Use of Ḣiyal in Islamic Finance and its Sharī‘ah Legitimacy

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Abstract

Sharī‘ah legitimacy of Islamic banking has been a subject of intense debate and discussion among the religious scholars. A group of ʿulama hold the opinion that current Islamic banking practices are un-Islamic. Their major objection on Islamic banking and finance is that it heavily relies on Ḣiyal, i.e., stratagems and subterfuges to circumvent sharī‘ah prohibitions on riba, which frustrate the higher objectives of the sharī‘ah. The purpose of this paper is to examine whether Islamic financial products and banking transactions are in nature of stratagems that frustrate the purpose and spirit of law or they are only clever uses of law with a view to provide solutions to difficult problems without frustrating the purpose of Islamic law. The article is divided into two sections. Section-I deals with classical approach towards treatment of legal devices. Section-II deals with the application of Ḣiyal to modern Islamic finance. In this section, subversive Ḣiyal such as baiʿ al-ʿinah, tawarruq, commodity murabaha and sale and lease back ṣukūk have been discussed. In the analysis of the author, such legal devices oppose the higher objectives of sharī‘ah relating to Islamic economics and finance. This section also deals with such legal devices which suggest a way out or outlet from difficult situation. An attempt has been made to determine whether a particular device simply overcomes rigidity and inconvenience or it circumvents sharī‘ah prohibitions. The paper emphasizes the centrality of maqāṣid al-sharī‘ah in ijtihad and fatwa in the field of Islamic finance. It suggests that in developing financial products, maqāṣid al-sharī‘ah should be given prime consideration; otherwise Islamic finance will lose its real merit and substance.

Key Words: Ḣiyal, Makhārij, Maqāṣid al-Sharī‘ah, Tawarruq, Baiʿ al-ʿinah, Shariah prohibitions, Islamic finance, ṣukūk.

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1. Introduction

Sharī‘ah Legitimacy of Islamic banking has been a subject of intense debate and controversy among the religious scholars. A group of ‘ulama holds the opinion that current Islamic banking practices are not Islamic in real sense. A major objection raised is that Islamic banking heavily relies on hiyal i.e. certain stratagems and subterfuges to circumvent certain sharī‘ah prohibitions especially those on riba. These scholars contend that murabaha and ijarah are merely hiyal not real Islamic alternatives to conventional banking. The background of this paper is that on 29th August, 2008, a fatwa was issued by the ‘ulama belonging to prominent religious seminaries of Pakistan in which they declared the present Islamic banking un-Islamic. Their main objection is that it is primary structured on hiyal that frustrate higher purposes of sharī‘ah.¹ The products developed by the banks may conform to the letter of Islamic law, but frustrate the spirit and purpose of law. The purpose of this paper is to examine whether the Islamic financial products and banking transactions are in the nature of stratagems that frustrate the purpose and spirit of law or they are only clever answers to difficult problems, commonly known in Islamic jurisprudence as makhārij i.e. a way out without frustrating the spirit and purpose of law. It attempts to determine whether a particular legal device simply overcomes the inconvenience and rigidity in law or it frustrates the purpose and spirit of sharī‘ah. The paper will also investigate whether the classical jurists acknowledge hiyal as a tool of fatwa and legal reasoning. In this regard, different approaches in the treatment of hiyal in classical Islamic law will be studied.

The paper will deal with the issue of hiyal and its current relevance to Islamic banking in two sections. In Section-I, concept and treatment of hiyal in classical Islamic law will be discussed. Section-II will deal with the applications of hiyal in modern Islamic finance.

2. Concept of Ḥiyal in Islamic Law

2.1 Ḥiyal: Meaning and Forms

Ḥilab literally means an artifice, device and stratagem. Technically it may be described as the use of legal means for extra-legal ends that could not, whether themselves are legal or illegal, be achieved directly with the means provided by the sharī‘ah. It enables persons who would otherwise have had no choice but to act against the provisions of sacred law, to

¹ See, Murawwajah Islami Bankari, pp.229-232; Takmilah al-Radd al-Fiqhi, p.45.
arrive at the desired result while actually conforming to the letter of the law. Thus, *hiyal* (legal artifices) constitute legal means by which one can arrive at judicial outcome otherwise prohibited by the law.\(^2\)

*Ḥilah* in Islamic jurisprudence is used in two meanings. Firstly as tricky solutions to difficult problems without frustrating the purpose of law; they are clever uses of law to achieve legitimate ends. They are employed to overcome inconvenience in law. Such *hiyal* are considered to be lawful. The Hanafi and Hanbli jurists prefer to call them *makhārij* i.e. outlets rather than *hilas*.\(^3\) Secondly, as device and subterfuge to circumvent certain *sharīʻah* prohibitions or to evade certain obligations. Such *hiyal* are declared unlawful by the fuqaha.

An example of a clever use of law is indirect exchange of superior dates with inferior dates, suggested in the hadith of Companion Bilāl (RA).\(^4\) The requirement of Islamic law in the exchange of dates with dates is that dates on both sides should be equal. Now if a person wants to exchange it’s inferior quality dates with superior quality, it has to ignore quality difference and exchange it on the basis of equality in weight on both sides. Any difference in the quantity will make the transaction, a transaction of *riba al-fāḍl*. The solution to this problem is to sell inferior quality in market and buy from the proceeds of sale required superior quality. In this way the parties can overcome a difficulty without jeopardizing the letter of Islamic law. [This, however, is not a *ḥilah* in real sense; it is the act legalized by the Holy prophet (pbuh), the lawgiver, himself].

Unlawful is used either to circumvent a prohibition or to evade obligation. An example of *ḥilah* intended to circumvent *sharīʻah* prohibition on *riba* is *baiʿ al-ʻinah*. *Baiʿ al-ʻinah* is to sell a property on credit for a certain price and then to buy it back at a price less than the sale price on prompt payment basis, both the transaction take place simultaneously in the same session of contract.\(^5\) For example, A sells a commodity to B for Rs. 100/- on a one-year’s credit. A, then buys the commodity back for Rs 80/- from B on immediate payment. In the above

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case, A is a creditor and B is a debtor, A has advanced loan of Rs. 80/- under the cover of sale transaction in which he earns a surplus of 20 rupees. Another form of bai’ al-‘inah is to sell commodity on cash and then buy it back at a higher price to be paid at some specified time in future. In this case, the prospective debtor sells an object to the prospective creditor. The debtor immediately repurchases the object for a higher amount payable at a future date. Thus transaction amounts to a loan with certain increase.

The majority of Muslim Jurists consider this transaction invalid because the intended objective of the transaction opposes the objective laid down by the lawgiver.6 This form of transaction, in their view, is nothing more than a legal device aimed at circumventing the obstacle posed by the prohibition of riba. It is a fictitious deal in usurious loan transaction that ensures a predetermined profit without actually dealing in goods or sharing any risk.

The example of hilab intended to evade some shari‘ah obligation is gift of zakatable amount before completion of one year in order to avoid zakāb. Similar to this is a situation where a person combines scattered animals to reduce the amount to be paid on account of zakāb. For example, a person owns forty sheep and his two sons also have forty sheep each. They combine them together as single property to give one sheep instead of three sheep on account of zakāb. Conversely, a person has forty sheep. He sells two sheep so that he is exempted from obligation.7

The last category of unlawful hiyal is reflected in a famous shari‘ah Maxim: “Every legal artifice whereby nullification of a right or affirmation of a wrong is devised is unlawful”.8 It suggests that a legal artifice which serves as means to violate some established principle of Islamic law and also defeats the intention of the law is unlawful. Conversely any legal artifice that does not contravene an established legal principle is valid and may be permissible in Islamic law.

A hilab affected on a debt transaction is generally treated as unlawful hilab because it intends to give some extra benefit to the creditor. Buy-Back agreement, sale with right of redemption belong to this category. A

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6 Badawi, Nazriyyah al-Riba al-Muharram, Cairo al-Majlis al-A’la li Re’ayat al-Funun, 1940, p.203
7 Bukhari, al-Sahīh, Kitab al-Zakah, Hadith No.1382
famous maxim states: *hilah* affected on debt is a *hilah* for *riba*. Some examples of *hiyāl* on debt transaction are: to mortgage a house with the creditor and allow him to stay in it, or to sell an object to the prospective debtor for an exaggerated price and then immediately lend him some money or to buy from him certain commodity at a lower price or to lease him some asset at a rental higher than its prevailing market rate.

Ibn Qudamah (d. 620 H) alludes to the above stated categories in his celebrated work *al-Mughnī*. He writes:

Unlawful *hilah* means to do an act which is apparently permissible with the intention to achieve some unlawful purpose such as to do a prohibited thing or avoid some obligation or nullify a right. The permissible *hilah*, on the other hand, is sought to overcome difficulty and inconvenience (in law), with the purpose to abstain from an unlawful act or thing.¹⁰

### 2.2 Treatment of *Hiyāl* in Islamic Law Schools

Juristic schools vigorously differ on the legitimacy of *hiyāl*. Their views falling across spectrum: The Hanafis and Shafi’s take the most lenient position. They declare them valid. Even the apparently subversive artifices are valid in these schools although immoral. *Bai‘ al-‘inah* (buy-back agreement) for instance is lawful in Shafi‘ī School. Their argument is that it is the external form of contract and not the underlying intention that determines the validity of a contract or otherwise.¹¹ The Hanafi jurists allow *nikāb tahlīl*, intervening marriage to facilitate remarriage between divorced couple after thrice repudiation (irrevocable divorce of major degree). They also allow *bai‘ bil waṣf* i.e. sale with right of redemption under need. Hanbali jurists have taken a balanced position on the issue. They allow only those legal devices that provide a way out from a difficult situation and consequently overcome inconvenience in law.¹² Maliki jurists condemn *hiyāl* and declare them invalid. They even block ways that may lead to an evil. They call it sadd al-dhara‘ī. In the following lines, we will discuss the approaches of schools for the treatment of *hiyāl* in some detail.

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2.2.1 Hanafi Approach in Ḥiyal

As noted earlier, the Hanafi jurists have taken a liberal and flexible position on Ḥiyal. In the classical Hanafi books many instances of legal devices are observable where the boundaries between lawful Ḥiyal and unlawful Ḥiyal appear to have blurred. Fatawa Hindiyah (compendium of Hanafi legal opinions) offers many legal devices whereby a lender can charge certain increase on his amount from the borrower. In one case Ibn ‘Abidin, author of Radd al-Muhtār, suggests that if creditor wants to give extension in time to his debtor against some increase in amount, he may buy some commodity against the amount of debt from the debtor and then sell the same commodity to him on credit at a higher price. For example he wants to increase the amount of loan from 10 dirham to 13 dirham, for extension in time of repayment; he can do it by buying commodity for 10 dirham (which is the amount of loan) from debtor, and sell it on credit for 13 dirhams. Ibn ‘Abidin claims that in this way he has been saved from indulging in riba.\(^{13}\) We notice here that the solution suggested by Ibn Abidin, clearly violates the purpose of law. It is a subterfuge to circumvent prohibition of riba.

Hanafi jurists have also allowed bai’ bil wafa (sale with right of redemption) which carries the attribute of riba. This is a transaction in which a person in need of money sells a commodity to a lender on the condition that whenever the seller wishes, the lender (the buyer) would return the purchased commodity to him upon surrender of the price.\(^{14}\) The reason for its designation as wafa is the promise to abide by the condition of returning the subject matter to the seller if he too surrenders the price to the buyer. Like bai’ al-‘inah, this too is legal device for riba. The purchaser in this case is a creditor who benefits from the object held in his custody as pledge till the debtor pays him back his amount and retrieves his object. Islamic injunctions on pledge clearly provide that the creditor is not entitled to make profit out of the pledged property. Any profit drawn from it is interest. The Muslim jurists generally treat bai’ bil wafa as mortgage.

In another form, the borrower who owns certain property, sells that property to the lender, leases it back, pays rent on it (equaling interest),

\(^{13}\) See Fatāwā, Tanqīḥ al-Ḥamidiyah, vol.2, p.245
\(^{14}\) Ibn ‘Abidin, Radd al-Muhtar, vol.4, p.341
and then invokes a right to repurchase the property for the original sale price.\footnote{Al-Fātawā al-Hindiyyah, 3:209}

\subsection{Maliki Approach in Treatment of Ḥiyyal}

Maliki jurists take the most strict position on ḥiyyal. They condemn ḥiyyal and declare them invalid. Shatibi writes:

The prominent meaning of ḥilāb is to do an act which is apparently permissible with the purpose to nullify and violate some shari‘ah rule. Thus the ultimate purpose of act is to offend established principles of shari‘ah. For instance when a person makes gift of zakāb soon before the completion of year, he in fact does this, to evade the obligation. This goes without saying that to make gift in itself is a permissible act and abstention from zakāb is prohibited act. Now when he combines a permissible thing, with prohibited thing, he in fact intends to escape zakāb. Otherwise, making gift in itself is permissible but if it aims at avoiding zakāb then it is unlawful.\footnote{Shatibi, al-Muwafaqāt, vol.4, p.201}

To establish unlawfulness of ḥiyyal, Shatibi argues that shari‘ah was revealed for the purpose of regulating benefits which are universally applicable. He further argues that the aḥkām of shari‘ah are not the ends \textit{per se}. They are meant to realize certain objectives. These objectives are in fact the interests that the shari‘ah seeks to achieve by these aḥkām. Now when a person performs certain act that defeats that interest, he in fact violates the will of the law-giver.\footnote{Ibid, vol.2, p.385}

Maliki jurists are so strict on unlawfulness of ḥiyyal that they do not acknowledge even the lawful means which most probably lead to an evil. Maliki jurists call it \textit{sadd al-dhara‘i} which is permanent principle of legal reasoning in Maliki School. Imam Shatibi has described \textit{sadd al-dhara‘i} as use of a thing which has a benefit (maslahah) as a means to realize some unlawful end or to get to an evil (mafsdah).\footnote{Al-Muwafaqāt, vol.4, p.199} Another Maliki jurist, Qarafi defines it in the following words:

\textit{Sadd al-dhara‘i} is to annihilate the matter of means of corruption in order to eliminate it. If an act which is itself free from corruption

\begin{itemize}
  \item \footnote{Al-Fātawā al-Hindiyyah, 3:209}
  \item \footnote{Shatibi, al-Muwafaqāt, vol.4, p.201}
  \item \footnote{Ibid, vol.2, p.385}
  \item \footnote{Al-Muwafaqāt, vol.4, p.199}
\end{itemize}
(mafsadah) is used as means to corruption, Imam Malik prohibited that act in many cases.\textsuperscript{19}

Thus sadd al-dhara’i refers to an act which has a benefit but most probably leads to an evil which is equal to the benefit. The concept of sadd al-dhara’i, observes Kamali, is founded in the idea of preventing an evil before it actually materialize. It is therefore, not necessary that the result should actually happen. It is rather the objective expectation that a means is likely to lead to an evil result which render the means in question unlawful even without realization of the expected results.\textsuperscript{20}

The relationship between means (dhara’i) and hålab is that both lead to an evil. But the means i.e. dhara’i are not always associated with illegal motive. Sadd al-dhara’i basically contemplates preventing an evil before its occurrence. The question of intention to procure a particular result cannot be a reliable basis for assessing the means that leads to that result. The question of intention of perpetrator is not relevant to the adjective determination of the value of means. A hålab, on the other hand, is always exercised with intention and with the purpose to circumvent some sharî`ah prohibition. In bai’ bil wafâ, as we have observed earlier, the goods sold are in nature of mortgaged property. The transaction of sale authorizes the purchaser to benefit from the purchased goods which should not be permissible in the case of direct mortgage. Thus, the sale with right of redemption (bai’ bil wafâ) was adopted as a tricky device to circumvent the prohibition of benefiting from mortgaged property held as security with the creditor. Now since the hålab violates the spirit of Islamic law, it should be condemned and discouraged. Similarly, a dhari’ah should also be discouraged as long as it leads to unlawful end.

\textbf{2.2.3 Hanbli Approach}

Hanbli Jurists make distinction between the hålab to overcome inconvenience in law and the other to circumvent sharî`ah prohibitions. They call the former makhârij, and consider them valid.\textsuperscript{21} Ibn al-Qayyim a renowned Hanbli jurist has devoted full chapter to discussion on håyal. Ibn al-Qayyim, like his contemporary Maliki jurist Shatibi emphasizes the role of intentions in juridical acts. He writes:

\textsuperscript{19} Qarafi, \textit{al-Fûriq}, vol.2, p.32
\textsuperscript{20} Kamali, Principles of Islamic Jurisprudence, p.394
Intention is the essence of every juridical act. The act follows the intention. If the intention is valid, the act will be valid and if the intention is unlawful, the act would be unlawful. Thus if a person enters a sale transaction which he intends to be a means for *riba* transaction, the sale transaction would be treated as *riba*. The outward form of contract does not make it a sale transaction.\(^2\)\(^2\)

Ibn Qayyim regards *biyal* inconsistent with the spirit of *sharīʿah*. He compares *hilah* with *sadd al-dharaʿi* (plugging means towards unlawful ends) and concludes that doctrine of *biyal* is in sharp contrast to the principle of *sadd al-dharaʿi* in that the lawgiver through *sadd al-dharaʿi* intends to block the means towards unlawful ends whereas *hilah* opens means towards unlawful ends.\(^2\)\(^3\)

To prove the undesirability of *biyal*, Ibn al-Qayyim cites the *hadith* in which Holy Prophet (pbuh) cursed the Jews for circumventing the prohibition of fat of animals. The *hadith* reads: “May Allah (SWT) curse the Jews, when Allah (SWT) declared the fact of such animals unlawful, they melted it and enjoyed the price they received”. The fat of animal was prohibited for Jews. So they melted it and changed its form. They thought that prohibition did not apply to that new form. Thus, they continued benefiting from fat. Another form of benefit they devised was to sell it and enjoy the price. Ibn al-Qayyim after quoting this *hadith* writes: “Khattabi said: This *hadith* provides a proof that a *biyal* is invalid when it leads to commission of prohibited act. The mere change of word form and title does not change the *bukm* and effect, if there is no change in substance”.\(^2\)\(^4\)

Thus in the opinion of Ibn al-Qayyim intention and purpose of law is the touchstone to determine the validity / invalidity of a juridical act. Ibn al-Qayyim has given a number of solutions in his book to difficult problems which serve as precautionary measures which a prudent person should take before entering a transaction. Ibn al-Qayyim’s solutions are more close to *makhārij* than to stratagems and subterfuges. Following statement of Ibn al-Qayyim will explain the point.

If a person asked another person: Buy this commodity from this person at this price and I will buy it from you and will give you certain profit on it.” The person thought that if he bought, the

\(^2\)\(^2\) *Iʿlam al-Muwaqqiʿin*, vol.4, p.217, Egypt, 1388.H/1968 A.D.
\(^2\)\(^3\) *Ibid*.
\(^2\)\(^4\) *Iʿlam*, op.cit. vol.3, p.138
orderer might change his mind and refuse to buy it. In that situation he would not be able to return it to seller. The hilah in such situation is that he should buy it with khayár al-sharṭ (stipulated right of cancellation) for three days or more, and then present the goods to the orderer for sale. If he buys it at a stated price, the transaction will be enforced, but if he refuses he can return goods to original supplier by invoking his stipulated right of revocation i.e. khayár al-sharṭ.25

The case under discussion is that of “murabaha to purchase orderer”. Imam Ibn Qayyim instructs that in case the buyer apprehends that orderer will decline to buy promised goods, he should, as a precautionary measure, stipulate in the purchase contract his right to return. As such, this solution is more in nature of a precautionary device than a stratagem or unlawful hilah. It can also be described as a risk-management device. Thus the hiyal in Hanbli School are generally used in the sense of makhārij.

3. Use of Hiyal in Islamic Banks

In Islamic finance, hiyal have been in practice since its inception. In Pakistan, in 1984 the State Bank introduced twelve modes of financing. Many of them represented stratagems and subversive hiyal. But gradually the size of such hiyal was decreased. Now most of the hiyal in practice are in the nature of makhārij. They are wise answers to difficult problems rather than unlawful hiyal. They are cleaver uses of law to achieve legitimate ends. There are, however, some devices which certainly fall under the category of unlawful devices as they defeat the higher purposes of Islamic economics and finance. These legal devices have badly affected the originality and authenticity of Islamic banking. Here we will deal with such hiyal in Islamic finance. It is pertinent to note that the opponents of Islamic banking generally regard all the legal devices practiced in Islamic banks as unlawful hiyal while the proponents identify them as makhārij, rather than subversive hiyal.

3.1 Unlawful Hiyal in Islamic Finance

The legal devices discussed under this title are the hiyal that frustrate the purpose of law and circumvent sharī‘ah prohibition on riba. The list of such legal devices, inter alia includes bai‘ al-‘inah, tawarruq and

25 Ibid., vol.4, p.24
Commodity Murabaha transactions. Sale and lease back ṣukūk also partially fall in this category as they have the properties of *baiʿ bi l wafla* which has been declared invalid by the International Fiqh Academy.

### 3.1.1 *Baiʿ al-ʿinah*

*Baiʿ al-ʿinah* i.e. buy-back agreement is one of the transactions that defeat the purpose of Islamic law. In Pakistan, buy-back was one of the twelve modes of financing suggested by the State Bank of Pakistan in 1980s. In 1992 the Federal Shariat Court and Shariat Appellate Bench of Supreme Court in 1999 held buy-back void. Since then it is no longer practiced in Pakistan. Auditing and Accounting Organization for Islamic Financial Institutions has ruled for its invalidity. The Islamic banks in Malaysia still rely on buy-back agreement as mode of finance. The bank, for instance, sells piece of land to the customer on credit and then buys it back for cash at a lower price. The difference in price is the bank’s profit which is determined in advance. The reason for its practice in Malaysia appears to be is that the Shafī jurists hold such contract valid. The unlawfulness of purpose in their opinion does not affect validity of contract as long as illegal intention is not explicitly mentioned in the contract.

### 3.1.2 *Tawarruq*

*Tawarruq* is a transaction whereby a person who is in need of money, buys a commodity on credit from a certain person and then, sells it in the market on cash at a price less than the one at which he purchased from its owner. It is called *tawarruq* because the purpose of this transaction is to obtain *wariq* (silver) i.e. money or finance by a needy person. For example, A is in need of Rs. 20000. He approaches B with the request to sell him certain commodity on credit. B sells him a computer worth Rs.20000 for Rs.30000 on credit to meets his immediate need of money. A sells it in the market on cash for Rs.20000/- and gets money. He is indebted to B for Rs.30000/-.  

The classical Muslim jurists have divergent views about its legal status. A considerable number of Muslim jurists hold it invalid. In their opinion the motivating cause of the transaction is to get loan against certain increase. It is a subterfuge and a legal device to obtain money against a certain increase. Besides, it is an exchange of money for money with addition from one side.

Maliki Schools holds *tawarruq* invalid. The authoritative Maliki text *Mukhtasar Khalil* explains Maliki position on *tawarruq*. The author writes:
“If a person asks the other: Lend me eighty and I will return to you one hundred”. The other person says: It is not lawful but I will sell you a commodity worth eighty for one hundred. This is disapproved in Maliki School.

Hanafi School has two divergent positions on tawarruq. Zayla’i (d.743) identifies tawarruq as bai’ al-‘inah and disallows it. He says:

The form in which bai’ al-‘inah is practiced is that a needy person approaches a merchant and requests him to lend him some money. The merchant wants to earn from it but at the same time he does not want to be indulged in riba. So he sells to him a cloth worth ten for fifteen on credit so that the needy person could sell it for ten (which is the real value of cloth) on cash and meet his need. This is unlawful and reprehensible.

Ibn Humam (d.861), another Hanafi jurist, did not consider it preferable, although allowed it.

Shafi jurists emphasise that external form of contracts should be according to the requirement of Islamic Law. They are not concerned with the underlying intention. From this it can be concluded that they acknowledge the validity of tawarruq.

Hanbli scholars hold tawarruq valid. Al-Mardawi, a renowned Hanbli jurist writes:

“If a person needs cash, and for that purpose he buys a commodity whose value is hundred for hundred and fifty, it is lawful”. This is the ruling of Imam Ahmad.

Hanbli jurists regard it permissible. However, Imam Ibn Taymiyyah and Imam Ibn al-Qayyim do not agree with the acknowledged viewpoint of their school. They equate tawarruq with bai’ al-‘inah (buy-back agreement). Those who approve of tawarruq rely on the texts that permit sale such as the verse: Allah (SWT) has permitted bai’ and forbidden riba

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27 Zayla’i, Tabyīn al-Ḥaqāʾiq, vol.4, p.163.
They, however, lay down certain conditions for its validity. These are:

i) There is a real need for transaction. The person undertaking *tawarruq* needs money and he is unable to get loan from any source. However, if he can get loan, then he is not allowed to enter *tawarruq*.

ii) The contract in its form should not be similar to a *riba* contract. This occurs where the seller expressly mentions that he is selling a commodity worth one thousand (which is the real price) for twelve hundred, because this amounts to exchange of money for money with excess. It is, however, lawful if he apprises the prospective debtor of its real price and his profit margin.

iii) The debtor (buyer of commodity) should not sell it before taking its possession.

iv) The commodity should not be sold to the same creditor (seller in this case) at a less price.

The Fiqh Academy of Muslim World League in its 15th session had also allowed *tawarruq* with certain conditions. It, however, reviewed its *fatwa* in its 17th session and declared current *tawarruq* practices by the Islamic banks invalid.32

The procedure of *tawarruq* transaction in the Islamic banks is as follows:

The bank arranges a commodity for its customer from international market and then sells it to him on credit. The bank also agrees with the customer that it will sell it in the market as its agent. This can be illustrated by the following examples:

A, a customer approaches B, a bank with a request to lend him Rs.10000. B purchases an item for Rs.10000 from C, a dealer on cash, and sells it to A, for Rs.12000 on a credit of one year. B, then in its capacity as the agent of A, sells it to C for Rs.10000 on cash, and hands over Rs.10000 to A, the customer.

It is worth-mentioning that Hong Kong Shanghai Banking Company (HSBC) and many other banks use *tawarruq* as mode of personal financing. The working of *tawarruq* in HSBC is that it buys metals from international brokers and then sells them on to customers at a pre-agreed

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price that is payable over an agreed term. The customer appoints the bank its agent to sell the metals to a third party in the market. The proceeds are credited to creditor’s account.

It is evident from the above mentioned practices of *tawarruq* in the banks that it is only a legal device (*hilab*) to circumvent the obstacle posed by the prohibition of *riba* by making it a sale transaction while in fact it is an interest-bearing loan transaction. It is a credit vehicle and technique to provide cash / liquidity against an increase over and above the amount of finance. Even the possession of commodity is not taken by the prospective debtor. The commodity also does not move into his risk and liability. Main objections raised on *tawarruq* practice are as follows:

i) This is a trick to get cash now for more cash paid later.

ii) There are effectively only two parties i.e. no real, unconnected third party.

iii) There is a concealed buy-back.

iv) The metal, subject matter of *tawarruq*, does not move at all in relation to *tawarruq* sales; this renders the metal virtually wholly irrelevant since it serves simply as a prop to enable these deals to be transacted.

v) *Tawarruq* does not involve any kind of risk that is associated with normal and genuine commodity trading activities.³³

### 3.1.3 Commodity *Murabaha*

Similar to *tawarruq* is commodity *murabaha* which is practiced by some Islamic banks in various parts of the world also including Pakistan. It is a treasury product used mainly as a tool of liquidity management. The commodity *murabaha* is practiced in Pakistan in the following manner:

i) Upon the requirement of liquidity, Bank ‘ABC’ approaches the Islamic Bank (IB) for the requirement of funds. After the required approvals the IB and Bank ‘ABC’ enter into a Master Murabaha Facility Agreement (MMFA) to execute commodity *murabaha* transactions from time to time.

ii) After signing the MMFA Bank ABC submits an Order Form to IB for the total amount required; upon receiving the Order Form, IB purchases the commodity from the commodity broker/seller through telephonic recorded lines on spot basis at the prevailing market rate. The commodity (ies) could be a mix of different items such as pulses, fertilizer, rice etc.

iii) At the time of such Sale, IB appoints an IB Representative (Mugaddam or IB staff) for proper physical identification of the commodity and taking its possession at the broker’s/sellers warehouse.

iv) Upon taking possession by IB Representative, the commodity broker/seller acting in its capacity as a Seller (or Undisclosed Agent) furnishes Delivery Order and a Sale Invoice/Sale Warrant entitling IB to hold the title of the commodities.

v) After taking possession, IB has the right to ask for physical delivery, if necessary (the broker may charge additional transportation charges, if the goods are transported for delivery, which are not considered part of the selling price as the sale takes place on ‘as is where is’ basis).

vi) IB credits the purchase price against this purchase in a checking account of the broker being maintained with the IB.

vii) Before selling the commodity to Bank ‘ABC’ on murabaha basis the IB Treasury Office takes telephonic confirmation (on recorded lines) from IB Representative whether he has taken possession of the commodity (ies) by signing the possession letter.

viii) Upon affirmative confirmation, IB Treasury Office sells the same commodity through recorded telephonic lines to Bank ‘ABC’ at cost plus profit on deferred payment basis for ‘x’ number of days).

ix) A separate authorized representatives of Bank ‘ABC’ (Mugaddam or Staff member) also takes the physical possession of the goods from IB Representative at the commodity broker’s/seller’s warehouse.

x) After receipt of the title and possession of the commodities, Bank ‘ABC’ is free to hold or sell the commodities to any other 3rd party in the ready market.

xi) Bank ‘ABC’ pays IB for the commodity purchased on the maturity date, i.e. after completion of ‘x’ number of days.
As mentioned above, commodity *murabaha* is a treasury product. Through it, the liquidity need of a financial institution, generally a conventional bank is met. Thus, the excess funds of Islamic banks are used by conventional banks. According to a survey, more than 70 billion rupees of Islamic banks are placed with conventional banks through commodity *murabaha*. Since it has been devised to meet liquidity need of a financial institution, it is obvious that no party is interested in commodity. The commodity does not come into the possession or risk and liability of bank that buys it. It is only a *hilah* to get a certain fixed increase on the amount lent generally to the conventional financial institutions.

3.1.4 Sale and Lease-back Şukūk

Şukūk have been defined by the Accounting and Auditing organization for Islamic Financial Institutions (AAOIFI) in its *sharʿah* Standard No.17 as: “Certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of value of Şukūk, the closing of subscription and the employment of funds received for the purpose for which the Şukūk were issued”.

The standard gives examples of fourteen different types of investment Şukūk such as *ijarah* Şukūk, *salam* Şukūk, *mudarabah* Şukūk, *musharakah* Şukūk etc. Out of these, *ijarah* Şukūk are the most popular Islamic investment certificates which are rapidly gaining ground in the capital market.

There are three parties to the structure of *ijarah* Şukūk: the originator (beneficiary) of *ijarah* Şukūk; the Special Purpose Vehicle (SPV) the issuer of Şukūk and the investors (Şukūk holders). The beneficiary creates SPV as an independent legal entity that acts as trustee for investors. The originator/beneficiary sells specific asset to SPV. Şukūk are issued by the SPV against that asset. The proceeds of sale and passed on to the originator. It leases back the asset and pays rentals to investors through SPV. It also gives undertaking to buy it back on expiry of lease. Pursuant to this unilateral undertaking, it buys the asset at its face value.

In Pakistan, WAPDA and Motorway Şukūk are two important sovereign Şukūk which were based on sale and lease back structure. WAPDA needed finance to enhance power generation capacity at Mangla.

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So it issued sukūk worth 7000 million rupees against ten turbines installed at Mangla. For this purpose, WAPDA First Sukuk Company was created to act as SPV. The asset i.e. turbines were leased back to WAPDA for a period of seven years. WAPDA gave an undertaking that it would buy them back at the end of lease period at face value.

The above structuring of sovereign ijarah sukūk has been contested by many shari‘ah scholars. In the analysis of these scholars the most controversial and objectionable feature of this type of sukūk is the buy-back arrangement in it in explicit or implicit form. As we mentioned above, the SPV in case of sovereign ijarah sukūk is created by the Government which is the initiator, of and beneficiary from sukūk. The Government gives undertaking to buy it at face value. This is in the nature of put option to SPV. SPV, being a subsidiary of Government, is under obligation to exercise this option in favour of Government, the beneficiary. So it is almost certain that assets are reverted back to the Government on maturity. This is also similar to bai‘il wafa i.e. sale with right of redemption another controversial transaction of classical Islamic jurisprudence. In bai‘il wafa, a person, who is in need of money sells an object on the condition that after certain period he will buy it back from the buyer at face value i.e. at the price of first sale. International Islamic Fiqh Academy has declared this transaction invalid. The reason of its invalidity is that it puts restriction on proprietary right of owner as he is not allowed to dispose it off through sale or gift; rather it binds him to sell it back to the first seller, at face value. This transaction is more close to lending than selling. The seller in the first transaction is borrower and buyer lender. The property remains with the lender as mortgage from which he benefits. This is established fact that any benefit drawn from mortgaged property is riba. After the expiry of loan period, the first debtor, pays price and gets his asset back. The second sale in above structure is in fact return of loan amount to the lender.

Besides the above buy back and bai‘il wafa features in above ijarah sukūk, there are also some other controversial features in the arrangement. Some of such features are as follows:

i) In most of the cases, the ownership of the sold asset remains with the originator. It is not clear in what way the certificate holders own the asset.

35 Salman Syed Ali, Islamic Capital Market Products, Developments and Challenges, Occasional paper No.9, pp.52,53
36 Ibid.
Journal of Islamic Business and Management Vol.1 No.1, 2011

ii) Major maintenance of the leased asset is undertaken by the lessee (originator/beneficiary) which means that the risk related to ownership has not been transferred to the owners.

iii) On dissolution event (even in case of destruction) the lessee is bound to purchase leased property. This means that the risk is borne by the lessee.

iv) Almost all sukūk guarantee the return of principal to the sukūk holders at maturity in exactly the same way as conventional bond. This is accomplished by binding promise from either the issuer or the manager to repurchase the asset represented by the sukūk at the price at which these were originally purchased by the investors.

Maulana M. Taqi Usmani, a renowned and leading shari‘ah scholar of Islamic finance has expressed his dissatisfaction over a number of ijarah sukūk. His main concern has been that these sukūk violate the maqasid al-shari‘ah i.e. higher objectives of Islamic Law and Islamic Finance. In a working paper presented before the shari‘ah Board of AAOIFI, Maulana Usmani describes current ijarah sukūk, inimical to the objectives of the shari‘ah. He observes:

“If we consider the matter from the perspectives of the higher objectives of Islamic Law or the objectives of Islamic economics, then sukūk in which are to be found nearby all of the characteristics of conventional bonds are inimical in every way to these purposes and objectives. The whole objective for which riba was prohibited is the equitable distribution among partners of revenues from commercial and industrial enterprise. The mechanisms used in sukūk today, however, strike at the foundations of these objectives and render the sukūk exactly the same as conventional bonds in terms of their economic results”. 37

In order to make sukūk transaction shari‘ah compliant, it is necessary that these issues be addressed, otherwise it will remain a replication of the conventional bonds. In the present form, many sovereign sukūk are mere stratagems to circumvent riba.

37 Šukūk and Their Contemporary Applications, p.13
3.2 Ḥiṣayl as Makhārij in Islamic Finance

As opposed to subversive Ḥiṣayl, there are certain legal devices which do not frustrate the purpose and spirit of law. They are clever uses of law to achieve legitimate ends. Legal devices in Islamic banks predominantly belong to this category. Following examples can be cited to prove this proposition.

Case No.1

Penalty for Default in Islamic Banks

In conventional Banking where interest-based loans are advanced to the customers, the amount of loan keeps on increasing according to the period of default. On the other hand, in murabaha and ijarah financing; the two major financing products in Islamic banks, once the price is fixed, it cannot be increased. However, this restriction is sometimes exploited by dishonest customer who deliberately avoid to pay the price at its due date, because he knows that he will not have to pay any additional amount on account of default or late payment.

In order to resolve this issue, some contemporary scholars have suggested that the dishonest customers who default deliberately should be made liable to pay compensation / penal charges to the financial institution for the loss it may have suffered on account of such default.

It is argued in favor of charging compensation that the Holy Prophet (pbuh) has condemned the person who delays the payment of his dues without a valid cause. In well-known hadith he has said:

“The well-off person who delays the payment of his debt, subjects himself to punishment and disgrace”.

This Hadith allows corporal punishment for the delinquent debtor as well as blacklisting the delinquent debtor and exposing him in the public. This ruling, however, does not apply to the case of genuine default. The financial institution therefore, should verify the causes of default. If it is established that the default of the customer is due to poverty, no penalty or compensation should be charged or claimed from him, rather he should be given respite until he is able to pay. The Holy Qur’an says: “And if he

39 Muhammad Taqi Usmani, op.cit. p. 133.
(the debtor) is short of funds, then he must be given respite until he is well off” (2:280).

Some contemporary scholars have suggested that some fine i.e. a certain quantity of money should be imposed on the defaulter. Such a fine can be proportional to the sum of money involved. It can also be related to the actual period of delay. But this proposal has not been accepted by the majority of Muslim jurists because it makes the fine similar to *riba*. The International Fiqh Academy of OIC has also rejected the proposal. In its judgment in 1990, it held: “If the buyer/debtor delays the payment of installments after the specified date, it is not permissible to charge any amount in addition to its principal liability, whether it is made a precondition in the contract or it is claimed without a previous agreement, because it is *riba*, hence prohibited in *sharī‘ah*”. In another resolution adopted in 2000, it reaffirmed the above, but added: “It is permissible to include a Penalty Provision in all financial contracts except when the original commitment is a debt. Imposing a Penalty Provision in debt contract is usury in the strict sense”. It also lays down that the loss that may be compensated includes actual financial loss incurred by the partner, any other material loss and the certainly obtainable gain that he misses as a result of his partner’s default or delay. It does not include moral loss. These resolutions provide some relief only to those affected by delays in fulfillment of *salam/istisna* obligations. The amounts owed in installment sales and *murabaha* sales having become debts remain outside their purview.

The latest response to the challenge came from the Accounting and Auditing organization of Islamic Financial Institutions (AAOIFI), Bahrain. This response makes a penalty for default automatic. AAOIFI has suggested a self-imposed penalty on the customer. The *sharī‘ah* standards of AAOIFI, which represent a successful attempt by the contemporary Muslim scholars at harmonization and standardization of *sharī‘ah* views on Islamic banking, have suggested that: ‘the contract of *murabaha* should consist of an undertaking from the customer to pay an amount of money or a percentage of the debt, to be donated to charitable causes in the event of a delay on his part in paying installments on their due date. The *sharī‘ah* supervisory board of the Financial Institution must have full knowledge that any such amount is indeed spent on charitable causes, and not for the benefit of the Financial Institution itself.”

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40 Shariah Standard No. 8, Murabaha to the Purchase Ordered, Article 5/6, p. 126.
This rule is based on a ruling given by some Malikī jurists who say that if a debtor is asked to pay an additional amount in case of default, it is not allowed by *sharī‘ah*, because it amounts to charging interest. However, in order to assure the creditor of prompt payment, the debtor may undertake to give some amount in charity in case of default.41

The State Bank of Pakistan also favours this solution. In its guidelines relating to *murabaha*, it says:

It can be stipulated while entering into the agreement that in case of late payment or default by the client, he shall be liable to pay penalty calculated at a certain percentage per day or per annum that will go to the charity fund constituted by the bank. The amount of penalty cannot be taken to be a source of further return to the bank (the seller of the goods) but shall be used for charitable purpose. The bank can also approach competent courts for award of solatium which shall be determined by the courts at their discretion, on the basis of direct and indirect costs incurred, other than opportunity cost.42

From this discussion, it can be concluded that AAOIFI’s ruling on penalty for default is an effective mechanism to deter the delinquent debtors from intentional and deliberate default that causes harm to the financial institutions. Thus, compulsory charity suggested by AAOIFI serves as a way-out (*makhraj*) for the problem of delinquent debtor.

**Case No.2**

In conventional banks, hedging against fluctuation in value of currency is affected through forward and future currency contracts in which both the counter-values are deferred to a future date, while the requirement of Islamic law is that both the counter values should be exchanged in the same session of contract.

In Islamic banks, hedging against future devaluation of currencies is affected through unilateral promise to buy/sell given by the client i.e. importer or exporter. This is done in the following manner:

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41 This is the opinion of Mohammad ibn Ibrahim ibn Dinar. See, Hattib al-Maliki, *Taḥrīr al-Kalām fi Masa’il al-Iltizām*,
i) A customer (exporter/importer formally requests the bank for a forward promise to buy/sell foreign currency to hedge against foreign currency rate fluctuation in future.

ii) The bank issues to the customer “promise to sell/purchase” as the case may be as per approved format. This promise to sell/purchase records the promise between bank and customer to sell/buy foreign currency at a future date.

iii) The customer signs and returns the “promise to sell/purchase” to the bank.

iv) The actual transaction takes place on maturity date and both counter values are exchanged.

The hedging can also be done through the execution of back to back interest free loans using different currencies without receiving or giving any extra benefit provided these two loans are not contractually connected to each other.

4. Conclusion

In the preceding pages we have analysed approaches of fuqaha in the treatment of šiyāl. We have noted that Maliki and even Hanbli jurists regard them invalid. Hanbli fiqh allows only those legal devices which provide solutions for difficult problems. The legal devices suggested by Hanbli jurists are in fact precautionary measures and risk management devices. Shafi‘īs acknowledge permissibility of šiyāl though they consider them immoral. Hanafi jurists, especially the later jurists (mutakhkhirun) are liberal and flexible on the issue of šiyāl. The later Hanafi jurist have used šiyāl as mode of legal reasoning and issued many fatwas on the basis of šiyāl.

In the present Islamic finance, many legal devices are used in order to overcome inconvenience and rigidity of law. Through the device of makhārij, practical and viable solutions have been provided by the sharī‘ah scholars involved in Islamic finance. There are, however, certain legal devices which have adversely affected the originality and authenticity of Islamic banking. Tawarruq and commodity murabaha belong to this category. It appears that the emphasis of Islamic finance experts in these products has been on the external form of contract and Islamicity of contract rather than its spirit and substance. In our opinion, the islamicity of objective and purpose of transaction is equally important as its external form. The Islamic finance experts should fully utilize the
potential of *sadd al-dhara‘i‘* and *maqaṣid-al-sharī‘ah* in deriving rulings and taking decisions in Islamic Banking and Finance.

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