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RECTIFICATION OF *UQUD AL-FASIDAH* (VOID CONTRACTS) IN ISLAMIC FINANCIAL INSTITUTIONS

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Abstract

Shariah compliance is the most critical element in the operations of Islamic financial institutions. In order to ensure the Shariah compliance, some samples of IFIs' products are reviewed and audited. The audit practices has led to growing findings which reveal cases of uqud al-fasidah (void contracts) in IFIs. Thus, the articles discusses the issue by recommending several actions for IFIs in dealing with void contracts. The article highlights seven common causes of void contract related with bay' al-tawarruq transaction. Some of the void instances can be rectifiable and some are non-rectifiable. As Shariah Non-Compliance (SNC) is treated seroiusly by IFIs and the regulators, the dicussion will provide insights on how to reduce the SNC incidences and to minimse their financial impatcs to relevant parties.

Keywords: *Shariah scholars, ijtihad, Islamic finance innovations*

INTRODUCTION

The risk of Shariah non-compliance is a very important issue and significant in the operation of Islamic banking system. The Islamic Financial Services Board (IFSB) defines the risk of Shariah non-compliance as the risk arising from the failure of Islamic financial institutions to adhere to the Shariah principles established by the Shariah council at Islamic financial institutions (IFIs). The risk of Shariah non-compliance brings negative impact on the operations of Islamic financial institutions not only in Malaysia, but worldwide. Within the risk hierarchy in the management of IFIs, Shariah non-

compliance risk is considered as top priority risk for two important reasons. First, the majority of investors and stakeholders view Shariah compliance as the most crucial element in maintaining long-term relationship with IFIs. Second, any uncertainties and inconsistencies with Shariah principles will lead to the cancellation of a transaction and this will cause monetary losses to IFIs.

Appropriate valuation and inspection are required before any contract is executed especially for *bay' al-tawarruq* based product. *Bay' al-tawarruq* contract has been widely used in the offering of products and services in IFIs in Malaysia. Despite being a popular contract, *bay' al-tawaruq* appears to be the riskiest contract in terms of its compliance to the Shariah's principles. This is because the contract itself involves sequences of transactions which required to be implemented in the correct legal manner. Any mistakes or wrongdoing by IFI's officers in the commodity trading will lead to Shariah non-compliance risk. As *bay' al-tawarruq* is currently the best available alternative contract in the market, most of IFIs have no other options but except to strengthen their current procedures and operations of *bay'al-tawarruq* contract. Thus, the Shariah Advisory Council of Bank Negara Malaysia (BNM) has set guidelines for the implementation of structured *bay' al-tawarruq* in reference to IFIs in Malaysia. Failure to comply with these guidelines will expose IFIs to the Shariah non-compliance risk. It includes the need to observe the legal terms from all aspects of *bay' al-tawarruq* contract such as execution of each contract in commodity trading, the right to own and possess the commodity, as well as the absence of elements of sale and repurchase from a same broker.

Based on this backdrop, the present article highlights some instances of Shariah non-compliance (SNC) incidences occurred in IFIs and their rectification plan in correcting (*tashih*) the invalid contracts. The article concentrates on SNC incidences and their rectification plan involving *bay' al-tawarruq* contract or known as commodity *murabahah* based product.

INCIDENCE OF SHARIAH NON-COMPLIANCE (SNC)

Normally, potential Shariah non-compliance incidences are discovered by review or audit teams in IFIs. Both teams are the ones who review and audit selected samples of business transactions to ensure that IFIs are free from any Shariah non-compliance issue. Any initial findings by the review and audit teams will be brought to the attention of Qualified Shariah Officer (QSO). The QSO will evaluate the issue and decide whether to classify the findings into potential Shariah non-compliance incidence or otherwise. If any finding is classified as potential shariah incidence by QSO, then the matter will be presented to Shariah Committee (SC). The SC will elaborate the matter and determine the legal status of the incidence. According to al-Mahbubi (2017)

there are differences among IFIs in Malaysia about their approaches and justification in determining the SNC incidence. The decision may vary from one Islamic bank to another depending on the Shariah Committee's decision on each bank. Nonetheless, there six four common causes for potential SNC in bay al-tawwaruq based products as we will discussed later.

I. No subject matter (commodity) in the *bay'al-tawarruq* transaction

SNC incidence occurs in IFI when *bay' al-tawarruq* contract is conducted without a subject matter. The absence of subject matter in a *bay' al-tawarruq* contract will invalidate the contract because subject matter in a sale contract is essential. According to the principle of Islamic commercial law, the very essence of a sale contract is to exchange subject matter with price, therefore there is no sale contract if a subject matter does not exist.

Islamic financial institutions (IFIs) may consider performing *taḥwīl al-ʿaqd* (substitution) method in rectifying such a void *bay' al-tawarruq*. It refers to the cancellation of the earlier contract and enter a new contract between the contracting parties. This method is often applied to convert the fasid (void) contract to another valid contract. The application of this method is based on the suggestion of Abdul Rahman bin Auf who proposed to Abdullah bin Umar RA to perform *tahwil al-ʿaqd*. Abdullah bin Umar borrowed some money from bayt al-mal for business purpose based on al-qarḍ (loan) contract. Hence, based on the loan contract Ibn Umar would not be able to share his profit with *bayt al-mal*. In order to solve the issue, it was suggested by Abdul Rahman bin Auf that the loan contract was cancelled and changed with *mudharabah* which is a form of partnership contract. The companions who witnessed this event approved the transaction.

Thus, IFI has the option to perform *taḥwil* (substitution) from a fasid contract executed earlier into another contract as it deems appropriate. For example, since commodities are found to be non-existent during the contract of *bay' al-tawarruq*, the contract may be convertible to the contract of bayʿ al-salam. In other words, the purchased commodity does not exist during the contract but will be delivered in the future as described in detail. IFI must be prepared to fulfil all the procedures necessary to complete the *bayʿ al-salam* agreement. If the transaction requires IFI to act as an agent, then it is advisable to apply the concept of taṣarruf fuḍuli provided that IFI obtained approval from the client upon completion of all transactions. All transactions involved through the *taḥwil al-ʿaqd* (substitution) method must be communicated to the customer to ensure transparency.

ii. No clear agreement was spelled out between the bank and customer prior to execution of trading transactions

SNC incidence also occurred in IFI because the *bay' al-tawarruq* contract was executed without a proper document between IFI and the customer. For example, a customer came to IFI seeking for financing. Then, IFI conducted a *bay' al-tawarruq* transaction to disburse the financing without having a proper agreement related to the bay al-tawaruq contract with the customer. Hence, the customer did not even know that he or she was involved in purchasing and selling the commodity in the process of obtaining the financing. In this case, the *bay al-tawarruq* transaction is considered invalid because it is not supported by any contract.

The incident may be rectified by adopting the concept of *taṣarruf fuḍuli*. This means that the IFI will act as an agent and conduct a *bay' al-tawarruq* transaction on behalf of the customer (principal) without informing the customer. After the transactions are completed, then only the customer is informed about the *bay' al-tawarruq* transaction, its key implications, and their rights as customers. The validity of the bay' al-tawarruq transaction will be pending on the customer's agreement. If the customer agrees, the transaction will be rendered valid. If the customer disagrees the transaction will become null and void and IFI will bear all the losses.

The Miliki, Ḥanafi jurists and Imam Shafi`i (*qawl qadim*) were of the view that *taṣarruf fuḍuli* is permissible but the permissibility is suspended until it is approved by principal. However, it is important to note here that tasaruf fuduli does not mean that a person can act on behalf of others freely. Before an agent can sell or purchase on behalf of his principal, the agent must obtain a general mandate. In this case, the general mandate is indicated by the customer's application to seek for financing from the bank. Based on the application, the bank will execute bay al-tawarruq in order to grant the customer his financing.

III. Insufficient commodities during the *bay' al-tawarruq* contract

Shariah non-compliance incidence also occurred when *bay' al-tawarruq* was conducted with insufficient underlying commodities. As Shariah emphasizes on the accurate and exact quantity of subject matter during the contract, the insufficient commodities will render it (the contract) to be invalid. For example, customers need financing of RM1 billion, and the existing commodities can only be used for transactions of up to RM100 million.

In order to rectify the issue, IFIs could use the existing commodity as a backup asset and make multiple transactions. Disbursement can only be made after the completion of each transaction. For instance, in the earlier illustration the commodities worth RM100 million could be used 10 times to raise RM1billion of financing. However, if the customer chooses to continue the contract for the purpose of commodity ownership rather than financing, IFI must be prepared to supply the commodity adequately.

IV. Using Shariah non-compliant underlying assets in *bay' al-tawarruq*

One of the issues related to the *bay' al-tawarruq* contract is that the underlying asset used is a non-Shariah compliant asset. This includes defective assets which are no longer appropriate to be sold in the market. It was revealed that a bay al-tawarruq transaction was made through an international commodity trading platform whereby the underlying asset used was the damaged / shattered iron that was stored more than 10 years. The traded asset was a defective asset which had no value (al-Quradagi as cited in Mahbubi 2017). This contradicts with the principle of Shariah which stipulates that the subject matter in a sale contract must be valuable and recognized by Shariah. As hadith of Jabir r.:

سمع رسول الله صلى الله عليه وسلم يقول عام الفتح وهو بمكة ",أن الله حرم بيع الخمر والميتة والخنزير والأصنام)"البخاري:2236

"He heard the Messenger of Allah say on the opening day of Mecca when he (Jabir) was in Mecca. Indeed, Allah and His Messenger forbade the sale of liquor, carcass, pig and statue."(Al-Bukhari:2236)

The BNM Tawarruq policy document also states that the assets in a *bay' al-tawarruq* based transaction must be a recognized, value-specific, assignable asset. The same view is shared by Majlis Ulama Indonesia (Council of Indonesian Scholars). Failure to comply with this condition will result in the termination of bay' al-tawarruq contract.

However, a question arises on how to rectify a *bay' al-tawarruq* contract which used non-compliance or defective assets? It is decided that the *bay' al-tawarruq* contract which used non-compliance or defective assets should be cancelled. The non-compliance or defective assets must be returned to the original owner (seller). For settlement of the cancelled contract, the buyer / bank may recover the price paid to the seller and any profit generated from the trading should be channelled to charity.

V. Using Non-shariah compliance collateral in a *bay' al-tawarruq* contract

One of the main requirements in the assessment of creditworthiness of bank's customer is to have adequate collateral. Collaterals can be in the form of physical assets such as real estates and vehicles and may also be in the form of financial assets such as stocks and fixed investment certificates. The issue arises when the asset that the customer pledged in the *bay' al-tawarruq* financing is a non-Shariah compliant asset.

From the Islamic point of view, the terms of the collateral are the same as the terms of the goods / assets in the sale contract. This is based on the legal maxim:

ما جاز بيعه جاز رهنه

"Anything that is permissible for sale, it is also permissible for collateral"

Thus, assets that are used as collateral must be in existence, valued and recognized by Shariah. Al-Kasani of the Hanafi jurists add an additional criterion which is deliverable. Therefore, Shariah non-compliant goods cannot be taken as collateral. Similar views were also shared by the Maliki, Shafi'i and Hanbali jurists.

Based on the majority of jurists' opinions, the BNM Tawarruq Policy documents has explicitly required that the collaterals in Tawarruq financing must be Shariah compliant assets. Therefore, for conventional fixed deposits, the amount that can be used as collateral is the principal deposit only, excluding the profit. In Shariah Standard no.39, AAOIFI also states that "*a mortgage asset must be a Shariah compliant property. It must be specific and can be delivered*".

In conclusion, non Shariah-compliant collateral assets will render the *rahn* contract invalid. However, an invalid collateral does not mean that the entire *bay' al-tawarruq* contract is void. As *bay' al-tawarruq* and *rahn* are two separate contracts, the invalidity of the latter will not affect the former contract. This means the bay' al-tawarruq contract remains valid even though its supporting contract (*rahn*) turns to be invalid. Collateral is not one of the essential components or legal determinants of *bay al-tawarruq* validity. It is incorporated into the *bay' al-tawarruq* contract as a risk control mechanism to guarantee reimbursement in the event of default or bankruptcy. Therefore, defect in the supporting of contract does not mean that the *bay' al-tawarruq* is invalid or void.

For the purpose of rectification, the customer must enter a new rahn contract by pledging a Shariah-compliant asset. In contrast, if the bay al-tawarruq contract is void or invalid then the rahn contract is also void. This is in line with the fiqh legal maxim which states:

التابع لا يفرد بالحكم

"*Those who adhere to an object cannot be punished separately*".

VI. The purpose of financing is not in line with shariah requirements

Islamic banking institution is one of the business entities founded under the Shariah framework, so every product and service offered must comply with the requirements and principles outlined by Shariah. However, there is possibility of Shariah non-compliance risk whereby the financing granted to customers is used for the purposes that are contrary to Shariah principles. This clearly shows the violation of Islamic banking institutions' terms and conditions and the Shariah principles is violated. In this regard, the Shariah Advisory Council (SAC) has decided in its 58th meeting dated April 27, 2006 that:

> *"Islamic financial institutions are not permitted to provide financing to companies, bodies or individuals who are clearly involved in Shariah non-*

compliant activities such as gambling, liquor companies and prostitution premises" (Bank Negara Malaysia 2010).

The decision of the SAC is based on the consideration that granting such financing would result in the income of Islamic financial institutions being generated from activities which are not permitted by Shariah. This prohibition is also in line with the Qur'an in verse (5:2) as follows:

"... and help one another to do good and to be feared, and to one another do not commit sin (evil) and invasion ..." (Surah al-Maidah 5: 2)

Fuqaha has discussed the issue, whether such a contract is valid or void. The Maliki and Hanbali jurists view that an aqad (contract) which the purpose of financing is not in line with Shariah, is considered null and void. Examples include banning the sale of wine to liquor companies, renting buildings for use as churches (places of worship of other religions), and selling firearms to robbers and terrorists (Al-Bahuti, 3: 181; Al-Zuhaily 2004, 4: 240). This view is supported by Ibn Qudamah, who stated that:

إذا ثبت هذا فإنِا يحُرم البيع ويبطل إذا علم البائع قصد المشتري إما بقوله أو بقرائن مختصة به تدل على ذلك

"If it is confirmed, (that juice is used to produce wine), then the contract of sale is illegal and void. If the seller knows the intention of the buyer; whether through verbal expressions or with specific instructions that reflect its purpose" (Ibn Qudamah 1985).

The view of the Hanbali jurists above is based on the Quranic verse in Surah al-Maidah (5:2) which prohibits Muslim to get involved in committing sin and evil, and it is also a mechanism for preventing something that can lead to harm known as sadd al-dzariah. (Al -Zuhaily 2004, 4: 240). The implication is that any contract involving fraud, breach of trust and manipulation is considered null and void. The Maliki and Hanbali jurists also based their argument on a hadith reported by Anas r.a, that prohibited the sale of grape to the wine producer:

قال أنس بن مالك :لعن رسول الله في الخمر عشرة :عاصرها ومعتصرها وشاربها وحاملها والمحمولة إليه وساقيها وبائعها وآكل ثمنها والمشتري لها والمشتراة له

"It is reported from Anas ra that the Messenger of Allah (may peace be upon him) has cursed ten people who are involved in alcohol: those who produce liquors, those who request for production of alcohol, who drink alcohol, those who bring it, those who ask for alcohol, those who serve alcohol for others, those who sell liquor and eat from its sale's profit, those who buy liquors, those who was bought alcohol for him "(Ibn Majah, Hadith no. 3381).

The above Hadith clearly describes the prohibition on everyone who is involved in the whole chain of alcohol industry either as producers or as consumers (al-Najdi, 1998).

In contrast, the Hanafi and Shafii jurists viewed that the utilisation of funds to activities which are conflicting with Shariah principles is haram (illegal). However, these acts would not render the contract null and void.

They agreed that funding a grape farm for alcohol production purpose is haram, but the contract itself is valid (Zuhaily 2004). The Hanafi jurists differentiate between batil and fasid contracts. According to Hanafis jurists, a contract turns into a batil contract when its salient features (rukn) and the main objectives of the sale (*muqtada al-bay`*) are contradictory with Shariah principles, such as sales of illegal commodities and liquor, prostitution, leasing for building a church (other religious places of worship), firearms sale to robbers and terrorists.

This is in line with the resolution passed by the Shariah Advisory Council (SAC) at the 58th meeting dated April 27, 2006 requiring that funding be provided only to companies, bodies or individuals who are known to be involved in activities that are clearly in line with Islamic law (Bank Negara Malaysia) 2010). If the bank is aware of any conflicting activities after the financing is approved, termination of the contract should be made immediately, and it is not permissible to rectify the contract. Any income generated from the financing should be channelled to charity and cannot be returned to the customer. This is to avoid the incomes of Islamic financial institutions generated from unlawful activities according to Shariah (Mohamad Mahbubi 2017; Asyraf Wajdi Dusuki et al. 2013).

Meanwhile, a contract will be considered *fasid* when its terms and conditions (*shurut*) are contradictory to the Shariah requirements. The implication is that the terms are void and need to be reconciled. However, the contract itself remains valid.

Noted that majority of jurists do not distinguish between batil and fasid contracts. The difference was only found in the Hanafi jurisprudence (Ibn Humam n.d; Ibn Abidin 1985; Al- Dusuqi 1934; Al-Nawawi 1985; Al-Ramli 1938; Ibn Qudamah 1985; Al-Shirbini n.d, Al-Khalili 2019).

There is no rectification that can be done if a contract is rendered null and void (batil). The contract should be cancelled (*fasakh*). Once, the contract is cancelled it will have no effect to the contracting parties. Any proceeds from what was traded and transacted should be returned to customers. On the other hand, bank is not entitled to claim any repayment. However, a fasid (void) contract could be rectified to become a valid contract. In the following section, we show one example how a fasid contract can be converted to a valid contract after rectification is done.

In some legal document for *bay' al-tawarruq* based product, there is a clause stating that customers as buyers are prohibited from taking commodities during the murabahah phase. The standard operating procedures (SOP) is designed in such a way so that buyers would not intend to acquire the commodity. For example, bank will impose high cost for transporting the commodity in case it is required by customer.

According to Hanafi jurists, such condition will render the *bay' al-tawarruq* contract fasid. This is because customer should be given full access to the ownership of the goods purchased through the bay al-tawarruq transaction. According to AAOIFI, the most important condition for confirming *bay' al-tawarruq* contract is that the commodity should be accepted by the buyer without any additional terms. Majority of jurists are of the opinion that if the terms are invalid, the contract is void and illegal. But Hanafi jurists view that the contract falls under void (*fasid*) contract. They further explain their views on how to treat invalid terms which lead to a contract to become void (*fasid*).

Firstly, the invalid terms should be ignored. Neither the seller nor the buyer should execute the invalid terms. For example, if a seller sells an asset with a term that buyer will not sell or give the asset to another party, the term is void but the contract remains valid. Hence, the terms should not be executed by the contracting parties. Secondly, the invalid term should be removed from the contract. For example, if a seller sells an asset with a term that the buyer should not intend to own the asset, the term itself must be removed to maintain the validity of the contract. The difference between the former and the latter is that the invalid term in the latter affects the substance of contract (muqtada' al-aqad) but not in the former.

Therefore, in order to maintain the validity of the *bay' tawarruq* contract mentioned earlier, Islamic bank must remove the invalid term. The bay al-tawarruq contract will render void (*fasid*) unless the term which denies the right of buyer to own and possess the purchase asset is removed. The right of owning and possessing purchased asset is considered as important element in a sale contract. One cannot imagine purchasing an asset but been denied possessing it.

CONCLUSION

Islamic financial institutions (IFIs) give serious attention to the occurrence of Shariah non-compliant (SNC) incidences in their institutions. This is because SNC incidences will reduce the level of trust among customers about IFIs' compliance to principles of Shariah, and subsequently will affect their profits. As far as Shariah is concerned, profits generated from SNC incidences cannot be treated as income to the bank. Depending on the causes of SNC, some invalid contracts are not rectifiable. The non-rectifiable contract should be cancelled and IFIs are required to enter new agreement with customers. They are not rectifiable mainly because the contracts have defects related with the salient features (arkan) and substance of contract itself (muqtada 'aqd).

However, if SNC incidences are related with terms and conditions, the contracts are rectifiable. This view is adopted from the Hanafis jurists who distinguish between null (batil) and void (fasid) contracts. Examples of

rectifiable SNC incidences in bay' al-tawarruq contracts include no clear agreement was spelled out between the bank and the customer prior to execution of trading transactions, insufficient commodities to back up trading, and using non-shariah compliant collateral. Profits resulted from rectifiable SNC incidences can be recognized as incomes provided that IFIs remove the non-compliance terms or condition and make necessary rectification plans as suggested by their Shariah Committee.

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