%20FINANCE-JUNE%202015-17-08-2015-16.pdf>> accessed 16 October 2016

hand”¹⁰⁸ It is stipulated that if one currency is to be exchanged with another type of currency (represented in the *Sunnah* by gold and silver), it must be done on the spot basis as implied by the phrase ‘hand to hand’. In other words, both seller and buyer should possess their monies in the same contractual session before they separate. Failing of which will invalidate the contract as it would be tantamount to *Riba* (this point will be further addressed under the subsection *Riba*).

Looking at the modern practice of the currency trading, especially when the exchange takes place between institutions rather than individuals and involves a huge amount of money, the seller and buyer will not receive the money physically. Rather, the amount will be credited into their account. Further, the delivery of currency is not made at the same time and on the same date when the transaction is concluded. Instead, the payment is settled on the T+2 basis (two days after the transaction date)¹⁰⁹. Provided a strict interpretation derived from the *Sunnah* as quoted above is to be employed here such a practice certainly does not meet the stipulated condition ie the exchange to be executed on the spot basis.

Nevertheless, the *Shariah* authority such as the SAC of BNM has resolved this matter with a new approach. In its 38th meeting dated 28 August 2003, the SAC has reached to the conclusion that the delivery and settlement in the question of currency exchange on the T+2 basis is permissible.¹¹⁰ Not only that, but it also ruled in favour of the forward foreign exchange where the execution of the contract takes place in future date (after one or three months for instance) although the contract is entered at the present day.

Giving the justification for the ruling of the exchange using the T+2 formula in its delivery, the SAC is of the opinion that such a practice is still permissible since the duration is required by the contracting parties to confirm the trade and such a method has been accepted and recognised as a customary business practice. In this case, even though the original rule as derived from the *Sunnah* is not strictly followed, the SAC had put a high consideration on the customary practice (termed as ‘*Urf*’) in ensuring the protection of *Maslahah* (interest) and the removal of hardship. The IFIs would be in an inferior position as compared to the others and would be in a great difficulty due to the inability to fairly compete in the business market should the question is not to be looked into with a new dimension and perspective. The adherence to the original rule, therefore, defeats the purpose of *Shariah* itself as to be

¹⁰⁸ Abul Hussain Muslim Ibn Al-Hajjaj, *English Translation of Sahih Muslim* (Vol 4, Abu Tahir Zubair ‘Ali Za’I ed, Nasiruddin al-Khattab tr, Darussalam 2007) 306

¹⁰⁹ Bank Negara Malaysia, ‘*Shariah Resolutions in Islamic Finance*’ (2nd edn, October 2010) 137

¹¹⁰ *ibid*

accommodative and relevant in all circumstances. As for the case of forward foreign exchange, it resolves that such a practice is permissible based on the unilateral promise (termed as *Wa'ad Mulzim*) where the agreement entered is considered as a mere promise that binds the promisor and any non-fulfilment of the promise may be compensated.¹¹¹

The case mentioned above is one of many other cases which demonstrates how Islamic law is dynamic and equipped with enough flexibility. Through a process termed as '*Ijtihad*', Muslim jurists who have acquired certain specific knowledge and skills reached the level of '*Mujtahid*' (jurist consult), address the new arising matters by issuing the juridical opinion by employing specific methodologies prescribed in the Islamic legal theory (*Usul Fiqh*). This process of *Ijtihad* serves as a useful tool to preserve the survival characteristic of the *Shariah* as well as to enrich the treasure of Islamic knowledge.¹¹²

2.5 *Ijtihad*

Ijtihad is an Arabic term derived from the word *Jahdu* which means hardship (*Masyaqqah*).¹¹³ In its technical meaning, this term refers to the endeavour of a jurist to formulate the rule of law on the basis of evidence found in the sources.¹¹⁴ The jurists practising *Ijtihad* are expected to expend their maximum effort to master and apply the principles of legal theory in order to unearth God's law.¹¹⁵ Since this process is vital in informing which conduct is acceptable or otherwise, it is very much encouraged to be undertaken by those qualified jurists to the extent that it is considered as communal obligation (*Fardh Al-Kifayah*)¹¹⁶. In addition, the practice of *Ijtihad* is facilitated by the removal of charge of sin from the jurist consult if he erred in his conclusion. Instead, he will be rewarded with one reward whereas in the event when the conclusion is sound, he will be rewarded by two rewards as per mentioned by the Prophet, "If a judge passes a judgement having exerted himself to arrive at what is correct, and he is indeed correct, he will have two rewards. If he passes judgement having exerted him to arrive at what is correct, but it is incorrect, he will have one reward".¹¹⁷

¹¹¹ *ibid*

¹¹² Nadiah Sharif al-'Umri, *Al-Ijtihad fi al-Islam: Usuluhu, Ahkamuhu, Afaquhu* (3rd edn, Muassasah al-Risalah 1985) 13

¹¹³ *ibid* 18

¹¹⁴ Bernard Weiss, 'Interpretation in Islamic Law' in Ian Edge (ed), *Islamic Law and Legal Theory* (Dartmouth 1996)

¹¹⁵ Wael B. Hallaq, 'Was the Gate of Ijtihad Closed?' in Ian Edge (ed), *Islamic Law and Legal Theory* (Dartmouth 1996)

¹¹⁶ Yusuf al-Qaradhawi, *Al-Ijtihad fi al-Shariah al-Islamiyyah: Ma'a Nazarat Tahliliyyah fi al-Ijtihad al-Mu'asir* (Dar al-Qalam 1996) 78

¹¹⁷ Ash'ath, *English Translation of Sunan Abu Dawud*, vol 4 (n 38) 171

It is observed that in the discourse on *Ijtihad* there are some significant points which will be significantly addressed by the scholars. For instance, the issue of the eligibility (*Ahliyah*) of the jurist who undertakes this exercise has been detailed out for it would ensure the validity and the credibility of the reached decision. Should the decision offered by a jurist who fails to fulfil these requirements, it will not hold any credit.¹¹⁸

In this regard, several crucial knowledge and skills are made as mandatory for the jurist to possess. This includes the adequate knowledge of law-related verses in the Quran as well as in the *Sunnah*.¹¹⁹ In addition, he must also be well-versed with the issue of abrogation (*Naskh*) to ensure that the verse of the Quran or *Sunnah* he is working with is still valid for the purpose of deriving law.¹²⁰ Adequacy in the Arabic language knowledge in the sense that he is capable of understanding the jargon and its application in the Arabs' tradition is also required since the two main sources for Islamic law (the Quran and the *Sunnah*) are originally in the Arabic language.¹²¹ It is, however, important to mention Al-Ghazali's remark here that these requirements are only relevant to the jurist who wish to exercise the *Ijtihad* in all areas of the substantive law.¹²² Should he practise *Ijtihad* in one area (for instance in the commercial law), he need not = fulfil all the requirements but instead only to know the methodological principles and the textual material required to answer that particular issue.¹²³

The second issue to be discussed in this respect is pertaining to the segment in which *Ijtihad* is exercisable. It is important to note from the outset that a jurist does not have authority to call a new *Ijtihad* upon a case where its ruling has been unanimously agreed by all leading scholars of the Muslim community of any period after the demise of the Prophet (*Mujma' Alaih*). Therefore, Al-Ghazali had added another requirement for a jurist to be regarded as a *Mujtahid* which is knowing the matters of *Mujma' Alaih* for he will not give a contradicting opinion to the reached consensus and deviate from the established law.¹²⁴

Ijtihad is also not applicable where there is a clear text from the Quran or *Sunnah* which has resolved the issue in question provided such a text is decisive in respect of its authenticity (*Qati'ah Al-Thubut*) and its meaning (*Qati'ah Al-Dilalah*).¹²⁵ In the case where the text is

¹¹⁸ Hasan bin Hamid bin Maqbul al-'Usoimi, *Al-Khilaf: Anwa'uhu wa Dhawabituhu wa Kaifiyatu al-Ta'ammuli Ma'ahu* (Dar Ibnu al-Jauzi 2009) 157

¹¹⁹ Abu Hamid Muhammad bin Muhammad al-Ghazali, *Al-Mustasfa: Min 'Ilm al-Usul* (Vol 4, Hamzah bin Zuhair Hafiz ed, Sharikah al-Madinah al-Munawwarah li at-Tiba'ah 1993) 6

¹²⁰ *ibid*

¹²¹ *ibid*

¹²² Hallaq, 'Was the Gate of Ijtihad Closed?' (n 115)

¹²³ *ibid*

¹²⁴ Al-Ghazali, *Al-Mustasfa: Min 'Ilm al-Usul* (n 119) 8

¹²⁵ Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (3rd edn, The Islamic Text Society 2003) 470

authentic but speculative in its meaning (*Qatiah Al-Thubut Zanniah Al-Dilalah*), or with doubtful authenticity but definite in terms of its meaning (*Zanniah Al-Thubut Qatiah Al-Dilalah*), or speculative in respect of its authenticity and meaning (*Zanniah Al-Thubut Zanniah Al-Dilalah*) *Ijtihad* can validly operate.¹²⁶

In these circumstances, the *Mujtahid* will strive to discover the law by making an interpretation on the specific meaning of the relevant text.¹²⁷ The process of *Ijtihad* also involves the work of extending the law to the new cases which are not mentioned in the Quran or the *Sunnah* and yet have the similarity to those pre-mentioned cases. By applying the *Qiyas* (this concept will be explained further later), the *Mujtahid* will be looking at the effective cause (*'Illah*) of both cases and decide whether the extension of law is valid or not.¹²⁸ The *Mujtahid* might also decide to extend the established law to the new case by extending the general principles of *Maqasid Al-Shariah*.¹²⁹ This requires understanding on the issue, related general principles as well as *Maqasid Al-Shariah* thus makes *Ijtihad* in this sense perhaps more complex and challenging but still can be mitigated by exercising the collective *Ijtihad* (*Ijtihad* done by a group of qualified jurists).¹³⁰

2.6 Sources of Law

Following the previous discussion, this subsection discusses the sources from which the jurists consult derive the law through the exercise of *Ijtihad*. The knowledge on such (knowledge of the sources) not only explains the basis of the derived ruling, but it also indicates the degree of credibility held by it. This is because the sources of law do not rank in *pari passu*. Rather, they can be divided into various categories, each of which implies the different level of strength in terms of the legal basis that can be produced.

In general, these sources can be classified into various categories, depending on the basis of the classification. For instance, in terms of its origin, the Quran and *Sunnah* are considered as the sources which originated from the text of revelation known as textual sources (*Al-Nusus*) and this classification views both as the primary sources. The secondary sources, on the other hand, are the sources which originated from the power of reasoning, known as non-textual

¹²⁶ *ibid*

¹²⁷ Dusuki (n 2) 177

¹²⁸ *ibid*

¹²⁹ *ibid*

¹³⁰ *ibid*

sources (*Al-Ra'y*).¹³¹ In terms of the agreement (or disagreement) among the jurists on their utilisation, these sources can be divided into three groups. The first group is the sources which is unanimously accepted by all such as the Quran and the *Sunnah*.¹³² The second group is the sources which are largely accepted by the majority of scholars (*Jumhur*) albeit some of them (relatively small in number) do not recognise these sources as a source from which the law could be derived such as *Ijma* and *Qiyas*.¹³³ The last group comprises sources which the dispute over their acceptability among the jurists is quite significant. Among the sources which fall under this category are the *Istihsan* and *Masalih Al-Mursalah*.¹³⁴ This difference apparently has become one of the contributing factors towards the variety of opinions in the Islamic jurisprudence throughout the time.¹³⁵

2.6.1 *Quran*

In the hierarchy of sources for Islamic law, the *Quran* is at the top of the list as the primary source. Rooted from the word *Qaraa*, literally, it means the act of reading or recitation.¹³⁶ In its technical meaning, it is defined as the speech of Allah, sent down upon the last Prophet Muhammad in its precise meaning and precise wording, transmitted to the people by numerous persons both verbally and in writing.¹³⁷

As suggested by this definition, the Quran, in terms of its transmission, is construed as certain in its totality due to the fact that the entire community of Muslims was involved in the transmission process from one generation to another.¹³⁸ It is argued, therefore, based on the theory of consensus that it is inconceivable for the entire Muslim community to conspire in distorting or forging it.¹³⁹ Any possibility of error or collaboration of forgery is eliminated through this recurring transmission from one generation to the next through numerous channels during each stage.¹⁴⁰ In addition, the originality of the Quran is guaranteed by Allah himself when He said, “Indeed, it is We who sent down the message [the Quran] and indeed,

¹³¹ *ibid* 152

¹³² Abd al-Karim Zaidan, *Al-Wajiz fi Usul al-Fiqh* (6th edn, Muassasah Qurtubah 1976) 148

¹³³ *ibid*

¹³⁴ *ibid*

¹³⁵ Al-'Usoimi (n 118) 45

¹³⁶ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 56

¹³⁷ Dusuki (n 2) 153

¹³⁸ Wael B. Hallaq, *Shari'a: Theory, Practice, Transformation* (Cambridge University Press 2009) 93

¹³⁹ *ibid*

¹⁴⁰ *ibid*

We will be its guardian”.¹⁴¹ These facts certainly among the antithesis to the claim made by the orientalist that some verses of the Quran were forged by the jurists in the later centuries.¹⁴²

Pertaining to its codification, the Quran was not compiled during the lifetime of the Prophet in the same manner as what can be witnessed today (in one single copy). This is due to the fact that the revelations were still ongoing at that time and the chance for a verse to be abrogated was still there. However, it was completely recorded in writings before the decease of the Prophet although these records were kept separately.¹⁴³ During the reign of Abu Bakar, the first Caliph of Islam, the initiative to compile those records took place for the first time and it reached the final stage of compilation during the time of the third Caliph, Uthman.¹⁴⁴

The Quran, in its thematic classification, is divided into several categories covering all the subset of *Shariah* starting from matters related to the system of belief (*Aqidah*), the ethic (*Akhlaq*) as well as the legal injunctions (*Ayat Ahkam*). In addition, the Quran also contains the historical stories about the nations before the time of the Prophet including the Messengers who were sent to them.¹⁴⁵

It is agreeable among the jurist and modern scholars that there are around 500 verses in the Quran related to the legal content.¹⁴⁶ Therefore, while it is true that the Quran is primarily a book of religious and moral prescription, it also encompasses the piece of legislation.¹⁴⁷ This qualifies the Quran to also be considered as legal documents to be observed as per mentioned by the Quran itself, “And We have revealed to you [o Muhammad] the Book [the Quran] in truth, confirming that which preceded it of the Scripture and as a criterion over it. So, judge between them by what Allah has revealed ...”.¹⁴⁸ Nevertheless, this does not mean that the Quran is like other legislation materials such as statutes. Rather, the injunctions in the Quran mostly come in the concise manner (*Mujmal*) which will be elaborated further by other sources such as the *Sunnah* (this point will be touched again in the discussion of *Sunnah*). This again reiterates the point on the universality of the *Shariah* as the basic code which serves as the general principles on which all the substantive laws are built upon that can suit in all different times and places.¹⁴⁹

¹⁴¹ Quran [Al-Hijr 15: 9]

¹⁴² Muhammad Mohar Ali, *The Quran and The Orientalists* (Jam’iyat Ihyaa’ Minhaaj al-Sunnah 2004) 241

¹⁴³ Jalaluddin al-Suyuti, *Al-Itqan fi ‘Ulumi al-Quran* (Shu’aib al-Arnaud ed, Muassasah al-Risalah 2008) 129

¹⁴⁴ *ibid* 132

¹⁴⁵ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 65

¹⁴⁶ Hallaq, *Shari’a: Theory, Practice, Transformation* (n 138) 93

¹⁴⁷ *ibid*

¹⁴⁸ Quran [Al-Maidah 5:48]

¹⁴⁹ Zaidan, *Al-Madkhal li Dirasah al-Shariah al-Islamiyyah* (n 106) 188

Among the example of the verse that contains legal injunction is the verse 188 of Chapter 2. The verse reads, “And eat up not one another’s property unjustly (in any illegal way such as stealing, robbing, deceiving etc), nor give bribery to the rulers (judges before presenting your cases) that you may knowingly eat up a part of the property of others sinfully”. By virtue of this verse, any transaction which can be proved as unjust or depriving any party’s right in any way is considered as void and null in the eyes of the *Shariah*. Despite the changes in the mode of business throughout the time, this verse and alike can offer the general principle that clarifies the position of the *Shariah* on the new and unprecedented commercial contract.

2.6.2 *Sunnah (Prophetic Tradition)*

Sunnah is the second source of Islamic law. Literally, it means a clear path or a beaten track.¹⁵⁰ It is the sayings, actions or whatever that has tacitly been approved by the Prophet.¹⁵¹ On one hand, the *Sunnah* is considered as another form of divine revelation other than the Quran as mentioned in the Quran itself, “Nor does he speak from [his own] inclination. It is not but a revelation revealed”.¹⁵² Nevertheless, it differs from the Quran in the sense that the words used are not the precise words from God but rather the message was conveyed in the Prophet’s words. It is worth to note here that the term *Sunnah* might be distinguished from the term *Hadith* although both might also be used interchangeably. While *Sunnah* covers a broader meaning as it includes the sayings, doings and tacit approval of the Prophet, *Hadith*, however, only refers to the narrated sayings of the Prophet.¹⁵³ Based on this distinction, it can be said that *Hadith* is not *Sunnah per se* but a subset of *Sunnah* instead.

Since the *Sunnah* is also a divine revelation, it is vested with the similar level of authority held by the Quran. From one angle, it can be said that the *Sunnah* is functioning as the complementary source to the Quran. In some instances, it explains the law that has been established by virtue of the Quran in more detail whereby in other cases, its function is merely to reiterate the established law.¹⁵⁴ The *Sunnah* would also specify (*Takhsis*) the general statements (*‘Am*) in the Quran.¹⁵⁵ However, from another angle, the *Sunnah* also can be

¹⁵⁰ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 75

¹⁵¹ *ibid*

¹⁵² Quran [Al-Najm 53: 3-4]

¹⁵³ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 75

¹⁵⁴ Zaidan, *Al-Madkhal li Dirasah al-Shariah al-Islamiyyah* (n 106) 194

¹⁵⁵ *ibid*

regarded as the 'stand-alone evidence' since there are also laws founded through it independently while the Quran has not mentioned anything about it.¹⁵⁶

2.6.2.1 *Sunnah to Explain the Quran*

The obligation of giving away alms (*Zakah*) to the needy, for instance, is derived from various verses of the *Quran* as in the second chapter, verse 110 where Allah said, "And perform the prayers and give *Zakah* and whatever of good [deeds that God loves] you send forth for yourselves before you, you shall find it with Him. Certainly, He is All-Seer of what you do". Nevertheless, the question on the required amount to be given away for such a purpose has not been detailed out in the *Quran*. Instead, it has been explained by the *Sunnah*. In this respect, the Prophet is reported to say, "No *Zakah* is imposed on less than five *Awsuq* [equivalent approximately to 3 kilograms]¹⁵⁷ of dates, no *Zakah* is imposed on less than five *Awaq* [200 Dirham]¹⁵⁸ of silver, and no *Zakah* is imposed on less than five camels".¹⁵⁹ As such, it is clear that the threshold is fixed at the rate of 3 kilograms, 200 dirham and five camels depending on the case.

2.6.2.2 *Sunnah to Reiterate and Specify the Quran*

In the Quran, it is mentioned "And do not consume one another's wealth unjustly or send it [in bribery] to the rulers in order that [they might aid] you [to] consume a portion of the wealth of the people in sin, while you know [it is unlawful]".¹⁶⁰ The *Sunnah*, in this respect, reiterates such message by providing a supporting statement by saying "It is unlawful to possess the property of a Muslim without his freely given consent".¹⁶¹

For the case where the *Sunnah* specified the general statement of Quran or establishing new ruling, which is not mentioned in the Quran, the prohibition of *Riba Fadl* (excessive exchange of specific items) can be a good example. Although *Riba* has been condemned and prohibited by virtue of various verses of the Quran, such verses are quite general and only referring to one type of *Riba* namely *Riba Duyun* (usurious loan) which would only occur in the case of

¹⁵⁶ *ibid*

¹⁵⁷ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 78

¹⁵⁸ *ibid*

¹⁵⁹ Muhammad Muhsin Khan (tr), *The Translation of the Meanings of Sahih Al-Bukhari: Arabic-English* (Vol 2, Darussalam 1997) 282

¹⁶⁰ Quran [Al-Baqarah 2: 188]

¹⁶¹ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 28

excessive repayment of debt. It is *Sunnah* that further specifies this general prohibition and brings forward the prohibition of another type of *Riba* namely *Riba Fadl* (usurious sale), by saying “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like equal to equal and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to hand”.¹⁶²

By virtue of this *Hadith*, it is understood that *Riba* could also occur in the trading of these six items (known as *Ribawi* item) should it fails to meet both conditions imposed ie must with equal weights (like for like) and be executed on the spot basis (hand to hand) or fails to meet one of them, as the case may be (in the latter subsection, the subject of *Riba* shall be revisited and discussed in greater depth).

2.6.3 *Ijma’ (Consensus Opinion Among Jurist)*

Unlike the previous two sources, *Ijma’* is a rational-based evidence which does not directly partake in the divine revelation. Nevertheless, it is a binding proof of Islamic law like the Quran and *Sunnah* where no scholars have ever challenged its authority. *Ijma’*, in its literal sense, means to determine and to agree upon something.¹⁶³ It refers to the unanimous agreement of the *Mujtahidin* (the plural form of *Mujtahid*, the jurist consult) of the Muslim community of any period after the demise of the Prophet on any matters although some expert confined it to legal matters only.¹⁶⁴

The utilisation of *Ijma’* is supported by the Quran as well as *Sunnah* although in an indirect way. Allah said in the Quran, “And whoever opposes the Messenger after the guidance has become clear to him and follows other than the way of the believers – We will give him what he has taken and drive him into hell, and evil it is as a destination”.¹⁶⁵ Here, the phrase ‘the way of believers’ is interpreted as the agreement of the believers and the way that they have chosen (their consensus). As such, the adherence to this way is made as mandatory while departing from it is condemned and forbidden. In addition, the prohibition to depart from ‘the way of believers’ is mentioned side-by-side with the prohibition to disobey the Prophet. This certainly indicates the degree of severity for the offence of departing the *Ijma’* since it is indirectly equated to disobeying the Prophet. As for the support from the *Sunnah*, it is

¹⁶² Al-Hajjaj (n 108)

¹⁶³ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 90

¹⁶⁴ *ibid*

¹⁶⁵ Quran [An-Nisa 4: 115]

reported that the Prophet once said, “My community shall never agree on an error”.¹⁶⁶ This *Hadith* assures that it is impossible for Muslims—represented by their qualified scholars—to unanimously agree on something which is wrong, or something could lead them to deviate from the truth. Thus, the consensus agreement of the qualified scholars can be considered as a reliable tool in deciding a verdict of law.

Notwithstanding *Ijma*’ holds a high rank in the hierarchy of the sources of Islamic law, its feasibility, especially in the present days, is something arguable. This is due to the fact that the locality pattern of these qualified scholars has changed especially after the period of the ‘Rightly Guided *Khulafa*’ (the period ended in 661 CE by the decease of the fourth Caliph, Ali bin Abi Talib). Prior to that, most of the scholars were residing in Medina thus making it easy for them to meet and discuss any issues that may arise within the Muslim community.¹⁶⁷ Should an agreement is reached among themselves and there are no dissenting views known on that particular matter, the agreement will then be considered as an *Ijma*’ decision. However, with the expansion of the Islamic empire, some scholars chose to settle down in other areas such as Kufah in Iraq and Levant (Sham). This eventually hindered them from getting together and reaching a consensus on any particular issue. Instead, they performed the *Ijtihad* on the individual basis and many of them established their own methodology of deducing the rulings which eventually led to the establishment of various legal schools of thought (*Mazahib*).¹⁶⁸ In the present days, it can be said that there is no serious attempt to reintroduce *Ijma*’ in its actual sense. The existence of platforms such as *Majma’ Fiqh Al-Islami* under the Muslim World League and International Islamic Fiqh Academy under the Organisation of the Islamic Conference (OIC) may be leveraged to study the possibility to introduce an authoritative body which can be recognised as the representing body for the Muslim nation as a whole where any ruling issued by this body will have the binding effect of *Ijma*’.¹⁶⁹

2.6.4 *Qiyas (Legal reasoning by Analogy)*

The fourth source of which all scholars (except for very little) accept as one of the sources of Islamic law is *Qiyas*. Originally *Qiyas* means measuring or ascertaining the length. In its technical meaning, *Qiyas* is defined as the extension of a *Shariah* value from the original case

¹⁶⁶ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 92

¹⁶⁷ *ibid* 91

¹⁶⁸ *ibid* 96

¹⁶⁹ *ibid*

to a new case because the latter has the same effective cause- known as *'Illah* – as the former.¹⁷⁰ A scholar, in using *Qiyas* to deduce ruling, aims to extend the same ruling of the original case—which is generally from the text of Quran or *Sunnah*—to the new case based on the shared effective cause. Although some scholars opined that *Qiyas* could not be accepted as it only creates a ruling that is detached from the text of the Quran or *Sunnah*, it actually develops the existing law by widening its application of law contained in the text.¹⁷¹ No clear evidence from the Quran to show the permissibility of *Qiyas*. Nevertheless, several occasions had occurred in the time of Prophet which illustrated the application of *Qiyas* in determining the ruling such as the narration as follow:

A woman from the tribe of Juhaina came to the Prophet and said, “My mother had vowed to perform Hajj [pilgrimage] but she died before performing it. May I perform Hajj on my mother's behalf?” The Prophet replied, “Perform Hajj on her behalf. Had there been a debt on your mother, would you have paid it or not? So, pay Allah's debt as He has more right to be paid.”¹⁷²

In answering the question asked, the Prophet had invoked the *Qiyas* by aligning the effective cause in both cases and subsequently gave the similar position of the original case to the case in question.

As *Qiyas* is very practical in deducing ruling for the new arising matters by linking them to the precedent case, it is used widely by the contemporary *Shariah* scholars in determining their position towards any particular problem. The case of currency trading as pointed before is one of the good instances in *Qiyas* application. As indicated previously, the exchange between two different currencies can only be valid and permissible if such a transaction is concluded on the spot basis as stipulated by the *Sunnah*. From the phrase, ‘Then you may sell as you wish provided that the exchange is hand to hand’, it is concluded that in the case where gold is to be exchanged with silver or vice versa, that exchange is required to be executed on the spot basis. During the later stage, this requirement is also extended to the exchange between any different currencies such as Malaysian Ringgit (MYR), United State Dollar (USD) and so on. This is because most of the scholars concur on the fact that the effective cause by which one may extend the rules of *Riba* to other commodities by way of *Qiyas* is

¹⁷⁰ Dusuki (n 2) 158

¹⁷¹ *ibid*

¹⁷² Muhammad Muhsin Khan (tr), *The Translation of the Meanings of Sahih Al-Bukhari: Arabic-English* (Vol 3, Darussalam 1997) 62

‘their being in the nature of money (*Thumniyyah*)’. Since the modern currencies serve the function money, thus, the same requirements are imposed on gold and silver exchange in this respect apply.¹⁷³

2.6.5 *Istihsan*

As mentioned earlier, there are also sources which receive a divided level of acceptance among the jurists including those who are representing one of the four primary schools of Islamic law (Hanafi, Maliki, Shafie and Hanbali). One of the examples of this type of source is the legal reasoning technique called *Istihsan*. Literally, the word *Istihsan* means ‘to approve or to deem something preferable, to consider something as good’. It is a method of exercising personal opinion in order to avoid rigidity and unfairness which might result from literal enforcement of the existing law.¹⁷⁴ Via *Istihsan*, the strong precedent is abandoned for a weaker precedent since such is deemed to serve the ideas of justice and public interest in a better way.¹⁷⁵

Whereas Hanafi, Maliki and Hanbali have validated *Istihsan* as a secondary source of law, Shafie on the other hand, holds the contrary opinion and refused to give any credence in their formulation of legal theory.¹⁷⁶ For the latter, every case involving a Muslim has a binding legal norm (*Hukm Lazim*) drawn from the Quran, the *Sunnah*, or *Ijma*’ or at least, an indication on one of these three sources.¹⁷⁷ Applying the reasoning by analogy (*Qiyas*), if the case in question fits within the meaning of an established case, the legal norm for latter shall also be applied to the former. Should there are more than one established case, the norm of the case with the nearest resemblance shall prevail.¹⁷⁸ In other words, for them, there is no other valid means of reasoning in delivering a legal opinion other than by way of Quran, *Sunnah*, *Ijma*’ or reasoning by analogy (*Qiyas*).¹⁷⁹

On the contrary side, the proponents of *Istihsan* managed to present justification to qualify this concept as a viable concept of legal reasoning. According to them, what is meant by *Istihsan* is the abandonment of reasoning by analogy (*Qiyas*) in favor of the Quran, the

¹⁷³ Mohammed Obaidullah, *Islamic Financial Services* (Scientific Publishing Centre 2005) 24

¹⁷⁴ Laldin, *Introduction to Shariah & Islamic Jurisprudence* (n 82) 102

¹⁷⁵ *ibid* 103

¹⁷⁶ Kamali, *Principles of Islamic Jurisprudence* (n 125) 324

¹⁷⁷ John Makdisi, ‘Legal Logic and Equity in Islamic Law’ in Ian Edge (ed), *Islamic Law and Legal Theory* (Dartmouth 1996)

¹⁷⁸ *ibid*

¹⁷⁹ *ibid*

Sunnah, consensus or necessity (*Dharurah*).¹⁸⁰ *Istihsan* also could be observed in the preference of stronger of two *Qiyas* over the other.¹⁸¹ For instance, in deriving the ruling for the case in question, one solution may be apparent by way of *Qiyas* but, on more detail examination, it becomes clear that the *Hadith* on which it was based is weak while another tradition which is not immediately apparent is stronger (strength and weakness in this respect is decided by looking whether the cause—‘*Illah*—generating the legal norm in the hadith has been duly identified and exists in the case in hand) in the sense that it is appropriately applicable as a solution.¹⁸² Thus, it is held that *Istihsan* is really the preference for one source over another which is made either on the basis of predetermined priorities or through reasoned elaboration of the law.¹⁸³

It has been asserted by some observers of Islamic law that the notion of equity in Western law is embodied in the concept of *Istihsan*.¹⁸⁴ This claim seems to be true since both are inspired by the principle of fairness and conscience as well as authorises departure from a rule of positive law when its enforcement leads to an unfair result.¹⁸⁵ Nevertheless, *Istihsan* as a technique of legal reasoning stands in a sharp contrast to the idea of equity as understood in Western law. It might be agreeable that *Istihsan* is motivated by the interest in promoting public good (*Maslahah*) or removing hardship.

Nevertheless, such must be justified by the provision in the Quran, *Sunnah*, *Ijma*’ or by ‘*Illah*’ identified from these sources.¹⁸⁶ Equity, on the other hand, derives its legitimacy from the belief in a natural right or justice beyond the positive law.¹⁸⁷

The legitimacy of *Istisna*, a *Shariah*-compliant contract which is widely used in Islamic finance is derived, for instance, by virtue of *Istihsan*. In this contract, a manufacturer agrees to produce an item with specific descriptions at a determined price and manufactured from his own materials with his own effort (if the materials are from the customer, it will be a lease contract).¹⁸⁸ According to the general rule of sale, the subject matter which is yet to exist should not be sold as such a sale is considered as a form of ‘*Bay Al-Gharar*’—an invalid sale due to uncertainty.¹⁸⁹ In the case of *Istisna*’, the issue of uncertainty appears since the subject

¹⁸⁰ *ibid*

¹⁸¹ *ibid*

¹⁸² *ibid*

¹⁸³ *ibid*

¹⁸⁴ *ibid*

¹⁸⁵ Kamali, *Principles of Islamic Jurisprudence* (n 125) 323

¹⁸⁶ Makdisi (n 177)

¹⁸⁷ *ibid*

¹⁸⁸ Dusuki (n 2) 207

¹⁸⁹ Aldohni (n 79) 50

matter does not exist at the time when the agreement is entered and the payment is done by the customer, partially or in full. However, based on *Istihsan*, this contract is still considered as a valid contract since the specified description of required assets has been found enough to eliminate the uncertainty element from the main agreement.¹⁹⁰

2.6.6 *Masalih Mursalah*

Another example of the source which receives a divided acceptance among the jurist is *Masalih Al-Mursalah*. It refers to the unregulated public interest (*Maslahah*) due to the absence of textual authority on its validity or otherwise.¹⁹¹ Jurists from the Shafie legal school rejected *Masalih Al-Mursalah* as a valid source of law while the majority of jurist from the rest three schools accepted it.¹⁹²

Notwithstanding the fact that neither Quran nor Sunnah can provide a clear evidence on the validity of *Masalih Al-Mursalah*, there are many general statements in the Quran as well as the practices of the Prophet that indicate its application. For instance, in verse 107 of Chapter 21 Allah said “And we have sent you [o Muhammad] not but as a mercy for all that exists”. Also, it is reported that the Prophet once said “Allah loves to see His concessions (*Rukhsah*) being observed just as He loves to His strict laws being observed”.¹⁹³ From such provisions, it can be understood that *Shariah* was sent upon the creatures as a mercy from Allah. Through the obligation and rules imposed, it aims to render benefit, prosperity and benefit to them and prevent harm and hardship. The imposition of concessions, for instance, also portrays the accommodative nature of *Shariah* which takes the current need of human being into account and its readiness for adjustment to suit that need.

Despite its legality, the application of *Masalih Al-Mursalah* in deducing rulings should always be subjected to several restrictions. Such restrictions are significant to ensure *Masalih Al-Mursalah* does not become an instrument of arbitrary desire or individual biasness.¹⁹⁴ Among these restrictions are the *Maslahah* should be the genuine *Maslahah* (*Haqiqiyah*), not the imaginary one (*Wahmiyyah*) which vested with the reasonable probability that any ruling

¹⁹⁰ *ibid*

¹⁹¹ Dusuki (n 2) 161

¹⁹² Elvan Syaputra and others. ‘Maslahah as an Islamic Source and its Application in Financial Transactions’ (2014) 2(5) *Journal of Research in Humanities and Social Science* 68

¹⁹³ Muhammad Nasiruddin al-Albani, *Irwa al-Ghalil fi Takhrij Ahadith Manarus Sabil* (Vol 3, Al-Maktab Al-Islami 1979) 9

¹⁹⁴ Mohamad Akram Laldin, ‘Understanding the Concept of Maslahah and Its Parameters When Used in Financial Transactions’ (2013) 3(2) *Journal of Islamic Business and Management* 151

derived in pursuit of it will outweigh the harm that might ensue from it.¹⁹⁵ The *Maslahah* also must be general in nature (*Kuliyyah*) in the sense that any ruling issued on the basis of *Maslahah* must be able to prevent harm or render benefit to the people as a whole rather than only benefit one particular person or group of persons.¹⁹⁶ It must also, in any time, not in the contradictory position with any provisions of the Quran, *Sunnah* and *Ijma'*.¹⁹⁷

There are numerous rulings addressing the new arising matters in Islamic finance which are founded on the basis of *Maslahah*. One of the examples is the resolution by the SAC of BNM Malaysia pertaining to the incorporation of *Ibra'* (rebate) clause in the sale-based financing. Formerly, Islamic banks, at their discretion, might grant *Ibra'* to their customer who manages to make the full settlement before the stipulated time. Nevertheless, since it is accorded on the discretionary basis, the customer was in doubt whether or not he is entitled to such a rebate should he make the early settlement. From the banks' side, incorporating the *Ibra'* clause in the contract might trigger the issue of uncertainty (*Gharar*) in the selling price.¹⁹⁸

Responding to this issue, the SAC in its 101st meeting has resolved that BNM may require the Islamic banks to grant *Ibra'* to their customer who settled his debt obligation arising from the sale-based financing prior to the stipulated time. BNM may also require the banks to incorporate terms and conditions on the *Ibra'* in the financing agreement in order to eliminate any doubt on the entitlement of the customer to the *Ibra'*.¹⁹⁹ Following this development, BNM has also issued the 'Guideline on *Ibra'* (Rebate) for Sale-Based Financing' which makes the grant of *Ibra'*s as compulsory. By virtue of paragraph 6.1 of the Guideline, the banks are required to grant to all customers who have settled their financing obligation before the end of the financing tenure.²⁰⁰ Indeed, this resolution and the said Guideline were issued as a manifestation of *Maslahah* and its implementation.

2.7 Legal Maxim

Apart from the sources as mentioned above, a point of law can also be decided based on the legal maxims. In general, a legal maxim provides the general principle which is presented in a simple format consisting of the general rules of *Shariah* in a particular field related to it. It is a

¹⁹⁵ *ibid*

¹⁹⁶ *ibid*

¹⁹⁷ *ibid*

¹⁹⁸ Bank Negara Malaysia, 'Shariah Resolutions in Islamic Finance' (n 109) 123

¹⁹⁹ *ibid*

²⁰⁰ Bank Negara Malaysia, 'Guidelines on *Ibra'* (Rebate) for Sale-Based Financing' (January 2013) para. 6.1

predominant rule, if not a comprehensive one, that applies to most of the relevant cases, such that their ruling can be known from it.²⁰¹

Typically, these legal maxims will come in short and pithy yet contain comprehensive meanings, and they are distributed across the whole range of issues.²⁰² They are formulated by the jurists based on the extensive analysis (known as *Istiqra'*) through which the commonalities between diverse cases are identified as well as the distinguishing factors between cases which might appear to be identical in the first glance. In other words, legal maxims identify the nature and pattern of the law in one particular issue. As such, these maxims serve as an effective tool in assisting a jurist in providing the sought legal ruling for the new arising matters which are not directly covered by the texts of the Quran and *Sunnah* nor been addressed by the previous jurists. Some might argue since these maxims are man-made, their authority is not at par with the legal sources such as the Quran and *Sunnah*. This statement, albeit true to a certain extent, cannot deny the significant role played by the maxims which can help the jurists, at least, to make an 'educated guess' in the initial stage before seeking for stronger evidence from the primary sources.

The development of legal rulings in Islamic finance is much attributed to the application of legal maxims. Contemporary scholars use them frequently in order to ensure that every new question arisen could be sufficiently addressed and adequately answered. Among the maxims that are commonly used in the area of Islamic finance are as follows:

2.7.1 The General Principle Conferring Validity of Contracts is the Consent of Both Parties, and the Effective Terms and Conditions are What They Agreed

This maxim is derived from the Quran where it is mentioned, "O you who believe! Do not consume one another's wealth wrongfully; rather, let there be trade by mutual consent ...".²⁰³ This maxim lays down among the fundamental principles pertaining to the law of contract. In constructing a contract, the primary ingredient is the mutual consent between the involved parties. The effective terms and conditions will be based on the agreement reached upon by them. Nevertheless, it is not an absolute right for them to customise one particular contract since the legal effects of the contact and its validity still depend on several other factors such as its conformity to the fundamental rules of *Shariah* like the prohibition of *Riba*. If a debtor,

²⁰¹ Laldin and others (n 39) v

²⁰² *ibid* vii

²⁰³ Quran [An-Nisa 4:29]

for example, agrees to pay more than the amount he has taken as a debt from his creditor, the agreement is still considered as invalid as the additional amount paid is tantamount to *Riba*. Also, any stipulated terms and conditions in an agreement should not disregard the fundamental effect of contract (*Muqtada Al-Aqd*). For instance, the seller of a house cannot stipulate in the sale contract that the buyer shall not stay in the house. Such a term will render that sale contract void (*Batil*), or at least, voidable (*Fasid*) since the fundamental effect of the sale is to transfer the ownership of the house to the buyer so he can enjoy the full privileges such as the privilege to stay in it.

In modern Islamic finance, there are a lot of modifications that have been done to the classical arrangement where these modifications are based on the mutual consent between the involved parties that does not contravene to any of *Shariah* basic requirements. For instance, in the case of *Mudharabah*, the capital provider (*Rabbul Mal*) and the project manager (*Mudharib*) are entitled to the earned profit of the venture which will be divided between them based on the pre-determined ratio. In the event of a loss, the loss will be solely borne by the capital provider. However, in 2004, the Malaysian Islamic banks have introduced a new mechanism in distributing profit for *Mudharabah* investments, known as Profit Equalization Reserve (PER).²⁰⁴ Through this mechanism, an allocation of the relatively small amount taken from the gross income to be put in the reserve account will be executed. This reserve will be used to top-up the rate of return in the situation where the banks are making a lower return as compared to the market rate.²⁰⁵ Although this kind of arrangement seems to depart from the classical form of *Mudharabah* as explained above, the act of waiving some portion of the profit upfront by *Rabbul Mal* is justifiable based on this maxim which regards mutual consent between the involved parties is at the core of the contract.

2.7.2 In Contracts, Greater Weight is Given to Intention and Meaning Than Words and Forms

This maxim brings the similar understanding entailed by the famous principle in accounting 'substance over form'. It refers to the situation where the wording used in the contract is conflicting with the intention of the contracting parties. Ideally, a contract is to be understood and applied on the basis of the words contained in it since the main purpose of having a contract itself is to manifest the intention of the contracting parties. However, it is undeniable

²⁰⁴ Amir Shaharuddin, 'Maslahah-Mafsadah Approach in Assessing the Shari'ah Compliance of Islamic Banking Product' (2010) 1(1) International Journal of Business and Social Science 129

²⁰⁵ Bank Negara Malaysia, 'Shariah Resolutions in Islamic Finance' (2nd edn, October 2010) 29

that the contract, for whatever reason, might be customised in such a way where it does not reflect the real intent. In such an event, the majority of jurists ruled that the intention and substance take precedence over the form of the contract.²⁰⁶ This position is backed by several authorities such as the saying of the Prophet that mentioned, “Actions are ties only to intentions and every person will earn that which he intended”.²⁰⁷

The treatment to deposit account based on the *Wadiah* at Islamic banks is a good example to illustrate how this maxim is applied. In its classical sense, *Wadiah* is a safekeeping contract where the owner of the asset keeps the asset with a custodian for safekeeping purposes.²⁰⁸ Since it is a contract entered on the basis of charity (*Wadiah Yad Amanah*), the custodian is not liable to indemnify for the damage or loss provided such events do not occur due to the custodian’s negligence. The custodian, acting merely as a safe keeper, is responsible to give back the property to its owner upon request but has no right to utilise the asset without permission from the owner as well as not entitled to the profit gained from the property, if any. However, there is also another type of *Wadiah*, namely *Wadiah Yad Dhamanah*. Under this type of *Wadiah*, the custodian is entitled to use the deposited property for trading or any other purposes and has a right to any income derived from such an utilisation. Nevertheless, he is liable for the damage or loss should they occur.²⁰⁹

Since Islamic banks, just like their conventional counterparts, need to use the money which is deposited into savings or current accounts for other business purposes, the accounts cannot take the form of *Wadiah Yad Amanah*, but instead, they are contracted based on *Wadiah Yad Dhamanah*.

Here, it can be observed that the *Wadiah Yad Dhamanah*-based deposit account, despite being ‘branded’ as *Wadiah*, resembles the features of a loan (*Qard*). This is because effectively the bank is acting as a creditor in such a way where it can use the borrowed property (deposited money), need to give back the property when requested by the owner (the customer) and has an obligation to indemnify the owner in the event of damage or loss regardless the cause of such events. As such, scholars are of the opinion that all *Shariah* requirements on a loan contract are also applicable in the case of *Wadiah Yad Dhamanah*- based deposit account since the real contractual relationship established between the bank and the depositor is

²⁰⁶ Laldin and others (n 39) 48

²⁰⁷ Muhammad Muhsin Khan (tr), *The Translation of the Meanings of Sahih Al-Bukhari: Arabic-English* (Vol 1, Darussalam 1997) 45

²⁰⁸ Ismail Mahayudin and others, *Islamic Banking Operations: The Malaysian Experience* (UiTM Press 2014) 27

²⁰⁹ Dusuki (n 2) 271

debtor-creditor rather than custodian-depositor.²¹⁰ In other words, although the contract entered between both parties is worded as a ‘*Wadiyah* contract’, in the eyes of the *Shariah*, it is a loan contract in the real sense by virtue of the maxim, ‘In contracts, greater weight is given to intention and meaning than words and forms’.

2.7.3 What Has Been Engaged [It] Cannot Be Engaged by Another

This maxim has broad application ranged from the issues related to worship, marital as well as financial transaction. It refers to the situation where one particular subject matter cannot accept any further encumbrance due to the fact that it has already being tied to the existing commitment. In the case of marital for example, a man cannot propose to a woman who is already engaged to another man until the current engagement is being resolved or he is permitted to do so. It is because the woman has given her commitment to her fiancé and therefore cannot offer the same commitment to another man. Likewise, in the case of trading, if a seller sold his goods to a buyer, he cannot sell the sold goods to another party even though the buyer has yet to collect or have the full possession of it. This position is based on the *Hadith* of Prophet which mentioned, “No man should try to enter into a transaction that his brother (in faith) has already started; nor may he propose to a woman whom his brother has already proposed to (and been accepted) except by his permission”.²¹¹

The case of *Rahn* (collateral) is among the best examples to illustrate how this maxim is being applied. *Rahn* is a supplementary arrangement executed between a creditor and his debtor where the creditor takes certain property as a security against the debt.²¹² Several conditions have been laid down by the jurists in order to ensure its validity which related to *Sighah* (the form of contract), *Rahin wa Murtahin* (contracting parties), *Marhun* (collateral asset), as well as *Marhun bih* (debt/liability). Pertaining to the collateral asset, among the requirements that need to be observed is that the asset cannot be sold while being put under collateral. This requirement is derived from the maxim ‘What has already been engaged, it cannot be engaged by another’ since the collateralised property is now vested with the encumbrance by which restricts its owner (typically the debtor himself) to make another dealing such as to sell it to another party.

²¹⁰ Bank Negara Malaysia, ‘Shariah Resolutions in Islamic Finance’ (n 109) 102

²¹¹ Abu Dawud Sulaiman bin Ash’ath, *English Translation of Sunan Abu Dawud*, vol 2 (Abu Tahir Zubair ‘Ali Za’I ed, Yaser Qadhi tr, Darussalam 2008) 519

²¹² Dusuki (n 2) 259

In the current practice of Islamic banks, this application can be seen in various dealings such as in the house financing product. Via this product, the bank will provide the financing facility to its customer for the purpose of purchasing the house and the purchased house, throughout the tenure of financing, will also serve as the collateral (*Marhun*) to secure the customer's payment obligations towards the bank. During such a period, the debtor (customer) is not permitted to sell the house to another party except with the permission of the bank as the creditor. In the event where the customer fails to settle his debt, the bank has the authority to sell the house, collect the owed amount from the proceeds of the sale and return the surplus to the customer, if any.²¹³

2.8 Major Prohibition in Islamic Finance from the Perspective of *Maqasid Al-Shariah*

It is established by now that as far as the *Shariah* is concerned, justice is paramount and shall be upheld in every single aspect of life, including the commercial activities. Therefore, Islamic finance is of the promotion and implementation of risk sharing due to the fact that it manifests the sought justice as compared to risk transferring. In other words, risk sharing becomes the cornerstone of Islamic finance since it is compatible with the notion of justice.

Pursuant to the above, it can be understood that any business dealing with the aim to generate profit therefore must be embedded with this characteristic, the absence of which shall render such dealings impermissible in the eyes of the *Shariah*. In this respect, *Riba*, gambling and *Gharar* are among the prohibited modes of business due the absence of the element of risk sharing as shall be discussed in the following subtopics.

2.8.1 *Riba*

2.8.1.1 *Riba Duyun*

The first prohibition is on the element of *Riba*. It is interesting to note that *Shariah* is not alone in this prohibition. Instead, *Riba* is also condemned and prohibited in Christianity and Judaism although neither the practice of modern Christianity nor Judaism applies the ban on charging or receiving interest.²¹⁴ *Riba* is an Arabic word derived from the word *Rabwun*

²¹³ The Concept of al-Rahn from the Shariah Perspective' (*Maybank*) <www.maybank2u.com.my/iwov-resources/islamic-my/document/my/en/islamic/scoe/knowledge-centre/articles/Concept_al-Rahn_from_the_Shariah.pdf> accessed 31 July 2016

²¹⁴ Aldohni (n 79) 7

which literally means to grow, expand, increase, inflate, excess.²¹⁵ In many works, this terminology is being translated as usury or interest even though both words do not really cover the full understanding of *Riba*. As far as the *Shariah* is concerned, *Riba* can be divided into two categories based on the nature of the transaction which gives rise to it. The first category is *Riba Al-Duyun* which occurs in a loan arrangement, hence the name (*Duyun* is the plural form of the word *Dayn* which means loan). It refers to any unjustified increment in the form of cash or in-kind over the principal amount borrowed.²¹⁶ As such an excess is as a result of the delay of the debt repayment (regardless it is stipulated at the beginning and charged proportionately to the time taken for repayment or imposed at the time of default only) it also may be referred to as *Riba Nasiah* (*Riba* in deferment). Since this is the only type of *Riba* that had been established by virtue of the Quranic injunction as per mentioned in Chapter 1, it may be referred as the *Riba Quran* as well.

The Arabs during the pre-Islamic era used to equate *Riba* from this type with trading since the former, in their opinion, would bring profit to the creditor as much as the latter does to the trader. This position has been rebutted by the Quran since these two things are very different in nature. While making the profit out of trading is entirely legit, the increment in borrowing and lending money whether in kind or cash over the principal amount is unjustified. Rather, it is merely an act of manipulation where the creditor takes advantage on the needy who seeks for financial assistance. Since it clearly violates the value of justice, the *Shariah* condemns such an act and considers it as a major sin as per mentioned in the verse:

Those who consume interest cannot stand [on the day of Resurrection] except as one stands who is being beaten by Satan into sanity. That is because they say, ‘Trade is [just] like interest’. But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns [to dealing in interest or usury]—those are the companions of the Fire; they will abide eternally therein.²¹⁷

As explained in Chapter 1, the violation of justice in this *Riba*-based loan arrangement can be observed in the perspective of economic activities where the creditor who lends his money

²¹⁵ Adnan Trakic and Hanifah Haydar Ali Tajuddin (eds), *Islamic Banking & Finance: Principles, Instruments & Operations* (CLJ Publication 2012) 57

²¹⁶ Dusuki (n 2) 179

²¹⁷ Quran [Al-Baqarah 2: 275]

based on the *Riba* arrangement to finance a business venture loan secures his return in the form of interest which has been fixed upfront regardless of the performance of the business venture. Effectively, this would transfer the entire business risk solely to the debtor (the venture owner/entrepreneur) who bears the responsibility to make the loan payment including in the circumstance where the business is experiencing the loss. Some might argue that in such an arrangement, the creditor bears the credit risk ie the possibility of loan default by the debtor. However, it must be clearly understood here that it is not risk taking *per se* that legitimise the gained profit since a gambler, for instance, also takes a risk during the gambling (and gambling is another prohibited element in Islamic finance as shall be explained later).²¹⁸ Instead, the consideration is on the opportunity for risk sharing.²¹⁹ It is argued that in the absence of interest rates, the creditor would have to share in all the risks that the entrepreneur has to bear in producing, marketing, and selling a product. However, by decoupling his future gains from all activities of the entrepreneur ie loaning money of the present day for more money in the future, the financier transfers all risk to the entrepreneur.²²⁰ Moreover, the risk of default is normally mitigated by taking security and collateral which is to be set-off in the event of default. Taking the advantage of this practice, the creditor may be led to the predatory lending behaviour.²²¹

In addition, the injustice in terms of risk distribution, in this case, can also be looked from the perspective of property right. In a *Shariah*-compliant benevolent loan contract (termed as *Qard Hassan*) the lender transfers the ownership of the loaned money thus its property rights to the borrower which entails the obligation on the borrower to make the full repayment once the loan reaches its maturity. Since the property rights of the loaned money belong to the borrower throughout the loan tenure, the lender, hence, has no entitlement whatsoever to the additional payment in relation to the money. Nevertheless, this is not the case in the *Riba*-based loan. Instead, the property rights stay with the original owner (the lender) over which he claims an additional sum to be paid (in the form of interest) as the ‘rental’ of the money hence transfers the entire risk of this arrangement to the borrower.²²² Since the lender supposedly has no proprietary rights during the loan tenure as in the case of *Qard Hasan*, the *Shariah* does not recognise such an interest to be deemed as his profit. It is important to note here that to claim that the rental payment in the *Riba*-based loan is similar to the rental payment in the

²¹⁸ Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2nd edn, John Wiley & Sons (Asia) Ptc. Ltd. 2011) 103

²¹⁹ *ibid*

²²⁰ *ibid*

²²¹ Bouheraoua and others (n 50) 9

²²² Alhabshi (n 61) 42

leasing arrangement (*Ijarah*) is inaccurate. This is because both cases are in divergence since the liability in the event of loss of the asset in the case of leasing is upon the original owner (the lessor) whereby in the case of the *Riba*-based loan, the responsibility lies upon the borrower. This fact, hence, puts a flaw in such an equation.

Finally, the *Riba*-based loan is also unacceptable from the perspective of moral and ethics which, as explained earlier in this chapter, constitute an integral part of the *Shariah*. This is because a loan, in the eyes of the *Shariah*, is considered to be a gratuitous contract which is given as an act of charity.²²³ As such, it is not supposed to be manipulated as a means to accumulate wealth by charging the interest on the needy who seeks for the assistance. Such a manipulation puts him under an undue burden and may lead him to a deep cycle of debt.

It is important to note here that the prohibition is not confined to the loan arrangement only. Instead, it also covers the increment of the amount which arises from sale transactions such as the increase in lieu of delay or postponement of payment of a due debt for a deferred payment sale.²²⁴ That being the case, the *Shariah* wishes to eliminate not merely exploitation that is intrinsic in the institution of interest, but which is inherent in all forms of dishonest and unfair exchanges in business dealings.²²⁵

2.8.1.2 *Riba Fadhl*

The second type is the *Riba* in exchange contracts (*Riba Buyu*). It is also referred to as *Riba Fadhl* (excess in exchange) and *Riba Al-Sunnah* as its prohibition is derived from the *Sunnah*. The main reference for this case is the *Hadith* which has been repeated in several places in this chapter “Gold for gold, silver for silver wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal, and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to hand”.²²⁶

Riba in exchange contracts takes place when a *Ribawi* commodity is exchanged for an unequal amount of the same commodity or when the amounts are equal but one of the counter values is delivered later.²²⁷ In other words, if a *Ribawi* item is to be exchanged with the same commodity (for example, gold for gold or wheat for wheat), it must be done with an equal amount and concluded on the spot basis. Failing to observe these two requirements will

²²³ Iqbal and Mirakhor (n 218) 68

²²⁴ Munawar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking* (Palgrave Macmillan 2005) 7

²²⁵ *ibid*

²²⁶ Al-Hajjaj (n 108)

²²⁷ Trakic and Tajuddin (n 215) 65

render that particular exchange void due to *Riba Fadl*. However, if the commodities differ (for instance, gold is to be exchanged with silver or wheat is to be exchanged with barley), the exchange can be executed with an unequal amount provided it is concluded on the spot basis. This is what it meant by the phrase, “If the commodities differ, then you may sell as you wish provided that the exchange is hand to hand”.

Nevertheless, the rules mentioned above are not applicable if the exchange takes place between two different commodities, for instance, between gold and wheat. In such a case, the transaction can be of different amount and deferred according to the willing seller and willing buyer rule.²²⁸

Arguably, *Riba Fadhl* was prohibited as it can be used as a ruse in committing *Riba Nasiah*. For instance, by using a sale contract, one might sell 10 grams of gold in exchange for 12 grams of gold on the deferred basis under the pretext that such a sale is permitted whereby, in reality, such an arrangement is a typical loan with the deferred additional payment. As to ‘block the evil mean’, the Prophet has prohibited the exchange of these six commodities which were used as a medium of exchange at some time or the other during his time unless it is done on the spot and with equal amount should they are to be exchanged against each other.²²⁹ It is also opined that the restriction as such is imposed as a discouragement for barter trade in a monetised economy due to the difficulty such a mode of trading entails in measuring the counter-value precisely.²³⁰ Resorting to one standard measurement like money in this respect, serves the value of justice in a more regulated manner.

2.8.1.3 *Riba in the Present Days*

Throughout the development of Islamic finance industry since its emergence until the present days, numerous resolutions, rulings, guidelines and so forth have been issued in order to ensure that all activities carried out by the IFIs are in adherence to the *Shariah* requirements, particularly concerning *Riba*. For instance, the SAC of BNM, in its 95th meeting in 2010 resolved that the IFIs are allowed to impose *Ta’wid* (compensation) as well as *Gharamah* (penalty) on their customer who has defaulted in his payment obligation.²³¹ On one hand, this

²²⁸ Dusuki (n 2) 180

²²⁹ Trakic and Tajuddin (n 215) 65

²³⁰ M. Umer Chapra, ‘The Nature of Riba in Islam’ (2006) 2(1) The Journal of Islamic Economics and Finance (Bangladesh) 7

²³¹ Ezani Yaakub and others, ‘Late Payment Charge in Islamic Bank’ (The 5th International Conference on Financial Criminology (ICFC) 2013) 385

permission will infringe the rule of *Riba Al-Nasiah* as it will incur additional amount above the original outstanding amount.

On the other hand, the absence of such an imposition will trigger a moral hazard issue on the part of the customer since, under the conventional banking system, a customer who defaulted in payment can be charged with an interest payment. By assuming the customer has payment obligation to both Islamic and conventional banks, he is much likely to prioritise the obligation to the latter rather than the former. Such a situation would certainly put the former at the inferior position. As to meet in the middle ground, the SAC ruled that notwithstanding *Ta'widh* is permissible, the IFIs are only allowed to charge such based on the actual loss suffered by them as a result of the late payment.²³² The charge must also not exceed 1 per cent per annum on the outstanding profit payments and the total shall not be compounded.²³³ As for *Gharamah*, the amount charged can be collected but shall not be recognised as an income but instead to be channeled to the charitable purposes.²³⁴ Having such a mechanism in place, the IFIs will not be in contravene with the *Shariah* requirements pertaining to *Riba* should they decide to invoke the charge and at the same time, have the 'deterrent mechanism' intact to protect their interest.

As for *Riba Fadhl*, the application of its rules in the modern Islamic finance can be observed in the case of currency exchange as explained earlier. BNM, in its regulatory policy pertaining to currency exchange (*Bai Sarf*) issued on 11 April 2018 requires the exchange involves the same type of money (for example, Malaysian Ringgit for Malaysian Ringgit), to be done at par.²³⁵ In the case where the exchange involves different currencies eg British Pound with Malaysian Ringgit, it can be done with unequal values (1 Pound for 5.4 Malaysian Ringgit, for instance) provided the transaction is to be concluded on the spot basis as required by the *Hadith* as mentioned earlier.²³⁶

2.8.2 *Gambling and Gharar (Uncertainty)*

Combating injustice in risk distribution continues through the prohibition of gambling and *Gharar*. As both share certain features which could be interrelated, the discussion on both is put under the same subsection.

²³² *ibid*

²³³ *ibid*

²³⁴ *ibid*

²³⁵ Bank Negara Malaysia, 'Bai' al-Sarf (Currency Exchange)' (11 April 2018) para. 14.5

²³⁶ *ibid* para. 14.6

2.8.2.1 Gambling

Among the comprehensive definitions of gambling is “the betting of something of value with unnecessary risk with the hope of gain based on the elements of chance and uncertain events that may involve, to a certain extent, economic manipulation and, on occasion, loss of the contextual elements of economic reality”.²³⁷

This definition covers gambling in the form of ‘game-playing’ as well as business transactions and in the same time highlights the significant aspects of gambling such as risk, the hope of gain and the element of chance. In gambling, the thing is purely based on chance where any party might gain at the expense of the loss of the other party.²³⁸

As mentioned earlier, it is not the risk *per se* that brings legitimacy to a business dealing. Gambling, in this case here, also involves risk taking such as in regular trading as the sale does. Nevertheless, the risk of gambling is deemed as ‘unnecessary risk’ and therefore cannot justify its validity. This is due to the fact that the risk does not occur naturally as part of the normal course of business in every economic activity but instead purposely created to manipulate human greed to acquire wealth. While willingness to take entrepreneurial risk is very much encouraged as it enhances the economic activity in the society and fulfils its needs, risk in gambling does not add any economic value to them.²³⁹ Through gambling, winning or losing will be determined merely by chance without having to do any relevant works for such an entitlement. This is certainly an unjust means for one to consume other’s property.²⁴⁰

Islam has explicitly prohibited the act of gambling through various authorities. For instance, the Quran at one place admitted that gambling could bring ‘goodness’ as much as intoxicant could give benefit to its drinker even though the harm they may cause is greater than the benefit that they may offer “They ask you about wine and gambling. Say, “In them is a great sin and [yet, some] benefit for people. But their sin is greater than their benefit ...”.²⁴¹ In later revelation, the Quran stated its total ban on these two things by saying, “O you who have believed, indeed, intoxicants, gambling, [sacrificing on] stone alters [to other than Allah], and divining arrows are but defilement from the work of Satan, so avoid it that you may be successful”.²⁴² It is also worth to mention here that apart from the economic impacts of

²³⁷ Hussin Salamon and others. ‘Speculation: The Islamic Perspective; A Study on al-Maisir (Gambling) (2015) 6(1) Mediterranean Journal of Social Science 373

²³⁸ Dusuki (n 2) 183

²³⁹ Dusuki (n 2) 184

²⁴⁰ Trakic and Tajuddin (n 215) 71

²⁴¹ Quran [Al-Baqarah 2:219]

²⁴² Quran [Al-Maidah 5:90]

gambling, there is also a social impact from this kind of activity. In this regard, the Quran says, “Satan only wants to cause between you, animosity and hatred through intoxicants and gambling and to avert you from the remembrance of Allah and prayer. So, will you not desist?”²⁴³ Thus, gambling not only will bring harm to the economic productiveness of one particular society but also will lead to other social problems such as hatred and endless dispute between people.

2.8.2.2 *Gharar*

Other than *Riba* and gambling, *Gharar* is another prohibited element which may render one particular contract null and void if such a feature exists in it. Literally, *Gharar* means uncertainty, ambiguity, danger or peril.²⁴⁴ In its technical meaning, this term refers to the ambiguity in a contract that may lead to the unknown result in which the contracting parties, or any of them, not know what could be achieved from the entered contract.²⁴⁵

This prohibition of *Gharar*, just like the prohibition on *Riba* and gambling, comes under the notion of justice which *Shariah* aims to serve. The occurrence of *Gharar* in any business dealings may lead to the injustice and oppression on any of the involved parties, and to a certain extent, loss of properties.²⁴⁶ In certain circumstances, *Gharar* may also cause infringement to the fundamental principle of contract namely mutual consent if the party's approval over the transaction is given based on the insufficient knowledge or access to the relevant information of the subject matter. From the perspective of risk, the case of *Gharar* is in divergence with the regular sale as the risk in the former is considered avoidable if sufficient steps are taken prior to the conclusion of the intended dealing while in the latter the risk arises out of nature of the business.

Gharar can exist whether in the contract itself or in the subject matter of the contract.²⁴⁷ As for the former, it can occur, for example, when a contract is drafted ambiguously in the sense that it fails to deliver the accurate content of the contract to the involved parties. In the latter, *Gharar* can exist in the case where the subject matter is inexistence, unknown, or it is incapable of being delivered.

²⁴³ Quran [Al-Maidah 5:91]

²⁴⁴ Trakic and Tajuddin (n 215) 71

²⁴⁵ *ibid*

²⁴⁶ Dusuki (n 2) 181

²⁴⁷ Marjan Muhammad and others (eds), *Islamic Capital Markets: Principles & Practices* (International Shari'ah Research Academy for Islamic Finance (ISRA) 2015) 94

There is no direct verse in the Quran mentioning about the prohibition of *Gharar* except the general statements prohibiting all forms of business dealings which can potentially cause injustice to any of the involved parties. For instance, the Quran mentions, “O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent ...”.²⁴⁸ It is without a doubt that *Gharar* falls under the prohibition of ‘consume one another’s wealth unjustly’. However, the issue of *Gharar* has been highlighted through various records of the *Sunnah* where certain modes of sale are prohibited due to the element of *Gharar* embedded within them. For instance, *Bai Mulamasah* and *Bai Munabazah* are the sales where, in the former, a buyer is only allowed to feel a garment but cannot unfold it to examine what is in it and in the latter, a sale concluded when a potential buyer throws his garment to another without making any inspection.²⁴⁹ Both modes were practised during the pre-Islamic era and with the commencement of the Islamic era, they are deemed as the instances of void sale due to the element of *Gharar*.

It is important also to note here that there are certain exceptional in the case of *Gharar*. Unlike *Riba* where the ban is absolute, *Gharar*, however, is tolerable to some degree of *Gharar*.²⁵⁰ For example, in some parking areas, all users are paying the parking ticket with the same amount irrespective of how long they park their cars. Supposedly, the parking time and its charge should be specified since it is the subject matter of the contract. However, in this case, a flat rate is acceptable since the uncertainty is minimal (termed as *Gharar Yaseer*) and customarily accepted.

As mentioned earlier, both gambling and *Gharar* are similar to a certain extent in the sense that both resemble uncertainty over gain and loss.²⁵¹ In both cases, the existence of uncertainty is a clear-cut case of injustice as it either brings benefit or harm to either party involved (zero-sum) without valid justification.²⁵² This arrangement clearly goes in a contradictory way to the risk sharing as upheld by the *Shariah*. They are also can be regarded as interrelated as in the existence of *Gharar* element in a contract, the parties involved are exposing themselves to the gambling-like risk such in *Bai Mulamasah* and *Bai Munabazah* as mentioned above.

²⁴⁸ Quran [An-Nisa’ 4:29]

²⁴⁹ Dusuki (n 2) 181

²⁵⁰ Muhammad and others (n 247) 93

²⁵¹ *ibid* 97

²⁵² *ibid*

2.8.2.3 *Gambling and Gharar in the Present Days*

In the present days, the conventional insurance is a good example of a non-*Shariah* compliant product due to the existence of the elements of gambling and *Gharar*. Via the insurance, the insurer offers a financial protection to the insured party during the occurrence of calamities through the execution of the insurance contract between them in which the insurer agrees to underwrite the subject risk of such a contract.²⁵³ Although a human's life will be continually exposed to various perils such as theft, accident, sickness and so forth, these perils are uncertain as to when they will occur or to what degree the loss could be, should such events take place. Hence, the insurance serves as a useful tool to reduce these uncertainties in such a way that the risk and uncertainty are mitigated when the losses are to be shared or distributed among the exposure units.²⁵⁴

Admittedly, the *Shariah* concurs with the idea of 'insurance'. This is manifested, inter alia, through the practice of blood money payment in the case of murder by *Aqilah* (the close relative of the convicted killer) to the victim's legal heir. The ancient Arab tribes had to be ready to make financial contributions on behalf of the killer coming from their tribe. Such contributions are similar to the premium payments in insurance and the payment to the victim's legal heir is similar to indemnity in insurance practice. This practice was approved during the time of the Prophet.

Nevertheless, the *Shariah* does not approve the practice of modern conventional insurance. In this regard, the Malaysian National Fatwa Council has resolved that the conventional insurance specifically the life insurance, as a void practice because of the presence of elements such as interest, uncertainty and gambling.²⁵⁵ The element of *Gharar* can be observed in the operation of the conventional insurance where the gain and loss for both the insurer and the insured party will be determined based on circumstances (insured perils) which might or might not happen. The insured party may get indemnified in the occurrence of insured peril but if anything does not happen at all, they will not get anything from the premium paid. This uncertainty makes money paid (as the premium) to the insurer is as good as the betting money put in the gambling.

²⁵³ Dusuki (n 2) 500

²⁵⁴ *ibid*

²⁵⁵ Wan Marhaini Wan Ahmad, 'Some Issues of Gharar (Uncertainty) in Insurance' (2002) 10(2) *Jurnal Syariah* 61

To avoid such an event, *Takaful* was formulated based on the spirit of cooperation and goodwill in providing material security against unexpected future loss, damage or peril.²⁵⁶ This, to a certain extent, mirrors the application of the *Aqilah* system as mentioned above. Unlike in conventional insurance where the premium paid belongs to the insurer (insurance company) with the obligation on its end to indemnify the insured party, the money paid to the *Takaful* fund belongs to all participants of the fund who have given their commitment to guarantee mutually, help and cooperate to one another. The *Takaful* operator is merely the manager of the fund who will receive the managing fee for the undertaken task. By altering the nature of the product, *Takaful* manages to satisfy the same need as insurance does while not comprising the *Shariah* requirement of gambling prohibition.

2.9 Conclusion

This chapter explains the fundamental aspect of Islamic finance which is rooted from the umbrella body of Islamic governance named *Shariah*. The *Shariah* differs from the other legal regimes as it covers much wider segments such as the system of belief, the ethics and moral as well as the Islamic law/*Fiqh* itself. It is hardly to witness any separation between them. The *Shariah* is a systematic body which is strong in its fundamental yet flexible to address new arising issues through the process of *Ijtihad* which shall be undertaken by the qualified jurists. By relying on various sources of Islamic law, they have come out with the positive laws in various branches to regulate human daily conducts.

More importantly, as established in Chapter 1, *Shariah* has clearly put the objectives it aspires to achieve through the operation of all of its branches; to uphold justice among the people. As evident by the sources of Islamic law, the *Shariah* puts great emphasise on justice as it becomes among the central themes of the Quran (the primary source of *Shariah*) and must be observed at all times.

Under this notion of justice, the question of fair risk distribution arises and becomes an integral part of Islamic finance. As far as Islamic finance is concerned, justice must be upheld through, inter alia, the fair risk distribution. As such, three elements namely *Riba*, *Gharar* and *Maysir* (gambling) are deemed as prohibited under the Islamic commercial law and their existence in any commercial transaction may render them null and void. As these three elements entail risk shifting (the risk shall be borne only by one party) or cause injustice

²⁵⁶ Nik Norzrul Thani and others, *Law and Practice of Islamic Banking and Finance* (2nd edn, Sweet & Maxwell Asia 2010) 220

between the parties involved, their existence defeats the fair risk distribution and is deemed as counterproductive to the justice in trading as propagated by *Shariah*.

It is on the same ground that Islamic finance emphasises the significance of risk sharing in all commercial dealing with the purpose of generating profit. Its existence is essential to justify the enrichment while its absence may implicate the existence one of those three prohibited elements thus invalidate the dealing in question. In the case of *Musharakah Mutanaqisah* home financing, for instance, the failure to effectively demonstrate the idea of risk sharing through its operation may put the validity of the product at stake in the eyes of the Islamic commercial law (due to the issue of risk shifting, for instance) and defeats the attempt to fulfil one of the important objectives of the *Shariah* ie to uphold justice (more on this point will be addressed as this study continues). In the next chapter, the discussion will be focusing on one of the Islamic finance business models, namely *Musharakah* as one of the platforms through which the idea of risk sharing is manifested.

Chapter 3. *Musharakah*

3.1 Introduction

The previous discussions have asserted the significance of risk sharing as the manifestation of risk taking in the landscape of Islamic finance. The vital role it plays in a *Shariah*-compliant commercial dealing has been backed not only by legal texts from the Quran and *Sunnah* but also indicated by the understanding of *Maqasid Al-Shariah* which seeks to promote fairness in the business conduct. As discussed in Chapter 1, risk sharing exists in a sale contract through the specialisation and cooperation which lead to co-dependency between the economic agents, hence risk sharing. However, some subscribe to the approach of distinguishing between risk sharing and risk bearing. For them, it is risk bearing rather than risk sharing that takes place in a sale contract where the seller bears the risk of the asset (as well as the risk of *Khiyar Aib*-the risk of the contract being rescinded due to defect on the subject matter) while the buyer bears the risk of the price before each of these risks is being transferred to the counterparty. Nevertheless, the difference observed in this regard does not hold much significance since through either approach, it is agreed that risk must be assumed by the involved parties whether it shall be mutually shared or it shall be borne by each of them based on their respective capacity.

In the case of *Musharakah* such difference, however, is irrelevant. It is widely known and accepted that this equity partnership arrangement is a typical example of risk sharing. The parties of *Musharakah* share the risk emanated from the same asset (the *Musharakah* venture) and shall suffer the loss at the same point of time. It is an equitable arrangement in such a way where the comingling of the partnership assets (the capital contributed by each partner) entails their equitable entitlement to the profit and loss that is contingent to the future event and shall be based on the pre-agreed ratio.²⁵⁷ Therefore, *Musharakah* is deemed to be among the major business models to manifest the idea of risk sharing which supposedly to be championed by and widely used in the Islamic finance segment.

This chapter intends to discuss *Musharakah* and how the idea of risk sharing is being operated via this business model. It starts with the discussion of the basic understanding of *Musharakah*; its definition and types based on the basis of the classification. Subsequently, the discussion shall be looking at the basis of profit entitlement in *Musharakah* as held by the four major schools of law in the Islamic jurisprudence. As shall be explained later, jurists

²⁵⁷ Bouheraoua and others (n 50) 5

from different schools of law hold various opinions on the validity of certain form of *Musharakah*. These differences are caused by their differences in recognising the basis for profit entitlement although it is anonymously agreed that the primary objective of having a partnership is to attain profit. As such, the discussion on this note shall address these differences and explain the argument of each group. This shall be followed by the discussion on the general requirements of *Musharakah* from three aspects namely the nature of capital, the profit and loss distribution as well as the termination of partnership. Finally, the focus of this chapter will be on the application of *Musharakah* in the home financing product which takes *Musharakah Mutanaqisah* as its underlying structure as well as the *Musharakah Sukuk* with the same underlying structure. The same products shall be put under the analysis in Chapter 6 where the extent to which the Malaysian legal and regulatory framework support the idea of risk sharing through the product of *Musharakah* shall be gauged.

3.2 *Musharakah*: An Overview

The term '*Musharakah*' found its root from the word *Shaaraka* which means to share.²⁵⁸ It refers to the partnership between two or more parties to finance a business venture where all parties contribute capital either in the form of cash or in-kind.²⁵⁹ Although the term is widely used in the present day particularly when reference is made with regard to the equity-based Islamic mode of financing, it connotes a rather limited understanding as compared to the term '*Shirkah*' (sharing or partnership) which is used more commonly in the works of literature of Islamic jurisprudence.²⁶⁰

3.2.1 *Shirkah Al-Milk*

In general, *Musharakah* can be divided into two categories. The first category is *Shirkah Al-Milk* (propriety partnership). It refers to the joint ownership of two or more persons over one particular property.²⁶¹ This type of partnership could take place voluntarily (referred to as *Ikhtiyariyah*) or compulsorily (referred to as *Ijbariyah*). As for the former, the ownership is established in the instance where the partners jointly purchase an asset, or it is obtained by

²⁵⁸ Zaid Hamzah, *Islamic Private Equity & Venture Capital: Principles and Practice* (Ahcene Lahsasna ed, IBFIM 2011) 55

²⁵⁹ *ibid*

²⁶⁰ Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Maktaba Ma'ariful Quran 2007) 31

²⁶¹ *ibid*

them as a result of will or a gift.²⁶² As for the latter, the partnership comes into existence automatically such as in the case of inheritance where all the entitled legal heirs inherit and come into the joint ownership of the deceased's property.²⁶³

3.2.2 *Shirkah Al-Aqd*

The second category is *Shirkah Al-Aqd* (contractual partnership). This type of partnership differs from the propriety partnership in the sense that it is a commercial partnership whereby the latter does not come into existence by a mutual agreement to share profits and risks thus hardly to be considered as a partnership as understood in the commercial sense. It can be further divided into several types. For instance, in terms of the capital contribution, it can be classified into three categories, namely *Shirkah Amwal* (monetary partnership), *Shirkah Amal* (labour partnership) and *Shirkah Wujuh* (partnership in goodwill). The first category refers to the arrangement where all the partners invest some capital (the nature of capital includes the monetary form/ cash as well as in-kind).²⁶⁴ The second category, which is also known as *Shirkah Abdan*, *Shirkah Taqabbul* or *Shirkah Sina'i* refers to the partnership where all the partners are jointly undertaking to provide some services to their customer and the earned profit (through the payment of the rendered service) will be distributed among them based on the pre-agreed ratio.²⁶⁵ As for the third category, it is a bilateral agreement between two or more parties to conclude a partnership based on the partners' reputation to buy an asset with a deferred payment for the purpose of making a profit from its sale while they undertake to fulfil their obligation to the percentages determined by the partners.²⁶⁶ For instance, A and B form a partnership in goodwill where they buy a commodity from a vendor which cost them RM1000. Instead of paying the price, both of them use their reputation to convince the vendor to grant them with deferred payment. They also make an agreement between both of them that the profit share ratio for this partnership will be 50:50. After succeeding to sell the commodity with RM1500, they pay the vendor the cost price (RM1000) and share the surplus (RM500) as their profit based on the pre-agreed ratio. Therefore, each of them gains RM250 (50 per cent of the whole profit).

²⁶² Dusuki (n 2) 246

²⁶³ Usmani, *An Introduction to Islamic Finance* (n 260) 31-32

²⁶⁴ Zuhairah Ariff Abd Ghadas and Engku Rabiah Adawiah Engku Ali, 'Partners' Limited: Limited Liability in Partnerships Structure: An Overview of the Common Law and the Shariah' (2010) 1 Shariah Law Report 45

²⁶⁵ Usmani, *An Introduction to Islamic Finance* (n 260) 32

²⁶⁶ Dusuki (n 2) 247

From the perspective of terms of the contract, the contractual partnership can be divided into two types, namely *Shirkah Mufawadhah* (unlimited partnership) and *Shirkah Inan* (limited partnership).²⁶⁷ *Shirkah Mufawadhah* refers to the unlimited investment partnership in which each partner contributes equally to the capital and enjoys full and equal authority in transacting with the partnership capital or property.²⁶⁸ In this partnership, partners are regarded as the agents of each other as well as acting as surety for other partners.²⁶⁹ As such, all partners, according to some of the jurists, are responsible for all dealings done by the other partner as they share all rights and obligations equally.²⁷⁰ These jurists also seem to take a strict approach to the question of equality as they deem the individual equality in all respects as one of the prerequisites for a valid *Mufawadhah* partnership. For instance, the partnership between an adult and a minor is invalid even with the permission of the minor's parents due to the inequality in personal status.²⁷¹ The question of equality also extends to the religious affiliation where the *Mufawadhah* partnership cannot be formed between a Muslim and a non-Muslim. In these jurists' argument, such 'mixed' *Mufawadhah* partnership may engage with the commercial transactions where some of which might not be in compliance with the *Shariah* thus disqualifying the Muslim partner from the full participation as entailed by a *Mufawadhah* partnership.²⁷² However, another group of jurists have taken a different approach in this respect. For them, the term *Mufawadhah* in partnership is confined to the nature of the relationship between the partners and does not extend to any other aspect of the association.²⁷³ Thus, there is no requirement for equality in the personal status of the prospective partner. Rather, it connotes a general partnership mandate by which each partner confers upon his colleague full authority to dispose of their joint capital in any manner intended to benefit their association.²⁷⁴

On the other hand, *Shirkah Inan* (limited partnership), the form which partially resembles the features of many legal modern limited partnerships, does not require equality in the partners' contribution nor in the legal right for using the partnership property.²⁷⁵ The partners are to contribute a specific amount of money in such a way that gives each of them a right to deal in the assets of the partnership on condition that the profit is to be distributed according to the

²⁶⁷ Dusuki (n 2) 246-247

²⁶⁸ Ghadas and Ali (n 264)

²⁶⁹ *ibid*

²⁷⁰ Al-Zuhaily (n 41) 452

²⁷¹ Joni Tamkin Bin Borhan and Mohamad Taqiuddin bin Mohamad, 'Conducts of Partners in al-Shirkah al-Mufawadah: An Analysis from Hanafi's Classical Sources' (Seminar Ekonomi Islam Peringkat Kebangsaan 2009)

²⁷² *ibid*

²⁷³ *ibid*

²⁷⁴ *ibid*

²⁷⁵ Al-Zuhaily (n 41) 452

pre-agreed ratio.²⁷⁶ In terms of the legal right in dealing with the partnership asset, each partner may only transact with the partnership capital according to the terms of the partnership agreement and to the extent of the joint capital hence making their liability towards third parties several but not joint.²⁷⁷ Each partner shall only be responsible for dealings that he performed and only bears the loss in proportion to his contribution to the partnership's capital.²⁷⁸

3.2.3 *Mudharabah*

There is another form of partnerships, known as *Mudharabah* (profit sharing and loss bearing), which some jurists regard as a type of *Musharakah* although they describe it as a silent partnership. Technically, it refers to the partnership in profit where the capital is provided by the *Rabbul Mal* (capital provider) while the counterparty, known as *Mudharib* provides labour.²⁷⁹ This makes the arrangement in *Mudharabah* different as compared to the typical arrangement in *Musharakah* where all the partners shall contribute their capital to the investment. Another significant difference between these two models is pertaining to the element of loss bearing. As mentioned before, in *Musharakah*, the incurred loss from the investment shall be shared by all the partners to the extent of their capital contribution. However, in the case of *Mudharabah*, the loss will be solely borne by the capital provider while the *Mudharib*'s 'loss' is restricted to the fact that his labour has gone in vain and his work is not fruitful.²⁸⁰

3.3 Bases for Entitlement to the Profit of *Musharakah* from the Islamic Jurisprudence Standpoint

As asserted earlier, *Musharakah* is among the major business models with the idea of risk sharing serves as the backbone of their structures. Jurists unanimously agree that, in principle, the concept of *Musharakah* denotes mutual risk taking by each partner whereby he bears the relevant risks of the business venture and therefore is entitled to a portion of profit, if any. However, they appear to hold different opinions as to the basis for partners' entitlement to the

²⁷⁶ Dusuki (n 2) 246

²⁷⁷ Ghadas and Ali (n 264)

²⁷⁸ Al-Zuhaily (n 41) 452

²⁷⁹ Dusuki (n 2) 249

²⁸⁰ Usmani, *An Introduction to Islamic Finance* (n 260) 47-48

profit in a *Musharakah* business venture. This difference had eventually led to the different views on the validity of some forms of *Musharakah*.

3.3.1 *The View of Hanafi and Hanbali Schools of Law*

In this regard, a prominent jurist of the 6th century from the Hanafi school of law by the name Al-Kasani had mentioned that the entitlement to profit in the case of *Musharakah* depends on three subjects (bases). The first basis is wealth (*Mal*) which is obvious as the profit is derived from the growth of the asset he contributed as capital into the venture. The second basis is labour (*Amal*) where the one who provides his energy and workmanship to the business venture is entitled to a portion of profit such as a *Mudharib* in the case of *Mudharabah*. The final basis is liability (*Dhaman*) where the one who contributes it is entitled to a portion of the business profit as the compensation for his liability to bear the loss should it incurs. In his opinion, if the *Mudharib* is made to bear all the losses by virtue of the agreement entered between him and capital provider, the *Mudharib* is entitled to all the profit of the venture.²⁸¹

The similar view held by Ibn Qudamah, the renowned jurist consult of the Hanbali school of law. In his opinion, the partner is entitled to profit due to his contribution of wealth, labour or both. As for *Dhaman*, he argued that it becomes the basis for the entitlement to profit in the case of *Shirkah Abdan* as much as it does in the case of *Mudharabah* where in both cases, the partners (in *Shirkah Abdan*) and the *Mudharib* (in *Mudharabah*) provide labour work.²⁸²

²⁸¹ Al-Kasani says in this respect: The original [ruling], in our view, is that entitlement to profit is due to wealth or labour or liability for bearing loss. As for the entitlement due to wealth, it is obvious because profit is a growth in the capital and belongs to its owner. It is for this reason that the Rab al-Mal in the contract of *Mudharabah* is entitled to profit. As for labour, the *Mudharib* is entitled to profit due to his labour, and likewise the partner. As for liability (*Dhaman*), if the *Mudharib* were made to bear the liability for loss, he would be entitled to the entire profit [of the *Mudharabah*] as compensation for his liability due to the fact that profit [entitlement] goes with liability [emphasise added]. Refer 'Alauddin Abu Bakar bin Mas'ud Al-Kasani, *Badai' Sanai' fi Tartibi Asy-Syarai'* (Vol 7, Ali Muhammad Muawwadh and Aadil Ahmad Abdul Maujud eds, Dar Al-Kutub Al-Ilmiyyah 2003) 517

²⁸² Ibn Qudamah says :

Labour ('*Amal*) is a basis for entitlement to profit. It is, therefore, allowed for the partners to have differing shares in the profit even if both of them contribute labour, similar to the case of two *Mudharibs* engaged with one [investor at two different profit-sharing ratios]. That is because one of them may be more expert in trading and more capable than the other; hence, he can stipulate a greater share of the profit for his labour, similar to stipulation of profit for the labour of the *Mudharib*. This partnership [ie *Sharikat al-'Inan*] is based on both wealth and labour. Each partner would be entitled to profit if they contributed only one of them. Likewise, they are entitled due to a combination of the two. When there is no stipulation, then the profit is divided among them according to their capital contributions. However, when there is a stipulation, it is the primary consideration and must be honoured. Refer Abdullah bin Ahmad, *Al-Mughni* (Vol 7, 3rd edn, Dar 'Aalam al-Kutub 1997) 138

Also, he says:

Dhaman is a basis for entitlement to profit, as evidenced in *Sharikat al-Abdan* (labour partnership). The acceptance of work imposes liability upon the person accepting the work [as an independent contractor] and provides a basis for entitlement to profit. It is, therefore, similar to the acceptance of wealth in *Mudharabah*. The

Based on this position, both Hanafi and Hanbali schools of law permit all three types of *Musharakah*; *Shirkah Amwal*, *Shirkah Abdan* and *Shirkah Wujuh*.

3.3.2 *The View of Maliki Schools of Law*

The situation as mentioned above, however, does not fully illustrate the position held by the Maliki school of law. It is because the jurists of this school had ruled out the liability *per se* to be the basis of profit entitlement in *Musharakah*. As such, *Shirkah Wujuh* is deemed as invalid since in this type of *Musharakah*, there is neither monetary capital nor labour work is contributed. Instead, the basis of the partnership is merely the liability for the price of goods purchased on credit.

As for *Shirkah Amwal*, it is accepted as a valid partnership since wealth is a valid basis for profit entitlement.²⁸³ In the case *Shirkah Abdan*, the jurists of this school are of the opinion of its validity although they might be in dispute as to the basis for the profit entitlement. Some of them asserted that labour is not an independent basis but rather subservient to wealth.²⁸⁴ However, it is also can be traced in some of the school's legal scriptures that labour might as well be deemed as an independent basis for the profit entitlement as it may substitute the wealth.²⁸⁵

3.3.3 *The View of Shafie Schools of Law*

The approach taken by the Shafie school law seems to be the most stringent as compared to the others since partnership, according to its jurists, is confined to the partnership in wealth only. It is the only basis for the profit entitlement and likewise, the loss is shared on such basis.²⁸⁶ Hence, the only valid form of partnerships under *Shirkah Al-Aqd* is *Shirkah Amwal*.

labour of the worker [in *Sharikat al-Abdan*] entitles him to profit just as the labour of the *Mudharib* does [in *Mudharabah*]. [*Sharikat al-Abdan*] is thus considered like *Mudharabah*. Refer Abdullah bin Ahmad, *Al-Mughni* (Vol 7, 3rd edn, Dar 'Aalam al-Kutub 1997) 113

²⁸³ In this regard, it is reported that Imam Malik had said that loss is commensurate with the partners' capital (wealth) and profit are commensurate with their capital (wealth). Refer Sahnun bin Saeed Al-Tanukhi, *Al-Mudawanah Al-Kubra* (Vol 12, Wizarah Al-Syuun Al-Islamiyah Wa Al-Auqaf Wa Al-Dakwah Wa Al-Irshad Al-Mamlakah Al-Arabiah Al-Suudiah) 59-60

²⁸⁴ Muhammad bin Ahmad bin Muhammad bin Ahmad bin Rusyd Al-Hafid, *Bidayatul Mujtahid wa Nihayatul Muqtasid* (Vol 4, Muhammad Subhi Hassan Hallaq ed, Maktabah Ibnu Taimiyyah 1994) 9

²⁸⁵ Sahnun bin Saeed Al-Tanukhi, *Al-Mudawanah Al-Kubra* (Vol 12, Wizarah Al-Syuun Al-Islamiyah Wa Al-Auqaf Wa Al-Dakwah Wa Al-Irshad Al-Mamlakah Al-Arabiah Al-Suudiah) 42-43

²⁸⁶ Al-Sharbini says: "Profit and loss are based on the capital contributions." Muhammad bin Muhammad Al-Khatib Al-Sharbini, *Mughni Al-Muhtaj Ila Ma'rifati Maani Alfaz Al-Minhaj* (Vol , Dar Al-Kutub Al-Ilmiyyah 2000)

3.4 General Requirements of *Musharakah*

The variety of opinions held by the jurists is not limited to the question pertaining to the basis of profit entitlement in *Musharakah* which had led to the different positions towards the legality of a certain form of *Musharakah* as explained above. Rather, the discourse extends to some other aspects which are more general, covering most of the types of *Musharakah*. These aspects are like the nature of capital, the rule pertaining to the profit and loss distribution as well as the termination of *Musharakah* venture. Such requirements demonstrate the ability of *Musharakah* as a business model to promote justice and operate the idea of risk sharing as entailed by *Maqasid Al-Shariah*.

3.4.1 Nature of Capital

The first aspect is pertaining to the nature of capital. Most of the jurists are of the opinion that the contributed capital for the purpose of *Musharakah* venture should be in the monetary form (cash) whereby contribution in the form of commodities or goodwill (in-kind) is not acceptable.²⁸⁷ This position is taken by considering the possibility of a partnership contract to be terminated and the partners have to resort to the redistribution of the joint capital among themselves. If the joint capital in question is, for instance, in the form of commodities such redistribution would not be able to take place as they may have been sold at that point of time.²⁸⁸ In addition, commodities are always distinguishable from each other, whereby, a partnership essentially means the mixing of capital in the sense that any part of the partnership's capital that perishes must perish in the property of all partners.²⁸⁹ The absence of this feature defeats the purpose of establishing a partnership ie to mutually attain profit from the pooled asset. As each asset still exclusively belongs to its owner's private ownership, any profit derived from such asset will be solely owned by its owner.

The second group of jurists, however, holds the contrary position. For them, the capital does not necessarily have to be in cash but can also be in-kind.²⁹⁰ For them, in the case where the contributed capital is the commodity, the partner's share shall be determined based on the commodity evaluation according to the market price prevalent at the date of the contract.²⁹¹

²⁸⁷ Ahmad (n 42) 123

²⁸⁸ Usmani, *An Introduction to Islamic Finance* (n 260) 38

²⁸⁹ Al-Zuhaily (n 41) 459

²⁹⁰ *ibid* 460

²⁹¹ Usmani, *An Introduction to Islamic Finance* (n 260) 38

There is also an approach taken by the third group of jurists where they make a distinction between the commodities which can be replaced with other similar commodities should they be damaged (*Zawatul Amthal*) and the commodities which cannot be replaced in such situation but need to be compensated by paying their value instead (*Zawatul Qeemah*). They held that the former group of commodities is eligible to be the capital of *Musharakah* partnership while the latter cannot form part of the shared capital.²⁹²

It is apparent that the disagreement among the jurists in this respect revolves around the issue of *Gharar* (uncertainty) in terms of the value of the capital contributed. As explained in Chapter 3, *Gharar* is deemed as one of the major prohibited elements in Islamic finance since it causes injustice and oppression on the involved parties as well as infringes the fundamental principle of contract ie mutual consent; the circumstances of which that go against the spirit of justice. In the case of *Musharakah*'s capital, *Gharar* may trigger certain problematic circumstances in the event where the *Musharakah* needs to be terminated, and the partners have to resort to the redistribution of the join capital as mentioned before. Hypothetically speaking, if the capital is a commodity, it may have been sold at the point of time where the redistribution is sought, or the value of commodity might be fluctuating. Such situations make the existence or the value of the capital uncertain should it need to be redistributed and potentially drag the partners into a dispute among themselves. In addition, having clear information about the value of the capital is essential since the loss distribution ratio has to be proportionate to the percentage of capital contribution (this point shall be readdressed further later). Therefore, the uncertainty in terms of the capital value (due to the value which keeps fluctuates, for instance) may also cause injustice and difficulty to determine the right portion of loss to the partners.

However, this position appears to be not favourable to the authorities and standard setting organisations in the present days. For instance, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a standard setting body based in Bahrain, in its *Shariah* standard no.12 pertaining to Partnership (*Musharakah*) and Modern Companies rules that it is permissible, with the agreement of the partners, to participate in *Musharakah* partnership by non-cash assets (in-kind) after evaluating their cash equivalent in order to determine the share's value.²⁹³ The same position is also held by SAC of BNM. In its *Musharakah* Regulatory Policy, SAC held, inter alia, that the capital for a *Musharakah*

²⁹² ibid 40

²⁹³ Accounting and Auditing Organization for Islamic Financial Institutes (AAOIFI), 'Shari'a Standard (12) Partnership (Musharaka) and Modern Companies', para. 3.1.2.1

partnership may be in the form of cash or in-kind including intangible assets.²⁹⁴ In addition, it also requires that in the case where the capital is in kind, it shall be valued in monetary terms at the time of entering into the contract either by agreement between the partners or by a third party which may include experts, valuers, or any other qualified person.²⁹⁵

This requirement, which conforms to the position held by the second group of jurists as mentioned above, seems to be able to mitigate the issue of uncertainty and the potential dispute as mentioned above since the value of the capital will be valued by the independent third party based on a pre-fixed date ie the time of entering the contract. In addition, as mentioned in Chapter 3, the existence of uncertainty, generally, does not necessarily render the arrangement void if it is minor (*Gharar Yaseer*). Furthermore, allowing the capital in the form other than cash also seems more practical and can serve the interest of modern business better (in the later part of this chapter, an example from the practice on *Sukuk* will be pointed out to demonstrate how the capital is being contributed in the form of non-cash). Therefore, the issue of uncertainty in this respect cannot prevail against the legitimate interest based on the legal maxim which reads “what is prohibited out of pretext may be allowed for the prevailing good”.²⁹⁶ The uncertainty, if exist, may be deemed as minor thus allowable.

3.4.2 Profit and Loss Distribution

The second aspect is regarding the profit and loss-sharing arrangement. This point is among the most frequent points to be addressed in any literature work pertaining to *Musharakah*. This is because the arrangement in profit and loss between partners is the hallmark of *Musharakah*, the adherence to which ensures its effectiveness in manifesting the idea of risk sharing as well as its conformity to the principle of fairness as propagated by *Maqasid Al-Shariah*.

From the Islamic commercial law standpoint, in order to avoid any element of *Gharar* which may lead to future dispute, the ratio of profit sharing between partners must be pre-determined at the point of the conclusion of the contract. The return cannot be a sum of money or a percentage of the capital but in the form of an undivided percentage of profit.²⁹⁷ In this respect, paragraph 3.1.5.1 of AAOIFI *Shariah* standard no.12 reads "profit distribution mode

²⁹⁴ Bank Negara Malaysia, ‘Musyarakah’ (April 2015) para.15.2

²⁹⁵ *ibid* para 15.3

²⁹⁶ Kotb Rissouni, ‘The Precept: “What is Prohibited out of Pretext May be Allowed for the Prevailing Good” Applied Foundation Study’ (2009) *Majallah Jamiah asy-Syariqah lil Ulum asy-Syar’iyyah wal Qanun*

²⁹⁷ Dusuki (n 2) 248

among partnership parties should be stipulated in the partnership contract, and profit distribution should be determined as common percentages of profit, and not by a lump-sum amount or percentage to capital".²⁹⁸

As to the question of the allowed quantum, the jurists disagree whether the profit should be proportionate to the partner's capital contribution or it may vary. Some of them opined that it is mandatory for each partner to get profit in proportion to his investment.²⁹⁹ Therefore if, for instance, the partner contributed 25 per cent of the total investment capital, then he is entitled up to 25 per cent of the profit derived from the venture. The second opinion offered by the jurists is that the profit share does not necessarily to be proportional to the capital contributed. Rather, it may be determined in accordance with the agreement between the partners.³⁰⁰ As such, it is permissible if a partner, who contributed 25 per cent of the total capital to share the profit with his partner equally, provided such arrangement is mutually agreed between them beforehand. It is mentioned in paragraph 16.2 of the *Musharakah* Regulatory Policy of BNM that "The profit-sharing ratio (PSR) in the *Musyarakah* shall be proportionate to the capital contribution of each partner unless mutually agreed otherwise at the time of entering into the *Musyarakah* contract".³⁰¹

There is also third opinion pertaining in this respect which partially similar to the second opinion (the profit does not necessarily in proportionate with the capital contributed) except in the circumstance where a partner stipulated an express condition in the agreement that he will remain as a sleeping partner (a partner which only contribute capital to the venture and does not involve in the operation of the venture) throughout the tenure of the venture. In such a case, his share of profit cannot be more than the ratio of his investment.³⁰² This last position is observed to be adopted by the AAOIFI in its *Shariah* standard where paragraph 3.1.5.3 of *Shariah* standard no.12 read:

In principle, profit percentage should be equivalent to the percentage of the capital share; and partnership parties are entitled to agree on profit percentage different from the capital share, provided that the percentage in excess to capital share should not be assigned to the party who stipulated not to work.³⁰³

²⁹⁸ Accounting and Auditing Organization for Islamic Financial Institutes (n 293) para. 3.1.5.1

²⁹⁹ Usmani, *An Introduction to Islamic Finance* (n 260) 36

³⁰⁰ *ibid* 36-37

³⁰¹ Bank Negara Malaysia, 'Musyarakah' (n 294) para.16.2

³⁰² Usmani, *An Introduction to Islamic Finance* (n 260) 37

³⁰³ Accounting and Auditing Organization for Islamic Financial Institutes (n 293) para. 3.1.5.3

As for the loss distribution, it is unanimously agreed by the jurists that the loss incurred from the investment shall be borne by the partners in accordance to their capital contribution.³⁰⁴ This is due to the fact that loss is the event of capital depletion where a partner is expected to bear only the loss from the portion of his investment. Paragraph 3.1.5.4 of AAOIFI *Shariah* standard no.12 states that:

Loss percentage should be equal to the percentage of capital participation, and it is not permitted to agree that one of the parties should bear the loss or assign loss at percentages different than ownership shares. It is not forbidden, upon realisation of loss, that one party bears the loss without prior stipulation.³⁰⁵

Paragraph 17.1 of the *Musharakah* Regulatory Policy of BNM echoes the similar position by stating “Any loss incurred by the *Musyarakah* shall be borne by the partners proportionate to their capital contribution to the *Musyarakah*”.³⁰⁶ This position is derived from the legal maxim that says, “The profit should be based on the mutual agreement and the loss should be limited to the capital contributed”.

To run a *Musharakah* venture, every partner has the right to take part in its management and to work for it or, upon a mutual agreement, appoint one of them to be the managing partner.³⁰⁷ This is different as compared to *Mudharabah* since, in the latter, the capital provider (*Rabbul Mal*) has no right to participate in managing the business. In this regard, the AAOIFI *Shariah* standard no.12 clearly held that each partner (in *Musharakah*) reserves the right to perform activities within the interest of the business such as purchasing and selling at spot or deferred payment while they need to obtain the permission of partners for actions that entail damages such as giving donation or granting loans.³⁰⁸ In such a case where the partner also acts as the managing partner, he is entitled to an agreed remuneration for his service in addition to his share in profit sharing as a partner.³⁰⁹ Apart from that, it is also permissible for the partners to appoint a third party (non-partner) as the manager. In such a case, the manager is entitled to an assigned remuneration taken from the partnership expense.³¹⁰

³⁰⁴ Ahmad (n 42) 145

³⁰⁵ Accounting and Auditing Organization for Islamic Financial Institutes (n 293) para. 3.1.5.4

³⁰⁶ Bank Negara Malaysia, ‘Musyarakah’ (n 294) para. 17.1

³⁰⁷ Usmani, *An Introduction to Islamic Finance* (n 260) 41-42

³⁰⁸ Accounting and Auditing Organization for Islamic Financial Institutes (n 293) para. 3.1.3.1

³⁰⁹ Noraziah Che Arshad and Abdul Ghafar Ismail, ‘Shariah Parameter for Musharakah Contract: A Comment’ (2010) 1(1) *International Journal of Business and Social Science* 145

³¹⁰ Accounting and Auditing Organization for Islamic Financial Institutes (n 293) para. 3.1.3.3

3.4.3 Dissolution of *Musharakah*

Under the notion of justice, mutual agreement is the key concept in the dissolution of *Musharakah*, it may be dissolved by several ways such as it reaches its maturity (the date of which is already determined in the contract, hence mutually agreed) or by the agreement of all partners *Musharakah* or by actual dissolution of assets should it participate in a specific deal.³¹¹ Any partner may also, without having to close down the partnership, invoke his withdrawal by serving notification of the same to other partners while such action will not have any repercussion on the outstanding dealings.³¹² In the circumstance where the *Musharakah* partnership is decided to be terminated, the underlying asset shall be distributed between the partners on the pro rata basis provided that the capitals are in cash.³¹³ If it is in another form, the mutual agreement among the partners shall determine whether they shall resort to the liquidation or partition of the asset.³¹⁴ On the other hand, if the *Musharakah* is going to continue its course, the staying partners may opt to purchase the leaving partner's share or, in the case where there is a dispute over the share price for instance, the leaving partner may compel the other partners to liquidate or distribute the assets among themselves.³¹⁵

3.5 Application of *Musharakah* in Islamic Finance Product

3.5.1 *Musharakah Mutanaqisah* Home Financing

Currently, there are a number of *Shariah*-compliant products which are structured based on the principles of *Musharakah* for the purpose of extending credit facility (financing) as well as investment and wealth management. One of them is the *Musharakah Mutanaqisah* (diminishing partnership) home financing which becomes one of the alternatives to the conventional method used by the financial institution such as banks in extending the credit facility to their customer for the purpose of property acquiring. As the product's name suggests, it is a *Musharakah*-based product which entails a partnership between the involved parties. However, the second part of the name ie *Mutanaqisah* implies that the product does

³¹¹ *ibid* para. 3.1.6.3

³¹² *ibid* para. 3.1.6.1

³¹³ Usmani, *An Introduction to Islamic Finance* (n 260) 42

³¹⁴ *ibid*

³¹⁵ *ibid* 42-43

not operate in the classical sense of *Musharakah* but instead it involves a certain extension of the original *Musharakah*.

Musharakah Mutanaqisah refers to the partnership entered by two or more parties on a particular asset or venture where one partner has given the other partner the right to redeem, diminish or gradually acquire his share in the partnership during the tenure of partnership in the sense that eventually, the shareholding will be 100 per cent owned by the latter.³¹⁶ From the perspective of the contractual relationship, it differs from the conventional credit facility where, in the latter, the contractual relationship established between the parties involved (for instance, between the bank and its customer) is typically creditor-debtor. However, in the former, the relationships between both parties vary since the whole financing model is built from the combination of two or more distinctive contracts such as the contract of partnership (*Musharakah*), the contract of lease (*Ijarah*) as well as the contract of sale (*Bai*).³¹⁷

The move taken by the IFIs in Malaysia to embrace this structure in their home financing product signifies a positive development of the Islamic finance industry as it implies the departure from the heavy reliance on the debt-based products such as BBA. BBA, which used to be the major product of financing in some countries such as Malaysia, is a facility where the financier (the bank) initially buys the house from the customer (with the price equivalent to the cost of the financing amount) and sells it back to the customer plus of its profit margin.³¹⁸ Although this product is deemed as *Shariah*-compliant, it sparks a controversial debate among the stakeholders as the facility offered appears as not quite departing from what is entailed by the interest-based conventional facility. Instead of charging customer with interest, the bank charges a profit derived from the buy-and-sell contract in which the profit rate is dependent on the market interest due to arbitrage activities. This makes the BBA-based facility converges to the conventional mode where the computational formulas are similar to the conventional and where the profit rate tracks the market interest rate.³¹⁹

More importantly, the BBA-based facility lacks the element of risk sharing which is really important to justify the creation of profit. This is because despite the requirements imposed by the Islamic commercial law for the bank to hold the ownership of the property which entails, inter alia, the inclusion of all liabilities arising such as defects, the bank, as shown by the

³¹⁶ Mohd. Johan Lee, *Legal Documentation for Islamic Banking* (IBFIM 2014) 117

³¹⁷ Hanira binti Hanafi, 'Critical Perspectives on Musharakah Mutanaqisah Home Financing in Malaysia: Exploring Legal, Regulative and Financial Challenges' (Doctoral Thesis, Durham University 2012) 88

³¹⁸ Meera and Razak (n 66)

³¹⁹ *ibid*

BBA documentations is merely a financier which is excluded from all liabilities.³²⁰ As discussed at the early part of this chapter, the wisdom of making *Bai* (sale) as the alternative for *Riba* is because the profit generated from the former incorporates risk taking while the latter, is the action of making a profit by shifting the risk to the counterparty so it will become risk free. Thus, the construction of the BBA contract which eventually resulted in discharging the bank from all liabilities, defeats the very purpose of the *Shariah* as mentioned above ie to embed the risk sharing element in its contract while the brand used which implicates a sale is merely pretentious.

The situation is different in the *Musharakah Mutanaqisah* home financing as compared to the BBA home financing since the former is not a sale contract. Instead, the primary contract underlies its structure is *Musharakah* which is based on partnership (equity). As partners, the bank and the customer jointly own the property in question thus bear the risks arise from the partnership (hence risk sharing) such as loss or damage of the property (due to fire, for instance) which would render impact on their share and profit (or rather loss) they might be entitled to. This situation is different in the BBA home financing where the debt payment to the financier would not be affected under any circumstance, and the risk of the property would be solely borne by the customer.

In addition, the customer (on his capacity as the partner) would periodically make payment to the bank which shall comprise the rental payment and the instalment of unit purchasing. The value of the property under the *Musharakah Mutanaqisah* home financing would always reflect the market price and the rental is determined by the market rental values.³²¹ Such arrangement is contrary to the BBA financing where the selling price in the latter does not reflect the market as the mark-up for the deferred payment is substantial.³²² As such, partners in *Musharakah Mutanaqisah* are exposed to risks such as the fluctuation of the value of the property which will have an impact on the financier's profit (reflected through the rental payment) and overall obligation of the customer. Therefore, the profit generated is duly justified (as a result of the financier's willingness to assume the risk) and appears more genuine as compared to the situation in the BBA financing where the profit is akin to the interest of the conventional interest-based loan where the risk, if any, is negligible.

It is also important to note here that the relationship between the parties involved is partner-partner rather than creditor-debtor. Since *Riba* arises typically from debt, invoking

³²⁰ *ibid*

³²¹ *ibid*

³²² *ibid*

Musharakah Mutanaqisah seems to be promising as it has the appropriate capacity to mitigate the *Shariah* non-compliance risk namely the occurrence of *Riba*. Therefore, it offers a rather genuine product which conforms with the *Shariah* legal injunctions pertaining to risk instead of just replicating and sugar coating the conventional product like in the case of BBA.

The operation of *Musharakah Mutanaqisah* in providing credit facility for the purpose of property acquiring can be divided into three stages namely the formation of *Musharakah*, the execution of *Ijarah* (leasing) contract and the execution of *Bay'* (sale) contract. Initially, the customer identifies the desired property and signs a Sale and Purchase (S&P) agreement with the developer and pays a deposit, for instance, 10 per cent from the selling price of the property. This amount will be considered later on as his contribution to the partnership. Subsequently, he shall approach the bank to apply for the financing. Upon the application approval, both parties (customer and the bank) will enter into a *Musharakah Mutanaqisah* agreement with the bank's contribution will be equivalent to the financing amount applied. Up to this point, the banks and the customer jointly own the property. However, due to the market practice as well as certain legal consequence, only the bank's name or the customer's name will be registered as the legal owner in the title of the property.

Under the first circumstance where the bank is registered as the legal owner, it becomes the registered proprietor of the property, and at the same time, the trustee for the beneficiaries (where it holds the property on trust) and one of the beneficiaries (the other beneficiary is the customer).³²³ The said trust is created and evident by a stamped trust deed and registered under section 344 of NLC 1956.³²⁴ By having this arrangement, the property will be sold in the market in the event of customer's default, the proceeds of which will be shared between the

³²³ Rafe Haneef, Sherin Kunhibava and Edib Smolo, 'Musharakah Mutanaqisah and Legal Issues: Case Study of Malaysia' (2011) 3(1) ISRA International Journal of Islamic Finance 93

³²⁴ Section 344 of NLC 1956 reads:

344. (1) Where, by any instrument of dealing or order of the Court or Land Administrator, any alienated land or share or interest therein is transferred or transmitted to, vested in or created in favour of any person or body "as trustee", or two or more persons or bodies "as trustees", the Registrar shall so describe him, it or them in the memorial of registration.

(2) The proprietor or co-proprietors of any alienated land, and any person or body in whom any share or interest in alienated land is for the time being vested, may apply to the Registrar to be registered in respect of that land, share or interest "as trustee", or, as the case may be, "as trustees", and the Registrar shall give effect to any such application by making the appropriate addition to, or amendment of, the existing memorial of registration.

(3) Where the words "as trustee" or "as trustees" have been included in any memorial of registration pursuant to sub-section (1) or (2), or the corresponding provisions of any previous land law, any instrument declaring the trusts to which the land, share or interest is subject may, upon payment of the prescribed fee, be deposited with the Registrar for safe custody and reference; and no instrument of dealing shall be unfit for registration by reason only of the fact that it refers to any instrument so deposited.

(4) Sub-sections (1) and (2) shall have effect subject to the provisions of section 36 of the Trustee Ordinance, 66 of 1949 (which inter alia provides that, except in the case of any immovable property vested in trustees for charitable, religious or public purposes, the number of trustees of any immovable property shall not exceed four.

beneficiaries after deducting the outstanding cost and payments such as outstanding rents and legal fees.³²⁵ Nevertheless, registering the property under the bank's name is deemed as 'unfavoured' due to two reasons. The first reason is the customer's perception which is shaped by the conventional mortgage practice where the property is always registered under his name.³²⁶ The second reason is the possible liability linked to the property in the event of a torturous claim such as injury or death of a person. In such events, the bank may be held liable should the title show that the legal owner of the property is the bank.³²⁷

Under the second circumstance where the customer is registered as the legal owner, he becomes the registered proprietor of the property, and in the same time, the trustee for the beneficiaries (where it holds the property on trust) and one of the beneficiaries (the other beneficiary is the bank).³²⁸ Under this arrangement, the customer pledges his share over the house to the bank as a security for the performance of his payment obligations. Under his capacity as the trustee, the customer registers a charge over the whole property in favour of the bank although, in theory, the trustee should only charge the customer's share of it, not the bank's share as well. This is due to the requirement imposed by the NCL 1956, particularly section 241(b), which only allows a charge on the whole part of a land rather than a part of it only.³²⁹ In the event where the customer defaults the payment, the bank may sell the charged property; should there is surplus from the sale, it shall belong to the customer while if there is a shortfall, the customer shall be liable to pay for such amount to the Bank based on the

³²⁵ Haneef, Kunhibava and Smolo (n 323)

³²⁶ *ibid*

³²⁷ *ibid*

³²⁸ *ibid*

³²⁹ Section 241 of NLC reads:

241. Powers of charging.

(1) Subject to sub-section (3)-

(a) the whole, but not a part only, of any alienated land;

(b) the whole, but not a part only, of any undivided share in alienated land; and

(c) any lease of alienated land,

may be charged under this Act with-

(aa) the repayment of any debt, or the payment of any sum other than a debt; or

(bb) the payment of any annuity or other periodic sum.

(2) The powers conferred by sub-section (1) shall include power to create second and subsequent charges.

(3) The said powers shall be exercisable in any particular case subject to-

(a) any prohibition or limitation imposed by this Act or any other written law for the time being in force;

(b) any restriction in interest to which the land in question is for the time being subject; and

(c) in relation to leases, the provision thereof, express or implied.

(4) Without prejudice to paragraph (a) of sub-section (3), no charge may be granted to two or more persons or bodies otherwise than as trustees or representatives.

purchase undertaking given earlier.³³⁰ (In Chapter 6, the point of this purchase undertaking shall be re-addressed for further discussion).

The second stage is where the bank will lease its portion, for example, 90 per cent of the property to the customer. Throughout the tenure of leasing, the customer will also buy the units of the bank's share over the property by paying an additional amount in addition to the rental payment. As such, the bank's share will be reduced gradually each time the sale takes place. By the end of the leasing, the customer will own the whole property, and the complete ownership will be transferred to him.

3.5.2 *Musharakah Sukuk*

Another example for the *Musharakah*-based products is *Musharakah Sukuk*. Some regard this particular product as a direct counter product for the bond in the conventional finance. Therefore, they tend to define it as the *Shariah*-compliant bond or simply, Islamic bond. This position is held presumably because both products, in one hand, aim to satisfy the same need namely to mobilise the funds from surplus spending units such as savers (investors) to shortage spending units such as corporations and government.³³¹ However, this simplistic approach has provided an inaccurate understanding due to the fact that both products, despite their similarity in terms of the goal to achieve, structured in different ways resulting in different behaviour and legal consequences. For instance, in the case of bond, the certificate merely serves as a proof of debt obligation issued by the issuer to the bond holder (investor).³³² Throughout the bond tenure, the holder gains his income in the form of face value which is a fixed amount of funds that the issuer is obligated to pay upon the maturity as well as the coupon (interest) which is a fixed amount of funds that the issuer is obligated to periodically pay until the bond is matured.³³³ On the contrary, *Sukuk* is structured in such a way that makes the *Sukuk* holder owns part of the underlying asset of that particular *Sukuk*. This subsequently shall determine to what extent his entitlement to the profit (or loss) of the investment.³³⁴ As such, the contractual relationship established in a bond issuance cannot be other than debtor-creditor. This is dissimilar to the case of *Sukuk* issuance where the

³³⁰ Haneef, Kunhibava and Smolo (n 323)

³³¹ Tahmoures A. Afshar, 'Compare and Contrast Sukuk (Islamic Bonds) with Conventional Bonds, Are They Compatible?' (2013) 9(1) *Journal of Global Business Management* 44

³³² Nafis Alam and others, 'Are Islamic Bond Different from Conventional Bonds? International Evidence from Capital Market Test' (2013) 13(3) *Borsa Istanbul Review* 22

³³³ Afshar (n 331)

³³⁴ Alam and others (n 332)

relationship established may vary depending on the underlying structure used. For example, there is *Ijarah* (leasing) *Sukuk* where the main relationship established between the party who is seeking for the finance and the certificate holder (investor) is lessor-lessee. In *Mudharabah Sukuk*, the relationship established between both parties is project manager (*Mudharib*)—capital provider (*Rabbul Mal*).

Musharakah is one of the contracts which may be used in the *Sukuk* structuring. Through the issuance of *Musharakah Sukuk*, funds are mobilised for establishing a new project, developing an existing one or financing a business activity on the basis of a partnership contract.³³⁵ As such, the certificate holders, rather than merely become the creditors, become the partners (*Shareek*) and own the project or the underlying asset according to their respective shares. As for the issuer of the *Sukuk* (typically although not necessarily a SPV; a special purpose vehicle which is a bankruptcy remote entity set up to fulfil narrow, specific or temporary objectives purpose) will act as the *Wakeel* (agent) to act for and on behalf of the certificate holders or become as one of the *Musharakah* partners, depending on the agreed arrangement.³³⁶ In a typical *Musharakah* arrangement, the capital in the form of monetary (cash) will be contributed by the issuer on behalf of the *Sukuk* holders while the originator or obligor (the party which is seeking for the fund) makes a contribution in-kind, typically the *Musharakah* asset.³³⁷ The issuer then enters into a joint venture with the originator where both parties own the undivided rights over the *Musharakah* assets. All the profits generated (as well as the loss incurred) from the management and operations of the *Musharakah* assets will be distributed based on the pre-agreed ratio. In order for this structure to work within the ambit of a finance arrangement, the originator will give an irrevocable undertaking to purchase the units owned by the issuer by way of declining/diminishing (*Mutanaqisah*) *Musharakah* concept.³³⁸ Via this mechanism, the unit or shares in the *Musharakah* owned by the issuer will be decreasing or diminishing as and when the proceeds generated are paid into the *Musharakah* account, and the issuer collects the periodic distributions to which it is entitled (which makes the originator's shares increase). The originator eventually will obtain full ownership of the units or shares, and the *Musharakah* venture dissolves.³³⁹ One of the

³³⁵ Abdul Ghafar Ismail, 'Sukuk Structure: An International Comparison' (2009) Working Paper in Islamic Economics and Finance No. 1015

<www.academia.edu/4418065/Sukuk_Structure_An_International_Comparison> accessed 13 September 2018

³³⁶ *ibid*

³³⁷ Securities Commission Malaysia, *Sukuk* (Abdulkader Thomas ed, Sweet & Maxwell Asia 2010) 189

³³⁸ Muhammad al-Bashir Muhammad al-Amine, 'Sukuk Market: Innovation and Challenges' (2008) 15(2) *Islamic Economic Studies* 14

³³⁹ Securities Commission Malaysia (n 337) 191

examples of such arrangements is the *Musharakah Sukuk* issued in 2006 by Kuala Lumpur Sentral Berhad (KLSBB).

Briefly, in this case, KLSBB forms a *Musharakah* venture with the investors (which were represented by KLSBB as their agent and initial trustee) where KLSSB contributes the capital in-kind (valued at RM254) to the *Musharakah* Venture and the Investors provides the required capital of up to RM720 million in cash which makes their respective stake 26:74. Concurrently with the execution of the *Musharakah* agreement, KLSSB on its capacity as the agent to the Investors issues certificates (*Sukuk*) to the Investors. The *Sukuk* represents the Investors' undivided proportionate interest in the *Musharakah* Venture. KLSSB was also appointed as the Manager for the *Musharakah* venture.³⁴⁰

Profits generated by the *Musharakah* Venture is calculated and distributed at the end of every six-month intervals between KLSBB and the Investors on the basis 99:1 where the entitlement of Investors to be capped at RM1,000 per annum. The Investors had agreed to waive any amount in excess of RM1,000 such surplus shall be payable to KLSSB (as the management fee).³⁴¹ By using its portion of profit or repayment proceeds of its advances to the *Musharakah* Venture or both (as the case may be) KLSSB also purchases the *Sukuk* holders' share in the *Musharakah* Venture in accordance with a pre-agreed six monthly schedule as evidenced by a deed of undertaking hence causing the investors' stakes to diminish gradually.³⁴²

The dissolution of *Musharakah* venture can also take place in such a way where the originator gives an irrevocable undertaking to purchase entire *Musharakah* units during the *Sukuk* maturity or in the event of default. However, this purchase undertaking should not be based on the exercise price calculated by referring to the face value of the *Sukuk* as this will tantamount to capital guarantee and therefore, jeopardising the idea of risk sharing (more on the issue of capital guarantee in Chapter 5). Rather, it should be based on the net asset value, market value, cash equivalent value or any price agreed upon at the time of purchase.³⁴³ The issuance of *Sukuk* programme up to RM370 million in nominal value by Putrajaya Holdings Sendirian Berhad (PjH) is among the issuances where the structure contained the purchase

³⁴⁰ Principle Terms and Conditions of the Proposal by Kuala Lumpur Sentral Sdn. Bhd.
<<http://issuance.sc.com.my/MemberAccessIssuance/documents/view-file/2383>> accessed 24 September 2018

³⁴¹ *ibid*

³⁴² *ibid*

³⁴³ Securities Commission Malaysia (n 337) 205

undertaking which causes the originator to purchase the entire *Musharakah* units (rather than gradually like in the case of KLSSB) once triggered.

The *Sukuk* was issued for the purpose of PjH's *Shariah* compliant financing to Putrajaya Management Sdn Bhd for the construction cost and working capital purposes in relation to the development of the Ministry of International Trade and Industry building. Its tenure shall be more than one year and up to 15 years given it reached its maturity on or prior to the expiry of the *Sukuk Musharakah* programme.³⁴⁴

In this case, the *Sukuk* holders (Investors) shall from time to time form a *Musharakah* arrangement with the PjH (the issuer and the obligor/originator as well) to invest in trust assets, which in this case, refer to PjH's business of leasing and sub-leasing of two lots of a building in Putrajaya by entering into a *Musharakah* agreement as partners. PjH will also act as the asset trustee where it holds the trust assets for the benefit of the *Sukuk* holders and itself via a declaration trust.³⁴⁵ As for the capital contribution, the *Sukuk* holder will contribute capital in the form of cash whereby the issuer will contribute the trust asset as the capital in kind.³⁴⁶

The certificate (*Sukuk*) issued by the Issuer to the investors represent the *Sukuk* holders undivided proportionate interest in the venture. Both of the Issuer and the Investors will be sharing the profits generated from the venture based on a fixed profit-sharing ratio. The losses, on the other hand, shall be borne by the Issuer and the Investors in proportion to their respective interest in the venture and limited to each capital contribution to the venture. Since this is a programme which contains a number of tranches of issuance, the expected profit rate/rates will be determined at the point of issuance of the respective *Sukuk*.³⁴⁷ In the occasion where the distributable profits generated from a venture is more than the relevant expected payment (which is calculated based on the expected profit rate), the surplus will be retained by the Manager of the venture (in this case, PjH also) as the incentive fee. However, if the distributable profits do not meet the relevant expected payment, the obligor shall make the top-up payments, the amount of which shall be equal to such deficiency as an advance which will be set-off against the exercise price during *Musharakah* dissolution.³⁴⁸ The profit

³⁴⁴ Principle Terms and Conditions of Proposed Sukuk Musharakah Programme by Putrajaya Holdings Sdn. Bhd. <<http://issuance.sc.com.my/MemberAccessIssuance/documents/view-file/4597>> accessed on 27 March 2017

³⁴⁵ *ibid*

³⁴⁶ *ibid*

³⁴⁷ *ibid*

³⁴⁸ *ibid*

will be paid on the semi-annual basis or any other date as may be agreed. The profit may also be distributed on the one-off basis for *Sukuk* which does not have periodic distribution.³⁴⁹

This *Musharakah* venture will be dissolved once the respective *Sukuk* reaches its maturity or during the occurrence of any triggering factors deemed as the 'Dissolution Events' (such as the failure of the issuer to pay due amount or to perform its obligation under any of relevant circumstance). In such circumstances (whichever takes place earlier), PjH, in its capacity as the obligor shall purchase the relevant *Sukuk* holders' undivided proportionate interest in the trust assets by invoking the purchase undertaking given earlier.³⁵⁰ This will be done at a price, commonly referred as the 'Exercise Price', determined in the manner as provided in that purchase undertaking.

It is important to note in this regard, however, that the application of the purchase undertaking mechanism in *Musharakah Sukuk* is rather controversial among the scholars and practitioners of Islamic finance since such application might jeopardise the idea of risk sharing which is supposed to be the essence of this type of *Sukuk*. Through the purchase undertaking clause, the issuer secures its right to buy back the right over the underlying asset (*Sukuk* asset) upon the maturity of the *Sukuk*, for instance.³⁵¹ By repurchasing the underlying asset, the contract relating to *Sukuk* is dissolved in such a way where the issuer buy the *Sukuk* while the investors recover their principal amount.³⁵² As such, a prominent contemporary scholar by the name Taqi Al-Uthmani has criticised the practice of giving purchase undertaking at nominal value (face value), particularly in *Musharakah Sukuk* as not in line with *Shariah* since it is tantamount to guaranteeing the principal amount to the investors.³⁵³ Such arrangement therefore goes against the concept of risk sharing as established earlier. In addressing the said concern, AAOIFI had issued a ruling by which disapproves the practice of giving purchase undertaking at nominal value. Instead, such undertaking must be based on market value or at a price to be agreed on at the sale timing.³⁵⁴ Nevertheless, in other jurisdiction like Malaysia, purchase undertaking at nominal value is still allowed until the present days.³⁵⁵

³⁴⁹ *ibid*

³⁵⁰ *ibid*

³⁵¹ Khairun Najmi Saripudin and others, 'Case Study on Sukuk Musharakah Issued in Malaysia' (2012) 12 (2) Middle-East Journal of Scientific Research 168

³⁵² *ibid*

³⁵³ Muhammad Taqi Usmani, 'As-Sukuk wa Tatbiqotuha al-Mu'asirah' (*Kantakji*) <<https://kantakji.com/media/8028/m191.pdf>> accessed 27 November 2018

³⁵⁴ Takao Moriguchi and others, 'Contemporary Practices of Musharakah in Financial Transactions' (2016) 3 (2) International Journal of Management and Applied Research 65

³⁵⁵ *ibid*

3.6 Conclusion

The discussions in the first two chapters (Chapter 1 and Chapter 2) had set the scene for the subsequent discussions by laying down the foundations to the answers of the research questions. It is established that risk sharing is at the heart of Islamic finance for its existence is essential in every commercial dealing with the aim to generate profit. It is also asserted that *Musharakah* is among the main business models endorsed by the Islamic commercial law which can demonstrate the implementation of risk sharing as propogated by *Shariah*. Therefore, the discussion in this chapter (Chapter 3) meant to demonstrate how the idea of risk sharing is being operationalised through *Musharakah*.

Upon establishing the basis for the partners' entitlement to *Musharakah* profit which led to the deliberation pertaining to the valid forms of *Musharakah*, the discussion of this chapter addressed the salient requirements on *Musharakah*. It presented three requirements imposed on *Musharakah* pertaining to the nature of capital, the profit and loss distribution and the dissolution of *Musharakah*.

The first requirement is pertaining to the nature of capital. In this regard, the jurists are divided into three groups; the ones who disallow the capital other than in monetary form, the ones who allow the capital to be in monetary form and otherwise (in-kind) and the ones who allow the capital to be in monetary form and in-kind provided the latter can be replaced with the similar thing instead of compensating the value should it damage. The differences among the jurists on this point are due to their concern of the existence of the element of *Gharar* (uncertainty) which may go against the interest of justice and lead to the dispute among partners. In the case where the capital is not in monetary form (inkind) and the *Musharakah* venture is to be terminated, the existence of the capital as well as its value is uncertain as it may have been sold or the value of commodity fluctuates at the point of time where the redistribution to the partners is sought due to the termination. In addition, since the loss ratio distribution need to correspond to the percentage of capital contribution, the uncertainty in terms of capital value (due to the value which keeps fluctuates, for instance) may also cause injustice and difficulty to determine the right portion of loss for the partners. Apparently, the opinion held by the second group of jurists (participation with in kind capital is permissible) is more practical in fulling the need of modern business nowadays thus adopted by various standard setting bodies like AAOIFI and BNM. To mitigate the concern on the existence of *Gharar* thus ensuring *Musharakah* to uphold the justice as required by *Maqasid Al-Shariah*,

they stipulated that the valuation of the in kind capital in its cash equivalent must be agreed upon by all partners.

The second requirement is pertaining to the profit and loss distribution. This requirement is the most essential requirement in this regard as it does not only involve the issue of justice but also the issue of risk sharing directly. In order to ensure fairness, it is required in *Musharakah* for the ratio of profit sharing to be determined up (stipulated in the contract) to eliminate Gharar. Furthermore, for the purpose of operating risk sharing, it is also required for the share of profit to be in the form of an undivided percentage of the overall profit rather than a sum of money or a percentage of the capital. This is important as the adherence to which will ensure that the entitlement to the profit is reflecting the actual performance of the business and the risk is genuinely shared among the partners. However, the jurists hold different views on the profit rate; whether the profit rate should correspond to the percentage of the capital contributed or it may vary based on the agreement between the stakeholders.

As for the loss, they unanimously agreed that it should be proportionate to the capital contributed since loss is the event of capital depletion where a partner is expected to bear only the loss from the portion of his investment. In addition, since the partners of *Musharakah* may participate in the venture's management and work (unlike in *Mudharabah* where the capital provider has no right to such), they may be appointed as the managing partner. In such a case, the managing partner is entitled to an agreed remuneration (as the consideration for his work) in addition to his profit share, the entitlement of which due to his exposure to the risk of investment (if a third party is appointed as the manager, his fee shall be taken from the partnership's expenses).

The third requirement is pertaining to the dissolution of *Musharakah*. To ensure fairness, mutual agreement is the key concept in the dissolution of *Musharakah* as it may be dissolved through several ways such as it reaches its maturity (the date of which is already determined in the contract) by the agreement of all partners, or by serving a withdrawal notice from the quitting partner. Upon the dissolution, the *Musharakah* asset shall be distributed between the partners on a pro rata basis provided that the capitals are in the form of cash. If it is in another form, the mutual agreement among the partners shall determine whether they have to resort to the liquidation or partition of the asset. On the other hand, if the *Musharakah* is going to continue its course while some partner is leaving, the staying partners may opt to purchase the leaving partner's share. In the circumstance where there is a dispute over the share price, the leaving partner may compel the other partners to liquidate or distribute the assets among themselves.

The way *Musharakah* concept is being applied thus operating the idea of risk sharing can also be observed through two *Musharakah*-based products namely the *Musharakah Mutanaqisah* home financing and *Musharakah Sukuk*. In the case of *Musharakah Mutanaqisah* home financing, rather than operating the debt-based financing (such as the BBA home financing) in which the financier becomes the creditor while the customer is the debtor, it operates the equity-based financing where both are considered as partners whom the property in question is proportionally belong to. As such, they bear the risks that would arise from the partnership (hence risk sharing) such as loss or damage of the property (due to fire, for instance) which would render impact on their share and profit (or rather loss) they might be entitled to. This situation is different in the BBA home financing where the debt payment to the financier would not be affected under any circumstance, and the risk of the property would be solely borne by the customer.

In addition, the customer (on his capacity as the partner) would periodically make payment to the bank, the amount of which shall comprise the rental payment and the instalment of unit purchasing. The value of the property under the *Musharakah Mutanaqisah* home financing would always reflect the market price and the rental is determined by the market rental values. Such arrangement is contrary to the BBA home financing where the selling price in the latter does not reflect the market as the mark-up for the deferred payment is substantial. As such, partners in the *Musharakah Mutanaqisah* home financing are exposed to risks such as the fluctuation of the value of the property which will have an impact on the financier's profit (reflected through the rental payment) and overall obligation of the customer. Therefore, the profit generated is duly justified (as a result of the financier's willingness to assume the risk) and appears to be more genuine as compared to the situation in BBA financing where the profit is akin to the interest of the conventional interest-based loan where the risk, even if it exists, is negligible.

The operation of risk sharing can also be observed vividly in the structure of *Musharakah Sukuk*. Through the issuance of *Musharakah Sukuk*, funds are mobilised for establishing a new project, developing an existing one or financing a business activity on the basis of partnership. Unlike in the case of conventional bond where the bond holders merely serve as the creditors, the *Sukuk* holders in *Musharakah Sukuk* are partners in the venture and have the undivided proportionate ownership of the *Musharakah* asset (the venture). As for the issuer of the *Sukuk* (typically, although not necessarily, a SPV), it will act as the Wakeel (agent) to act for and on behalf of the certificate holders or become as one of the *Musharakah* partners, depending on the agreed arrangement. In a typical *Musharakah Sukuk* arrangement, the

capital in the form of monetary (cash) will be contributed by the issuer on behalf of the *Sukuk* holders while the originator or obligor (the party which is seeking for the fund) makes an in-kind contribution, typically the *Musharakah* asset. The issuer then enters into a joint venture with the originator where both parties own the undivided rights over the *Musharakah* assets (and share the risk of the venture as well). All the profit generated (as well as the loss incurred) from the management and operations of the *Musharakah* assets will be distributed based on the pre-agreed ratio.

It is obvious from the arrangement as mentioned above that the *Musharakah Sukuk* entails a different risk profile from what a conventional bond does. Since the *Sukuk* holders are not merely creditors but partners instead, their gain will depend on the performance of the venture; they shall be entitled to the profit based on the pre-agreed ratio or they have to bear the loss in proportionate to their capital contribution. Such arrangement, therefore, exemplifies risk sharing in such a way where the partners (including the issuer of the *Sukuk* in the case where it is also one of the partners) are collectively exposed to the risk (hence risk sharing) rather than expecting the fixed coupon payment irrespective of the performance of the venture like in the conventional bond.

This study, therefore, asserts that the ability of *Musharakah* as a business model to promote justice and operate the idea of risk sharing is visible through the requirements imposed on *Musharakah* as well as the operation of *Musharakah* through the *Musharakah Mutanaqisah* home financing and the *Musharakah Sukuk* as discussed in this chapter. This should be answering the first research question (the first subsidiary research question); how does *Musharakah* help to operationalise the idea of risk sharing?

Chapter 4. The Malaysian Legal System

4.1 Introduction

Notwithstanding the foundation of Islamic finance is the *Shariah* which makes it universal in terms of its basic understanding (like impermissibility to conduct business which involves *Riba* and *Gharar*) and the fundamental spirit it aspires to safeguard (such as serving the justice) from the perspective of legal and regulatory framework, the law pertaining to the Islamic finance businesses varies depending on the jurisdiction in which such businesses take place. It can be observed that *Shariah*, in this respect, plays a diverse role. In some jurisdictions such as Afghanistan, Bahrain, Iran, Pakistan, Saudi Arabia and Sudan where *Shariah* is the fundamental law of the land (or, at least, a key source of the law of the land), it represents a significant part of the framework imposed to govern the Islamic finance matters. Nevertheless, in some other jurisdictions, *Shariah* does not constitute part of the applicable governing framework.³⁵⁶ The case of *Beximco Pharmaceuticals Ltd & Ors* as referred earlier in Chapter 1 exemplifies how the *Shariah* does not carry much significance in the eyes of the law. Although the case in question is the case of Islamic finance and the agreement involved clearly provided that reference should be made to, inter alia, the *Shariah*, the British court had disregarded the provision and what it had implied. Instead, it built its judgement solely in accordance with the relevant English law.

This chapter explains the Malaysian legal framework with the focus on the position of Islamic finance within its jurisdiction. The Malaysian legal system is interesting in this respect as it recognises the *Shariah* as one of its integral branches although, in general, the country adopts the English common law system. English law which includes the common law, rules of equity and legislation is the predominate source of the Malaysia law and remains the source and one of the greatest contributors to the Malaysian jurisprudence until today.³⁵⁷ However, this duality of legal system poses, to a certain extent, complexity in cases where the *Shariah* and English law are concurrently involved like in the Islamic finance cases. Other than the uncertainty in the governance framework as highlighted in Chapter 1, the complexity is also reflected by the attitude shown by the court while interacting with the Islamic finance cases (further elaboration on this point at the latter part of this chapter). Since this study is to

³⁵⁶ Inwon Song and Carel Oosthuizen, *Islamic Banking Regulation and Supervision: Survey Results and Challenges* (International Monetary Fund 2014) 7

³⁵⁷ Abdul Hamid Mohamad and Adnan Trakic, 'The Reception of English Law in Malaysia and Development of the Malaysian Common Law' (2015) 44(2) *Common Law World Review* 123

examine one of the Islamic finance products, namely *Musharakah* from the legal and regulatory perspectives, the discussion in this chapter holds its significance by clarifying the juridical boundary within which this study takes place. It begins by considering the statutory basis of the reception of English law in the Straits Settlements as well as in the other parts of Malaysia (the Federated Malay States, the Unfederated Malay States and Sarawak and Sabah – States of Borneo). As shall be explained later, the reception methods vary (either via the doctrine of reception or the doctrine of transformation) although both eventually lead to the same effect ie the application of English Law in Malaysia.

Following the discussion as mentioned above is the discussion pertaining to the application of English Law in Malaysia by virtue of section 3 and section 5 of the Civil Law Act 1956 (CLA 1956; section 3 provides the general application of English law whereby section 5 provides the application of English law in commercial matters. The step taken here further emphasises the significant position which English law holds in the Malaysian legal system. Subsequently, the attention shall be drawn to the current legal landscape with the preliminary focus on the Federal Constitution 1957 (FC 1957) as the apex law for the country. The power separation between the Federal and the states in it as demonstrated through the FC 1957 has caused the Islamic finance matters to be the subject under the purview of the civil courts rather than the *Shariah* courts; both types of court are established and vested with powers as described in the First and the Second List of the Ninth Schedule of the FC 1957.

Finally, the discussion in this chapter shall look at a few cases which had been brought before the courts to illustrate the way the courts look into them. The conclusion from this exercise, together with the outcome from the previous discussions in this chapter shall prepare the readers with the reality of legal and regulatory held within the Malaysian jurisdiction pertaining to the matters related to Islamic banking and finance where *Musharakah* is one of them.

4.2 The Reception of English Law Through the British Colonisation

The examination of the historical events that finally had caused the reception of the English law in the local law of Malaysia starts by looking at the three geographical segments of Malaya (as Malaysia was then known) namely the Straits Settlements³⁵⁸ (which mainly

³⁵⁸ Straits settlements were a group of British territories located in South East Asia. Established in 1826, these settlements under the administration of East India Company, a company founded for the purpose of trading monopoly in South East Asia, East Asia and India. For further information, refer to Lennox Algernon Mills and

consist of Penang, Singapore and Malacca), the States of Borneo (Sarawak and Sabah) and the Malay States. The reading should go back to – at least – as early as 1780s when Captain Sir Francis Light of East India Company (the Company) landed in the ‘Prince of Wales Island’ (the then Penang) with a garrison of marines on 15 July 1789 even though the connection between the British empire and Malaya had begun by individual and trading ventures much earlier than that ie circa 1576 to 1684.³⁵⁹ Formed in 1600 and received a Royal Charter for fifteen years from the English Crown, the Company’s principal objective was to trade thus made its connection with Malaya was entirely non-political at the beginning although starting from 1684 onwards the political considerations had become part of its overall objective.³⁶⁰

4.2.1 Penang

Penang was the first territory of Malaysia to be occupied by the British empire in the mission of extending its domain towards South East Asia.³⁶¹ Formerly belonging to Kedah (also spelt as Quedah), it was ceded from the Sultan (Ruler) of Kedah who asked, in exchange, for British protection in the event that his state was attacked by Siam (as Thailand was then called). However, the British had ignored this request which made the Sultan felt betrayed thus attempted to retake the possession of Penang in 1791.³⁶² As the attempt failed, he was forced to enter into a new treaty with the British by which the cession of the island was confirmed in return for 6000 dollars as the pension for the Sultan thus marked the beginning of the era of British colonialism in Malaysia.³⁶³

The introduction of the Royal Charter of Justice in 1807 (First Royal Charter) marked the beginning of the statutory introduction of English law into the land. It is through this First Royal Charter the Court of Judicature of Prince of Wales’ Island had been established with the jurisdiction in all civil, criminal and ecclesiastical matters.³⁶⁴ At this juncture, an interesting question arises regarding the status of Penang; whether it was a settled colony or rather a ceded colony. The answer to this question is significant as it will determine the nature

Chares Otto Blagden, ‘British Malaya 1824 – 1867’ (1925) 3(2) Journal of the Malayan Branch of the Royal Asiatic Society 1.

³⁵⁹ Salleh Buang, *Malaysian Legal History: Cases and Material* (2nd edn, Dewan Bahasa dan Pustaka (DBP) 2015) 3

³⁶⁰ *ibid*

³⁶¹ Rau and Kumar, *General Principles of the Malaysian Legal System* (International Law Book Services 2008) 33

³⁶² *ibid*

³⁶³ *ibid*

³⁶⁴ *ibid* 34

of the law of the land (*lex loci*) at the time of the establishment of the colony. It is argued that originally Penang was *terra nullius* (land without sovereignty). As such, English law was introduced to the island by virtue of the doctrine of reception founded in the English common law which entails the application of the English law to the newly colonised English territories (hence settled) if they were found ‘uninhabited ‘or ‘infidel’ (against the law of God).³⁶⁵

Nevertheless, the claim that Penang was *terra nullius* is rather contentious. Some are of the opinion that Penang was inhabited at the time of British occupation based on the records found in the register of surveys dated 1975 which indicate that the island was inhabited by the Malay population as early as 1705.³⁶⁶ With regard to the governing legal system, there is no concrete evidence, however, to indicate what law was applied in the island except one could speculate that it followed the Kedah’s law.³⁶⁷ The proponent of this view, therefore, does not concur with the claim asserting that the introduction of English law to the Straits Settlements through Charters of Justice is grounded in the doctrine of reception.

In this respect, Sir Benson Maxwell R, in his judgement for the case of *Reg v Willans*³⁶⁸ said that when Francis Light together with his garrison came to Penang, they did not come as colonisers but rather to possess a ceded island. As such, the English Law could only become the personal law of the garrison members. Nevertheless, it is also held in the same time that the law of Kedah³⁶⁹ could not apply to Penang due to the fact that during the time, it became a British possession, there are no inhabitants in the island to claim the right of being governed by the existing laws nor tribunals were in existence to enforce any. Concerning the First Royal Charter, Sir Maxwell commented that there is no law akin to it that was introduced simultaneously and the Charter directed the Court to ‘give and pass judgement and sentence according to justice and right’ which indicated a direction to the court to apply the law of England.³⁷⁰

In the case of *Ong Cheng Neo v Yeap Cheah Neo & Ors*,³⁷¹ it is held by the Privy Council that the question whether Penang was a ceded or settled territory is immaterial in this regard. This is due to the fact that there was no traces of any laws having been established there before it was acquired by the British. As such, in either view, the law of England is to be taken as the

³⁶⁵ Mohamad and Trakic (n 357)

³⁶⁶ *ibid*

³⁶⁷ *ibid*

³⁶⁸ [1858] 3 Kyshe 16

³⁶⁹ It was argued by the Attorney General for the plaintiffs in the case of *Fatimah & Ors v Logan & Ors* that ‘Mohammedan law’ (Shariah) was the law of Kedah as its ruler is a ‘Mohamedan’ (Muslim).

³⁷⁰ Salleh Buang, *Malaysian Legal History: Cases and Material* (2nd edn, Dewan Bahasa dan Pustaka (DBP) 2015) 5

³⁷¹ [1872] 1 Ky 326

lex loci so far it is applicable to the circumstances of the place and modified in its application by these circumstances.

Through the series of promulgation of the Royal Charters, English Law had escalated into a dominant position over the Straits Settlements. Not only the Royal Charters were vested with the retrospective effect, but the religions and the customs would also have been considered insofar they were consistent with the principles of common law and the notion of justice as promulgated by the common law. The retrospective effect of the First Royal Charter was demonstrated in *Kamoo v Bassett*.³⁷² This is the case in which the plaintiff filed an action for assault, battery and false imprisonment against the defendant who was his ex-employer and claiming damages for 600 dollars. In June 1806, the plaintiff who is a native of Bengal had agreed to be employed as a table-servant in Penang by the defendant who was a Lieutenant-Colonel of 10th Regiment, Bengal Native Infantry with 6 dollars per month as salary. The relationship between them turned sour as the plaintiff had been severely ill-treated by the defendant such as been whipped 20 times with a rattan by order of the defendant on 20 July 1807. The defendant also had ordered the plaintiff to be brought into the Grand Parade and caused the plaintiff to be tied up to a stake and had him whipped 100 times with a cat-of-nine-tails. He then placed the plaintiff under confinement for two and a half months before dismissing him from service.

The trial Recorder, Stanley R, in his judgement affirmed the retrospective effect of the First Royal Charter. Even though the injury was inflicted before the promulgation of the First Royal Charter and before the establishment of the Court of Justice, it was extended to civil injuries which have been sustained as well to crimes that have been committed before the Charter. The court held the defendant liable and gave the verdict in favour of the plaintiff—150 dollars with costs (the amount granted was smaller than what had been prayed since, according to the Recorder, the law might not be so generally known at that time).

In the circumstance where the Islamic law is conflicting with the English law, the latter shall prevail as per the court's decision of *In the Goods of Abdullah*.³⁷³ This case was about the application to set aside the granted administration to the widow of Abdullah (the deceased) as well as to admit an alleged will to probate. Abdullah, a Muslim who died in Penang devised all of his property by a will whereby according to the Islamic law, a Muslim can only devise his property to non-beneficiaries (legal-heirs) up to one-third of the entire estate. In its

³⁷² [1808] 1 Ky 1

³⁷³ [1835] 2 Ky 8

decision, the court held that the will was valid as it conformed to the English even though the involved parties are Muslims and the will was contrary to the *Shariah*.

The Recorder for the trial, Malkin R, commented that he was bound by the uniform course of authority to hold that the introduction of the First Royal Charter into the settlements had introduced the existing Law of England.³⁷⁴ He also added that it would be very difficult to prove the existence of any definite system of law which was applied prior to the English's occupation and any man who wishes to devolve his estate according to any different law has to express the same clearly and the court will be bound to ascertain that law and apply it for him.³⁷⁵

Although the deciding Recorder had mentioned that it would be really difficult to claim any other system of law as the law for Penang before the occupation of the British ie before the promulgation of the First Royal Charter as mentioned above, there was an attempt to claim that prior to the promulgation of the First Royal Charter, the applicable law in Penang was the *Shariah*. In the case of *Fatimah v Logan*,³⁷⁶ where the issue brought before the court was to determine what was the applicable law in determining the validity of the will, it is submitted by the Attorney General, on behalf of the plaintiff that the validity of the will should be determined according to the *Shariah*. This submission was justified by him based on, inter alia, the ground which claims that before the promulgation of the First Royal Charter, the *Shariah* was in force in Penang. The Charter, according to him, made no alteration on this respect since Penang was part of Kedah's territories and its Sultan was a Muslim. Therefore, the *Shariah* should continue to be in force until there is evidence to back its alteration by the competent authority. Hackett J, in his judgement for this case, however, disagree with this theory which he regarded as 'untenable' due to the fact that Penang was an uninhabited and was 'occupied and settled by British subjects in the name of King of England'. From his point of view, the case, therefore, would seem to fall to the general rule of the settled colony—the English settlers brought with them the law of England.³⁷⁷ Affirming that the First Royal Charter had finalised the answer to the question of the *lex loci* of Penang, he, therefore, stating that – at least – by the introduction of the Charter in 1807, the law of England had become the law of the land and all who settled there became subject to this law. Hence, the capacity to make a will must be decided by the English law instead of the *Shariah*.

³⁷⁴ Buang (n 370) 10

³⁷⁵ *ibid*

³⁷⁶ [1871] 1 Ky 255

³⁷⁷ Buang (n 370) 16

4.2.2 Malacca

As for Malacca, another territory of the Strait Settlements, the legal scene at the time of its cession to the British was different from what had been witnessed in Penang. As explained above, the English law which eventually became the law in Penang either due to its status as a settled colony or because of the absence of any known laws established there prior to the British occupation (as per mentioned by Malkin R in *In the Goods of Abdullah*). However, in the case of Malacca, the law applicable at the time of its transfer to the British was the Malay customary law (known as *adat*), Muslim law (*Shariah*), customary law of other local non-Malay inhabitants and certain Dutch laws.³⁷⁸

Before the arrival of British in 1825, Malacca was colonised by the Portuguese starting from 1511 and subsequently, followed by the Dutch starting from 1641. During this period until the end of Dutch era in Malacca, there was a time interval where the British took temporary possession of Malacca in 1795 before it was re-occupied by the Dutch in 1818. During this temporary possession, the British did not pay much attention to the reorganisation of Malacca's administration whereby the in-charge officer was merely empowered to execute the proceedings of the Dutch Council of Justice without any changes in principle.³⁷⁹ In 1824, the British and the Dutch entered into the Anglo-Dutch Treaty (also known as the Treaty of London) which had caused the British to take permanent possession of Malacca in 1825. It was only then they started to establish the regular administration of law.

The Second Royal Charter of Justice (Second Royal Charter) was granted in 1826 to establish the Court of Judicature of Prince of Wales, Singapore and Malacca. This effectively had extended the jurisdiction of English law from Penang to Malacca (and Singapore as well). As mentioned earlier, Malacca is different as compared to Penang since the former was a ceded colony with a firmly entrenched *lex loci* in existence and therefore, must continue to be applied to the local population until it is determined otherwise by means of a new legislation providing to the contrary.³⁸⁰

³⁷⁸ Rau and Kumar (n 361) 36

³⁷⁹ Ahmad Ibrahim and Ahilemah Joned, *The Malaysian Legal System* (Dewan Bahasa dan Pustaka (DBP) 1987) 20

³⁸⁰ Buang (n 359) 37

4.2.3 States of Borneo (Sarawak and Sabah)

In the case of Sabah and Sarawak, English law was introduced to the lands against a different legal and political backdrop as what had been witnessed in other parts of Malaysia. The issue of uncertainty concerning their *lex loci* has never arisen neither the presence of foreign powers such as Portuguese and Dutch.³⁸¹ Prior to the application of the English law in these lands, the laws applicable were the *Shariah*, the native law as well as the custom so far as reasonable.³⁸² Sarawak, Sabah, parts of the Philippines and Indonesian Borneo were once under the domain of the Sultan of Brunei. In order to overcome the civil revolt, the *Bendahara* of Brunei met James Brooke³⁸³ and asked for his assistance for which, in return, he would appoint him as the Governor of Sarawak. Brooke managed to resolve the problem and became the first ‘White Rajah’ of Sarawak 1841. In 1843, he took the first step in legislating the law by preparing, printing and publishing eight sets of law providing for the punishment of murder, robbery and any other serious crimes as well as permitted all men to trade or labour according to their pleasure and to enjoy their gains and protected the native from exploitation but otherwise permitted freedom of trade and traffic.³⁸⁴ Later in 1888, both Sarawak and Sabah (Sabah was known as North Borneo then) became British protectorates.

Unlike in the Straits Settlements where the application of English was extended by virtue of the Royal Charters (via the doctrine of reception), a formal endorsement by an act passed by the parliament for the application of English law into Sarawak and Sabah was needed.

Amongst these two, Sarawak was the first to pass a formal law endorsing the application of English Law in 1928 by the passing of Order L-4, or Law of Sarawak Ordinance 1928 by the British administration.³⁸⁵ In the case of *Kho Leng Guan v Kho Eng Guan*³⁸⁶ English law was acknowledged as one of the threefold legal sources in Sarawak. In this case, the question brought to the court was to determine what law to be applied in a contractual relationship between two Chinese brothers in regard to a joint family house. After the decease of their mother, both of them had a quarrel over the right of the property. In his contention, the

³⁸¹ *ibid* 193

³⁸² Ibrahim and Joned (n 379) 30

³⁸³ James Brooke, born on 29 April 1803 at Secore in the suburbs of Benares, was a lieutenant in Bengal army of East India Company. He was involved in the first Burmese War in 1824 where he was injured badly. After resigning from the military, he became an adventurer whose exploits in the Malay Archipelago which eventually led him to involve with the political struggle of the Sultanate of Brunei. For further information, read Steven Runciman, *The White Rajah: A History of Sarawak from 1841 to 1946* (Cambridge University Press 2011).

³⁸⁴ Rau and Kumar (n 361) 38

³⁸⁵ Section 2 of the Ordinance provides: The law of England, in so far it is modified by Ordinance enacted by the Governor with the advice and consent of the Council Negeri, and in so far it is applicable to Sarawak having regards to native customs and local conditions, shall be the law of Sarawak.

³⁸⁶ [1936] SCR 60

respondent claimed that this case should be decided by the Chinese custom. The trial judge however disagreed. In his judgement, he emphasised that the material legal sources of the law of Sarawak are as follows³⁸⁷:

- a) Orders and other written laws enacted by or with the authority of His Highness the Rajah.
- b) English law in so far as it is not modified by the law comprised in (1) and in so far as it is applicable to Sarawak, having regard to native customs and local conditions.
- c) Certain laws and customs of the races indigenous to Sarawak, including *Mohamedan law (Shariah)* and other native law or custom in so far as it is reasonable.

As for Sabah, Civil Law Ordinance 1938 was passed to formally introduce the English law to the State where its main content was pretty much the same with the Law of Sarawak Ordinance 1928.³⁸⁸ In 1949, the British introduced the Sarawak Application of Law Ordinance and the North Borneo Application of Law Ordinance (the latter was for Sabah) was introduced in 1951, and these two new sets of law abolished the Law of Sarawak Ordinance 1928 and Civil Law Ordinance 1938 respectively. These new ordinances provide that the common law of England and the doctrine of equity, together with statutes of general application as administered or in force in England at the commencement of the Ordinance shall be the law in Sarawak or Sabah (as the case may be) insofar the circumstances of Sarawak and Sabah and its inhabitants permit and subject to such qualifications as local circumstances and native customs render necessary.³⁸⁹

4.2.4 Malay States

The third segment (after Straits Settlements and Borneo States ie Sarawak and Sabah) of Malaysia which needs to be looked at is the Malay states. These states can be divided into two categories, namely the Federated Malay States (FMS) and the Unfederated Malay States (UFMS). The FMS comprises Perak, Selangor, Negeri Sembilan and Pahang were administered under the advice of the British resident by virtue of the treaty entered by the

³⁸⁷ Buang (n 359) 199

³⁸⁸ Rau and Kumar (n 361) 39

³⁸⁹ *ibid* 40

States' Rulers and the British Government.³⁹⁰ The UFMS comprises Kelantan, Terengganu, Kedah, Perlis and neighbouring islands which the protection, right of sovereignty, administration and control over these states were transferred by Siam (Thailand now) to Britain by virtue of Anglo-Siamese Treaty 1909 due to Siam's inability to match the orderly government provided in the Federated Malay States.³⁹¹ Another state by the name Johore was also grouped under the UFMS although it did not fall under the said Anglo-Siamese Treaty. Instead, it received protection from the British by virtue of a treaty of protection entered in 1885.

Prior to the intervention by British, the prevailing law in these states was the customary law where *Adat Perpatih* (digests and tribal sayings of *Minangkabaus* from Sumatra and Negeri Sembilan) was dominant in most areas of Negeri Sembilan and parts of Malacca as well and *Adat Temenggongin* other parts (Malay indigenous patriarchal law mixed with Hindu and Muslim law).³⁹² Mostly unwritten, these customary laws have adopted the Muslim law of marriage and divorce to a considerable extent while *Adat Temenggong* also showed some influence of Islamic law in criminal matters.³⁹³ In this respect, Edmund J pointed out in the judgement of *Shaik Abdul Latif & Ors v Shaik Elias Bux*³⁹⁴ that 'Mohamedan law' modified by local customs was the only law applicable to the Malays before the Rulers entered into the treaties with the British. Further, it was reinstated by Thorne J who delivered the majority judgement of the Court of Appeal in *Ramah binti Taat v Laton binti Malim Sutan*³⁹⁵ that Islamic law is the law of the land which must be taken in the judicial consideration by the Court. All this demonstrates the level of respect Islamic law commanded from the local Malay communities and probably the reason why Islamic law and Malay custom remained largely unaffected by the British.³⁹⁶ Also, this had become a catalyst to the development of a parallel court system and the non-interference by the civil court on the matters under the purview of the *Shariah* court as provided by the FC 1957 (more on this in the upcoming subsection).³⁹⁷

By 1888, through a number of treaties entered with the rulers, British firmly establish its control over Malay states such as Perak, Selangor, Pahang and Negeri Sembilan. By virtue of these treaties, the Rulers agreed to accept the advice given by the British except for matters

³⁹⁰ *ibid* 5

³⁹¹ *ibid*

³⁹² *ibid* 37

³⁹³ Ibrahim and Jones (n 379) 25

³⁹⁴ [1915] 1 FMSLR 204

³⁹⁵ [1927] 6 FMSLR 128

³⁹⁶ Mohamad and Trakic (n 357)

³⁹⁷ *ibid*

touching the Malay religion and custom even though the interference with the Muslim law and its administration still could be observed in all the Malay states despite the said clause.³⁹⁸

As for the introduction of English law to the Malay states, initially, since they are merely British protectorates, English law was not introduced by legislation despite its principle were introduced by English and English-educated judges in matters which were not provided for in local laws.³⁹⁹ British influence was increasing from day to day which favoured the introduction of English law indirectly. The Rulers, acting on the advice of the British Residents, enacted some laws which emulated the Indian codification of the principles of English law covering main branches of law such as criminal, evidence, criminal procedure, contract and land. For instance, the Penal Code of Strait Settlements which was based on the Indian Penal Code was adopted in Perak by Order in Council of 28 June 1884 and by other states after that. The Evidence Ordinance of the Strait Settlements, an ordinance based on the Indian Evidence Act was adopted in Selangor in 1893 and Perak in 1894 prior to its implementation in other states. The Indian Contract Acts initially adopted by the Selangor Courts regulation 1893 and followed by enactments in Perak, Selangor and Negeri Sembilan in 1899 and Pahang in 1900. The Criminal Procedure Code of India was adopted and enacted in various Malay states forming the Federated Malay States in 1900 while Land Enactments were enacted in various states in 1897 and later in 1903 which introduced the Torrens System of title registration. By this adoption, the former Malay-Muslim laws were replaced by laws which built upon the principles of English law.⁴⁰⁰

Apart of the legislation process, the Malay Rulers also were advised by the British Residents to set up courts of Justice, and this also introduced the new system of hierarchy of courts. As for the judges, they were all trained in the British system, and this naturally made them referred to the law which they are familiar with ie English law in the events where there was a lacuna in the written law. This practice was confirmed with the introduction of the Civil Law Enactment 1937 and followed by the Civil Law Ordinance 1956 which introduced the English Law to the rest of Federation of Malaya.⁴⁰¹

³⁹⁸ Ibrahim and Joned (n 379) 27

³⁹⁹ *ibid*

⁴⁰⁰ *ibid* 28

⁴⁰¹ *ibid*

4.3 Malaysian Governance and Legal System Nowadays

In present days, Malaysia has emerged as one of the developing countries with a mature structure in its governing system. It is a federation with a strong core central government and thirteen state governments where both (Federal and state government) are allocated with separate jurisdiction by FC 1957 as per described in the First List (Federal List), the Second List (State List) and the Third List (Concurrent List).

Malaysian laws can be classified into two main categories ie the unwritten law and the written law. As to the former, it does not mean that it is totally not written anywhere. Rather, it refers to laws which neither being enacted by the legislature (Parliament or State Legislative Assembly) nor established in Federal or states constitutions but derived from the decision made by the courts. This group of law comprises the principles of English law, the judicial decisions of the High Courts, Court of Appeal and the Federal Courts—the Superior Courts —(including the decisions of the former Supreme Court and Judicial Committee of the Privy Council which were in force prior to 1985 until 1995), and the customs of the local inhabitants so far accepted as laws by the courts.⁴⁰²

Of the judicial decision, it is an essential element of the English common law system which Malaysia has inherited. It refers to decisions in point of law by judges of the High Courts that have not been reversed or overruled by the superior courts and decisions of the Court of Appeal and Federal Court.⁴⁰³ By virtue of the doctrine of *stare decisis*, a legal ruling of superior court binds all inferior courts and serves as precedent to decide cases before the courts, and to that extent these rulings serve as laws. In the case of *Public Prosecutor v Datuk Tan Cheng Wee & Anor*,⁴⁰⁴ Chang Min Tat FJ emphasised the position this doctrine holds in the Malaysian law system by saying, “It is, however, necessary to reaffirm the doctrine of *stare decisis* which the Federal Court accepts unreservedly and which it expects the High Court and other inferior courts in a common law system such as ours, to follow similarly”.

The second group ie the written law refers to the law embodied in the Federal and the state constitutions and in a code or a statute including the subsidiary or delegated legislation.⁴⁰⁵ It consists of the Federal Constitution as well as the State Constitution, legislation enacted by Parliament (for the Federal level) and the State Legislative Assembly (for the state level), and

⁴⁰² Rau and Kumar (n 361) 48

⁴⁰³ *ibid* 44

⁴⁰⁴ [1980] 2 MLJ 276

⁴⁰⁵ Rau and Kumar (n 361) 47

subsidiary or delegated legislation made by person or bodies which were empowered for the same by the Acts of Parliament or the Enactments of House of Legislative.

It is important to note here that notwithstanding the strong connection it has with the British governance system, Malaysia, being an independent sovereign country, does not strictly adopt the style of the British government in administrating the country. Instead, it has chosen its own way of administration which renders significant differences as compared to the system it operates in the United Kingdom. For instance, in the United Kingdom, the Parliament is sovereign which has traditionally meant that the law it makes takes precedence over the law originating from any other source (though membership of the European Union has compromised this principle)⁴⁰⁶, Malaysia, however, subscribes to the doctrine of constitutional supremacy. This means that the Federal Constitution is regarded as the highest law against which the validity of all other enacted law is tested.⁴⁰⁷ In this regard, article 4(1) of the Federal Constitution provides, “This Constitution is the supreme law of the Federation and any law passed after Merdeka Day which is inconsistent with this Constitution shall, to the extent of the inconsistency, be void”.

Among the cases which demonstrate the supremacy of the Federal Constitution is *Dewan Undangan Negeri Kelantan & Anor v Noordin bin Salleh & Anor*⁴⁰⁸ where a proviso of Kelantan State Constitution has been declared as void since it contravened the Federal Constitution in the question of the right of citizen to form, to join (or not to join), or resign from an association. In this case, the respondents won in a general election and became the member of State Legislative Assembly. However, article XXXIA of the Kelantan State Constitution (Part One) provides as follows:

If any member of the Legislative Assembly who is a member of the political party resigns or is expelled from, or for any reasons whatsoever ceases to be a member of such political party, he shall cease to be a member of the Legislative Assembly and his seat shall become vacant.

As such, the Assembly resolved that the first and the second respondent ceased to be the member of Assembly as both had resigned from the political party for which they stood and were elected in the election. As both seats were declared vacant, a by-election was held in the constituencies concern wherein both respondents re-contended but defeated.

⁴⁰⁶ Catherin Elliot and Frances Quinn, *English Legal System* (17th edn, Pearson 2016) 43

⁴⁰⁷ Rau and Kumar (n 361) 50

⁴⁰⁸ [1992] 1 MLJ 697

The respondents brought their challenge on the validity of article XXX1A of the Kelantan State Constitution before the High Court. In their contention, they claimed that such an act taken by the Assembly was contravened to article 10(1)(c) of Federal Constitution which guarantees the fundamental right of freedom of association. The Court, in favour of respondents, declared that the said article is void under the article 4(1) of Federal Constitution to the extent that it imposes a restriction on the respondents to exercise their fundamental right to resign from a political party. The appellant appealed to the Supreme Court (the highest court in hierarchy back then) against the decision on the basis, inter alia, that the High Court's decision was *ultra vires*. However, it was dismissed and the previous decision was upheld.

Malaysia is headed by the Yang di-Pertuan Agong who is elected among the Rulers of nine Malay states through the Conference of Rulers. Upon appointment, the Yang di-Pertuan Agong shall hold the office for five years even though he may at any time resign from the post or be removed by the Conference of Rulers. Despite being the Supreme Head of the Federation, most of his functions and duties are ceremonial. In exercising his functions under the constitution or federal law, he is to act in accordance with the advice of the cabinet or minister acting under the general authority of the cabinet. However, the constitution has provided certain functions to be exercised by him according to his discretion such as appointing a Prime Minister, withholding of a consent to request for the dissolution of Parliament, and calling of a meeting of the Conference of Rulers concerned solely with privileges, position, honours and dignities of the Rulers and any action at such a meeting.⁴⁰⁹

Malaysia subscribes to the idea of separation of powers between three main branches of administration. The first branch is the legislative which has the power to make laws. The second branch is the executive who has the power to govern. The third and final branch is the judiciary which is empowered to hear and determine disputes and to try offences and punish offenders.⁴¹⁰ This judicial power is exercised through a system of courts where these courts are supreme against the aforementioned branches of the Government. This is because the courts are totally independent of anybody and they can pronounce on the legality or otherwise of executive acts of Federal or state government. They also have the authority to pronounce on the validity or otherwise of any law passed by Parliament and state legislatures and to interpret the meaning of any provision of the Federal and state Constitution.⁴¹¹

⁴⁰⁹ Ibrahim and Joned (n 379) 189

⁴¹⁰ Rau and Kumar (n 361) 61

⁴¹¹ *ibid*

As for the hierarchy, courts in Malaysia can be grouped into two segments, namely the Superior Courts and the Subordinate Courts. In the first group (the Superior Courts), there is the Federal Court at the apex of the rank followed by the Court of Appeal and the High Courts. In the second group (the Subordinated Courts) there are the Session Courts and the Magistrate courts. Working at the parallel system is the *Shariah* courts at the state level which vested with very limited jurisdiction of Islamic law (more on this shortly). Since the *Shariah* enactments are enacted by the respective State Legislative Assembly instead of the House of Representative under the Parliament, the punishment provided for some offences might be different from one state to another.

4.4 Islamic Finance in Malaysian Jurisdiction: An Overview from the Perspective of the Federal Constitution 1957 and Civil Law Act 1956

4.4.1 Federal Constitution 1957 (FC 1957)

As mentioned above, the Federal Constitution is the apex law for Malaysia. As such, the identification on the position of Islamic finance in the Malaysian jurisdiction starts by looking into this matter from the FC 1957's point of view. Malaysia runs a dual judicial system where the civil court co-exists with the *Shariah* court. In this regard, Article 121(1) of the Federal Constitution provides for the establishment of the civil court whereby its power and jurisdiction are to be conferred by Federal laws. As for the *Shariah* court, the State Legislature is granted with the power to pass laws for the constitution, organisation and procedure of the court as per paragraph 1 of the Second List (known as the State List as it enumerates State's jurisdiction) set out in the Ninth Schedule. As such, except for the *Shariah* courts in the Federal Territories, the other *Shariah* courts are considered as State courts as they are established under various state laws which provide for their constitution, jurisdiction and procedure.⁴¹² As prescribed by the State List and to the contrary of the civil court, the jurisdiction of the *Shariah* court is very limited and has power only over persons professing the religion of Islam.

The separation between the jurisdiction of Federal and State is also demonstrated by the by the Article 74(1) and Article 74 (2), both read as follow:

⁴¹² *ibid* 183

74(1) Without prejudice to any power to make laws conferred on it by any other Article, Parliament may make laws with respect to any of the matters enumerated in the Federal List or the Concurrent List (that is to say, the First or Third List set out in the Ninth Schedule).

74(2) Without prejudice to any power to make laws conferred on it by any other Article, the State List (that is to say, the Second List set out in the Ninth Schedule) or the Concurrent List.

Relatively, the First List (the Federal List) covers much more items than what are enumerated in the Second List (the State List). The latter is limited to certain specific items such as land, forests, state holidays, Islamic law and personal and family of persons professing the religion of Islam including the Islamic law relating to succession, testate and intestate, betrothal, marriage, divorce, dower, maintenance, adoption, legitimacy, guardianship, gifts, partitions and non-charitable trusts such as *Wakafs* and so forth as set out in paragraph 1 of the State List.⁴¹³ The former, on the other hand, is more extensive as it enumerates all things which do not fall under any other list, among which are matters pertaining to 'Finance' that include banking; money lending; pawnbrokers; control of credit.⁴¹⁴ Moreover, also fall under the same list is matters regarding contract including partnership, agency and other special contracts.⁴¹⁵ It also reiterates the Federal jurisdiction pertaining to the civil and criminal law and procedure and the administration justice including the constitution, organisation, jurisdiction and powers of all courts other than the *Shariah* court.⁴¹⁶

Based on the above-mentioned provisions, it can be said that as far as FC 1957 is concerned, all matters pertaining to finance and banking, regardless whether they are from the conventional or Islamic segment, fall under the purview of the civil court. This is due to the fact that the banking matters are being put under the Federal List without exclusion whatsoever. This arrangement, however, does also imply that Islamic law is not applicable in the case of Islamic banking and finance despite the existence of the *Shariah* court (the State

⁴¹³ Paragraph 1 of the Second List, the Ninth Schedule reads: Except with respect to the Federal Territories of Kuala Lumpur and Labuan, Islamic law and personal and family law of persons professing the religion of Islam, including the Islamic law relating to succession, testate and intestate, betrothal, marriage, divorce, dower, maintenance, adoption, legitimacy guardianship, gifts, partitions and non-charitable trusts; *Wakafs* and the definition and regulation of charitable and religious endowments, institutions, trusts, charities and charitable institutions operating wholly within the State; Malay customs. *Zakat Fitrah* and *Baitulmal* or similar Islamic religious revenue, mosques or any Islamic public places of worship, creation and punishment of offences by persons professing the religion of Islam against precepts of that religion, except in regard to matters included in the Federal List; the constitution, organisation and procedure of *Syariah* courts, which shall have jurisdiction only over person professing the religion of Islam and in respect only of any of the matters included in this paragraph, but shall not have jurisdiction in respect of offences except in so far as conferred by federal law, the control of propagating doctrines and beliefs among persons professing the religion of Islam; the determination of matters of Islamic law and doctrine Malay custom.

⁴¹⁴ Federal Constitution, the First List of Ninth Schedule para. 7(j)

⁴¹⁵ *ibid* para. 4(e)(i)

⁴¹⁶ *ibid* para. 4(a) & (b).

court). Rather, the common law principles are to be applied in such cases since the competent court for the adjudication of Islamic banking and finance cases is the civil court. In the context of Malaysia, Islamic law is only to be practised in the *Shariah* court while in almost all matters of jurisdiction, the common law principles are applied in the civil court.⁴¹⁷

The question about the competent jurisdiction for the Islamic banking and finance matters in Malaysia has been put to rest by a number of decision made by the courts. For instance, in the case of *Bank Islam Malaysia v Adnan Omar*⁴¹⁸, the defendant raised a preliminary objection that the civil court had no jurisdiction to hear the case based on Article 121(1); the civil courts shall have no jurisdiction in respect of any matter within the jurisdiction of the *Shariah* courts. NH Chan J overruled the said objection based on two grounds; the first ground is that Islamic banking cases do not fall under *Shariah* court since the plaintiff, an Islamic bank does not have religion but merely a corporate body and thus will not subject to the jurisdiction of the *Shariah* court as provided by the State List.⁴¹⁹ The second ground is that the proper forum to try Islamic banking cases is the civil court which has the jurisdiction to hear banking matters including Islamic banking by virtue of the Federal List under the Ninth Schedule of the Federal Constitution 1957.⁴²⁰

The above-mentioned decision is further affirmed by the decision made for the case of *Mohd Alias Ibrahim v RHB Bank & Anor*.⁴²¹ In his judgement, Mohd Zawawi Salleh J clarified that notwithstanding Islamic law falls under the jurisdiction of the *Shariah* courts, in the case involving banking transactions based on Islamic law principles, it is the civil courts that will have the jurisdiction to hear the matters. This is by virtue of the Federal List in the Ninth Schedule of the Federal Constitution where the law relating to finance, trade, commerce and industry falls within.

⁴¹⁷ Zulkifli Hasan, *Shariah Governance in Islamic Banks* (Edinburgh University Press Ltd 2012) 107

⁴¹⁸ Civil Suit S3-22-101-91 as reported in Rusni Hassan, Ahmad Azam Othman and Norlizah Mokhtar, *Islamic Banking in Malaysia: Case and Commentaries* (CLJ Publication 2017) 97

⁴¹⁹ Rusni Hassan, Ahmad Azam Othman and Norlizah Mokhtar, *Islamic Banking in Malaysia: Case and Commentaries* (CLJ Publication 2017) 98

⁴²⁰ *ibid*

⁴²¹ [2011] 4 CLJ 654

4.4.2 *Civil Law Act 1956 (CLA 1956)*

It is essential as well in this respect to look at one of the Acts of Parliament namely Civil Law Act (CLA 1956). This is due to the fact that this Act, particularly section 3⁴²² and section 5⁴²³, further illustrates the strong relevance English law holds to the Malaysian legal system and, in the case here, the Islamic finance matters. As explained before, the official introduction of English Law into Sarawak and Sabah was made through the passing of the Application of Law Ordinance 1949 and the North Borneo Application of Law Ordinance 1951 respectively while for the Malay States, it was made through the passing of the Civil Law Enactment 1937 and followed by the Civil Law Ordinance 1956. By 1963 when Malaysia was formally established (comprising all the Malays states, the Straits Settlements, Sabah, Sarawak and

⁴²² Section 3 reads:

3. (1) Save so far as other provision has been made or may hereafter be made by any written law in force in Malaysia, the Court shall—

(a) in Peninsular Malaysia or any part thereof, apply the common law of England and the rules of equity as administered in England on the 7 April 1956;

(b) in Sabah, apply the common law of England and the rules of equity, together with statutes of general application, as administered or in force in England on 1 December 1951;

(c) in Sarawak, apply the common law of England and the rules of equity, together with statutes of general application, as administered or in force in England on 12 December 1949, subject however to subparagraph (3)(ii):

Provided always that the said common law, rules of equity and statutes of general application shall be applied so far only as the circumstances of the States of Malaysia and their respective inhabitants permit and subject to such qualifications as local circumstances render necessary.

(2) Subject to the express provisions of this Act or any other written law in force in Malaysia or any part thereof, in the event of conflict or variance between the common law and the rules of equity with reference to the same matter, the rules of equity shall prevail.

(3) Without prejudice to the generality of paragraphs (1)(b) and (c) and notwithstanding paragraph (1)(c) —

(i) it is hereby declared that proceedings of a nature such as in England are taken on the Crown side of the Queen's Bench Division of the High Court by way of habeas corpus or for an order of mandamus, an order of prohibition, an order of certiorari or for an injunction restraining any person who acts in an office in which he is not entitled to act, shall be available in Sabah to the same extent and for the like objects and purposes as they are available in England;

(ii) the Acts of Parliament of the United Kingdom applied to Sarawak under sections 3 and 4 of the Application of Laws Ordinance of Sarawak [Cap. 2] and specified in the Second Schedule of this Act shall, to the extent specified in the second column of the said Schedule, continue in force in Sarawak with such formal alterations and amendments as may be necessary to make the same applicable to the circumstances of Sarawak and, in particular, subject to the modifications set out in the third column of the said Schedule.

⁴²³ Section 5 reads:

5. (1) In all questions or issues which arise or which have to be decided in the States of Peninsular Malaysia other than Malacca and Penang with respect to the law of partnerships, corporations banks and banking, principals and agents, carriers by air, land and sea, marine insurance, average, life and fire insurance, and with respect to mercantile law generally, the law to be administered shall be the same as would be administered in England in the like case question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by any written law. at the date of the coming into force of this Act, if such question or issue had arisen or had to be decided in England unless in any case other provision is or shall be made by any written law.

(2) In all questions or issues which arise or which have to be decided in the States of Malacca, Penang, Sabah and Sarawak with respect to the law concerning any of the matters referred to in subsection (1), the law to be administered shall be the same as would be administered in England in the like case at the corresponding period, if such question or issue had arisen or had to be decided in England, unless in any case other provision is or shall be made by any written law.

Singapore although Singapore left the Federation later in 1965), all the then existing statutes were repealed and amalgamated into a single act by the name Civil Law Act 1956 applicable to the whole Malaysia.

By virtue of section 3 of CLA 1956 the court in Peninsular Malaysia (where all the Malay states, Penang and Malacca are situated in) shall apply the common law of England and the rules of equity as administered in England on 7 April 1956, the date when this Act came into force (the cut-off date). Such an application depends on three conditions namely insofar no provision had been made at that point of time either by written law in Malaysia; and so far as permitted by the circumstances of the States of Malaysia and their respective inhabitants; as well as subject to qualifications as local circumstances render necessary. The quite similar conditions are also applicable in the case of Sarawak although some differences can be spotted such as the cut-off. Therefore, as far as the Malaysian legal system is concerned, not only English law used to be the law in some part of its land (such in the Straits Settlements) and subsequently, renders strong influence in shaping the modern Malaysian laws, it also would be the law to be referred to and to be applied in circumstance where the lacuna in law exists.

Section 5 further implicates the same effects section 3 does but with the concentration on commercial matters. By virtue of section 5, the English commercial law as administered in England on 7 April 1956 shall be applicable in Peninsular Malaysia in the absence of any local written law with the difference in terms of the cut-off date as for Penang, Malacca, Sarawak, and Sabah. However, it is observed that section 5 uses the expression 'the law to be administered' whereby in section 3 the expression used is 'as administered'. Hence, the English commercial law is to be applied in a much broader than what is provided in section 3 which points to the specific sources of English law that may be used.⁴²⁴

Admittedly, these provisions do not bring much effect anymore especially after the independence of Malaysia in 1957. The Parliament of Malaysia has passed laws on most of the commercial matters mentioned in section 5 thus reducing the reliance on the provision. In the same time, the call to abolish the Act, either *in toto* or only certain sections, has also been voiced by a number of Malaysian legal scholars who is generally of the view that Malaysia is mature enough to search for local solutions within the Malaysia law and its courts' decisions in the case of a lacunae.⁴²⁵ Nevertheless, until the shift from the *status quo* takes place, the existence of these sections continues to affirm the application of English law by the civil

⁴²⁴ Mohamad and Trakic (n 357)

⁴²⁵ *ibid*

courts in Malaysia which, as established earlier, have the jurisdiction over the Islamic banking and finance matters. As such, all the transactional laws ie the laws governing contractual relationships between contracting parties in commercial matters such as Contract Act 1950 (CA 1950), Partnership Act 1961 (PA 1961) and Hire Purchase Act 1967 (HPA 1967) shall be similarly applicable to both conventional as well as Islamic commercial arrangements. The provisions create a further gap between the *Shariah* legal system of Malaysia and the Islamic banking and finance matters since the *Shariah* law and its courts shall have no interference in such cases even though in the case of a lacunae since the law to be referred to is the English law.

4.5 The Interaction of the Competent Courts with Islamic Finance Matters

Pursuant to the previous discussions, it is established by now that notwithstanding the *Shariah* is at the heart of Islamic finance, in the context of Malaysian legal perspective, it is a subject matter under the purview of the civil courts. In the eyes of the courts, both conventional and Islamic, commercial matters shall be governed by the same legal regime which is founded on the principles of the English common law. The case of *Bank Kerjasama Rakyat Malaysia Berhad v Emcee Corporation Sdn Bhd*⁴²⁶ illustrates such similarity in the legal treatment. This is the case brought before the Court of Appeal where the appellant had granted the respondent a facility using the Islamic banking principle of BBA. Both parties executed two agreements on the same date, the first of which was the Property Purchase Agreement (PPA). Under PPA, the respondent sold 22 pieces of land to the appellant for RM20 million. The second agreement was the Property Sale Agreement (PSA). Via this PSA, the appellant sold back to the respondent the same properties with deferred payment terms through 36 monthly instalments. As security for the repayment of the sale price under the PSA, the respondent charged to the appellant 15 pieces of the land under the National Land Code 1956 (NLC 1956). The respondent, however, failed to pay the instalment. The appellant issued a Form 16D notice under the NLC 1956 (Notice of Default with Respect to A Charge) and filed an originating summons against the respondent. The respondent failed to comply with the Form 16D notices and the appellant filed an originating summons against the respondent for an order for sale under section 256(3) of the NLC⁴²⁷. The High Court dismissed the application

⁴²⁶ [2003] 1 CLJ 625

⁴²⁷ Section 256 reads:

256. Application to Court for order for sale.

(1) ...

(2) ...

on the fact that the appellant had breached its agreement with the respondent to release an initial sum of RM5 million to the respondent. The appellant appealed, and the Court of Appeal held that there was nothing that brought the application for sale of the charged property within the three categories of cause to the contrary to warrant the refusal of the order for sale.⁴²⁸ Therefore, the Court allowed the appeal with costs and deposit to be refunded to the appellant.

What is relevant here is what had been said by the judge when delivering the verdict. Abdul Hamid Mohammed, JCA clearly mentioned that although the facility given by the appellant to the respondent was an Islamic banking facility, it did not mean that the applicable law was different from the law applied if the facility was given under the conventional banking. In this case, the charge was a charge under the NLC 1965, the remedy available and sought was a remedy provided by the same act. The procedure is provided by the NLC 1965 and by the Rules of the High Court 1980 (now, it is Rules of Court 2012) and the court adjudicating it was the high court – a court under civil jurisdiction. Therefore, the same law was applicable, the same order that would be, if made, and the same principles that should be applied in deciding the application.

Arguably, the order for the sale of the charged land could also be obtained should the case be tried by the Islamic law. However, what is important to note here is that the Judge has laid down a rather important principle pertaining to the matters of Islamic banking and finance should they be brought to the court; the applicable law is the same law applicable in their conventional counterparts' trial so as to the sought-after remedies which shall be found within the civil jurisdiction framework rather than the *Shariah* jurisdiction framework. As this study seeks to examine one of the Islamic products (*Musharakah*) in the light of legal and regulatory framework, the perusal strikes a balance between the analysis from the *Shariah* perspective and legal and regulatory perspectives. Similarly, serious consideration must be given equally to all of them (*Shariah*, law, and regulation) in any advancement or

(3) On any such application, the Court shall order the sale of the land or lease to which the charge relates unless it is satisfied of the existence of cause to the contrary.

⁴²⁸ The definition of 'cause to the contrary' was based on the judgement of the Federal court in the case of *Low Lee Lian v Ban Hin Lee Bank Berhad* [1997] 2 CLJ 36. The three categories are as follow:

- a) When a chargor who is able to bring his case within any exceptions to the indefeasibility doctrine in section 340 of NCL 1965.
- b) When a chargor could demonstrate that the chargee has failed to meet the conditions precedent for making of an application for an order for sale.
- c) When a chargor could demonstrate that the grant of an order for sale would be contrary to some rule of law or equity.

improvement on the product based on the reality of the existing legal and regulatory framework of Islamic finance in Malaysia.

4.5.1 The Changing Attitude of the Courts – The First Phase (1979-2002)

As much as the Islamic finance matters progress either in terms of the number of dealings (hence the increase in the number of cases brought to the court) or in terms of the complexity of the arrangement involved, the attitude shown by the courts in dealing with such matters changes over time. In the early phase, it can be observed that the decision made by them was likely to be in favour of the Islamic financial institutions since the concern was with the application of the classic common law approach by stressing the civil and technical aspects rather than deliberating *Shariah* issues.⁴²⁹ Among the cases which represent this phase is *Tinta Press Sdn Bhd & Ors v Bank Islam Malaysia*.⁴³⁰ In this case, the respondent had leased certain printing equipment to the appellant using Islamic financing facility known as *Ijarah*. The appellant then defaulted its obligation to make the monthly rentals payment. The respondent brought a legal action to the High Court in order to recover the rent as well as the possession of the equipment. An *ex parte* application for a mandatory injunction to enable possession of the equipment was also made and granted. The appellant attempted to set aside the mandatory injunction, but it was rejected, hence the appeal to the Supreme Court. The decision, however, was upheld. In delivering their judgement, the Judges of the Supreme Court stated that the learned Judge of the High Court was rightly concluded from the documents and the affidavit evidence that the agreement, in this case, was a lease agreement and not a loan agreement as it was claimed to be. Without resorting to the *Shariah* technicalities as to determine the true nature of the arrangement involved for instance, the Supreme Court applied the classic common law interpretational approach by looking at the wordings of the agreement entered to cause the facility which clearly indicated that the relationship between both parties are lessor and lessee rather than creditor and debtor.

The court was also observed to refrain itself from examining whether the disputed issues would contradict the religion of Islam in the case of *Dato' Hj Nik Mahmud Daud v Bank Islam Malaysia Bhd*.⁴³¹ By invoking the arrangement of BBA, the plaintiff had executed the PPA and the PSA with the defendant for lands. Through the PPA, the defendant made the

⁴²⁹ Zulkifli Hasan and Mehmet Asutay, 'An Analysis of Courts' Decisions on Islamic Finance Disputes' (2011) 3(2) ISRA International Journal of Islamic Finance 41

⁴³⁰ [1987] 1 CLJ 474

⁴³¹ [1998] 3 CLJ 605

purchase amounting to RM520, 000 before reselling them back to the plaintiff via the PSA with deferred payment of RM629, 200. Two days later, the plaintiff's attorney executed two charges of the properties in favour of the defendant as securities for the financing given. In his application, the plaintiff applied for an order that the charges, the PPA and the PSA be declared as null, void and no effect. To support his motion, the plaintiff raised that the execution of the PPA, the PSA and the charge document would clearly tantamount to a colourable exercise to defeat the very purpose and intention of the Kelantan Malay Reservations Enactment 1930 and the National Land Code 1956. This is due to the fact that section 7(i) of the said enactment prohibits any transfer or transmission or vesting of any right or interest of a Malay in reservation land to or in any person not being a Malay.⁴³² Further, the argument went on by saying the defendant was at all material times prohibited from accepting charges in respect of usury transactions (it is believed the basis of this particular contention is the premise that claiming the facility granted under *Bai Bithaman Ajil*, is equivalent to the usury-based conventional facility. Hence, the acceptance of the charge for the facility by the defendant was against the defendant's Articles of Association. However, this contention was finally abandoned at the outset of the hearing). The court, in dismissing such application, held that when the property purchase agreement was signed, the right that could be acquired by the defendant under the agreement at that point of time was only a right to a registrable interest which right was yet to crystallise into registrable interest. The court also said that as there was no evidence to show a change in the registered proprietorship of the properties pursuant to the execution of the property purchase agreement, the plaintiff was and is the registered proprietor of the said lands. Here, although the court found that the purchase and sale agreements were legally sound, the doubt expressed over the parties' intention to involve any transfer of proprietorship connoted that the sale and purchase agreements were merely a part of the process to facilitate finance, which is no different from any arrangements of loan provision under the conventional facility.⁴³³

⁴³² Section 7(i) of Kelantan Malay Reservations Enactment 1930 reads:

No right or interest of any Malay in reservation land and no right or interest in such land acquired by virtue of section 13A by any person not being a Malay shall be transferred to or transmitted to or vest in any person not being a Malay provided that leases of reservation land shall be valid to the extent specified in sub-sections (ii) to (v) below, save as provided in this Enactment.

⁴³³Aldohni (n 79) 205

4.5.2 *The Changing Attitude of the Courts – The Second Phase (2003 - 2007)*

However, the attitude shown by the courts as mentioned above changed in the second phase. In this phase, the courts demonstrated their critical approach in perusing the underlying *Shariah* contract offered by the IFIs.⁴³⁴ The judgement in the case of *Malayan Banking Berhad v Ya'kup bin Oje & Anor*⁴³⁵ can appropriately illustrate the same. In brief, this is the case where the plaintiff had granted the defendants with the Islamic financing facility under BBA amounting to RM80,094 to purchase a property. Pursuant to the PPA and PSA entered by them on 15 July 2003, the plaintiff agreed to purchase the property and subsequently sell the same to the defendants with deferred payment amounting to RM184,094. As a security, the defendants had charged the property in question. However, the defendants defaulted in the payment of instalments after they had made some. Therefore, the plaintiff sought an order for sale of the charged property in consequence of the defendants' breach by non-payment of the sum of RM167,797.10 due and owing as at 26 June 2006. Such amount was deemed as excessive and abhorrent to the notion of justice. The Court is sought to decide whether the plaintiff was entitled as of right to the full profit in the event the BBA was terminated at the early stage. It is held by the Court that the plaintiff is given an opportunity to file an affidavit stating that the plaintiff will give a pre-specified rebate (which must not be nominal but a substantial one) upon recovery of the sale proceeds.

What is material in this respect is the fact that the Judge had produced a comprehensive examination of the application of the BBA facility in this 30-page judgement. It covers the deliberation on the concept of justice of *Shariah*, the prohibition of *Riba*, the validity of BBA and the justice and equity. In fact, in granting the opportunity to the plaintiff to file the affidavit on the rebate (termed as *Ibra*), the Judge emphasised that the Islamic contract relating to commercial matters is not only subject to the terms of the contract but also must be decided subject to the Quranic injunctions and Islamic worldview. According to him, even though the Islamic commercial law does not allow the bank to state the rebate for default under the BBA contract, this does not stop it to openly state the rate of rebate and its policy without encapsulating in the BBA agreement. Further, although *Ibra* is unilateral, it does not stop the bank to voluntarily relinquish part of its claim or the court to demand for a proper concession to be granted upon default by the customer on equitable grounds. This position has

⁴³⁴ Hasan and Asutay (n 444)

⁴³⁵ [2007] 6 MLJ 389

indicated the improvement of the level of awareness and understanding of Islamic finance among the judges.⁴³⁶

Similarly, in *Affin Bank Berhad v Zulkifli Abdullah*⁴³⁷ and *Malayan Banking Berhad v Marilyn Ho Siok Lin*⁴³⁸ the judges in both cases had indirectly criticised the approach taken earlier by the earlier court decisions for heavily relying on the classic common law approach which entails a narrow interpretation.⁴³⁹ For them, the court has to examine further the practices of Islamic banking as whether they are in line with the intent of the *Shariah*.⁴⁴⁰ All this demonstrates, as mentioned earlier, the shifted attitude of the courts towards a more proactive approach in dealing with Islamic banking matters.

4.5.3 The Changing Attitude of the Courts – The Third Phase (2008-2010)

This is the phase where the courts became more critical towards the practice of Islamic banking as compared to the previous phase since it started to challenge the validity of the *Shariah* contract. The case to illustrate this situation is *Arab-Malaysian Finance Bhd v Taman Ihsan Jaya Sdn Bhd & Ors*.⁴⁴¹ This case contained twelve separate civil suits involving Bank Islam Malaysia Berhad and Arab-Malaysian Finance Berhad as the plaintiffs. Similar to the previous BBA cases, the question brought forward was whether the defendants have to pay the whole amount of the selling price in the event of a default. The defendants had approached the plaintiff for financing in order to complete the purchase of a property from a third party. The plaintiff agreed to give the defendants an Islamic finance facility via the principle of BBA. Under this agreement, the plaintiff had required the defendants to sell the bought property to the plaintiff for the balance of the purchase price according to the terms of PPA, which will be paid in cash. The plaintiff then sold the property back to the defendants under the PSA, wherein the defendants agreed to pay an agreed number of monthly instalments of specific sums. As security, the defendants were required to execute a charge or assignment of the property to the plaintiff. The total of the agreed instalments added up to the bank's selling price. The defendants, however, defaulted the payment causing the plaintiff to take legal action.

⁴³⁶ Hasan and Asutay (n 444)

⁴³⁷ [2006] 3 MLJ 67

⁴³⁸ [2006] 7 MLJ 249

⁴³⁹ Hasan and Asutay (n 444)

⁴⁴⁰ *ibid*

⁴⁴¹ [2008] 5 MLJ 631

What is important to be highlighted here is the stand taken by the deciding Judge towards the validity of BBA in the first place. In his judgement, Abdul Wahab Patail J had initially mentioned:

The court has the authority to look beyond the words of the agreement to the actual facts of the case in order to determine the substance of the transaction between the plaintiffs and the defendants before it draws any conclusions on the nature of the *Al-Bai' Bithaman Ajil* transactions. It is necessary to look beyond the labels used and look at the substance particularly in the light of the fact that the interpretation advanced by the plaintiffs resulted in the defendants being burdened with debt far more than that if they had taken interest based on a conventional loan.

This statement clearly indicated his departure from the approach as taken by the courts in the first phase as it shall look beyond the construction of the agreement in determining the substance of the transaction in question. Moreover, the court, in this case, did not only address the issue of the quantum to be paid as a result of the default occurrence, but rather it also questioned and as shall be explained later, invalidated the BBA contract itself which had never happen even during the second phase.

There are two issues against BBA that had been raised. Firstly, the Judge explained that the BBA is a bona fide sale in the case where the bank is the owner or had become the owner under a novation agreement. However, in the case where the bank purchased directly from its customer and sold back to the customer with deferred payment at a higher price in total, the sale is not a bona fide sale. Rather, it is a mere financing facility where the profit portion of such transaction rendered the facility contrary to the Islamic Banking Act 1983 (IBA 1983) was the then governing law for the institutions conducting Islamic banking business before its substitution with the IFSA 2013) since the whole transaction is practically the same with the conventional usury-based loan which is prohibited in Islam.

Secondly, he explained that the BBA mechanism is deemed as not involved in any element not approved by the religion of Islam only by the Shafie school of thought, not by the rest of the recognised schools (there are at least three more schools, namely Hanafi, Maliki and Hanbali). As such, it does not meet the requirement imposed by section 2 of IBA 1983⁴⁴² unless it is plainly stated that the facility is to be offered according to a specific school.

⁴⁴² Section 2 of IBA defines 'Islamic banking business' as follow:
banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam

Invoking section 66 of the Contract Act 1950 (CA 1950)⁴⁴³, he ordered for the plaintiffs' entitlement to return to the original facility extended. On the equitable ground, the plaintiffs are also ordered to obtain a price as close to the market as possible and account for the proceeds to the respective defendants.

This decision, however, had been reversed by the Court of Appeal in the case of *Bank Islam Malaysia Berhad v Lim Kok Hoe & Anor and Other Appeals*.⁴⁴⁴ The Court found that 'Islamic banking business' as mentioned in section 2 of IBA 1983 does not mean banking business whose aims, and operations are approved by all the four major schools of thought (*Mazhab*). The religion of Islam is not confined to the four recognised schools alone as there are also other sources of Islamic law available.

The celebrated decision by the Court of Appeal had come to the industry of Islamic finance industry's rescue. Should the High Court's decision be affirmed by the Court of Appeal (or rather unchallenged in the first place), it would become an event of catastrophe since BBA was the main instrument used by the IFIs in extending Islamic financing facility to their customer (it is reported that from 2003 until 2009 90 per cent of the Islamic finance cases registered were related to BBA).⁴⁴⁵ Nevertheless, this does not change the reality that the judges are ready to show their skepticism towards the practice in Islamic finance industry even though the practice has been in operation and endorsed by numerous *Shariah* authorities for a substantial period of time. In other words, the case has indicated that the civil court might take the initiative to question the Islamic aspect of Islamic banking cases in its capacity as a civil court.⁴⁴⁶

This recent development should be celebrated although it might also render certain concerns. On one hand, it illustrates the level of maturity the Malaysian legal system has reached in handling questions related to Islamic finance. Although Islamic finance is an offspring of the foreign system (*Shariah*), the judges of the civil courts have gradually built the positive attitude towards it by starting to scrutinise the matters at hand thoroughly including from the *Shariah* perspective and its worldview. On the other hand, this shift in the court's attitude inevitably entails that the Islamic finance matters be put under a more stringent perusal by the court. This poses a higher level of challenge to the relevant stakeholders such as the IFIs in

⁴⁴³ Section 66 of CA reads:

66. When an agreement is discovered to be void, or when a contract becomes void, any person who has received any advantage under the agreement or contract is bound to restore it, or to make compensation for it, to the person from whom he received it

⁴⁴⁴ [2009] 6 MLJ 839

⁴⁴⁵ Hasan and Asutay (n 444)

⁴⁴⁶ Aldohni (n 79) 205

ensuring the legal and regulatory compliancy of the product as well as to safeguard the validity of the product from being successfully challenged and denied. In addition, this matter can be even more complex since judges of the civil courts are trained in the English common law system rather than being the *Shariah*-qualified person for they might severely err in their understanding of the *Shariah* as what had happened in *Arab-Malaysian Finance Berhad*.⁴⁴⁷ Such wrong understanding, should it be applied in the courts' decision and not rectified would pose a reputational risk to the legal system as a whole. Any subsequent attempt to depart from the wrongly built decision would be lengthy as it would set a precedent for cases alike based on the doctrine of *stare decisis* as practised by all courts in the common law system.

It might be argued that the concern raised above is already mitigated by the creation of the Muamalat Court, a specialised court within the Commercial Division of the Kuala Lumpur High which is dedicated to try all Islamic banking and finance cases. However, it is observed that this court is not much different from the rest within the Commercial Division. They are all governed by the same procedure, practice direction (which is merely made to assign filing codes for registration of Islamic finance cases and other types of cases rather than providing any special procedure for adjudication of Islamic finance cases) and subject to the same administration.⁴⁴⁸ There is no requirement imposed that judges who are to head this court must demonstrate an adequate knowledge in *Shariah* and be adequately trained in Islamic banking and finance which makes its mere establishment fails to provide an antidote to the problems in Islamic finance.⁴⁴⁹

The power vested in the Shariah Advisory Council (SAC) of the BNM in this respect also appears insufficient. Admittedly, the SAC, as the highest *Shariah* authority in Islamic finance Malaysia, is empowered by the Central Bank of Malaysia Act 2009 (CBMA 2009), inter alia, to ascertain the ruling on any financial matter and issue a ruling upon a reference made to it.⁴⁵⁰ Furthermore, pursuant to a reference made by the court, the ruling issued by the SAC

⁴⁴⁷ [2008] 5 MLJ 631

⁴⁴⁸ Hizri Hasshan, 'Islamic Finance Litigation: Problem Within the Malaysian Civil Courts Structure' (2016) 20 Journal of Law and Society 33

⁴⁴⁹ *ibid*

⁴⁵⁰ Section 52 (1) of CBMA 2009 reads:

52.(1) The Shariah Advisory Council shall have the following functions:

(a) to ascertain the Islamic law on any financial matter and issue a ruling upon reference made to it in accordance with this Part;

(b) to advise the Bank on any Shariah issue relating to Islamic financial business, the activities or transactions of the Bank;

(c) to provide advice to any Islamic financial institution or any other person as may be provided under any written law; and

(d) such other functions as may be determined by the Bank.

shall be binding in court.⁴⁵¹ However, despite the wording of CBMA 2009 which seems to provide SAC with a semi or quasi-judicial power, the court seems reluctant to accept this position.⁴⁵² In this regard, the court in *Mohd Alias Ibrahim*⁴⁵³ clarified that when reference is made by the court to the SAC on any *Shariah* matter, it is merely required to make an ascertainment, not a determination of the Islamic laws related to the question. Rather than issuing a new ruling, the SAC is expected to find out which one of the existing rulings is the best applicable in Malaysia for the sake of ascertaining the relevant Islamic laws pertaining to the question at hand. It cannot be said to perform a judicial or quasi-judicial function since the process of ascertainment has no attributes of a judicial decision. In *Tan Sri Abdul Khalid Ibrahim v Bank Islam Malaysia Bhd*,⁴⁵⁴ the court further clarified that the function of the SAC is confined to the ascertainment of the Islamic law on financial matters. The ultimate issues which have been pleaded will still be decided by the court. Taking all this into consideration, it can be safely asserted that as far as the Malaysian legal system's status quo is concerned, the judges of the civil courts still have the final say in the decision making for the Islamic banking and finance cases.

4.6 Conclusion

This chapter clarifies the position of Islamic banking and finance in the Malaysian legal system. Notwithstanding the *Shariah* legal system which operates the Islamic law through the *Shariah* courts, constitutes part of the whole legal system, matters pertaining to Islamic banking and finance fall under the jurisdiction of civil courts which adopt the English common law system. Despite the establishment of the Muamalat Court as well as the SAC of the BNM, the ultimate decision pertaining to questions in Islamic finance cases lies within the verdict of the civil courts' judges who are trained in the English common law and would fall back to the same in finding the answer rather than being *Shariah* experts. Realising this reality, it is important at this juncture, therefore, to assert that in an examination pertaining to any of Islamic finance products (as for this study, *Musharakah*), an equal consideration must be taken from both the *Shariah* and the Malaysian English-based laws perspectives.

⁴⁵¹ Section 57 of CBMA 2009 reads:

57. Any ruling made by the Shariah Advisory Council pursuant to a reference made under this Part shall be binding on the Islamic financial institutions under section 55 and the court or arbitrator making a reference under section 56.

⁴⁵² Mohammad Azam Hussain, Rusni Hassan and Aznan Hasan, 'Analysis on the Development of Legislations Governing Shariah Advisory Council of Bank Negara Malaysia' (2015) 23(2) *Shariah Journal* 325

⁴⁵³ [2011] 4 CLJ 654

⁴⁵⁴ [2012] 7 MLJ 597

Chapter 5. The Legal and Regulatory Framework for *Musharakah*

5.1 Introduction

The discussion in Chapter 2 has clarified the position of Islamic finance in the Malaysian legal system. Despite the existence of the *Shariah* court and *Shariah* law system in the country, as far as the Malaysian context is concerned, all matters related to Islamic finance fall under the purview of the civil court and are governed by its laws which are based on the English common law system.

These said laws can be grouped into two categories. The first category is the enabling or regulatory laws. They refer to the distinct set of legal rules designed specifically to regulate the Islamic banking industry.⁴⁵⁵ They play a vital role in ensuring the stability of the Islamic banking system, and at the same time, they are essential to promote and protect the stability of the economy.⁴⁵⁶

The second category is the transactional laws. As explained in the previous chapter, the products of Islamic finance such as the home financing and *Sukuk* may take several underlying structures. The former, for instance, may be structured based on the BBA or *Musharakah Mutanaqisah* while the latter may be structured using *Ijarah*, *Mudharabah*, and so forth. As such, their operation involves various contractual transactions reflecting various contractual relationships subject to the aim and purpose financing of financing. These contractual relationships shall be governed by the relevant transactional laws simultaneously with the enabling laws. In this respect, the applicable laws to Islamic banking and finance are similar to the ones that are applicable to its conventional counterpart as mentioned by the Court in the case of *Bank Kerjasama Rakyat* (supra):

The BBA Facility is an Islamic banking facility. But that does not mean that the law applicable in this application is different from the law that is applicable if the facility were given under conventional banking. The charge is a charge under the National Land Code. The remedy available and sought is a remedy provided by the NLC. The court adjudicating it is the High Court. So, it is the same law that is applicable, the same order that would be, if made, and the same principle that should be applied in deciding the application.

⁴⁵⁵ Hassan, Othman and Mokhtar (n 419)

⁴⁵⁶ Aldohni (n 79) 122

This chapter explains what are the enabling and the transactional laws relevant in the case of *Musharakah*, particularly for the purpose of this study. It begins with the discussion on two sets of law from the first category (the enabling laws) namely the CBMA 2009 and the IFSA 2013. As shall be explained later, both laws do not only regulate the operation of Islamic banking and finance in Malaysia but also manage to act as the catalyst of risk-sharing improvement from the legal segment.

Subsequently, the discussion shall focus on the PA 1961 as the main transactional law. Although its application in the case of *Musharakah* might be contentious, it is arguably the most relevant law for *Musharakah* and *Musharakah Mutanaqisah* home financing as the Malaysian legal framework stands now. Next, the focus will be on the *Musharakah* regulatory policy issued by the BNM. Despite its status as a mere regulation rather than an act of parliament, it carries a significance for the purpose of this study, especially when a number of its provisions are deemed as 'Standard' which is legally compulsory to be followed by the IFIs. In the discussion of Chapter 6, these laws shall be brought forward again in the analysis to find the answer to the main research question for this study as explained in Chapter 1.

5.2 The Enabling/Regulatory Laws

5.2.1 Central Bank of Malaysia Act 2009 (CBMA 2009)

As described by the CBMA 2009 itself, this is an act to provide for the continued existence of BNM, its administration, objects, functions and powers, for consequential or incidental matters. Section 5 of CBMA 2009 enumerates the principal objects and functions of BNM. It aims to promote monetary and financial stability conducive to the sustainable growth of the Malaysian economy whereby its primary function is, inter alia, to regulate and supervise financial institutions which are subject to the laws it enforces.⁴⁵⁷

Although this act is neither designated exclusively for the governance of the IFIs such as the IFSA 2013 nor addressing the issue of risk sharing directly, there are a number of its provisions that are significant in regulating and supervising these entities under which the operation of *Musharakah* mainly takes place. For instance, section 2 defines 'Islamic financial business' as any financial business in ringgit or other currency which is subject to the laws which BNM enforces and is consistent with the *Shariah*. Section 27 establishes the

⁴⁵⁷ Central Bank of Malaysia Act 2009, s. 5(1) and s.5(2)(c)

duality of the financial system in Malaysia where it shall consist of the conventional financial system and the Islamic financial system. Section 60 provides that BNM shall be cooperating with the Government of Malaysia and its agencies including the statutory body, supervisory authority, international and supranational organisation to develop and promote Malaysia as an international Islamic financial centre.

CBMA 2009 also provides for a conducive and facilitative environment for the development of Islamic finance. This is demonstrated, inter alia, through the establishment of the SAC by virtue of section 51. As explained earlier, SAC plays a significant role in the ascertainment of Islamic law on any financial matter and issue a ruling upon the reference made to it. It also acts as the advisor for both the BNM and the IFIs (and to any person as provided under any written law) on any *Shariah* issues relating to Islamic financial business, its activities and transactions. Furthermore, the SAC also shall advise the BNM which has been empowered by virtue of section 59 with the authority to issue written circulars, guidelines, or notices on *Shariah* matters relating to the Islamic finance business carried by the IFIs. These guidelines have proven to be an important element of the development of the Islamic finance industry in Malaysia by providing the practical standard operational procedures (SOPs) for numerous Islamic business arrangements as well as addressing the issues arising in the industry. Later in this chapter, one of these guidelines pertaining to *Musharakah* shall be discussed as to demonstrate, inter alia, how the implementation of risk sharing is being strengthened through it.

5.2.2 Islamic Finance Services Act 2013 (IFSA 2013)

The second piece of legislation is the IFSA 2013. It is an act to provide for the regulation and the supervision of Islamic institutions, payment systems and other relevant entities and the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with the *Shariah* and for related consequential or incidental matters. Unlike CBMA 2009 which regulates both conventional and Islamic financial institutions, the IFSA 2013 is promulgated specifically as an omnibus legislation to regulate and supervise the IFIs in Malaysia such as Islamic banks through which products such as *Musharakah Mutanaqisah* home financing and *Musharakah Sukuk* are being developed and marketed as well as to promote the adherence to the *Shariah*.

This act has come into force on 30 June 2013 after being approved by the Malaysian Parliament in December 2012 and received the royal assent on 18 March 2013. It

amalgamates several separate laws under a single legislative framework, namely the Payment Systems Act 2003, the Exchange Control Act 1953, the Islamic Banking Act 1983 (IBA 1983) and the Takaful Act 1984 which were repealed on the same date of its enforcement. The promulgation of this act does mark a significant legal development for Islamic finance industry in Malaysia as it provides a far more detailed regime toward a transparent and regulated industry rather than only focusing on licensing of institutions, simple regulation of ownership and business conduct and the powers of the BNM to control the institutions as what had been seen under the IBA 1983.⁴⁵⁸

The IFSA 2013 comprises 291 sections and 16 schedules. It provides a comprehensive legal framework from the matters starting from licensing to winding up of an institution as what can be observed in Part III (Authorization) and Part XIV (Division 3–Winding Up). A number of unprecedented new elements in the regulatory and supervision of the IFIs in Malaysia have also been added to this new act. For instance, Division 1 of Part XVI which contains section 229 until section 244 is pertaining to the power of enforcement and penalties provided to the BNM. By virtue of this Act, the BNM may cause an investigation to be made, seize relevant documents or items and take civil or criminal actions against any parties. Such provisions did not exist in the previous IBA 1983 but instead adopting the similar provisions from the then Banking and Financial Institutions Act 1989 (BAFIA 1989) which has been repealed by the introduction of the Financial Services Act 2013 (FSA 2013).⁴⁵⁹

In order to strengthen the corporate and *Shariah* governances of the IFIs, the roles and functions of key individuals of these institutions are also being clarified through this Act. For instance, sections 65, 66 and 67 clarify the functions and duties of the board of directors whereby section 68 is regarding the disqualifications of a person from being, inter alia, appointed as the chairman of the board of directors, director, chief executive officer or senior officer.

Part IV of this Act deals with the *Shariah* requirements. Division 1 of this part is pertaining to *Shariah* compliance in which the duty of IFIs in ensuring the compliance with *Shariah* (section 28) as well as the power of BNM to specify standards on *Shariah* matters (section 29) are being spelt out. Division 2 of the same part deals directly with the issue of *Shariah* governance where the establishment of the *Shariah* committee (section 30) and duties of the committee and its members are being specified (section 32). All these facts being said, the

⁴⁵⁸ Mohd. Johan Lee and Umar Oseni, *IFSA 2013: Commentaries on Islamic Banking and Finance* (CLJ Publication 2015) 5

⁴⁵⁹ *ibid* 183

promulgation of the IFSA 2013 amplifies the clear aspiration of Malaysian legal segment to achieve the greater alignment with the *Shariah* in all matters related to Islamic finance.

5.2.2.1 IFSA 2013 Positive Development: The Legal Recognition of Shariah Contract

It is remarkable to observe in this Act that for the first time, several Islamic contracts are explicitly enumerated in an act of Parliament as contracts that can be used by the IFIs in their products. Section 2 provides the meaning of Islamic banking business as the business of provision of finance. The term 'provision of finance' is further clarified by the section like the following:

.... means entering into, or making an arrangement for another person to enter into, the businesses or activities which are in accordance with Shariah including—

- a) equity or partnership financing, including musyarakah, musyarakah mutanaqisah and mudarabah;⁴⁶⁰
- b) lease-based financing, including al-ijarah, al-ijarah muntahia bi al-tamlik and al-ijarah thumma al-bai`;
- c) sale based financing, including istisna`, bai` bithaman ajil, bai` salam, murabahah and musawamah;
- d) currency exchange contracts;
- e) fee based activity, including wakalah;
- f) purchase of bills of exchange, certificates of Islamic deposit or other negotiable instruments; and
- g) the acceptance or guarantee of any liability, obligation or duty of any person;

The enumeration of Islamic contracts as mentioned here implies that these contracts are recognised as valid from the legal standpoint. Such recognition brings a significant meaning since it reduces the hassle of lengthy defence should there be lawsuits filed by any party to challenge the validity of a *Shariah* contract as had been witnessed in *Dato' Hj Nik Mahmud Daud*. As explained before, the plaintiff in the case prayed for an order that the charges and both PPA and PSA be declared as null and void. In this attempt, several contentions had been

⁴⁶⁰ It is worth to note that 'musyarakah', 'musyarakah mutanaqisah' and 'mudarabah' here refer to the same structure of Musharakah, Musharakah Mutanaqisah and Mudharabah respectively. The spellings are retained as per stated in the Act for the sake of accuracy.

brought forward by his counsel, among which was that the defendant had gone against its Article of Association by accepting the charge for the facility whereby it was prohibited at all material times to accept a charge in a usurious transaction (this is to say BBA is not a *Shariah*-compliant contract as it involves *Riba*). Although this particular contention had been abandoned at the outset of the hearing, what had drawn the attention here was the lack of clarity on the status of certain *Shariah*-compliant contract such as BBA at that time. During the time when the case took place, IBA 1983 as the then governing law did not specify any contract as a *Shariah* compliant contract. Rather, the term 'Islamic banking activities' as provided by section 2 of IBA 1983 was loosely defined as 'banking business whose aims and operations do not involve any element which is not approved by the Religion of Islam'⁴⁶¹. Since the definition was too wide without a solid substance, the 'loophole' had been used by the plaintiff's counsel to challenge the *Shariah* compliance aspect of the BBA.

Similarly, in *Arab-Malaysian Finance Bhd.*⁴⁶² the judgement of the case had raised the same issue against the validity of the BBA. In the deciding judge's verdict, it was held that the way the BBA arrangement was undertaken under the facility in question had rendered it a non-bona fide sale although BBA, in principle, is a bona fide sale. As such, the portion of profit paid to the plaintiff rendered the facility 'contrary to the Religion of Islam' due to *Riba*. Again, the deficiency in the then governing law had caused such ambiguity which eventually put the whole industry at stake during its infancy level when the heavy reliance was put on BBA. Hence, the insertion of *Shariah*-compliant contracts into an act of Parliament such as the IFSA 2013 will definitely put to rest the possibility for the similar uncalled situation to arise.

Admittedly, it could be argued that the possibility for such situation to resurface has already been eliminated since the court's decision for *Arab-Malaysian Finance Bhd.* has been reversed by the Court of Appeal in *Bank Islam Malaysia Berhad*. By virtue of *stare decisis*, the decision from the Court of Appeal shall bind all the courts in their decision for such a case in the future. This claim, however, appears to be simplistic. While concurring with the argument that decision by the Court of Appeal had come to the rescue, such decision does only 'rescue' one specific contract ie BBA, the contract in question. This clearly is insufficient since there are many other contracts such as *Musharakah Mutanqisah* or *Ijarah Muntahia Bi Tamlik* (Islamic Hire-Purchase) and so forth that are still being exposed to the risk of being challenged in the absence of proper legal recognition.

⁴⁶¹ Islamic Banking Act 1983, s. 2

⁴⁶² [2008] 5 MLJ 631

Furthermore, the decisions of *Mohd Alias Ibrahim* and *Tan Sri Khalid Ibrahim* have also clarified the extent to which the SAC is empowered. As much as it is a point of contention, the SAC cannot be said as to perform a judicial or quasi-judicial function, nor that its decision binds the court. It is merely required to make an ascertainment, not a determination of the Islamic laws related to the question. Rather than issue a new ruling, it is expected to find out which of the existing rulings is the most applicable in Malaysia for the sake of ascertaining the relevant Islamic laws pertaining to the question at hand. The ultimate decision in a legal adjudication, thus, is still the prerogative of the court. As such, relying on the SAC to mitigate the ambiguity mentioned above is seemingly insufficient and might prove to be ineffective should the question on the validity of the *Shariah* contract arise, and the court holds a different view as compared to the ruling issued by the SAC. For the sake of argument, even if such reliance might be sufficient and effective, the ascertainment of the validity of a *Shariah* contract would require a lengthy process as it must be brought before the court first before it could be referred to the SAC. Having the contract enumerated in an act, however, can be considered as a preemptive move to ensure such a contention does not arise in the first place other than to secure its credibility in the eyes of the law.

5.2.2.2 IFSA 2013 Positive Development: Strengthening the Implementation of Risk Sharing

Another positive development that can be observed through the IFSA 2013 is pertaining to the initiative taken by the legislative branch in strengthening the implementation of risk sharing in the Islamic finance market. As initially explained in Chapter 1, there was no legal requirement on the IFIs to segregate the funds placed by their customer either into the deposit account (current or saving, CASA) or the investment account. Although these two types of accounts are supposed to serve different financial appetites (the former for safekeeping and the latter for investment ie making a profit), such difference was not made clear. For instance, although saving is principally for the purpose of safeguarding the money (hence the name), it was structured based on the *Mudharabah* which typically used for the purpose of profit making like an investment. Even though the validity of this application was justified, a more in-depth analysis would be able to show that such contract is not supposed to be used as the underlying contract for an account designated for the purpose of deposit taking due to their incompatibility.

To understand the nature of the deposit account, a classic case in the English Court, *Foley v Hill*⁴⁶³ is among the best cases to be referred to. In this case, the appellant, who was the co-owner of collieries with his friend (non-party in this case) in Staffordshire, kept a joint account at the respondent's bank at Stour-bridge, in Worcestershire. In April 1829, a sum of money was transferred from that account to a separate account then opened for the appellant. The respondent's bank, in a letter enclosing a receipt for the transferred sum, agreed to give a certain percentage of interest on it. From 1829 until 1834, when the joint account was closed, the appellant's share of the profits of the collieries was paid by cheques drawn on the joint account by the agents managing the collieries. These cheques were paid in cash or by bills drawn by them on their London bankers in favour of the appellant and none of them was paid into his (private) separate account. The only amount ever credited to that account was the initial sum together with the interest calculated by the bank up to the 25 December 1831, but not afterwards. The appellant filed his bill in January 1838, against the respondents, requesting that an account might be taken of the said sum received by the respondents for him on his private account since April 1829, with interest on the same at the rate, per annum as well as an account of all sums properly paid by them for or to the use of him on his said account since that day. The case was initially brought before the Vice-Chancellor, Sir James Wigram who ordered an account. The decision had been reversed by the Lord Chancellor, Lord Lyndhurst who heard the initial appeal. Later, the appellant appealed to the House of Lords. This time, their Lordships told the respondents' counsel that they did not need to address them and subsequently dismissed the appeal with costs.

What is important to be looked at in this respect is the fundamental principles pertaining to the money deposited to a bank laid by, Lord Cottenham who was sitting in the House of Lords for this appeal and replaced Lord Lyndhurst as the Lord Chancellor in his judgement as the following:⁴⁶⁴

Money, when paid into a bank, ceases altogether to be the money of the principal; it is by then the money of the banker, who is bound to return an equivalent by paying a similar sum to that deposited with him when he is asked for it. The money paid into a banker's is money known by the principal to be placed there for the purpose of being under the control of the banker; it is then the banker's money; he is known to deal with it as his own; he makes what profit of it he can, which profit he retains to himself, paying back only the principal, according to the custom of bankers in some places, or

⁴⁶³ [1848] 2 HLC 28

⁴⁶⁴ [1848] 2 HLC 28, 36-37

the principal and a small rate of interest, according to the custom of bankers in other places. The money placed in custody of a banker is, to all intents and purposes, the money of the banker, to do with it as he pleases; he is guilty of no breach of trust in employing it; he is not answerable to the principal if he puts it into jeopardy, if he engages in a hazardous speculation; he is not bound to keep it or deal with it as the property of his principal; but he is, of course, answerable for the amount, because he has contracted, having received that money, to repay to the principal, when demanded, a sum equivalent to that paid into his hands.

Based on the judgement noted above, it can be understood that when a customer deposits his money at a bank, he, in the real sense, is lending out his money to the bank. On its capacity as the borrower, the bank reserves the right to deal with money as it pleases in all intents and purposes. It is not answerable to the customer should it puts the money into jeopardy since, technically, the money ceases to be the customer's money and becomes its money instead. The bank, however, is responsible to repay the customer only the principal amount ie a sum equivalent to that paid money albeit the payment with small rate of interest might take place based on the practised custom.

By submitting that the established relationship between a bank and its customer in such a case is debtor-creditor, it is clear that the application of investment-oriented underlying contract like *Mudharabah* for deposit account is not suitable since the relationship established between the involved parties is project manager (*Mudharib*) – capital provider (*Rabbul Mal*). The incompatibility between these two arrangements (loan and investment) can be observed in many aspects. For instance, since the deposited money is construed as a loan, the bank (on its capacity as the debtor) has an obligation to guarantee the payment of the principal amount. Such circumstance clearly goes against the rule for *Shariah*-compliant investment which dictates that no guarantee shall be given to the capital contributed to the investment (this shall be explained further in the discussion of the *Musharakah* regulatory policy). Furthermore, the fact that the customer lends out his money and has no involvement in the bank's activity whatsoever other than expecting the repayment of the principal amount indicates the absence of the element of risk sharing which supposedly become the hallmark of a *Shariah* compliant investment. Mixing up the arrangement for lending purpose with the structure which is originally meant for investment purpose certainly creates the confusion and might render the reputational risk to the IFIs.

However, with the IFSA 2013 in the picture, the said potential ‘threat’ has now been mitigated. This is because the Act has clearly defined the investment account which has effectively made the distinction between money collected from the customer for the investment purposes or deposit taking purposes. In this regard, ‘Islamic deposit’ is defined as follows:

‘Islamic deposit’ means a sum of money accepted or paid in accordance with Shariah;

- a) on terms under which it will be repaid in full, with or without any gains, return or any other consideration in money or money’s worth, either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and person accepting it; or
- b) under an arrangement, on terms whereby the proceeds under the arrangement to be paid to the person paying the sum of money shall not be less than such sum of money...

Here, it is clear that the money which is taken for deposit purposes is guaranteed up to the principal amount and the payment can take place with or without any gains, return or any other consideration as it is meant only to safe keep the money. This is different from the money placed with the intention to gain profit through investment activity. In this regard, the Act defines an investment account as follows:

‘investment account’ means an account under which money is paid and accepted for the purposes of investment, including for the provision of finance, in accordance with *Shariah* on terms that there is no express or implied obligation to repay the money in full and—

- a) either only the profits, or both the profits or losses, thereon shall be shared between the person paying the money and the person accepting the money; or
- b) with or without any return;

The act expressly requires the account under which the money is collected operates for investment where there is no obligation, expressly or impliedly, for the money to be repaid in full. This provision certainly echoes the requirement by the *Shariah* for a valid investment ie no guarantee on the capital contributed.

The definition also addresses the distribution of profit and loss between the contracting parties (in this case, the bank and the customer) which is among the central issues in determining the validity of investment in the eyes of the *Shariah*. By virtue of item (a) and item (b) of the said

definition which allude two types of *Shariah*-compliant investments, namely *Musharakah* (where profit and loss are shared between partners) and *Mudharabah* (where only profit is shared), the customer, in his capacity as an investor, is not guaranteed with return but exposed to the possibility of gaining the profit or bearing the loss, depending on the performance of the investment. Indeed, such provision complements the *Shariah* aspiration and regulation pertaining to the justice management in the distribution of risk.

Taking all these facts into account, it is therefore submitted that, such new approach in defining deposit and investment accounts thus making a distinction between them not only reshapes the landscape of Islamic finance in Malaysia but also manifests the direction taken by its legislative branch in strengthening the practice and conduct of risk sharing-based business activity such as investment. Not only it can be considered as an early step for further leaps, this new development in the Malaysian legal regime certainly amplifies a good signal to the industry on the support offered by the regulatory end and its readiness to accommodate the effort of rejuvenating Islamic finance by reinforcing the idea of risk sharing in the Islamic banking and finance businesses.

5.3 The Transactional Laws

5.3.1 Partnership Act 1961 (PA 1961)

The first piece of legislation from the second group (transactional laws) is the PA 1961. It is an act of parliament which is in *pari materia* with the English Partnership Act 1890. Both statutes are almost identical in content despite the section numbers differing. Containing forty-seven sections, PA 1961, which has been revised in 1974, is divided into five parts; Part I–Preliminary, Part II–Nature of Partnership, Part III–Relations of Partners to Person Dealing with Them, Part IV–Relations of Partner to One Another, Part V–Dissolution of Partnership and Its Consequences. As discussed in the previous chapter, *Musharakah* covers a broad understanding for it is classified into various groups by the jurists, depending on which aspect those jurists were looking from. Nevertheless, in general term, the connotation that *Musharakah* brings revolves around the arrangement between two or more parties to combine their assets, labours or liabilities for the purpose of making a profit. Since such an arrangement is essentially a partnership from the legal standpoint, the PA 1961 becomes among the relevant transactional laws in the case of *Musharakah*.

5.3.1.1 The Relevance of the PA 1961 in the Case of *Musharakah*

As explained earlier, the way in which the Malaysian legal system works has excluded the *Shariah* from being the governing law for matters related to Islamic finance. Notwithstanding the existence of provisions such as section 28 of the IFSA 2013⁴⁶⁵ as well as other circulars, guidelines and so forth which entail the obligation on the IFIs to ensure that all of their business activities comply with the *Shariah*, such directives remain general and limited insofar permitted by the civil court as the competent court for Islamic finance adjudication.

Further, section 5 of the CLA 1956 entails the applicability of the common law of England and the rules of equity to commercial cases including partnership in the circumstance where there is no written law on such matters. This position is in line with the provision under section 47(1) of the PA 1961 which requires that the partnership venture must comply with law prescribed by the Act although the rules of equity and common law of England may be applicable so long there is no contradiction between them and the Act.⁴⁶⁶

Taking all these facts into consideration, it is asserted that the applicable law for *Musharakah* is the PA 1961. The applicability of the common law of England and the rules of equity ends with the existence of the written law ie the PA 1961, and since no exemption made by the court or any written law to exclude *Musharakah* from being a subject of the Act, it shall remain under the purview of the PA 1961.

5.3.1.2 PA 1961 *Vis-À-Vis* *Musharakah*

Previously, it is asserted that risk sharing is an essential element in a partnership from the Islamic finance standpoint. Nevertheless, such issue is not specifically addressed by any provision in the PA 1961. Presumably, this is due to the fact that even though this act, which is in *pari materia* with the English Partnership 1890, demonstrates the convergence of the idea of partnership with *Musharakah* to certain extent, it also demonstrates the divergence in the understanding of those two ie partnership recognised under the PA 1961 and *Musharakah* as prescribed under the Islamic jurisprudence. One of the instances for such convergence and

⁴⁶⁵ Section 28 of IFSA 2013 reads:

28.(1) An institution shall at all times ensure that its aims and operations, business, affairs and activities are in compliance with *Shariah*.

⁴⁶⁶ Partnership Act 1961, s. 47(1)

divergence is pertaining to the form of partnership as entailed by the provided partnership's definitions.

Section 3 of the PA 1961 defines partnership as 'the relationship which subsists between persons carrying on business in common with a view of profit'. The Islamic commercial law, on the other hand, has its own way of presenting the discussion of the *Musharakah* partnership. The jurists of Hanafi school of law defined *Musharakah* as a contract between a group of individuals who share the capital and profits.⁴⁶⁷ The jurists from the Maliki school of law defined it as the right for all the partners to deal with any part of the partnership's joint property.⁴⁶⁸ As for the jurists from the Hanbali school of law, *Musharakah* is the sharing of rights to collect benefits from or deal in the properties of the partnership whereby the jurists of Shafie school of law referred *Musharakah* as an establishment of collective rights pertaining to some property for two or more people.⁴⁶⁹

An overall analysis over the definitions of partnership as mentioned above would be able to show that partnership, as entailed by section 3 of the PA 1961, is similar to the one entailed by the Hanafi jurists since both refer to the commercial arrangement between the partners serving as a vehicle to carry out business in common with the aim to generate profit from it. As such, the concept of partnership is only confined within the scope of *Shirkah Al-Aqd* as established in the Islamic commercial law as discussed in Chapter 4 while omitting another type of *Musharakah*, namely *Shirkah Al-Milk*. *Shirkah Al-Milk*, as entailed by the definitions offered by the jurists of Maliki, Shafie and Hanbali schools of law, implicates the establishment of shared rights among a group of people over an asset as to enjoy the benefit derived from it or to deal in it without necessarily having a commercial aspect embedded in such sharing. For the purpose of this study, such position, therefore, triggers a serious concern since the *Musharakah Mutanaqisah* home financing in Malaysia is to take *Shirkah Al-Milk* as its underlying structure thus put the product's legal status at stake (more on this point shall be addressed later).

The discrepancy between the concept of partnership as understood in PA1961 and *Musharakah* of Islamic commercial law can be observed further by referring to section 4 of the PA 1961 where it provides for certain circumstances that cannot be construed as a partnership.⁴⁷⁰ In this respect, section 4(a) reads, 'joint tenancy, tenancy in common, joint

⁴⁶⁷ Al-Zuhaily (n 41) 447

⁴⁶⁸ *ibid*

⁴⁶⁹ *ibid*

⁴⁷⁰ Section 4 of the PA 1961 reads:

property, common property, or part ownership does not itself create a partnership as to anything so held or owned'. This provision further asserts that notwithstanding *Shirkah Al-Milk* is a recognised form of partnership under the Islamic commercial law, it does not receive such recognition from the PA 1961 since a mere joint property does not constitute a partnership under the Act. As such, this position blurs the legal status of the *Musharakah Mutanaqisah* home financing even further.

Section 4(c) of the PA 1961 is also relevant in this respect. This section provides that the mere receipt of a share of the profits from a business does not automatically make the recipient a partner hence denies the establishment of partnership.⁴⁷¹ Section 4(c)(ii) further excludes the person who receives remuneration from a share of the profits of a business from a person engaged in the business from being a partner (hence no partnership). As such, this section rules out *Mudharabah* (a form of *Musharakah*) from the list of the recognised form of partnership under the PA 1961. As explained in the previous chapter pertaining to the *Mudharabah* arrangement, the *Mudharib* will be participating in the business venture not through the capital contribution. Instead, his participation takes place by extending his

In determining whether a partnership does or does not exist, regard shall be had to the following rules:

- a) joint tenancy, tenancy in common, joint property, common property, or part ownership does not of itself create a partnership as to anything so held or owned, whether the tenants or owners do or do not share any profits made by the use thereof;
- b) the sharing of gross returns does not of itself create a partnership, whether the persons sharing such returns have or have not a joint or common right or interest in any property from which or from the use of which the returns are derived;
- c) the receipt by a person of a share of the profits of business is prima facie evidence that he is a partner in the business, but the receipt of such a share, or of a payment contingent on or varying with the profits of a business, does not of itself make him a partner in the business; and in particular—
 - i. the receipt by a person of a debt or other liquidated amount, by instalments or otherwise, out of the accruing profits of a business does not of itself make him a partner in the business or liable as such;
 - ii. a contract for the remuneration of a servant or agent of a person engaged in a business by a share of the profits of the business does not of itself make the servant or agent a partner in the business or liable as such;
 - iii. a person being the widow or child of a deceased partner, and receiving by way of annuity a portion of the profits made in the business in which the deceased person was a partner, is not, by reason only of such receipt, a partner in the business or liable as such;
 - iv. the advance of money by way of loan to a person engaged or about to engage in any business on a contract with that person that the lender shall receive a rate of interest varying with the profits, or shall receive a share of the profits, arising from carrying on the business, does not of itself make the lender a partner with the person or persons carrying on the business or liable as such:

Provided that the contract is in writing and signed by or on behalf of all the parties thereto; and

- v. a person receiving, by way of annuity or otherwise, a portion of the profits of a business in consideration of the sale by him of the goodwill of the business is not, by reason only of such receipt, a partner in the business or liable as such.

⁴⁷¹ Samsar Kamar Latif, *Partnership Law in Malaysia* (International Law Book Services 2015) 9

entrepreneurship skill and labour force. In return, he is entitled to a certain pre-determined portion of profit derived from the venture which whereby in the event of loss, such loss will be solely borne by the capital provider, *Rabbul Mal. Mudharib*, as such, receives a share of the profit of the business as the consideration of the ‘service’ extended, the exact circumstance referred to in section 4(c)(ii).

Based on the arguments as mentioned above, it is, therefore, asserted that notwithstanding the convergence of the fundamental ideas of partnership under the PA 1961 and the Islamic commercial law, the Act fails to recognise certain forms of *Musharakah* partnership such as *Shirkah Al-Milk* and *Mudharabah*. As mentioned above, such failure triggers concern on the status of certain *Musharakah*-based product such as *Musharakah Mutanaqisah* home financing which is structured based on the concept of *Shirkah Al-Milk*. This point shall be readdressed and further discussed in the next chapter.

5.3.2 *Musharakah Regulatory Policy*

As provided by CBMA 2009 and further reiterated in the IFSA 2013, the BNM is empowered to specify standards pertaining to *Shariah* matters in respect of carrying business, affair or activity which requires the ascertainment of Islamic law by the SAC as well as to specify standards relating to the matters which do not require the ascertainment of Islamic law.⁴⁷² In addition, the BNM may also specify standards on prudential matters such as corporate governance and risk management as well as on business conduct to financial service provider to ensure financial consumers will receive fair, responsible and professional service.⁴⁷³

⁴⁷² Section 29(1) and 29(2) of the IFSA 2013 read:

29. (1) The Bank may, in accordance with the advice or ruling of the Shariah Advisory Council, specify standards—

- (a) on Shariah matters in respect of the carrying on of business, affair or activity by an institution which requires the ascertainment of Islamic law by the Shariah Advisory Council; and
- (b) to give effect to the advice or rulings of the Shariah Advisory Council.

(2) In addition, the Bank may also specify standards relating to any of the following matters which does not require the ascertainment of Islamic law:

- (a) Shariah governance including—

- (i) functions and duties of the board of directors, senior officers and members of the Shariah committee of an institution in relation to compliance with Shariah;
- (ii) fit and proper requirements or disqualifications of a member of a Shariah committee; and
- (iii) internal Shariah compliance functions; and

- (b) any other matter in relation to the business, affair and activity of an institution for the purposes of compliance with Shariah.

⁴⁷³ Section 135(1) and 135(2) of the IFSA 2013 read:

135. (1) The Bank may specify standards on business conduct to a financial service provider for the purposes of ensuring that a financial service provider is fair, responsible and professional when dealing with financial consumers.

Further, the BNM also has the authority to issue guidance in writing consisting of such information, advice or recommendation as it regards appropriate with respect to the provisions of IFSA 2013 which can be facilitative for the purpose of carrying out and achieving the regulatory objectives of the Act.⁴⁷⁴

Pursuant to such, a regulatory policy by the title ‘*Musyarakah*’ has been issued by the BNM on 20 April 2015 and comes into effect starting from 1 June 2016. This regulatory policy was issued with the aim to provide reference on the *Shariah* rulings associated with *Musharakah*, setting out key operational requirements pertaining to the implementation of *Musharakah* as well as to promote end-to-end compliance with *Shariah* requirements including adherence to sound banking practices and safeguarding customers’ interest. The provisions in this policy can be divided into two categories, namely ‘S’ and ‘G’. S denotes the standard, requirement or specification which are made mandatory. Failing to comply with such may lead to one or more enforcement actions. G, on the other hand, refers to the guidance which consists of information advice and recommendation with the aim to promote mutual understanding and adoption of sound industry practices which are encouraged to be adopted.⁴⁷⁵ It comprises four parts where the first part (Part A) gives an overview for the policy. The second part (Part B) provides the compulsory *Shariah* requirements pertaining to *Musharakah* and its optional practices. Part C and Part D spell out the operational requirements on governance and oversight, structuring, risk management, financial reporting, and business and market conduct where the former focuses on the *Musharakah* venture while the latter focuses on the *Musharakah* financing.

As explained earlier, the jurists from different schools of law had a number of disagreements among themselves over certain issues involving *Musharakah*. These disagreements which led to the production of various rulings and positions had been properly recorded in the Islamic

(2) Without limiting the generality of subsection (1), standards specified under that subsection may include standards relating to—

- (a) transparency and disclosure requirements including the provision of information to financial consumers that is accurate, clear, timely and not misleading;
- (b) fairness of terms in a financial consumer contract for financial services or products;
- (c) promotion of financial services or products;
- (d) provision of recommendations or advice including assessments of suitability and affordability of financial services or products offered to financial consumers; and
- (e) complaints and dispute resolution mechanisms.

⁴⁷⁴ Section 277 of the IFSA 2013 reads:

277. The Bank may issue guidance in writing to any person or to any class, category or description of persons consisting of such information, advice or recommendation as it considers appropriate—

- (a) with respect to the provisions of this Act;
- (b) for the purpose of carrying out or achieving the regulatory objectives of this Act; or
- (c) with respect to any other matter which, in the opinion of the Bank, is desirable to give information, advice or recommendation.

⁴⁷⁵ Bank Negara Malaysia, ‘*Musyarakah*’ (n 294) para. 7.2

law literature works. Nevertheless, since the regulatory policy is meant to serve as the operation manual rather than a mere reference in the Islamic law, it needs to be clear and precise in terms of the direction it wishes the operation of *Musharakah* to be carried out. For instance, as what has been mentioned in the previous chapter, Muslim jurists have disputed over the legality of capital contributed to a *Musharakah* venture which is not in cash form. However, the policy indicates its preference in this issue by allowing the partners of *Musharakah* to contribute their capital in the form of cash or in-kind, including intangible assets. Should the latter be the case, the said in-kind capital shall be valued in monetary terms either by an agreement between the partners or by a third party such as experts, valuers, or any qualified at the point of time where the partners enter into the *Musharakah* contract.⁴⁷⁶ As such, while admitting there is a dissenting view offered by the jurists in this regard, as far as the Malaysian context is concerned, such question is no longer relevant.

5.3.2.1 Salient Requirements of the Musharakah Regulatory Policy: Capital of Musharakah

Through its provisions, the *Musharakah* Regulatory Policy does not only seek to ensure that the validity of *Musharakah* operation is achieved. Rather, the way it is constructed signifies the aspiration from the regulatory side to uphold and propagate the idea of justice through the promotion of risk sharing idea and the avoidance of the prohibited elements such as *Riba* and *Gharar*. The provisions pertaining to the capital requirement and profit and loss distribution among the instances to exemplify this fact.

In terms of *Musharakah* capital, the earlier discussion had addressed the nature of the permissible capital, whether it must be in cash or it might also be otherwise. However, there is another equally important point in this respect which needs to be addressed, namely debt as the capital of *Musharakah*. In this case, jurists unanimously agreed that debt such as receivables cannot be contributed as the capital of *Musharakah*. This is because the capital, should it be in the form of debt, cannot be immediately used for the purpose of *Musharakah* operation thus defeats the meaning of *Musharakah* which entails the co-mingling of the assets and the mutual rights of the partners to transact with them from the beginning.⁴⁷⁷ Allowing

⁴⁷⁶ Paragraph 15.2 and 15.3 of the Musharakah Regulatory Policy read:

G15.2 The capital may be in the form of cash or in-kind, including intangible assets.

S15.3 Where the capital is in-kind, it shall be valued in monetary terms either by agreement between the partner by a third party, which may include experts, valuers, or any other qualified person, at the time of entering into the musyarakah contract.

⁴⁷⁷ Ahmad, Al-Mughni (n 42) 125

debt to be contributed as capital, thus, would endanger the existence of partnership with uncertainty, *Gharar*.

The reason for such prohibition becomes stronger in the circumstance where one of the partners is the creditor who loans his money to the other partner and contributes the receivable as the capital. Such a situation triggers the risk of *Riba* because the receivable that is contributed as the capital may be construed as a loan which renders benefit (in the form of the entitlement to the *Musharakah* profit). As dictated by a well-known maxim established by the jurists, every loan which renders benefit is deemed as *Riba*, thus prohibited.⁴⁷⁸

As such, the *Musharakah* regulatory policy rules that all forms of debts shall not qualify as capital, including all receivables and payments due from other partners or third parties.⁴⁷⁹ Such position is consistent with the position taken by the AAOIFI in this respect. In its *Shariah* Standard no. 12, AAOIFI also rules that it is not permitted for mere debt to represent participation share in the partnership's capital unless the debt is appending to other item which is contributed as capital (for instance a manufacturing facility contributed as capital with all its rights and obligations).⁴⁸⁰ Adhering to this requirement is rather important not only to ensure the validity of *Musharakah* but also to safeguard the *Maqasid Al-Shariah* that aims to uphold the justice by eliminating the element of *Gharar* in the commercial transaction as well as to avoid the *Musharakah* arrangement from being fictitious which is manipulated as a stratagem to *Riba*.

The *Musharakah* regulatory policy also addresses another important point in this respect pertaining to the guarantee on the *Musharakah* capital. It is held by the majority of jurists that no guarantee is allowed to be extended on the *Musharakah* capital. This is due to the fact that *Musharakah* falls under the rubric of *Uqud Amanah*, the contract that is entered based on trust.⁴⁸¹ This is as opposed to another type of contract namely *Uqud Dhamanah*, which is entered based on guarantee. In the case of *Musharakah*, the partners are entrusting each other with their contributed capital and expected to cooperate in deriving profit from the venture which will be enjoyed together rather than one party has to assume an additional

⁴⁷⁸ Asyraf Wajdi Dusuki and Adelazeem Abozaid, 'Fiqh Issues in Short Selling as Implemented in The Islamic Capital Market in Malaysia' (2008) 21(2) JKAU: Islamic Econ. 63

⁴⁷⁹ Paragraph 15.5 of the *Musharakah* Regulatory Policy reads:
S15.5 All forms of debts shall not qualify as capital, including all account receivables and payments due from other partners or third parties.

⁴⁸¹ Asmadi Mohamed Naim and others, *Issues of Taqdir, Taaddi, Guarantees and Managing Moral Hazard in Mudarabah and Musharakah Products* (2013) ISRA Research Paper 58/2013, 24

responsibility of making sure that the capital of the other party is protected.⁴⁸² As the *Musharakah* property ceases to be the original owner's personal property but the venture's property instead, each partner is deemed as to release his counter partners from the responsibility to guarantee the capital should it damage or loss provided such damage or loss are genuine (not incurred out of negligence, for instance).⁴⁸³

Failing to adhere to this requirement will lead to several uncalled consequences. Firstly, the guarantee on capital of *Musharakah* venture, should it be given, will turn the nature of the contract from a trust-based contract into a non-trust-based/guarantee-based contract thus makes the contributed capital effectively as a loan given to the venture.⁴⁸⁴ As such, the profit derived from the investment activities would be similar to the interest which is tantamount to *Riba*.

Guaranteeing the capital will also cause the *Musharakah* to be a risk-free investment. In such a case, the guaranteed partner will have the chance to gain profit while does not have to expose himself to the risk of losing his capital. This violates the core trait of a *Musharakah* arrangement as a risk sharing vehicle where the partners are expected to have 'skin in the game' in order to justify their entitlement to the profit.

Hence, the *Musharakah* regulatory policy rules that the capital invested shall not be guaranteed by any of the partners or the manager of the venture. However, the partners are to be held liable and shall indemnify the venture for the loss of capital should the loss arise from their misconduct, negligence or breach of specified terms.⁴⁸⁵ This position appears to be similar with the AAOIFI *Shariah* standard which also does not permit the stipulation of capital guarantee by partner except for the case of misconduct, negligence or breach of specified terms (*Shariah* standard no.12, paragraph 3.1.4).

Nevertheless, the *Musharakah* regulatory policy does allow for each partner to be required to provide collateral which shall only be liquidated in the three circumstances as mentioned above. A guarantee can also be provided by an independent third party guarantee, provided that the execution of such guarantee shall be done via a separate contract and the independency of the

⁴⁸² Aznan Hassan and Zaharuddin Abdul Rahman, 'Musharakah: Isu Jaminan Perlindungan Modal dan Pengukuhan Kredit' (Muzakarah Cendekiawan Syariah Nusantara 5 2011), 6

⁴⁸³ *ibid* 8

⁴⁸⁴ *ibid*

⁴⁸⁵ Paragraph 15.14 and 15.15 of the *Musharakah* Regulatory Policy read:

S15.14 The capital invested shall not be guaranteed by any of the partners and/or the managers.

S15.15 Any partner, whether a managing partner or a non-managing partner acting as an agent for musyarakah, who has caused the loss of capital due to his misconduct (ta'addi), negligence (taqsir) or breach of specified terms (mukhalafah al-shurut) shall indemnify the musyarakah for the loss of the capital.

guarantor must be proved in such a way where the partner has no majority ownership or has control over the guarantor or vice versa.⁴⁸⁶ Such position is in line with that has been mentioned by the AAOIFII *Shariah* standard as it also allows the stipulation of the party to provide collateral to be liquidated during those three events as mentioned above. It also allows an independent third party to undertake to bear the loss on behalf of the partners provided that the third party does not own or is owned by the guaranteed party by more than 50 per cent (*Shariah* standard no.12, paragraph 3.1.4.2 and 3.1.4.3).⁴⁸⁷ Understandably, such threshold is set as to indicate the independency of the third party (the party which offers the guarantee) from the party who enjoys the extended guarantee.

For the sake of argument, it might be argued that the permission to provide collateral or guarantee from a third party in order to avoid the capital impairment jeopardises the core nature of *Musharakah* pertaining to risk taking. This argument, however, can be rebutted in several ways. Firstly, the permission to provide collateral does not apply in every circumstance. Rather, it is only applicable in the case of misconduct, negligence or breach of specified terms. Since it is submitted that *Musharakah* is a trust-based arrangement, the partners, therefore are expected to assume the fiduciary duty. The collateral, should it be provided, is only meant to mitigate the risk of failing to fulfil this particular duty. As for the risk associated with the business activities, the collateral does not give any influence whatsoever which makes the nature of the *Musharakah* intact.

Secondly, as to the permission of having a guarantor, such permission can only be exercised with two conditions ie the guaranteeing party must be totally independent (legally and financially) from the partners and the arrangement shall not be embedded in the venture's agreement but to be treated as a separate arrangement. Therefore, the guarantee can be considered as a supplement arrangement only whereby the execution of the venture does not

⁴⁸⁶ Paragraph 18 of the *Musharakah* regulatory policy reads:

18. Arrangement for guarantee

S18.1 Partners in musyarakah shall not guarantee the capital and/or profit.

G18.2 Notwithstanding paragraph 18.1, the following measures may be exercised:

- (a) each partner may be required under the musyarakah contract to provide collateral under the terms that it shall only be liquidated in the event of a misconduct (ta`addi) or negligence (taqsir) or breach of specified terms (mukhalafah al-shurut) of a contract by the partner(s); or
- (b) the musyarakah contract may require for the arrangement of an independent third party guarantee.

S18.3 Pursuant to paragraph 18.2(b), the following requirements shall be observed:

- (a) the guarantee shall be executed in a separate contract;
- (b) the guarantee shall be utilised to cover any loss or depletion of the capital; and
- (c) the third party guarantor shall be independent of the musyarakah venture such that it shall not be a related party, where:
 - (i) the partner(s) has majority ownership and/or has control over the third party; or
 - (ii) the third party owns or has control over the musyarakah venture

⁴⁸⁷ It is worth to note here, as for the third party guarantee, AAOIFI requires that it should be given without reward whereby the *Musharakah* regulatory policy of BNM is silent on this point.

depend on it. Furthermore, a strict requirement has been imposed to gauge the degree of independency of the guaranteeing party. This would be sufficient to ensure that the permission cannot be manipulated by the partner to provide or receive a guarantee, directly or indirectly. As such, the fundamental trait of *Musharakah* in terms of risk taking will be safely preserved.

5.3.2.2 Salient Requirements of the Musharakah Regulatory Policy: Profit and Loss Distribution

Profit and loss distribution is another crucial aspect in a commercial arrangement such as *Musharakah*. As mentioned in the previous chapter, there are three different opinions among the jurists as to whether the profit ratio should be proportionate to the capital contributed to the venture. It has also been mentioned previously that the AAOIFI had adopted the opinion saying that the profit is not necessarily proportionate to the capital contributed except in circumstances where a partner had stipulated express condition in the agreement that he will remain throughout the tenure of the venture. Thus, his share of profit cannot be more than the ratio of his investment. Such position is different from the one held by the *Musharakah* regulatory policy as it rules that the profit-sharing ratio in *Musharakah* shall be proportionate to the capital contribution of each partner unless mutually agreed otherwise at the time of entering into *Musharakah* contract.⁴⁸⁸ As for the loss, it is explained earlier that there is no dispute among the jurists that it should be proportionate to the capital contribution. As such, the *Musharakah* regulatory policy and the AAOIFI *Shariah* standard take the similar position in this respect.

It is interesting to observe here that the *Musharakah* regulatory policy is quite detailed in its description of profit and loss distribution. There is a clear requirement of not stipulating a pre-determined fixed amount of profit to any partners which may deprive the profit share of the other partner.⁴⁸⁹ This requirement is important as by adhering to it, the arrangement shall uphold the implementation of risk sharing and the notion of justice since the return is determined by the actual performance of the venture while its failure makes the arrangement behave similarly to a fixed-income instrument such as the *Riba*-based loan. Looking from

⁴⁸⁸ Paragraph 16.2 of the *Musharakah* regulatory policy reads:

S 16.2 The profit sharing ratio (PSR) in the *musyarakah* shall be proportionate to the capital contribution of each partner unless mutually agreed otherwise at the time of entering into the *musyarakah* contract.

⁴⁸⁹ Paragraph 16.5 of the *Musharakah* regulatory policy reads:

S16.5 The *Musyarakah* contract shall not stipulate a pre-determined fixed amount of profit to any partners which may deprive the profit share of the other partners.

another perspective, the prohibition of prefixing the amount of profit will effectively motivate the partners to execute the investment with due diligence since their gain depends on the performance of the venture. This certainly will stimulate an economic environment with a positive culture which encourages the real economic activities through entrepreneurship, something which is in line with the concept of *Hifz Mal* (the protection of wealth) championed by *Maqasid Al-Shariah* (more on this in Chapter 6).

The *Musharakah* regulatory policy also prescribes two methods of profit recognition that may be used. The first is the realisation based on the actual liquidation of the assets of the venture, known as *Al-Tandid Al-Haqiqi*. The second method, known as *Al-Tandid Al-Hukmi*, is the recognition in accordance with an acceptable profit recognition method which may include valuation according to the acceptable market methodology or the independent valuation or the valuation based on the estimated figures. Should the profit be recognised by the latter, a final consolidation and adjustment shall be undertaken to determine the actual profit. The *Musharakah* regulatory policy does allow a sum of money to be distributed prior to the valuation, provided such paid amount that exceeds the actual profit must be adjusted. Such stipulation of adjustment is important to ensure that the profit distribution is reflecting the actual performance of the venture and a fair wealth distribution can take place.⁴⁹⁰

There is also another point which is rather important to be highlighted at this juncture pertaining to the two concepts of *Musharakah*, namely *Shirkah Al-Aqd* and *Shirkah Al-Milk*. The *Musharakah* regulatory policy has put *Musharakah Mutanaqisah* for the purpose of asset acquisition in a relatively new perspective. Paragraph 21.2 reads, “Musyarakah Mutanaqisah with an asset acquisition must be governed by the principle of *Shirkah al-Milk* and therefore must have the effect of *Shirkah al-Milk* ...”. Paragraph 31.1 further reads, “Musyarakah financing refers to a financing using a Musyarakah contract structured to reflect a debt-based financing risk profile which is in line with the *Shariah* concept of *Shirkah al-Milk*”.

⁴⁹⁰ Para. 16.8 to 16.11 of the *Musharakah* Regulatory Policy read as the following:

S16.8 Profit shall be recognised based on the following methodology:

- (a) Realised basis by actual liquidation of assets of musyarakah partnership (*al-tandid al-haqiqi*); or
- (b) Constructive basis according to an acceptable profit recognition method which may include valuation according to acceptable market methodology or independent valuation or valuation based on estimated figures (*al-tandid al-hukmi*).

G16.9 In the case of profit recognised based on constructive basis, a profit reserve may be created.

S16.10 In the case of profit recognised based on constructive basis, a final consolidation and adjustment shall be undertaken to determine the actual profit, either:

- (a) at the end of a certain period; or
- (b) at the point of actual profit realisation.

S16.11 It is permissible to distribute a sum of money prior to valuation provided that any amount paid which exceeds the actual profit must be adjusted.

What is interesting here is the characterisation (termed as *Takyif Fiqhi*) given to the *Musharakah Mutanaqisah* home financing. It construes this particular financing instrument as *Shirkah Al-Milk* rather than *Shirkah Al-Aqd*. This approach invites further perusal and discussion since *Shirkah Al-Aqd*, as explained earlier, is the concept that is frequently used to refer to the partnership with a commercial goal. Furthermore, this policy has explicitly mentioned that *Musharakah* which is meant for the purpose of financing is as a debt-based financing risk profile which is in line with the concept of *Shirkah Al-Milk*. As *Musharakah*, in its original sense, connotes the equity ownership of the partners, this characterisation needs to be examined further, especially in terms of the ability of the *Musharakah* arrangement with this kind of character to uphold the idea of risk sharing which is the substratum of this particular arrangement.

5.4 Conclusion

This chapter identifies two enabling laws, namely the CBMA 2009 and the IFSA 2013 and two transactional laws, namely the PA 1961 and *Musharakah* Regulatory policy which constitute the legal and regulatory framework for the *Musharakah* operation in Malaysia. As asserted in the earlier discussion, despite being the subject matter of the *Shariah*, Islamic finance in the context of Malaysia falls under the purview of civil courts which adopt the English common law system. Although the country runs the dual legal systems in which the *Shariah* law and the common law work side by side, various provisions of law such as the First List of FC 1957, section 3 and section 5 of the CLA as well as the court's decision in *Alias Ibrahim*⁴⁹¹ entailed that the same set of law which is applicable in the case of conventional finance shall be equally applicable in the case of Islamic finance.

The first enabling law is CBMA 2009. Admittedly, this act is neither designed exclusively for the governance of the IFIs nor address the issue of risk sharing directly. Nevertheless, this act is relevant in this regard as it contains several significant provisions pertaining to the governance of the IFIs, the entities under which the *Musharakah* is being operated. These sections are section 2, section 27, and section 60, section 51 and section 59; the last two sections provide for the establishment of SAC and its power to specify the relevant guidelines pertaining to *Shariah* matters related to the Islamic finance businesses carried out by the IFIs respectively.

⁴⁹¹[2011] 4 CLJ 654

The second enabling law is the IFSA 2013. It is an omnibus legislation which is to provide for the regulation and the supervision of the IFIs. The promulgation of this act signifies a positive development of the Islamic finance industry in Malaysia. Furthermore, it also addresses the issue of risk sharing in order to further strengthen its implementation in the market. For instance, the IFIs are no longer allowed to invoke *Musharakah* (and *Mudharabah* as well) as the underlying structure for their deposit account (current or saving) due to several incompatibilities. For instance, a deposit account is considered as risk-free where the principal amount is guaranteed irrespective of the performance of the business while *Musharakah* and *Mudharabah* are meant for the purpose of investment; they are supposed to manifest the principle of risk sharing which would entail several things such as no guarantee on the principal amount, the distribution of profit is to be made based on the pre-agreed ratio based on the performance of the business while the loss to be commensurate with the amount contributed (the capital). As such, section 2 of the IFSA 2013 puts forward the distinction between a deposit account and an investment account; the sum accepted under the deposit account will be repaid in full (thus risk-free) with or without additional return while the sum accepted under the investment account shall be on terms that there is no obligation for the money to be repaid in full (thus expose the parties to risk, risk sharing).

The first transactional law identified for *Musharakah* is the PA 1961. Notwithstanding the provisions of law like section 28 of the IFSA 2013 as well as other circulars, guidelines and so forth which entail the obligation on the IFIs to ensure that all of their business activities comply with *Shariah*, such directives remain general and limited insofar permitted by the civil courts as the competent courts for Islamic finance adjudication. In addition, section 5 of the CLA 1956, further entails the application of the common law of England and the rules of equity in the commercial cases including partnership in the circumstance where there is no written law on such matters. Further, section 47(1) of the PA 1961 requires that the partnership venture must comply with the laws as prescribed by it although the rules of equity and common law of England may be applicable so long there is no contradiction between them. Since there is no exemption whatsoever in terms of its purview on *Musharakah* this act, therefore, is arguably to be one of the governing laws for *Musharakah* partnership.

The final transactional law is the *Musharakah* regulatory policy, issued by virtue of section 29(1) and 29(2) of the IFSA 2013 which empowered BNM to specify standards pertaining to *Shariah* matters. It pays an extensive attention on the issue of justice and risk sharing as required by the *Shariah*. Such positions are demonstrated through certain salient requirements

it imposes on *Musharakah*. These requirements are pertaining the eligibility of debt as capital, impermissibility of capital guarantee as well as the methods of profit and loss distribution. As deliberated at length earlier, all these requirements are important to ensure a smooth operation of *Musharakah* and to uphold the justice through the implementation of true risk sharing.

All these facts, therefore, provide the answer to the second research question (second subsidiary research question); what are the governing laws and regulation for *Musharakah* in Malaysia and how the issue of risk sharing is being addressed through them?

Chapter 6. The Legal and Regulatory Framework Vis-À-Vis Risk Sharing: An Analysis

6.1 Introduction

Up to this juncture, this study has explained the close relation between the notion of justice and risk sharing. The discussion on how the idea of risk sharing is being implemented through *Musharakah* has also been undertaken. In Chapter 4, the legal reality in Malaysia and the position of Islamic finance within it has been clarified while in Chapter 5, this study clarifies the relevant laws and regulation which constitute the governing legal and regulatory framework for *Musharakah* with the special reference to the provisions in which the aspect of risk sharing are being addressed. As the main question this study seeks to answer is pertaining to the extent of which the said governing legal and regulatory framework supports the manifestation of the idea of risk sharing through the *Musharakah* products, the discussion in this chapter addresses three separate aspects, namely *Shirkah Al-Milk* vis-à-vis *Shirkah Al-Aqd* (First Part), equity financing vis-à-vis debt financing (Second Part) and the legal recognition held for the *Musharakah* products (Third Part). The outcomes from such discussion formulate the answer to the main question of this study as mentioned above.

In the First Part, the discussion deals with the issue of *Shirkah Al-Milk* vis-à-vis *Shirkah Al-Aqd* where both concepts have been preliminarily discussed in Chapter 4. As mentioned in the previous chapter, it is observed that the provision of *Musharakah* Regulatory Policy rules that *Musharakah Mutanaqisah* shall take *Shirkah Al-Milk* (proprietary partnership) as its underlying form rather than *Shirkah Al-Aqd* (contractual partnership) Thus, it is important at the outset of the discussion to make a comparison between both concepts. The information gathered from this step shall be then used to examine how the variation of these concepts would render impact on the idea of risk sharing which supposedly to be upheld by the *Musharakah* products.

The Second Part deals with the issue of equity financing vis-à-vis debt financing. As mentioned earlier, the provision of the IFSA 2013 appears to be inconsistent with the provision of the regulatory policy in this respect; the former construes *Musharakah* and *Musharakah Mutanaqisah* as the instances of equity or partnership financing while the latter holds that *Musharakah* financing is to reflect the debt-based financing. Like in the First Part, the discussion begins by comparing both concepts before analysing the gathered information

to see the effect this variation could render to the implementation of the idea of risk sharing in the *Musharakah* products.

The discussion of Second Part continues in the Third Part where the legal recognition held for the *Musharakah* products is addressed. Such recognition plays an important role in determining whether or not the *Musharakah* products, as they stand now, truly represent the risk sharing concept as aspired by the *Shariah*.

The findings in this chapter, together with all other relevant discussions shall be gathered to formulate the conclusion and the recommendations of this study which shall be brought forward in Chapter 7.

6.2 First Part – *Shirkah Al-Milk* Vis-À-Vis *Shirkah Al-Aqd*: A Comparative Analysis of the Rendered Effect on Risk Sharing in Light of the *Musharakah* Regulatory Policy

Paragraph 21.2 of the *Musharakah* regulatory policy reads ‘Musyarakah Mutanaqisah with an asset acquisition objectives must be governed by the principle of *Shirkah al-Milk* and therefore must have the effect of *Shirkah al-Milk* as defined in paragraph 11.1(a)’.⁴⁹² Further, paragraph 31.1 reads, ‘Musyarakah financing refers to a financing using a Musyarakah contract structured to reflect a debt-based financing risk profile which is in line with the *Shariah* concept of *Shirkah al-Milk*’. It is by virtue of these clauses that one can safely establish that as far as the Malaysian context is concerned, the home financing product that wishes to use *Musharakah Mutanaqisah* as its structure shall take *Shirkah Al-Milk* as its basis. This is as opposed to another form of partnership recognised under the Islamic commercial law known as *Shirkah Al-Aqd*. As discussed earlier in Chapter 4, the former refers to the arrangement in which two or more parties become partners by way of co-owning the property in question. The latter, on the hand, refers to the form of partnership in which the parties involved enter into a contractual agreement to form a partnership which typically driven by the motive to generate the profit from the commercial activity.

Understandably, the *Musharakah Mutanaqisah* home financing is construed as *Shirkah Al-Milk* since the partnership in this product takes place in such a way where the financier (typically a bank) co-owns the property with its customer (the party seeking for the financing)

⁴⁹² Para.11.1 (a) reads “*Shirkah al-Milk* (Partnership in joint ownership) refers to possession of an asset by two or more persons with or without prior arrangement to enter into a sharing in joint ownership. Under *Shirkah al-Milk*, each partner's ownership is mutually exclusive. In this regard, one partner cannot deal with other partner's, asset without the latter's consent.

hence forming *Shirkah Al-Milk*. Throughout the tenure of financing, the financier gradually sells its portion of ownership to the customer until the customer obtains the full ownership of the property. However, the question that arises at this juncture is whether this product constitutes *Shirkah Al-Milk* in its real sense. Should the answer be affirmative, the subsequent question would be on the effect that such characterisation could render to the realisation of the idea of risk sharing.

6.2.1 *Shirkah Al-Aqd Vis-À-Vis Shirkah Al-Milk*

One might argue that the contention on whether *Musharakah Mutanaqisah* fits the features of *Shirkah Al-Milk* does not carry much significance since both *Shirkah Al-Milk* and *Shirkah Al-Aqd* are equally legitimate and recognised under the Islamic commercial law. Thus, the issue of its validity will not arise. However, an extensive examination will show that there are a number of material distinctions between these two forms of partnership which entail different sets of governing principles and operational requirements for each type of partnerships respectively. More importantly, such distinctions also imply the variance in terms of the nature of each type of partnerships which has a direct impact on, inter alia, the risk profile entailed by both forms of partnership as shall be proven later. As such, the jurists of Islamic law since the early age of the documentation of Islamic law until the present days, have made the matter of distinction between these two forms of partnership at the central of *Musharakah* discourse in their writings. The approach as to divide *Musharakah* into the co-ownership (*Al-Milk*) and the contractual (*Al-Aqd*) partnership was initiated by the jurists from Hanafi and Hanbali schools of law whereby the jurists from the other schools put their focus more on the usage of the co-ownership of an undivided asset.⁴⁹³ Until the present days, these issues still become a subject matter under the *Musharakah* discourse as what can be observed in the work of scholars such as Al-Zarqa and Usmani.⁴⁹⁴ It is worth to note here that the variety of opinion and approaches in addressing one particular issue among the jurists were never be the question of seeking who is right or wrong or to be seen as problematic or uncalled for. Rather, such variety is deemed as a mercy as it provides flexibility to the Islamic jurisprudence in addressing human daily conducts such as their commercial transactions.

⁴⁹³ Asmadi Mohamed Naim, 'Purchase Undertaking Issues in Musharakah Mutanaqisah Home Financing' (2011) 3(1) ISRA International Journal of Islamic Finance 25

⁴⁹⁴ *ibid*

6.2.1.1 *The First Aspect: Ownership of Musharakah Asset*

The distinctions as mentioned above can be observed in three aspects, namely the ownership of the *Musharakah* asset, the motive of partnership and the risk profile involved. As for the first aspect, it revolves around the issue of the creation of partnership. In this respect, *Shirkah Al-Aqd* refers to the partnership which is created through a contract that effects the mixing of properties, works and credibility for the purpose of making profit.⁴⁹⁵ Partners in *Shirkah Amwal* contribute cash or commodity into the capital pool while the partners in *Shirkah Amal* will jointly provide the profit-generating service. In the case of *Shirkah Wujooh*, the partnership is in credit in the sense that the partners will be leveraging their goodwill to purchase commodity with a deferred price and sell it with a higher price on the spot. Having this way, the contributed capital into the capital pool ceases to be the personal belonging of the partner. Instead, it belongs to the partnership in such a way that the partners have access to and may transact with it to generate profit based on the agreed partnership terms eg, limited partnership such as in *Shirkah Inan* or unlimited partnership like in *Shirkah Mufawadhah*.

Mixing the capital (properties or where it is relevant, labour or credibility) as stated above is indeed one of the essential attributions for *Shirkah Al-Aqd*. In fact, among the justifications provided by the group of jurists who of the opinion that the capital of *Musharakah* should not be in the form of non-monetary as discussed in Chapter 4 is such a condition of the property will make each capital contributed distinguishable from one another. As such, *Musharakah*, which fundamentally means co-mingling, does not take place. Hence, it can be observed that certain group of jurists (such as from the Shafie school of law) had taken an extreme approach by ruling that it is compulsory, in order to make the partnership valid, for the properties to be mixed prior to the conclusion of the partnership contract in a manner that makes them indistinguishable from one another.⁴⁹⁶ Failing of which, the properties will still exclusively belong to the partner's private ownership thus denies the existence of the partnership. Any profit gained, or loss incurred from the property, therefore, will not be shared between the partners.

On the other hand, the jurists from Hanafi, Maliki and Hanbali schools of law held that such mixing is not mandatory. In their view, a partnership is realised through a contract ie the partnership contract, not by the physical mixture of the properties.⁴⁹⁷ Since the subject matter of the partnership contract is the dealing (*At-Tasarruf*) on the venture, the contract is

⁴⁹⁵ Monzer Kahf, *Islamic Finance Contract* (2013) 163

⁴⁹⁶ Al-Zuhaily (n 41) 459

⁴⁹⁷ *ibid* 458

essentially a mutual agency (*Wakalah*) contract. Thus, there is no need for the properties to be mixed prior to the conclusion of the contract. Based on this premise, the concern regarding the exclusivity of the property in the circumstance where the mixture is absent is therefore mitigated. The *Musharakah* formed necessitates each partner to secure partial ownership over the property contributed by his counter partner. Hence, any profit gained (or loss incurred) shall be shared between the partners by virtue of *Musharakah*.⁴⁹⁸

Despite the disagreement between these two groups of jurists, it can be observed that both groups do have a common understanding of *Shirkah Al-Aqd*; partners are expected to share the ownership of property contributed into a common pool (the capital pool). They will act as the agent to each other (mutual agency) by which the profit or loss derived from the pool will be shared proportionately. The only difference lies in the action that constitutes such sharing; either through the physical mixture or the partnership contract. Therefore, it is also recorded that certain jurists came in the middle between these two opinions. For them, the properties do not have to be physically mixed as ruled by the first group, but they must be put in a common pool where all partners have the right to deal with them.⁴⁹⁹ The position, therefore, manages to highlight the common ground shared between all the jurists; *Shirkah Al-Aqd* is all about sharing the pooled resource although the way to operationalise it, as explained earlier, may vary depending on the type of the capital.

Nevertheless, in the case of *Shirkah Al-Milk*, the term ‘partnership’ implies a different understanding. The partnership does not refer to the sharing of resources nor the contract which empowers the partners with the agency rights. Rather, what is claimed as a partnership is merely referring to the partnership of two or more who obtain the proportional undivided ownership of one particular property, either optionally (*Ikhtiyarriyah*) or compulsory (*Ijabriyyah*). This being said, the property in question still belongs to each partner respectively based on the ownership percentage rather than being shared. Each partner (or rather, the co-owner) is actually independent in his transaction of his own portion.⁵⁰⁰ The partnership does not confer him with the right to deal with the property as a whole but limited only to his percentage of ownership instead. As for the other partner’s portion, prior consent must be obtained from its owner before he can use it (eg to sale or to rent).⁵⁰¹ Prior consent is also required in the circumstance where the owner would like to utilise his portion in a

⁴⁹⁸ Ahmad (n 42) 127

⁴⁹⁹ *ibid* 126

⁵⁰⁰ Naim (n 493)

⁵⁰¹ Abdul Sattar Abdul Ghuddah, ‘Takyif Sharikatai al-Aqdi wal Milki wa Atharuhu fi Tatbiqaati as-Sukuki wal Musharakah al-Mutanaqisah’ (*Kantakji*) <www.kantakji.com/media/8797/m234.pdf> accessed 5 February 2018

manner that affects the other owner such as modifying the property. As a result of this independence, the partner is entitled only to the profit derived from his portion and in the event of loss, it will be solely borne by him.⁵⁰²

6.2.1.2 The Second Aspect: Motive of Partnership

The second aspect of distinction is pertaining to the motive of partnership. From the discussion above, it is clear that the partnership which is formed under the concept of *Shirkah Al-Aqd* is a commercial partnership in which the partners enter into a contract to jointly conduct a business venture with the objective to generate profit. Partners in *Shirkah Amwal* are seeking for profit by investing some capital into the commercial enterprise that comes under the collective ownership of the partners as per the ratio of their capital.⁵⁰³ In the case of *Shirkah Amal*, partners are jointly undertaking to provide some services to their customers and the fee charged will be shared between them according to the agreed ratio.⁵⁰⁴ Similarly, partners in *Shirkah Wujooh* seek to generate profit by availing credit from the market using their credibility and sell the commodity to share the earned profit also at the agreed ratio.⁵⁰⁵

On the contrary, *Shirkah Al-Milk* is neither a commercial partnership nor formed for the purpose of profit sharing. Instead, the goal of constituting a partnership based on *Shirkah Al-Milk* is limited to obtaining the ownership of the property and benefiting from it.⁵⁰⁶ As such, there shall be no contract between the co-owners to use the property or to invest it through commerce or leasing or by any other means of earning profits.⁵⁰⁷

6.2.1.3 The Third Aspect: Risk Profile

The distinctions pertaining to the ownership of the underlying asset and the motive of partnership as established above lead to the third aspect of distinction namely the risk profile. Since partners in *Shirkah Al-Aqd* is aiming at making profit out of the business venture undertaken under the partnership, the Islamic commercial law rules that every partner must be willing to expose themselves to the risk of loss (capital depletion) hence risk sharing. This is by virtue of the legal maxim ‘liability accompanies gain’ which has been discussed previously

⁵⁰² Mustafa Ahmad Az-Zarqa, *Al-Madkhal Al-Fiqhul ‘Am* (Vol 1, 2nd edn, Dar al-Qalam 2004) 354

⁵⁰³ Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons, Ltd 2007) 309

⁵⁰⁴ *ibid*

⁵⁰⁵ *ibid*

⁵⁰⁶ Usmani, ‘As-Sukuk wa Tatbiqotuha al-Mu’asirah’ (n 353)

⁵⁰⁷ Az-Zarqa’ (n 502)

in this study. In addition, no capital or principal guarantee is allowed to be extended by any partner nor its quantum of return can be pre-determined. Instead, the profit and loss have to reflect the actual performance of the partnership business and subsequently to be shared among them based on the pre-agreed ratio. The profit percentage is flexible to be negotiated among the partners while the loss ratio should commensurate with their capital ratio. Failing to fulfil this requirement will trigger the case of *Gharar* and invalidate the partnership.⁵⁰⁸

However, due to the independency of the co-owners from each other in *Shirkah Al-Milk*, the issue of profit and loss sharing, and capital guarantee do not arise. In this case, the co-owner is only entitled to the profit and to bear the loss, if any, only to the extent of his portion of ownership.⁵⁰⁹ Furthermore, due to the fact that there is no motive to generate profit out of the establishment of the partnership under *Shirkah Al-Milk*, the exposure to the risk of loss is not a necessary consequence. Therefore, the partner may sell his portion of ownership to the other partner or non-partner at any price since such action is a simple sale between a willing seller and a willing buyer which is clearly permissible in the eyes of the *Shariah*. He may, in principle, invoke any mechanism (such as pre-fixing the sale price) to ensure his 'capital' (the price he paid to own his portion) does not deplete.

Thus, it can be concluded that *Shirkah Al-Milk* differs from *Shirkah Al-Aqd* as it does not imply sharing between partners nor its establishment with the intention to generate profit. More importantly, the way *Shirkah Al-Milk* is structured entails the absence of requirement on the partners to mutually share the risk of loss (and in return, mutually share the profit). As such, in *Shirkah Al-Milk*, the arrangement of profit and loss sharing as a manifestation of risk sharing shall not exist.

6.2.2 *Shirkah Al-Milk Based Musharakah Mutanaqisah Home Financing and Risk Sharing*

Pursuant to the discussion above, an extensive analysis would show that the approach of characterising the *Musharakah Mutanaqisah* home financing as a form of *Shirkah Al-Milk* as can be seen in the previously quoted provisions of the *Musharakah* regulatory policy is inaccurate and more importantly, negates the manifestation of risk sharing. In order to have a

⁵⁰⁸ For the sake of clarity, all facts in this paragraph, together with the references, have been mentioned earlier at various places in this study. They are brought here once again due to their relevance to the discussion of this chapter.

⁵⁰⁹ Ahmad Muhammad Mahmud Nassar, *Al-Istismar bil Musharakah fil Bunuk al-Islamiyah* (Dar al-Kotob al-Ilmiyah 2010) 35

clear picture of the basis of this assertion, this subsection shall start by discussing the operational structure of *Musharakah Mutanaqisah* home financing. Although the general idea of *Musharakah Mutanaqisah* home financing has been explained in Chapter 4, the discussion here will put the focus on the *Musharakah Mutanaqisah* home financing as it is operated in Malaysia as well as the mechanism of purchase undertaking embedded in its structure.

As far as the Islamic finance market of Malaysia is concerned, there are two models which have been approved by the BNM to be used by the IFIs for their home financing product using *Musharakah Mutanaqisah*.⁵¹⁰ In the first model, the bank and its customer will jointly purchase the house thus make them partners in the undivided asset. Subsequently, the customer will give promises (through a separate document) on two things: to lease the house and pay the rental which is equivalent to the bank's portion and undertake to purchase the bank's share on the monthly instalments within the tenure financing. As a result, the payment made by the customer shall comprise the rental amount plus the staggered share purchasing price. In the event of default of such payment, the bank shall auction the asset. The proceeds from which will be divided accordingly as per the capital ratio and subsequently, the bank shall use the customer's portion to deduct his default amount of rental.

The second model is also commenced by the joint purchasing of the house by the bank and its customer. Similarly, the customer, through a separate document, promises to lease the house with the rental amount equivalent to the bank's portion and to purchase its share by monthly instalments throughout the tenure financing. However, in this model, the customer also issues a second undertaking to grant the right to the bank to oblige the customer to buy the bank's share on credit in the event of default or to purchase customer's remaining share. This will leave the bank with several options should the customer defaulted his payment (which supposed to comprise the rental and share purchasing payments). The first option is the customer shall buy the bank's share on credit at the price that covers the bank's remaining share, unpaid rental (up to the point before the purchase undertaking is invoked), and other expenses. The customer therefore in indebtedness and the house will serve as a collateral.

The second option the bank has is to purchase (on credit) the customer's share at a pre-determined price, and the payment of the price shall be set-off against the default rental fee. Subsequently, the house (which now solely belongs to the bank) shall be auctioned; the proceeds from which will be used to pay the remaining defaulted rental amount and payment of the credit sale. Should there be any balance, it will be returned to the customer.

⁵¹⁰ Naim (n 493)

Both models have similarities in terms of the formed partnership where both co-own the house (hence *Shirkah Al-Milk*) as well the promise given by the customer to rent and to buy the bank's share throughout the financing tenure. However, the second model differs from the first model as in the former, there is a second undertaking issued by the customer. By virtue of this second undertaking, the bank secures its right to oblige the customer to purchase its share during the event of default or to purchase the customer's share at a pre-determined price.⁵¹¹

Operating *Musharakah Mutanaqisah* home financing within the set up as mentioned here thus triggers two problems that are related to the compatibility of *Shirkah Al-Milk* with the structure of *Musharakah Mutanaqisah* as well the aspiration to realise the idea of risk sharing. The upcoming subtopics will be discussing these two problems.

6.2.2.1 The First Problem – Inaccurate Definition

It has been established that among the main differences between *Shirkah Al-Aqd* and *Shirkah Al-Milk* is the former is meant for commercial purposes while the latter merely refers to the joint ownership belongs to two or more people over an asset where the co-owners do not have the arrangement to use the property or invest it through a commerce of leasing or any other means of earning profit. This clearly does not apply in this case where *Musharakah Mutanaqisah* is used by the bank as a financing means for its customer. Some argue that *Shirkah Al-Milk* exists, at least, at the initial stage where the bank jointly purchases the property with the customer, hence becoming his co-owner.⁵¹² This argument might be acceptable from the perspective of co-ownership *per se*. However, if the matter is to be perused from the perspective of financing, such argument is untenable. All the documents involved (such as the S&P agreements and the leasing agreement) as well the market common understanding would prove that the *Musharakah Mutanaqisah* in question is meant for the commercial purposes since its very inception. It has never been the intention of the bank from the property purchasing to make the house (even partially) as its asset. Rather, the purchase takes place only to enable the bank to extend the credit facility to the customer who seeks to own a house (through, buy, lease and sell its portion) while making a profit out of it.

To maintain *Musharakah Mutanaqisah* as *Shirkah Al-Milk* either throughout the whole process or only at the initial stage can also be problematic from the perspective of the

⁵¹¹ *ibid*

⁵¹² *ibid*

contractual sequence of the financing. It is explained earlier that the financing process begins with the customer identifies the desired property and signs the S&P agreement with the developer and pays a deposit. He will then approach the bank to apply for the financing. Once it is approved, both customer and bank will enter into the financing agreement, the point during which where all the relevant documents including the *Musharakah* agreement will be duly signed. The bank will issue an undertaking to pay the vendor and make the disbursement subject to the fulfilment of the terms and conditions.

From the sequence illustrated above, it is observed that the S&P agreement is entered between the developer and the customer (by paying the deposit, 10 per cent of the house price for instance) prior the formation of *Musharakah* between the bank and the customer (hitherto, the house does not belong to the partnership as it yet to be formed). It is only after this stage that the customer seeks for the financing from the bank which, if approved, the *Musharakah* is formed. The question arises here whether the share owned by the customer is qualified to be contributed for the formation of *Shirkah Al-Milk* since at the point where *Musharakah* is formed, the customer's ownership over his share is still conditional due to the fact that the S&P agreement may be rescinded if the terms and conditions are not met. As explained in the previous chapter, among the requirements on capital for a valid partnership is that the capital must be able to be utilised immediately. Any conditionality on the share's ownership may expose the partnership to be challenged on its validity.

Therefore, it is asserted here that the approach of construing *Musharakah Mutanaqisah* as *Shirkah Al-Milk*, especially in the case where it serves as a financing tool is inaccurate since its existence is with the commercial purposes. In addition, it potentially exposes the structure to the risk of being disqualified as a valid partnership due to the failure of the customer's share to meet one of the requirements imposed on the *Musharakah* capital ie to be able to be utilised immediately. Such inaccuracy does not only put the credibility of the *Musharakah* regulatory policy at stake as it can be easily challenged but also appears to be counterproductive to the manifestation of the idea of risk sharing, the point to be discussed in the next subtopic.

6.2.2.2 The Second Problem – Negating the Implementation of Risk Sharing

The following issue is pertaining to the effect of construing the *Musharakah Mutanaqisah* as *Shirkah Al-Milk*. This issue is significant for the purpose of this study as it renders a direct impact on the manifestation of the idea of risk sharing through the *Musharakah Mutanaqisah*

home financing. As explained earlier, despite being regarded as partners, the co-owners of *Shirkah Al-Milk* are independent from each other. This situation is totally different from the case in *Shirkah Al-Aqd* where partners are considered as mutual agents who are obliged to perform the fiduciary duty. This difference leads to the difference in terms of the risk profile assumed. The partners in *Shirkah Al-Milk* are not expected to share the profit and loss derived from the co-owned property. Rather, each of them is entitled only to the profit gained from his portion and to solely bear the loss should it incur. On the contrary, the partners in *Shirkah Al-Aqd* are bound to share the profit and loss according to the ratio which has been determined during the onset of the venture. This clearly implies that although both are a type of *Musharakah*, *Shirkah Al-Milk* is not designed for the purpose of risk sharing. As such, promoting *Musharakah Mutanaqisah* under the pretext of risk sharing and offering it as an alternative for the financing product such as BBA home financing are simply misleading and invite more confusion due to the serious incompatibility as shown here.

The independency or non-independency of partners in *Musharakah* also leads to another issue. The fiduciary-based relationship in *Shirkah Al-Aqd* entails, inter alia, that no guarantee for the capital loss can be provided by the partner to each other except if such loss arises due to the act of misconduct, negligence or breach of the specified terms as explained in Chapter 3. As such, it is not permissible for a partner, for instance, to promise to buy the other partner's share at a pre-determined price (the principal value of the portion, for instance) as such action is tantamount to guaranteeing the partner's share. This is certainly not the case in *Shirkah Al-Milk*. Each partner, as the sole owner of his portion, can rightfully sell or promise to sell his share to the other partner or non-partner at whatever price they agreed upon. The issue of capital guarantee, therefore, is irrelevant in this case.

Considering the approved models of the *Musharakah Mutanaqisah* home financing as explained earlier, the approach of construing it as *Shirkah al-Milk* is understandably in favour of the bank. By invoking *Shirkah Al-Milk* as the underlying concept, the provision of the second undertaking like in the second model seems justified. In the event where the customer defaults his payment, the bank, by virtue of the second undertaking, may oblige the customer to purchase its share or it may purchase the customer's share at a pre-determined price. In both situations, the bank is guaranteed two things. The first thing is that it can execute the partnership with the commercial purposes without having to face equitable rights and liabilities. This is because by requiring the customer to promise to purchase the asset in the occurrence of an event of default, the undertaking becomes a means to cease the partnership

liability.⁵¹³ The second thing is to have its capital guaranteed. Since the price of customer's share can be pre-determined, the bank can simply dictate the relevant purchasing price to be set-off with the default rental payments. The house, which now belongs solely to the bank, will then be auctioned to obtain its capital.⁵¹⁴

As the *Musharakah Mutanaqisah* home financing is claimed as *Shirkah Al-Milk*, the above situations appear not to contravene any rules. The partners (the bank and the customer) are not expected to assume the equitable liabilities, nor are they prohibited from selling their shares at a certain price even though such price is tantamount to capital guarantee. As it stands now, the bank can legally protect its capital while, at the same time, the customer might end up in an indebtedness while not able to obtain the house as sought earlier. Certainly, this circumstance is uncalled for at many levels. The argument here, thus, supports the earlier assertion that the *Musharakah Mutanaqisah* home financing, as it is held by the current regulatory framework, lacks the element of risk sharing thus fails to become an alternative to the BBA-based financing product as it is originally intended. Hence, it is submitted here that maintaining the status quo of *Musharakah Mutanaqisah* would be jeopardising the aspiration of implementing the idea of risk sharing through the product in question.

It is also worth to mention here that from the technical perspective, the current stand of the *Musharakah Mutanaqisah* home financing may be admitted as valid in the eyes of the law. Its financing agreement can be deemed as sound and effective for it complies with the existing rule and regulation. Nevertheless, since the arrangement involved indicates a serious state of bias and unfairness (as demonstrated by the fact that the bank's interest is well protected through the issued undertakings whereby the customer might end up in the indebtedness and in the same time fail to obtain the sought house), the current validity might be challenged in the future. By virtue of section 3 and 5 of the CLA 1956 and section 47(1) of the PA 1961 as cited earlier, it is expected for any commercial arrangement, and particularly in this case, the partnership to uphold the rules of equity as provided under the English common law insofar such rules do not contravene with any written law like the PA 1961. Should the unfairness and bias as pointed here be successfully proven before the court of law on the ground of equity, such a situation might potentially put the Islamic finance market at stake once again as witnessed in the *Arab-Malaysian Finance Bhd.* as discussed earlier. Similarly, from the perspective of *Shariah*, the validity of the *Musharakah Mutanaqisah* home financing might be defended on the basis that it takes a legitimate form of *Musharakah* ie *Shirkah Al-Milk*

⁵¹³ ibid

⁵¹⁴ ibid

(although this argument is rebutted by the present chapter). However, if this matter is to be perused from the perspective of *Maqasid Al-Shariah*, such unfairness and bias are clearly against the spirit of justice and untenable under the notion of *Shariah* as a whole.

As for the *Musharakah Sukuk*, the risk of having the same situation is less obvious since there is no legal provision whatsoever that dictate the concept that the *Sukuk* should be built upon. However, since the possibility of invoking *Shirkah Al-Milk* as the applicable concept for the *Musharakah Sukuk* is still there, the problems as mentioned above are not something far-fetched and may surface over time.

6.3 Second Part – Debt Financing Vis-À-Vis Equity Financing: A Comparative Analysis of the Rendered Effect on Risk Sharing in Light of the *Musharakah* Regulatory Policy

Continuing the earlier discussion, the discussion under this part seeks to analyse the extent to which the legal framework supports the manifestation of the idea of risk sharing through the *Musharakah* products from another perspective namely the equity and debt financings. As mentioned in Chapter 5, among the positive developments demonstrated by the IFSA 2013 is the enumeration of several Islamic contracts that may be engaged by the IFIs in their businesses, among of which are *Musharakah* and *Musharakah Mutanaqisah*, both are considered as equity financing (section 2). This move has moved the doubt, if any, on their legality. Nevertheless, what draws the attention at this juncture is the fact that both are deemed as the examples of equity or partnership financing.⁵¹⁵ This is because this position appears to contradict the provision of the *Musharakah* regulatory policy in this respect. Paragraph 31.1 of the *Musharakah* regulatory policy reads ‘Musyarakah financing refers to a financing using a Musyarakah contract structured to reflect a debt-based financing risk profile which is in line with the Shariah concept of *Shirkah al-Milk*’.⁵¹⁶ Subsequently, paragraph 31.2 reads,

‘The operational requirements for Musyarakah financing shall be similar to the requirements and expectations for debt-based financing. While the overarching principles as outlined in Part C are similarly applicable to Part D⁵¹⁷, specific requirements on Musyarakah financing are imperative to address the peculiarities

⁵¹⁵ For the sake of clarity, the relevant part of the section has been cited in Chapter 5

⁵¹⁶ Bank Negara Malaysia, ‘Musyarakah’ (April 2015) s. 31.1

⁵¹⁷ Part C of the *Musharakah* regulatory policy covers the operational requirements for *Musharakah* venture while Part D covers operational requirements for *Musharakah* Financing.

arising from the usage of additional contracts or concepts that transform the inherent risk-sharing element into credit risk’.

Here, two things are interesting to be pointed out. The first thing is the position held earlier of which to construe the *Musharakah Mutanaqisah* for the purpose of asset acquisition as *Shirkah Al-Milk* (paragraph 21.2) is re-emphasised by paragraph 31.1. The second thing is the latter, however, provides a total contradiction in terms of the characterisation as compared to the characterisation as provided by section 2 of the IFSA 2013 as mentioned above.

According to the *Musharakah* regulatory policy, *Musharakah Mutanaqisah* is expected to serve as a debt-based financing tool despite it is structured based on *Musharakah*.

This position is further asserted in the subsequent provision (paragraph 31.2) which provides the combination between the *Musharakah* contract with an additional contract or concept in a *Musharakah*-based product may transform the inherent risk sharing element of the product in question into credit risk (as shall be further explained later, credit risk refers to the risk of default on a debt that may arise from a borrower who fails to make required payments). This implies a transformation of the product from the equity-based nature to debt-based nature. As the *Musharakah Mutanaqisah* home financing is built upon several contracts such as the *Musharakah* (partnership), *Ijarah* (lease) and *Bai* (sale), undoubtedly paragraph 31.2 is relevant and applicable in its case.⁵¹⁸

Since the *Musharakah* and, by extension, the *Musharakah Mutanaqisah* home financing are expected to champion the implementation of the idea of risk sharing, it is crucial at this juncture to examine the salient differences between these two concepts and how they can render impact on the implementation of risk sharing. Subsequently, this study will suggest

⁵¹⁸ It is also interesting to look this matter from the way the products are being recorded in the financial report although the scope of this study does not directly cover the aspect of accountancy. By virtue of the principle ‘substance over form’ a record of transaction in the financial report shall be based on its economic substance or financial reality which may not necessarily similar to its legal form (Zurina Shafii and others, ‘An Appraisal of the Principles Underlying International Financial Reporting Standards: A Shariah Perspective – Part 1’ [2013] ISRA Research Paper 54/2013, 8). Since the *Musharakah Mutanaqisah* home financing (as well as the *Musharakah Sukuk*) shall be booked under the same group of debt-based product, this fact further supports that these products, in their real sense, are considered as debt-based products rather than equity-based products. For further information kindly refers to the 2016 Financial Report issued by Kuwait Finance House for *Musharakah Mutanaqisah* (Note 8) and *Petroleum Nasional Berhad* for *Musharakah Sukuk* (Note 23) at the links as follows:

- i) https://www.kfh.com.my/bpmapp-upload/download/fstore/0a14d001d033d0c9_268b9871_15ba966f606_f8e?fileKey=/fstore/0a14d001d033d0c9_268b9871_15ba966f606_f8e/040517_KFHMalyasia_Annual_Report_Year_2016.pdf
- ii) <http://www.petronas.com.my/investor-relations/Documents/annual-report/PETRONASAnnualReport2016.pdf>

some negative outcomes which may surface as a result of construing the *Musharakah Mutanaqisah* as a debt-based financing instrument rather than an equity-based instrument as provided by the *Musharakah* Regulatory Policy.

6.3.1 Debt Financing Vis-À-Vis Equity Financing

Admittedly, the financing segment under the Islamic finance comprises products from both debt and equity bases. The products based on *Ijarah* and *Istisna'* (debt-based) or *Musharakah* and *Mudharabah* (equity-based), for instance, are widely offered by the IFIs across the globe. Since it is a well-known governance practice by the IFIs to ensure that every product shall be verified by their *Shariah* Supervisory Board respectively as complying to *Shariah* prior to its offering to the public, the fact that these products are being offered in the market thus eliminates the doubt, if any, on their *Shariah* compliancy. However, the discussion on the difference between these two modes of financing is significant for the purpose of this study as both entail the different natures which subsequently lead to the different impacts on *Musharakah* in respect of the realisation of risk sharing via it.

As suggested by the term used, debt financing refers to the financing extended to its seeker in a manner where the seeker of funds becomes indebted to the fund provider.⁵¹⁹ It includes means of financing such as the provision of benevolent loan, termed as *Qard Hassan* (in the case of conventional debt financing, loan is extended against interest), the sale by deferred payment, lease and alike where the arrangement leads to the creation of indebtedness which becomes the liability to the party who seeks for the fund. For example, in the case of business financing based on *Tawarruq* (monetisation) which involves *Murabahah* (mark-up sale), the fund seeker (customer) will enter into an arrangement with the fund provider (bank) in which the bank sells a specified commodity (which was pre-bought from a vendor upon the request by the customer) to the customer on a deferred basis at cost plus profit.⁵²⁰ Subsequently, the customer will sell the commodity to the vendor (or different vendor) on a spot basis.⁵²¹ The bank then pays the customer the selling proceeds lump sum (the sought amount by the

⁵¹⁹ Muhammad Abdurrahman Sadique, 'Bringing Islamic Banks Closer to the Ideal: From Debt-Based Financing to Equity-Based Modes' (Kuala Lumpur International Business, Economics and Law Conference 7, Kuala Lumpur, April 2015)

⁵²⁰ Bank Islam, 'Application of Shariah Contracts in Bank Islam's Products and Services' (*Bank Islam*) <www.bankislam.com.my/en/Documents/shariah/Shariah_Booklet.pdf> accessed 6 February 2018

⁵²¹ *ibid*

customer that is to be used for his business requirements) whereby the customer pays the bank the purchase price (which now becomes his debt towards the bank) on the instalment basis.⁵²²

On the other hand, the fund in an equity financing is extended by way of capital participation in a joint venture, where practicable.⁵²³ It also covers financing with the purpose of asset acquisition like in the *Musharakah Mutanaqisah*. Unlike in the debt financing where an indebtedness is created, the injected fund is deemed as equity or capital which makes the financier as a partner rather than merely a creditor. This entitles the financier, on his capacity as a partner, to a share of profit realised through the venture while being exposed to erosion or total eradication in the event of loss.⁵²⁴

Here lies the core difference between the equity financing and the debt financing. The former entails mutual sharing of risks regarding the business venture and equitable distribution of return. While the indicative rate of return may be provided at the early stage, the actual return of all sharing parties will only be determined ex-post, depending on the actual performance of the business venture.⁵²⁵

Certainly, the above situation is not the case in the debt financing. Since the extended fund is a loan, it does not play any role in increasing the equity base but remains as a foreign element as far as the venture is concerned.⁵²⁶ It does not take a constructive share in enhancing the net worth but serves only the purpose of inflating the cash position temporarily irrespective of how large the debt amount is.⁵²⁷ As such, the performance of business does not become the financier's direct concern since any profit gained or loss incurred will be solely borne by the party who seeks for the fund (the business owner). In any situation, the financier is expecting the repayment of the loan lent out which shall comprise the principal amount together with the mark-up amount as the profit (like in the *Tawarruq*-based financing explained above) or with the pre-agreed interest amount (in the case of the conventional loan). Therefore, it is clear that the element of mutual risk sharing is absent in debt financing (the risk in the sale of *Tawarruq* as executed by Islamic banks, though might be argued to exist, is marginal). This puts it in the inferior position as compared to equity financing in the ideal backdrop of the Islamic finance.

⁵²² *ibid*

⁵²³ Sadique, 'Bringing Islamic Banks Closer to the Ideal: From Debt-Based Financing to Equity-Based Modes' (n 519)

⁵²⁴ *ibid*

⁵²⁵ *ibid*

⁵²⁶ Muhammad Abdurrahman Sadique, 'Islamic Banks Dilemma between Ideals and Practice: Debt or Equity' (2010) 10(2) *Global Journal of Management and Business Research* 147

⁵²⁷ *ibid*

As mentioned earlier, there is no doubt that debt financing as manifested in various products such as *Tawarruq* and BBA is endorsed as *Shariah*-compliant since, technically, it does not violate any juristic (*Fiqh*) requirements such as non-involvement in *Riba* (interest charging), *Gharar* (ambiguity in contract) and gambling (zero-sum element). Nevertheless, based on the understanding of both modes as explained above, it is clear that the aspiration of risk sharing is incompatible with the nature of debt financing. In addition, it also appears not to be in line with the spirit of *Maqasid Al-Shariah* and less favourable from the perspective of socio-economy. The next subtopic shall further address these assertions.

6.3.2 Debt Financing Vis-À-Vis Equity Financing from the Maqasid Al-Shariah and Socio-Economy Perspectives

As discussed in Chapter 3 under the subtopic of *Maqasid Al-Shariah*, the protection of property (*Hifz Mal*) becomes one of the aims to achieve through the implementation of *Shariah* along with human life (*Nafs*), intellectual (*Aql*), and progeny and offspring (*Nasl*). *Shariah* also aspires to uphold the justice in all segments of life including the economy and financial dealings. Based on these premises, it is among the ultimate objectives of *Shariah* to protect wealth through proper management and distribution.⁵²⁸ All the rulings of *Shariah* pertaining to various types of financial transactions, therefore, are supposed to protect the property and to ensure the justice is being served among the parties involved.⁵²⁹ Notwithstanding the debt financing being endorsed as *Shariah* compliant, it appears to fail this aspect.

This assertion of failure is based on the fact that the customer needs to pay more than the financing amount he takes within the stipulated period irrespective of the performance of any economic activities.⁵³⁰ This is totally different as compared to the situation in the equity financing where the return for the financier (partner) and its customer will depend on the outcome of the business activities. Indeed, such an arrangement promotes real activities and fair distribution of property which in turn closer to achieving the objective of *Shariah* in wealth management.⁵³¹

⁵²⁸ Noraini Mohd. Ariffin, Salina Kassim and Dzuljastri Abdul Razak, 'Exploring Application of Equity-Based Financing through Musharakah Mutanaqisah in Islamic Banks in Malaysia: Perspective from the Industry Players' (2015) 23(2) International Journal of Economics, Management and Accounting 241

⁵²⁹ *ibid*

⁵³⁰ *ibid*

⁵³¹ *ibid*

By looking from the bigger perspective of socio-economic justice, it is also asserted that debt financing could render several negative implications. One of them is the inequality in terms of the opportunity to engage with entrepreneurship. Although a person might have all the skills needed for him to be a successful entrepreneur, his chance of becoming so might be denied under the debt-based system due to the failure of securing capital. In order for a financing transaction to take place, trust needs to be established between him and the financier (the bank) which is mostly dependant on the availability of collateral.⁵³² Although this requirement is normal in the present banking practice, the applicant, despite his skills and abilities, might not be able to provide it due to his poverty and therefore could not secure the sought financing. However, under the equity-based system, such a case can be avoided. By invoking the *Mudharabah* arrangement, for instance, neither he has to provide collateral in order to obtain financing nor create a debt from the financing stream. Rather, the skills he has are sufficient to be contributed into the venture (while the bank provides the monetary capital) to enable him to start with the business activity. This is similar if *Musharakah* is to be used. Assuming he does not own sufficient liquidity, the venture still can commerce by contributing in-kind capital. Having this way, people from all background will stand the same chance to start a commercial venture.

In addition, debt financing, despite being arguably justified, resembles a significant level of similarity with the conventional loan which is based on *Riba* due the inherent credit risk entailed by both. It might be argued that since there is a sale being executed in the *Shariah*-compliant debt financing which entails, inter alia, the transaction risk shared between the involved parties, it manages to differ from the *Riba* transaction, hence its permissibility. However, this arrangement appears to be nothing more than sugar-coating the fixed-amount payment to the financier which, in that case, is akin to the payment in the conventional loan. Such a situation is more apparent when all the documentation involved have successfully excluded all liabilities from the financier thus makes the risk no longer significant (negligible) like in the BBA home financing as explained earlier.

The element of risk sharing entailed by the equity-based business also helps it to outweigh the debt-based business from the perspective of economy. Since the shared risk drives all the stakeholders to bear the risk of business failure, economic agents are concerned about the result of the business venture.⁵³³ Such system instils the good values in the business

⁵³² Ezry Fahmy Eddy Yusof, Jhordy Kashoogic and Asim Anwar Kamal, 'Islamic Finance: Debt versus Equity Financing in the Light of Maqasid al-Shariah' (2009) MPRA <<https://mpra.ub.uni-muenchen.de/20722/>> accessed 5 February 2018

⁵³³ Ariffin, Kassim and Razak (n 528)

management conducts in securing the success of the ventures as well as improving the transparency and reducing the moral hazard through an active participation of overseeing the business from the capital provider (financier).⁵³⁴

The existence of mutual risk element also acts as an effective stimulant towards innovation, entrepreneurship and creativity.⁵³⁵ This is because the entrepreneur would continue to improve his skill and talent to attract more capital providers while the capital providers, out of his concern about the survival of the business venture, would be driven to contribute in terms of innovation and creativity on ways to exceed the competition.⁵³⁶ All this will improve the skills of labour and the promotion of the productivity and creativity which will result in the better pricing (thus cheaper output and more demand of it) and enable more economic activity and benefit all the economic agents due to the circular flow of funds.⁵³⁷

One might claim that equity-based financing is less favoured to the financier as compared to the debt-based financing due to the former's risk profile. This claim does carry significance level of truth especially if it comes purely from the conventional finance's point of view. In general, businesses attempt to maximise profit and, thus, try to minimise risk and loss.⁵³⁸ This disposition is no difference with the IFIs. As such, the Islamic banks tend to emulate the conventional banks by avoiding risk as much as they could and often devoted their resources to the safer mode of financing.⁵³⁹ This makes equity-based products such as *Musharakah* and *Mudharabah* which entail the business risk to be shared between the involved parties become less appealing to them.

Admittedly, the fixed payment coming from the debt-based arrangement appears to be less risky as compared to the return that could be derived from the equity-based arrangement. Nevertheless, this claim is still debatable especially if the issue is to be perused from a larger perspective. This is due to the fact a debt based instrument that guarantees a safe return comprises the principal amount along with the fixed return would allure the financier to take a higher risk and 'invest' in such a relatively riskier project.⁵⁴⁰ This is further supported with the existence of mechanism like hedging where risk can be transferred to hedgers or

⁵³⁴ *ibid*

⁵³⁵ *ibid*

⁵³⁶ *ibid*

⁵³⁷ *ibid*

⁵³⁸ Farooq (n 63) 67

⁵³⁹ Azian Madun, Yusniza Kamarulzaman and Nur Fatimah Zahra Roslan, 'The Challenges on the Marketing of Equity-Based Financing Product of Islamic Banking' (*ResearchGate*) <www.researchgate.net/publication/265907846_THE_CHALLENGES_ON_THE_MARKETING_OF_EQUITY-BASED_FINANCING_PRODUCTS_OF_ISLAMIC_BANKING> accessed 5 February 2018

⁵⁴⁰ Hayat Khan, 'Some Implications of Debt versus Equity-Based Financing in the Backdrop of Financial Crises' (2015) 28(1) JKAU: Islamic Econ. 165

speculators via the derivative market. Again, this would encourage them to participate in the relatively risky projects.⁵⁴¹ Hence, to make an assertion that the financier and business owner would necessarily assume less risk in a debt-based arrangement is rather simplistic and inaccurate. In the context of global economy, the dependency of debt will encourage the sale of debt which opens the possibility of creating sub-prime loans as entailed by the model commonly known as originate-to-distribute. In the traditional banking practice, banks originated credits and held them until they reach the maturity, the practice termed as ‘originate-to-hold’. However, this practice began to shift from ‘originate-to-hold’ to ‘originate-to-distribute’; the banks originate a credit and sell or securitise a portion of it at the time of its origination or later.⁵⁴² As proven in 2007 during the global financial crisis, such practice has allured the financial institutions to create more debt in the market. This certainly will pose the increment of total risk in the economy as addressed earlier in Chapter 1.

6.3.3 Musharakah Mutanaqisah as Debt-Based Financing Instrument: Conflict and Negative Outcomes

Pursuant to the discussion above, it is clear that the approach of construing the *Musharakah Mutanaqisah* home financing as a debt-based financing instrument as demonstrated by the provisions of the *Musharakah* Regulatory Policy renders certain conflict and negative outcomes. Not only such position may potentially create a legal conflict⁵⁴³ in the future due to the inconsistency between the act of parliament such as the IFSA 2013 and the regulatory policy, it may also be a serious setback for the advocacy of the ideal implementation of risk sharing in the practice of Islamic finance in Malaysia. By recognising the *Musharakah Mutanaqisah* home financing as a debt-based financing instrument, it will eliminate the most significant hallmark of the product ie risk sharing. Therefore, it defeats the purpose of its introduction as an alternative to debt-based financing product such as the BBA home financing. The brand it holds, therefore, is over-stated and rather misleading. This certainly poses the reputational risk to the industry as a whole. Furthermore, the insertion of such provisions could imply a sign of dilution of the Islamic finance integrity in front of the conventional *Riba*-based system as it opts to follow rather than striving to safeguard its nucleus.

⁵⁴¹ *ibid*

⁵⁴² Vitaly M. Bord and Joao A. C. Santos, ‘The Rise of the Originate-to-Distribute Model and the Role of Banks in Financial Intermediation’ (2012) FRBNY Economic Policy Review 21

⁵⁴³ This includes the possibility of being challenged in the court of law due to the ambiguity of its true nature as what had been witnessed in the case of Arab-Malaysian Finance Bhd as cited earlier.

The said approach is also deemed as a regressive move to the initiatives that have been started since 2006, the year during which the *Musharakah Mutanaqisah* home financing was first offered in Malaysia by the Kuwait Finance House, KFH (in fact, in January 1989 Koperasi Belia Islam Malaysia Berhad (KBM), a cooperative institution under International Islamic University Malaysia (IIUM) had implemented the *Musharakah Mutanaqisah* for its house project).⁵⁴⁴ As asserted earlier, the motivation that drives the introduction and utilisation of *Musharakah Mutanaqisah* home financing in the Malaysian market is to depart from the then existing model of the BBA home financing. Since the latter is akin to the conventional loan (as both are debt-based instruments), the former is believed to offer the best alternative for customers to have the ideal model of home financing (or at least the closest one) which is built on the true spirit of Islamic finance ie risk sharing.

It is understandable for the IFIs to resort to the debt-based financing model such as the BBA home financing during the infancy stage of Islamic finance in Malaysia as the market was already used to the debt-based system. A drastic departure from the conventional method may invite some unpleasant confusions while the number of needed experts for the process of conversion from the debt-based to the equity-based system was relatively small. Nevertheless, after more than ten years that bore witness to the tremendous development of the industry, such an excuse is no longer relevant. All segments, including the legal and regulatory setup, are expected to be supportive and facilitative towards the further leaps. This certainly includes the illustration of the clearest distinction possible between Islamic finance and its conventional counterpart and what it could uniquely offer. However, with the said approach in the picture, the leap is effectively on the contrary direction.

6.4 Third Part – Legal Recognition: An Analysis on the True Nature of *Musharakah* in Light of Section 3 of the PA 1961

As to recap, it is established that all cases related to the Islamic finance, in the Malaysian context, are subject to the federal laws which are highly influenced by the English common law system. Also, since there is no proven exclusion as to the governing act, the prima facie case shows that *Musharakah*, as a form of partnership, falls under the purview of the PA 1961. Therefore, this subtopic seeks to analyse the recognition held by this act towards *Musharakah* and subsequently, the *Musharakah* products. It is mentioned earlier that there is

⁵⁴⁴ Khairul Hafidzi Mohd Subky and others, 'The Implication of Musharakah Mutanaqisah in Malaysian Islamic Banking Arena: A Perspective on Legal Documentation' (2017) 4(1) International Journal of Management and Applied Research 18

an inconsistency between the IFSA 2013 and the *Musharakah* Regulatory Policy as the former construes *Musharakah Mutanaqisah* as an equity financing whereby the latter construes it as a debt financing; both are proven to be contradicted in a number of aspect including the compatibility with the idea of risk sharing. Up to the present time, such inconsistency is yet to be resolved through any means such as the adjudication before the court of law. Therefore, the finding from this analysis is important as it shall help to infer the reality of *Musharakah Mutanaqisah* home financing within the existing legal and regulatory framework and how such reality gives impact on the implementation of risk sharing.

This study has also asserted that although the understanding of *Musharakah* in the Islamic commercial law does converge with the idea of partnership as provided by the PA 1961 in several aspects, nevertheless, the act fails to fundamentally recognise and comprehensively include *Musharakah* as a form of partnership. This is demonstrated through the provisions like section 4(a) and section 4(c). Section 4(a) provides among the things that are not being recognised by itself as a partnership, are joint property, common property, or part ownership. As such, the provision effectively excludes *Shirkah Al-Milk*. Although it is a legitimate form of *Musharakah* it is not recognised as a partnership under the PA 1961.

Section 4(c) further provides that the mere receipt of a share of the profits of a business does not automatically make the recipient a partner. Section 4(c)(ii) excludes a person who receives remuneration by a share of the profits of a business from a person engaged in the business from being a partner, thus, denies the existence of a partnership. This exclusion, therefore, rules out *Mudharabah*, a form of *Musharakah* from the recognised forms of partnership under the PA 1961. As explained in Chapter 4, the party who runs the business (*Mudharib*) in a *Mudharabah* arrangement will get into the business not by contributing capital but extending his entrepreneurship skill and labour force instead (while the capital will be contributed by the other party, the *Rabbul Mal*). In return, he is entitled to a certain portion (pre-determined) of the profit derived from the venture (in the event of a loss, it will be solely borne by the *Rabbul Mal*). Since the remuneration he received is derived from and determined based on the share of the profit of the business as the consideration of the ‘service’ extended, section 4(c)(ii) is applicable on *Mudharabah*, hence partially denies *Musharakah* as a form of partnership.

The above assertions lead to the discussion like the following; since it is proven that the PA 1961 does not recognise several forms of *Musharakah*, how does the law regard the *Musharakah Mutanaqisah* home finance and *Musharakah Sukuk*. To answer this, an in-depth perusal on section 3 of the act will be undertaken. The section defines partnership as ‘the

relationship which subsists between persons carrying on business in common with a view of profit'. Hence, a partnership, by virtue of this section, must contain certain essential elements namely business⁵⁴⁵, carried on in common and with a view of profit. In addition, the real intention in entering the contract shall also be accounted in order to determine the existence of a partnership. Nevertheless, these elements, jointly or separately, however, appear to inflict various incompatibilities with the *Musharakah Mutanaqisah* home financing as well as the *Musharakah Sukuk*.

6.4.1 The First Element – Business in Common

The Federal Court case of *Chooi Siew Cheong v Lucky Height Development Sdn. Bhd. & Anor*⁵⁴⁶ is among the important cases in which the legal principle in respect to the essential elements of a partnership as mentioned above is established. In this case, the plaintiff's father (landowner) and a developer had entered into a joint agreement (joint venture agreement) to develop a piece of land into a housing estate. The developer, through a deed of assignment, assigned all his right and liabilities under the joint venture agreement to the first respondent (first defendant) while the landowner, through an agreement, assigned all his rights to the appellant (plaintiff). The agreement also provided, inter alia, for the landowner to transfer the developer's lots in favour of the first respondent (first defendant) as well as for the appellant (plaintiff) to be made as a permanent director of the first respondent (first defendant). The first respondent (first defendant) was to hold all the developer's lots as the trustee until the completion and discharge of all of its obligations as specified in the joint venture agreement. In the circumstance where it failed to carry on with the housing development, the joint venture agreement required all the developer's lots to be re-transferred to the appellant (plaintiff).

Upon the first respondent (first defendant)'s failure to observe the conditions to construct the houses and therefore in breach of the said agreements, the appellant (plaintiff) sought in the High Court for the re-transfer of the developer's lots, only to realise that the second respondent (second defendant) had lodged a prohibitory order against the land in question, claiming the land was registered under the name of the first respondent (first defendant) who turned out to be a judgement debtor (to the second respondent/second defendant) for works undertaken by it on the land. It also claimed that it had no knowledge of any agreement

⁵⁴⁵ Section 2 of the PA 1961 provides that 'business' includes every trade, occupation, or profession.

⁵⁴⁶ [1995] 1 MLJ 513

between the appellant (plaintiff) and the first respondent (first defendant) at all material time. The trial Judicial Commissioner dismissed the application by the appellant (plaintiff) and affirmed the second respondent (second defendant)'s entitlement to file the prohibitory order and held that the sought re-transfer of the land could not be granted without first satisfying the judgement sum. He based his decision on the ground, inter alia, that as a party to the joint venture agreement, the plaintiff was a partner within the meaning of the term provided by the PA 1961. As a partner of the first respondent (first defendant), he was responsible for the debts of the partnership. This is in addition to the fact he was a permanent director of the first respondent (first defendant) as well. The appellant (plaintiff) appealed to the Federal Court. However, the appeal was dismissed.

Notwithstanding the learned Federal Court judges affirmed the decision made by the High Court on several bases, they, however, did not agree with the Judicial Commissioner of the High Court where the latter had construed the plaintiff as a partner within the meaning of the term as provided by the PA 1961. According to them, in determining whether or not a partnership exists, the intentions of the parties as it appeared from the whole facts of the case and the contract they had entered to must be considered. In this case, the appellant (plaintiff), through his father who was the party to the initial agreement, had provided the land and the first respondent (first defendant) was to provide the capital, labour and services to develop and build the land. Both were to share the ultimate product (terrace houses and shophouses which to be built in two phases) based on the agreed proportions (17:83 in the first phase and 23:77 in the second phase, all in the developer's favour) in such a way where each was to take certain sublots to the exclusion of other (with or without building erected thereon) with a complete freedom to deal or dispose as they respectively wished. That being said, each party had intended a wholly separate business which denies the element of 'business carried on in common' as required by section 3 of the PA 1961. Based on this fact, there is no partnership in existence between them in this case.

An old English case, *Coope & Ors v Eyre & Ors*⁵⁴⁷ also established, inter alia, the similar principle. In brief, the plaintiffs sold oil to the defendants which is to be received as soon as it was boiled and ready. By way of collateral security (two bills of exchange, placed in the hands of plaintiffs, one of which was accepted by the defendants-Eyre, Atkinson and Walton), both parties agreed that the plaintiffs should keep the oil in their possession till future date. Should the defendants did not pay for it upon the agreed future date, the plaintiffs were to

⁵⁴⁷ [1788] 1 H. Bl. 37

authorise the broker to resell it at the best possible price, and the difference of the price will be deducted from the bills placed in their hands. It turned out that the defendants neither paid for the oil nor took it away and the bill of exchange that had been accepted by the defendants was presented to them for payment and refused. The action was brought before the court for the recovery of payment.

It was insisted by the defendants that the contract for sale was made between the plaintiffs and Eyre only. The agreement entered between themselves did not constitute partnership (thus they are not the partners to Eyre) but merely a sub-contract. This is to exclude themselves from being jointly held liable should the verdict is in favour of the plaintiffs. Therefore, like in the previous case, the same question was brought before the court; whether or not a partnership exists between the defendants. Delivering his opinion, Gould, J (one of the trial judges) asserted that a partnership did not arise since 'there was no communication between the buyers as to profit or loss'. Every defendant secured his share of oils respectively and no interference with the share of the others but to manage his share as his wish. Lord Loughborough (the other trial judges), concurred with what has been said by Gould J. Admitting that communion of profit and loss is essential in this question, he added that for a partnership to be constituted the shares must be joint though not necessarily be equal. If the partners be jointly concerned in the purchase, they must also be jointly concerned to sale in the future. As this is not the case, which effectively denies the existence of 'business carried on in common', the partnership, therefore, did not exist. As such, together with other evidence, it was decided the only party liable (and from the legal standpoint, the only party the credit was given to) is Eyre.

6.4.2 *The Second Element – Real Intention*

Apart from the commonality aspect in business, other things such as the real intention, the relevant incidents which may include written or verbal agreement, the conduct of the parties at all times as well the surrounding circumstances may also be the determinant in ascertaining the status of a partnership. This was, inter alia, established through the case of *Aw Yong Wai Choo & Ors v Arief Trading Sdn Bhd & Anor.*⁵⁴⁸ In this case, the plaintiffs had entered into a sale and purchase agreement with the first defendant, a housing developer, where the land on which the houses were planned to be built belonged to the Perak state government, the second defendant. The first defendant failed to undertake the construction. Nevertheless, it was

⁵⁴⁸ [1992] 1 MLJ 166

continued by the second defendant. Upon the completion, the second defendant asked the plaintiffs to pay the houses with higher prices than what they had agreed with the first defendant, claiming that the houses were built with the superior specifications as compared to those that had been agreed before (between the plaintiffs and the first defendant.) Refusing to such, the plaintiffs claimed that both defendants had become partners in the business of developing housing estate and building houses on the land. Pursuant to which the agreement between the plaintiffs and the first defendant was entered. Hence, a legal remedy (specific performance) was sought after. In its defence, the second defendant denied, inter alia, that it was a partner to the first defendant by claiming it was merely sought to help the latter on a social or moral duty. Further, it claimed that it was never be the plaintiffs' intention to enter into a contract with it. As a non-party to the contract in question, hence, it could not be sued for the contract.

It was held by the court, inter alia, that a partnership did exist between the defendants. In the quest to determine the existence of the partnership, the court must find the real intention of the involved parties which is not necessarily the expressed intention. Rather, the relevant factors such as the relevant incidents, written or verbal agreement, the conduct of the parties at all times and all surrounding circumstances are also to be taken into consideration. In this case, there are several things that indicate the existence of the partnership between them. Among the instances is the provision in the agreement between the first and second defendant that provides 50 per cent of the profit of the development to be given to the latter, thus giving rise to a prima facie evidence of partnership. Admitting that the said provision did not constitute partnership conclusively, the court had also considered all the provisions in the agreement, particularly the ones pertaining to the joint appointment of architects, surveyors and so forth, the reserved right to the second defendant to inspect the project to ensure everything complied with all specifications and the right to inspect all books of accounts and the accounts which were required to be properly kept and audited. In addition, the brochure distributed to the potential buyers mentioned a 50/50 joint venture between the first defendant as the developer and the second defendant as the landowner. Therefore, the court granted the specific performance as prayed.

The discussion above triggers the question on the position of the *Musharakah Mutanaqisah* home financing under the PA 1961. As mentioned earlier, the product is meant as a financing tool through which the finance provision is provided by the bank to its customer. On the part of the bank, the aim is to gain profit from the selling price of its portion of the property as well as the rental payment made by the customer. The customer, on the other hand, seeks to

acquire the house. As such, there is no common business carried between both parties. This situation, therefore, disqualifies this product as a partnership recognised under the PA 1961. In addition, it is also claimed that the agreement used between the bank and its customer clearly states that this product is not a partnership and some agreements go to the extent where it is mentioned that no agency is implied.⁵⁴⁹ This poses a serious implication since the agency is among the essential elements of *Musharakah* with the commercial goal as explained in Chapter 4.

The same concern is also relevant in the case of *Musharakah Sukuk*, particularly in the issuance where an intermediary entity, known as Special Purpose Vehicle (SPV) is involved. SPV is a separate legal entity, set up by the originator/obligor (the original party seeking the fund) with the sole purpose of facilitating the transaction.⁵⁵⁰ It serves as the issuer of *Sukuk* as well as the trustee over the funds received from the investors. Typically, the originator contributes in-kind (eg business venture) while the SPV contributes cash normally from the proceeds of *Sukuk* issuance.⁵⁵¹ Both will enter into the *Musharakah* agreement in which specifies, inter alia, the profit and loss sharing ratio. Such profit (and loss) will be then distributed to the investors (via the SPV) in the form of periodic distribution amounts which will take place annually or semi-annually, depending on the agreement.

On the one hand, the existence of SPV admittedly is important and benefits both parties, the originator and the investors (*Sukuk* holders). Being a bankruptcy-remote body, any change in the originator's structure such as dissolution, merger or acquisition will not render effect to the relation it has with the *Sukuk* holders.⁵⁵² Furthermore, the SPV is liable to the *Sukuk* holders for default or delay, if any, rather than the originator thus minimises the risk to the originator.⁵⁵³ On the other hand, having SPV in the bigger picture of *Musharakah Sukuk* arrangement would make *Sukuk* holders, in the real sense, are not the partners in the venture. Rather, the partnership is created between the originator and the SPV which makes both as the actual partners of the venture. As such, the question of whether or not the arrangement is a partnership recognised under the PA 1961 once again arises. As established before, it is essential in a partnership for all partners to carry on the business in common. However, in this case, there is no common business carried out by both parties. The originator is seeking for the fund for its interest (eg specified project development or maybe merely for the company's

⁵⁴⁹ Haneef, Kunhibava and Smolo (n 323)

⁵⁵⁰ Abdullah Saeed and Omar Salah, 'Development of Sukuk: Pragmatic and Idealist Approaches to Sukuk Structure' (2014) (1) J.I. B.L.R 41

⁵⁵¹ Securities Commission Malaysia (n 337)

⁵⁵² Saeed and Salah (n 550)

⁵⁵³ *ibid*

working capital or other purposes) whereby the SPV is purposely being set up to serve as the conduit through which the money from the *Sukuk* holders is pooled. The latter (SPV) has no common interest in the business but only to channel the money into the venture while the *Sukuk* holders, apart from not being the partners, are merely the financiers whom their return happens to be determined by the performance of the venture.

From another angle, the intention of *Sukuk* holders to be partners concerned with the venture activity can be highly doubted given the existence of various mechanisms embedded in the *Sukuk*'s structure, particularly *Musharakah Sukuk*. Among the examples for the said mechanisms is the purchase undertaking through which the obligor of *Sukuk* will undertake to buy back the underlying asset from the *Sukuk* holders as can be seen in the structure of *Musharakah Sukuk* issued by the PjH as discussed in Chapter 4. Upon the dissolution declaration or the scheduled dissolution (whichever earlier), the obligor shall acquire the *Sukuk* holders' undivided proportionate beneficial interest in the *Musharakah* asset at the price which shall be calculated based on a certain pre-agreed formula.⁵⁵⁴ This mechanism allows the total return to the *Sukuk* holders to be 'fixed' or 'guaranteed', especially if the purchasing price is at face value of the *Sukuk*. In such a case, the risk presented by the *Sukuk* will be no longer based on the performance of the asset (*Musharakah* business) but the creditworthiness of the obligor (purchase undertaking provider) as it assumes the ultimate obligation to repay the *Sukuk*.⁵⁵⁵ This may indicate *Sukuk* holders, from the beginning of their subscription to the *Sukuk*, did not intend to be partners of the venture but to act as mere creditors instead. Furthermore, the *Sukuk* structure may also feature the top-up payment mechanism. The *Sukuk* holders were promised with the expected return from the venture of each tranche (for example, 6 per cent). Should the actual return fall short of this expected return (for example, 4 per cent), the obligor shall cover the difference (2 per cent) via the top-up payment.⁵⁵⁶ Although this payment may be set-off later, the existence of this mechanism further casts doubt on the intention of the *Sukuk* holders; whether they genuinely want to be partners in the venture whom their return will be based on the performance of the venture or to be the creditors whom their return is guaranteed regardless of the venture performance. Should the latter prevail, *Musharakah Sukuk* is certainly disqualified to be recognised as a partnership under the PA 1961.

⁵⁵⁴ Principle Terms and Conditions of Proposed Sukuk Musharakah Programme by Putrajaya Holdings Sdn. Bhd. (n 344)

⁵⁵⁵ Securities Commission Malaysia (n 337)

⁵⁵⁶ Principle Terms and Conditions of Proposed Sukuk Musharakah Programme by Putrajaya Holdings Sdn. Bhd. (n 344)

6.4.3 *The Third Element – View of Profit*

The existence of partnership in the *Musharakah Mutanaqisah* home financing can also be challenged based on the absence of the profit motive as required by the PA 1961. In fact, the case of *Coope & Ors v Eyre & Ors* as mentioned earlier also established that a simple co-ownership of property cannot constitute a partnership, something which is consistent with section 4(a) of the PA 1961 as discussed earlier. This certainly disqualifies the *Musharakah Mutanaqisah* home financing as a form of partnership since the *Musharakah* regulatory policy clearly provides that the *Musharakah Mutanaqisah* product with the purpose of asset acquisition shall be deemed as *Shirkah Al-Milk*, a non-profit partnership established in acquiring a property with co-ownership between the bank and its customer. It might be argued that in this arrangement, the bank intends to make a profit. However, this argument is inaccurate for several reasons. On the bank's side, the profit is not generated from the *Musharakah* itself since *Musharakah* is only used in the stage where the bank and its customer jointly own the property. Rather, it is derived from the rental payment by the customer (*Ijarah*) as well as the sale of the bank's portion to the customer (*Bai*). On the customer's side, the intention may not be to generate profit but to acquire the house for his basic necessity (shelter).

The similar argument may also be relevant in *Musharakah Sukuk* although it might not necessarily be the case all the time. Should the pooling of assets be intended for the parties to jointly own or acquire the asset (which will be determined by the agreement) rather than to generate profit, the contract shall be deemed as *Shirkah Al-Milk* instead of *Shirkah Al-Aqd*.⁵⁵⁷ Notwithstanding *Sukuk*, in general, is an investment tool, the structure that invokes *Shirkah Al-Milk* shall be exposed to the risk of not being recognised as a partnership by the law for the reasons as mentioned earlier.

There are also some other provisions in the PA 1961 which make it impossible for the *Musharakah* products to be recognised as a partnership. For instance, section 6 provides for the partnership to be called a firm and the name under which the business is undertaken is called the firm name.⁵⁵⁸ Since the current practice of the *Musharakah Mutanaqisah* and also *Musharakah Sukuk* does not require a firm to be established, the practice is therefore against

⁵⁵⁷ Securities Commission Malaysia (n 337)

⁵⁵⁸ Section 6 of the PA 1961 reads:

6. Persons who have entered into partnership with one another are, for the purposes of this Act, called collectively a firm, and the name under which their business is carried on is called the firm name.

the act.⁵⁵⁹ Section 47(2) further provides the maximum number of partners permitted for a partnership is not more than twenty.⁵⁶⁰ The restriction imposed by this section might not be problematic in the case of the *Musharakah Mutanaqisah* home financing since the arrangement typically involves a bank and a customer. However, it is definitely not practical to impose such restriction on the *Musharakah Sukuk* where the number of investors might be more than 20 to correspond with the sought fund which typically huge.

As such, notwithstanding the brand name that the *Musharakah Mutanaqisah* home financing (and *Musharakah Sukuk* as well) contains the term *Musharakah* which implies partnership, these products fail to meet the requirements for an arrangement to be recognised as one as established by the PA 1961 as well as the judgements from the courts. Although the conflict of nature (whether the products, especially the *Musharakah Mutanaqisah* home financing, are equity-based or debt-based) is yet to be resolved, the assertion of this failure infers that these products are not based on equity. Moreover, as highlighted in the note earlier, these products are to be booked in a financial report in the same group of other debt-based products since the financial report regards the actual substance of the product (its economic substance or financial reality) rather than its form. This fact may serve as a strong basis to assert that the products are debt-based and, therefore, gives a stronger ground on the concerns as mentioned in Subtopic 6.3.2 and 6.3.3.

6.5 Conclusion

This chapter is considered as the most important chapter in the entire study as it provided the answer to the main research question on the consistency between the current legal and regulatory framework in Malaysia with the implementation of risk sharing through the *Musharakah* by referring to the relevant products, that are, *Musharakah Mutanaqisah* home financing and *Musharakah Sukuk*. This study asserted that notwithstanding the governing laws and regulation amplify a strong signal to strengthening the implementation of risk sharing (especially through the provisions in the IFSA 2013 and the *Musharakah* Regulatory Policy), the current position held by the existing framework does not support such

⁵⁵⁹ Ahmad Zafarullah Abdul Jalil and others, 'Challenges in the Application of Mudarabah and Musharakah Concepts in the Islamic Finance Industry in Malaysia' [2013] ISRA Research Paper 56/2013, 23

⁵⁶⁰ Section 47(2) of the PA 1961 reads:

47. (1) ...

(2) Nothing in this Act shall be read to permit any association of more than twenty persons to be formed or to carry on any business in partnership contrary to 14(3)(b) of the Companies Act 1965[Act 125].

implementation. This is based on the fact that the framework, as it stands now, inflicts several problems and implies a different direction. Such problems can be divided into three parts.

The first part is pertaining to the issue of *Shirkah Al-Aqd* and *Shirkah Al-Milk*. By virtue of paragraphs 21.1 and 31.1 of the *Musharakah* Regulatory Policy, *Musharakah Mutanaqisah* home financing is to take *Shirkah Al-Milk* as its underlying structure. Although both *Shirkah Al-Aqd* and *Shirkah Al-Milk* are valid forms of *Musharakah* under the Islamic commercial law, they entail several significant differences. The first difference is pertaining to the ownership of *Musharakah* asset; in *Shirkah Al-Aqd*, the asset ceases to be the partner's personal belonging but to be shared by all partners instead hence gives them the access to and may transact with the asset to generate profit based on the agreed partnership terms. This is different from the situation in *Shirkah Al-Milk* where partners are neither sharing the resources (asset) nor having the right of mutual agency. Rather, each of them owns his portion based on his ownership percentage and is independent in his transaction. He is not entitled to the profit other than from his portion and is to solely bear the loss, if any.

The second difference is pertaining to the motive of partnership; partnership under *Shirkah Al-Aqd* is meant for commercial purposes such as to generate profit out of the undertaken venture and to share the profit based on the pre-agreed ratio. Partnership under *Shirkah Al-Milk*, however, is not meant for such purposes. Instead, its purpose is limited to obtain the ownership of the property and benefit from it. These two differences lead to the third difference, that is, the risk profile. Since partners in *Shirkah Al-Aqd* are aiming to making profit out of the venture, they are required to expose their portions to the risk of loss (hence risk sharing) and shall not have their capital guaranteed. This is different in *Shirkah Al-Milk* since the questions of risk sharing as well as the profit and loss distribution do not arise. This is due to the independency of each partner where each of them is only entitled to the profit from his own portion. Furthermore, since there is no motive to generate profit, risk sharing is not essential. This being said, a partner may obtain (or extend) capital guarantee on his 'capital' (the price he paid to own his portion) by invoking any mechanism when he sells his share such as pre-fixing the sale price.

Based on these facts, the move to construe the *Musharakah Mutanaqisah* home financing as *Shirkah Al-Milk* inflicts two major problems. The first problem is the product would be defined inaccurately. As previously discussed, *Shirkah Al-Milk* merely refers to the joint ownership belongs to two or more people over an asset where the co-owners do not have the arrangement to use the property or invest it through a commerce of leasing or any other means

of earning profit. This clearly does not apply in this case where the *Musharakah Mutanaqisah* home financing is used by the bank as a financing means for its customer.

The second problem arises as a result of construing the *Musharakah Mutanaqisah* home financing as *Shirkah Al-Milk* is such move negates the implementation of the idea of risk sharing. Since partners are practically the co-owners of the property who are independent from each other, they are not expected to share the profit and loss derived from the co-owned property (hence no risk sharing). Rather, each of them is entitled only to the profit gained from his portion and to solely bear the loss should it incur. This clearly implies that *Shirkah Al-Milk* is not designed for the purpose of risk sharing. As such, promoting the *Musharakah Mutanaqisah* home financing under the pretext of risk sharing and offering it as an alternative to other financing products like the BBA home financing are simply misleading and inviting more confusion.

In addition, by having the *Musharakah Mutanaqisah* home financing as *Shirkah Al-Milk*, each partner, as the sole owner of his portion, has the right sell or promise to sell his share to other partner (or non-partner as well) at whatever price they agreed upon. This, in effect, allows for capital guarantee (by pre-fixing the sale price, for instance) which is incompatible with risk sharing.

As for the *Musharakah Sukuk*, the risk of facing the same problems is less obvious since there is no legal provision whatsoever that dictate which underlying structure the *Sukuk* should be built upon. Nevertheless, such problems may surface over time should *Shirkah Al-Milk* is also to be taken as the underlying structure for the *Musharakah Sukuk*.

The second part is pertaining to the nature of the *Musharakah Mutanaqisah* home financing; whether it is an equity financing or a debt financing. In this regard, this study asserted that the current legal and regulatory framework is preliminary not consistent with the implementation of risk sharing as intended through the product like the *Musharakah Mutanaqisah* home financing due to the contradiction between the provisions in the IFSA 2013 and the *Musharakah* Regulatory Policy; the former construes the *Musharakah* and the *Musharakah Mutanaqisah* as the instances for equity financing whereby the latter provides the *Musharakah Mutanaqisah* home financing is to reflect the debt financing risk profile. This being said, the operational requirements and expectations from it shall be similar to the ones apply in the case of debt financing.

As both debt and equity financings entail several core differences which give impact on the implementation of risk sharing, it can be said that, from the perspective of the *Maqasid Al-Shariah*, debt financing fails to serve justice among the parties involved since the debtor needs to pay more than the financing amount he takes regardless the outcome of his business. This situation is different in equity financing where the arrangement it entails promotes the real economic activities and fair distribution of wealth (profit) since it depends on the actual performance of the venture. Debt financing also deprives the chance to participate in the entrepreneurship due to the failure of securing capital, for instance. Although a person might have sufficient skills and abilities to run a business, he might fail to embark for the same since he has no collateral to provide as a security to enable him to obtain the sought financing. Such a situation may be mitigated under the equity financing arrangement where he can contribute his labour (like in *Mudharabah*) or in kind capital (like in *Musharakah*). In addition, equity financing would stimulate innovation and creativity. The entrepreneur would continue to improve his skill and talent to attract more capital while the capital provider would perform due diligence on the business he is participating in as his income is directly depending on its performance.

Based on these comparisons, it is asserted that the approach of construing the *Musharakah Mutanaqisah* home financing as debt financing gives negative impacts on the implementation of risk sharing (not to mention the legal potential it may create due to the discrepancy between two sets of governing law as mentioned above). It eliminates risk sharing as the most significant hallmark of the product and makes the brand it holds as over-stated and misleads. Such situations pose the reputational risk to the Islamic finance industry as a whole. It is also a regressive move since the initial intention behind the introduction of the *Musharakah Mutanaqisah* home financing is to replace the BBA home financing, the debt financing. All these facts, therefore, further supports the assertion this study provides; the current legal and regulatory framework is not consistent with the implementation of risk sharing and fails the aspiration of justice.

In the third part, the discussion dealt with the legal recognition held for the *Musharakah Mutanaqisah* home financing. This is to further analysis the real nature of the product, and for this time, from the legal perspective. Based on the undertaken analysis, this study asserted that as far as the current framework is concern, the *Musharakah Mutanaqisah* home financing is not a partnership (and the same assertion applies in the case of *Musharakah Sukuk* in certain circumstances). This assertion is based on section 3 of the PA 1961 as well as various

judgments from the courts since it does not satisfy the essential elements of a partnership; business in common, real intention and view of profit.

Failing to be recognised as a partnership, therefore, infers that these financing products are not equity in nature but debt instead (not to mention, from the accountancy standpoint, they shall be booked in a financial report in the same group of other debt-based products). As such, all the concerns regarding the impact of debt financing on the implementation of risk sharing and justice and fairness advocacy through these products as mentioned before remain intact.

Chapter 7. Conclusion and Recommendation

7.1 Introduction

Pursuant to the discussions that had taken place throughout this study, this final chapter is dedicated to assert its overall conclusion. In addition, it also proposes several recommendations to address the identified issues as the way to move forward in addressing the implementation of risk sharing in the context of Islamic finance in Malaysia.

7.2 Conclusion and Recommendation

Based on the findings mentioned earlier, this study concludes that notwithstanding the significance of risk sharing in pursuit of justice in Islamic finance, the Malaysian legal and regulatory framework, as it stands now, does not support its implementation and operation in the *Musharakah Mutanaqisah* home financing. The approach to construing the product as *Shirkah Al-Milk* has been proven as inaccurate due to their differences in terms of the ownership of *Musharakah* asset, the motive of partnership and the risk profiles which eventually defeat the implementation of risk sharing.

This study, therefore, recommends for immediate action to be taken so as to rectify such characterisation by amending the relevant paragraph in the *Musharakah* Regulatory Policy. A further study may be undertaken to have a more in-depth look on the accuracy of characterising the *Musharakah Mutanaqisah* home financing as *Shirkah Al-Aqd* rather than *Shirkah Al-Milk* and the mechanism that might be applied as to replace the application of the second purchase undertaking. By having the *Musharakah Mutanaqisah* home financing as *Shirkah Al-Aqd*, the application of the second undertaking as in the second approved model of the *Musharakah Mutanaqisah* home financing (which entails financier may have its capital guaranteed) can no longer be justified. This situation is expected to drive the initiative to find the solution as to make the *Musharakah Mutanaqisah* home financing as a financing tool with the genuine risk sharing arrangement. This amendment also appears to be feasible since it does not require a lengthy process as an amendment on an act of parliament would be. It can be done on the regulatory body level ie BNM without having to go through the process in the parliament.

However, this study must admit that this conclusion is not conclusive in the case of the *Musharakah Sukuk* since there is no regulation dictates a specific form of *Musharakah* upon

which the *Musharakah Sukuk* shall be structured (eg *Shirkah Al-Milk* or *Shirkah Al-Aqd*). Nevertheless, the same conclusion may be reached should a regulation with the similar framework is to be applied in its case.

The existing legal and regulatory framework also fails to support the realisation of risk sharing due to the current standings of the IFSA 2013 and the *Musharakah* Regulatory Policy which are demonstrating a clear contradiction in terms of the nature of *Musharakah* and *Musharakah Mutanaqisah*; the former construes them as instances for equity or partnership financing whereby the latter rules that the *Musharakah Mutanaqisah* home financing shall reflect the debt-based financing risk profile and the combination with other contracts like sale and lease transforms the inherent risk sharing element into credit risk. Although both debt and equity-based financings are considered as *Shariah*-compliant, the impacts they both render respectively are different in terms of risk sharing. Based on the discussion held in this study, it is obvious that to maintain that the *Musharakah Mutanaqisah* home financing to reflect the debt-based financing risk profile will defeat the realisation of risk sharing.

Pursuant to the discrepancy in this respect between the IFSA 2013 and the *Musharakah* Regulatory Policy and the impacts both modes of financing shall render respectively to the realisation of risk sharing, it is recommended for a further research to be undertaken to determine the true nature of the product; whether it is an equity financing or a debt financing. This research is important at this point since this issue is yet to be resolved by any means such as the adjudication before the court of law. It can pave the way forward as to reconcile the discrepancy. The clarity of the legal and regulatory framework is essential in order to avoid any legal conflict that may arise. The governing law should be, at all time, consistent with the enabling law as to ensure the smooth operation of the Islamic finance industry.

The failure of the PA 1961 to comprehensively recognise *Musharakah* as a form of partnership is also a matter of concerns in this respect. As asserted by this study the *Musharakah Mutanaqisah* home financing is not a partnership as far as the PA 1961 is concerned. In addition, from the accountancy standpoint, it shall be booked in a financial report in the same group of other debt-based products. This situation further infers that the product is not an equity financing but rather a debt financing which is incompatible with the idea of risk sharing.

It is, therefore, recommended for the PA 1961 to be amended by inserting a special division as to address the equity partnerships under the Islamic finance such as *Musharakah* or *Mudharabah*. This insertion is important to ensure that product such as the *Musharakah*

Mutanaqisah home financing (as well as the *Musharakah Sukuk*) can be considered as a partnership from the legal standpoint and therefore can be expected to behave as an equity arrangement. This move does not only imply the consistency with what has been entailed by the IFSA 2013 but also compliments the initiative to strengthening the implementation of risk sharing as a result of the recognition given by the PA 1961 to the product as a partnership.

It is also important to note here that although this study puts its focus specifically on the *Musharakah Mutanaqisah* home financing as well as the *Musharakah Sukuk*, the finding and conclusion that have been asserted here may also relevant in the case of other *Musharakah*-based product. This is because this study deals with the overarching concept of *Musharakah* which may be applied in various products either for the purpose of investment or to acquire property (financing). Furthermore, the issue of risk sharing, from the *Shariah* standpoint, is not only relevant in *Musharakah* but universal in nature that applies in most of the commercial transactions, if not all. Therefore, any initiative to strengthening the implementation of risk sharing in the future, although may not fall within the specific remit of this study, can take this study as one of such work's references.

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