

# **The Challenges and Prospects of Islamic Finance in Australia: A Case Study of *Murabaha* Contract**

By

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## **I. DEDICATION**

This dissertation is dedicated to my parents, my wife Nura and children, Taha, Najib, Zakaria and Yusra, without whose contribution and patience I could not have completed this thesis.

## **II. ACKNOWLEDGEMENTS**

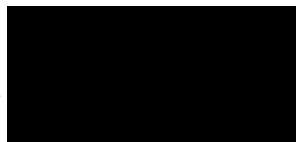
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## **III. STATEMENT OF AUTHENTICATION**

I, Abdulwahid Hassan, declare that the PhD thesis entitled (The Challenges and Prospects of Islamic Finance in Australia: A Case Study of Murabaha Contracts) is no more than 100,000 words in length including quotes, tables, figures, appendices, bibliography, references and footnotes. This thesis contains no material that has been submitted previously, in whole or in part, for the award of any other academic degree or diploma. Except where otherwise indicated, this thesis is my own work.

Signed\_\_\_\_\_



Date\_\_\_\_\_5/02/2020\_\_\_\_\_

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## **v. ABBREVIATIONS**

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADRS	Alternative dispute resolution system
BBS	<i>Bai' bithaman ajil</i>
BLR	Base lending rate
CBA	<i>Central Bank of Malaysia Act</i>
CISG	<i>UN Convention on Contracts for the International Sale of Goods</i>
IAA	<i>International Arbitration Act</i>
IAH	Investment account holders
IAIB	International Association of Islamic Banks
IICG	Islamic Investment Company of the Gulf
IIFM	International Islamic Financial Market
ICFAL	Islamic Co-operative Finance Australia Ltd
IDB	Islamic Development Bank
IFI	Islamic financial institution
IFSB	Islamic Financial Services Board (Malaysia)
UNCITRAL	United Nations Commission on International Trade Law
LC	Letter of credit
HSBC	Hong Kong and Shanghai Banking Corporation
KLRC	Kuala Lumpur Regional Centre
LIBOR	London Interbank Offered Rate

MCCA	Muslim Community Co-operative (Australia) Limited
PLS	Profit and loss sharing
Prophet	The Prophet Muhammad (Peace Be Upon Him)
SAC	Shariah Advisory Council
SSB	Shariah supervisory board
<i>SGA</i>	<i>Goods Act 1958</i>
TVG	Time value of goods
TVM	Time value of money
UAE	United Arab Emirates
<i>UCP600</i>	<i>Uniform Customs and Practice for Documentary Credits</i>
UK	United Kingdom



## VI. ABSTRACT

Islamic finance has become global: Islamic financial institutions and their customers from multiple jurisdictions are jointly participating in this international shift. Such financial institutions commonly use a *Murabaha* contract for financial operations. Consequently, as the foundation of Islamic financial transactions is the application of Islamic financial principles, such principles are being espoused in financial agreements and integrated into non-Islamic legal environments that may not give credit to Islamic principles. Parties to *Murabaha* may include a clause that states the contract should be governed by Islamic legal principles alongside domestic laws. However, the requirement of *Murabaha* to simultaneously comply with different legal systems may create disputes over interpretation and application, posing both regulatory and financial risks.

Within this context, this thesis employs a qualitative methodological approach to explore the feasibility of using Shariah compliant *Murabaha* in Australia. By examining Islamic and non-Islamic legal texts, academic journals and *Murabaha* dispute cases, the first objective of this project was to examine whether the different legal systems create any additional legal or financial risk to *Murabaha*. The second objective was to investigate how *Murabaha* disputes are settled in common law jurisdictions through an analysis of *Murabaha* cases in the United Kingdom and Malaysia, as there have not yet been any *Murabaha* legal disputes in Australian court history. The third objective of the thesis was to study different aspects of dispute resolution, litigation and arbitration to determine the most suitable dispute resolution system for *Murabaha* in Australia.

The thesis concluded that Islamic financial institutions' practice closely resembles *Murabaha* transactions with conventional financial practices. This allows them to enjoy similar economic advantages and receive the same legal treatment as conventional financial institutions. However, such close resemblance with the conventional financial system may risk diverting *Murabaha* from Islamic finance theory towards Shariah non-compliance. Moreover, the thesis found that Malaysia has established a regulatory financial system for Islamic finance that has eliminated Shariah non-compliance risk. On the other hand, the study demonstrated that even though the UK recognises Islamic finance system, it does not accept Shariah as a system of law capable of governing a contract. The UK treats *Murabaha* transactions as credit contracts that receive the same legal protection as conventional credit contracts. Similarly, Australia, a

Commonwealth country, takes the same position as British courts with regards to the *Murabaha* transactions. Furthermore, the study revealed that the arbitration is the most appropriate dispute resolution forum for *Murabaha* because it can accommodate Shariah law within domestic legal systems. The arbitration system obliges arbitral tribunals to decide disputes with reference to either the national law chosen by the parties or any considerations agreed upon, such as Shariah law. This flexibility closes the gap between Shariah principles and arbitration law and stabilises international commercial relationships in Australia.

Therefore, the study recommends that Australia should incorporate the Islamic rules governing *Murabaha* into its legal and regulatory system and consider adopting the Malaysian model because of its success in integrating Islamic banking and finance in a common law system. The study also recommends that the Islamic finance industry in Australia should adopt arbitration as an alternative dispute resolution forum for *Murabaha* disputes. For guidance, the study suggests that the Islamic finance industry implement AAOIFI Shariah Standard on Arbitration and the KLRCA Arbitration Rules. This would make *Murabaha* legally compliant and commercially desirable while also maintaining Shariah compliance within Australian law.

# CHAPTER 1: INTRODUCTION

## 1.1 Introduction

Islamic finance is based on four principles: *riba* (prohibition of interest), *gharar* (the prohibition of excessive uncertainty), *maysir* (prohibition of gambling) and the prohibition of financing or trading products that are illicit under shariah law.<sup>1</sup> Another important characteristic of Islamic financing is the requirement that all transactions are asset-backed and create real assets. Unlike interest-based finance systems that deal solely with money and monetary papers, Islamic finance is based on the principle of profit and risk sharing. Because of these prohibitions, Islamic scholars developed financial products using classical Islamic contracts like *mudarabah* (profit and loss sharing), *musharakah* (joint venture) and the concept of *murabaha* (mark-up) as alternatives to conventional financial products. The core Islamic financing modes, *musharakah* and *mudarabah*, are designed to facilitate financing between surplus holders and deficit holders by sharing the risk and return of the finance between the financier and the entrepreneur according to a pre-agreed ratio while the loss is borne by the financier.<sup>2</sup> Islamic financial institutions (IFIs) also provide finance that creates real assets on the basis of *salam* and *istisna'*: *salam* describes sales in which the seller undertakes to supply some specific goods to the buyer at a future date in exchange for the full, up-front payment of an advance price; *istisna'* refers to contracts for the acquisition of goods by specification in which the price is either paid at the time of contract, paid by instalment in accordance with progress or paid on completion of the job.<sup>3</sup>

While the profit and loss sharing (PLS) financing modes (*musharakah* and *mudarabah*) are considered the ideal Islamic financing products, the associated problems of adverse selection and moral hazard have made their implementation in conventional financial markets challenging.<sup>4</sup> These challenges have led Islamic banks and financial institutions to divert their main financing activities to fixed income trade financing modes like *murabaha* that were not originally accepted as modes of Islamic financing. *Murabaha* is widely used because it is market friendly and has the same economic effects as conventional financial products.<sup>5</sup> Islamic banks and financial institutions use it for financing of homes, consumer goods and commodities. As a result, *murabaha*—which can be classified as a sale contract as well as a credit contract—is the financing product most often used by Islamic financial institutions (IFIs), representing about 80 per cent of Islamic financing operations.<sup>6</sup>

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<sup>1</sup> Erdem Bafra, 'Prohibition of Riba Overagainst Time Value of Money in Islamic Banking' (2014) 76(2) *Izmir Review of Social Sciences* 1; Sherif Ayoub, *Derivatives in Islamic Finance: Examining the Market Risk Management Framework* (Oxford University Press, 2014).

<sup>2</sup> Simon Archer and Rifaat Abdel Karim, 'Profit-Sharing investment accounts in Islamic banks: Regulatory problems and possible solutions' (2009) 10(4) *Journal of Banking Regulation* 300-306.

<sup>3</sup> Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Brill, 2002) vol 20.

<sup>4</sup> Brian Kettell, *Introduction to Islamic Banking and Finance* (John Wiley and Sons, 2011).

<sup>5</sup> Usmani, above n 4.

<sup>6</sup> Salim Farrar, 'Accommodating Islamic Banking and Finance in Australia' (2011) 34(1) *University of New South Wales Law Journal* 413; Mohd Halim Kadri, *A Study of Selection of Islamic Financing Product in Malaysia* Regional Convention on Islamic Studies, Melaka.

Islamic banks and financial institutions in Islamic and non-Islamic countries overwhelmingly use *murabaha* financing to meet the demands of their customers; however, disputes invariably arise over the interpretation and application of *murabaha* transactions in the domestic and international markets. For example, a *murabaha* contract may include a clause that requires the contract to be governed by both Islamic law and Australian law. This would mean that the contract would be required to comply not only with the principles of Islamic law, but also with local domestic laws to be enforceable locally. Such a requirement can create a potential conflict of laws that could pose regulatory and financial risks for the *murabaha* transaction. This raises a question: which law or legal principles should govern the *murabaha* contract and its financial transactions? With this question in mind, this thesis explores the feasibility of using *murabaha* financing contracts in the Australian legal context and examines the possibility of achieving *murabaha* transactions compliant with Islamic principles within financing agreements governed by Australian common law. Overall, this thesis identifies the obstacles to the development in Australia of this niche financial sector.

First, this chapter provides a brief history of Islamic finance. Second, it summarises *murabaha* contract structure and the related financial products. Third, it discusses the key problem of the study. Fourth, it describes the methodology employed in this study. Fifth, it outlines the significance of the study. Sixth, it addresses the limitations of this research.

## **1.2 Brief History of Islamic Finance**

The origins of Islamic finance are in trade that has existed since the early stages of Islamic civilisation, in the course of which Muslims set up a financial system that did not charge predetermined returns. Throughout history, trade has been a lifeline for Arabs in the Arabian Peninsula; Islam endorsed existing contract practices, except those that were deemed unjust or exploitative.<sup>7</sup>

The first experiments in Islamic banking took place in India in the 1930s, during British colonial rule. These banks adopted similar practices to conventional banks. Then, in the 1940s and the 1950s, several experiments with small Islamic banks took place in Malaysia and Pakistan, the latter of which was part of India at the time. In 1956, the Malaysian government formed Tabung Hajji, a pilgrimage fund for Malaysian pilgrims.<sup>8</sup> Despite these early attempts, the first successful experiment in the theory and practice of Islamic banking and finance was the formation of Mitt Ghamr Investment Bank in Egypt in 1963.<sup>9</sup> These early IFIs were cooperatives established to arrange interest-free loans for farmers, small businesses and low-income people—they were not

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<sup>7</sup> Muhammad Shaukat Malik, Ali Malik and Waqas Mustafa, 'Controversies that Make Islamic Banking Controversial: Analysis of Issues and Challenges' (2011) 2(1) *American Journal of Social and Management Sciences* 41, 43.

<sup>8</sup> Angelo M Venardos, *Current issues in Islamic banking and finance: resilience and stability in the present system* (World Scientific Publishing, 2010).

<sup>9</sup> Abu Umar Faruq Ahmad, *Theory and Practices of Modern Islamic Finance: The Case Analysis from Australia* (Brown Walker Press, 2010); Hans Visser, above n 1.

commercial banks. The Dubai Islamic Bank, founded in the United Arab Emirates in 1975, was the first private commercial bank to base its operations on shariah principles.

An important milestone occurred in 1972 in Jeddah: a conference of finance ministers from 18 member countries of the Organization of Islamic Cooperation (OIC), which endorsed the Islamic banking system. Finance ministers from the OIC convened another conference in Jeddah in 1973 and agreed to establish the Islamic Development Bank (IDB) to assist the social and economic development of the member states. The establishment of the IDB in 1975 was a turning point for the Islamic banking industry that came just after the establishment of the first major Islamic commercial bank, the Dubai Islamic Bank.<sup>10</sup> The establishment of the Dubai Islamic Bank and the IDB was followed by the establishment of several more Islamic banks, including the Faisal Islamic Bank in both Sudan and Egypt and Kuwait Finance House in Kuwait in 1977.<sup>11</sup> Pakistan established a shariah-compliant financial system in the 1970s, and introduced a legal framework for that system. Similarly, Iran legislated a new banking law in August 1983 to replace the conventional banking system with an interest-free banking system; Iranian banks were given three years to align their operations with shariah principles.<sup>12</sup>

The establishment of an Islamic banking and finance system was attractive in the Muslim world. This was especially true in the religiously conservative Gulf States, which experienced an unprecedented oil boom in the 1970s. Further, the development of this system encouraged supporters of Islamic finance to put its principles into practice within the conventional banking system. As a result, the continued growth of Islamic finance continues to dominate conversations around the sector's future in the Middle East, Africa and South Asia; with a population of three billion people and a gross domestic product of US\$7.4 trillion, this is among the fastest-growing markets in the world.<sup>13</sup> A large part of Islamic finance's growth comes from international trade that generates USD18 trillion annually, of which finance represents nearly 90 per cent of worldwide business transactions.<sup>14</sup> In line with this trend, the Islamic financial system has grown over the past two decades. At the end of 2017, it was estimated that the Islamic financial system accounted for assets worth US\$2438 billion: US\$1721 billion held in banks, US\$110 billion in funds, US\$426 billion in *sukuk* (Islamic bonds) and US\$46 billion in *takaful* (Islamic insurance)<sup>15</sup>. In addition, in 2019, there were more than 300 international Islamic institutions operating in more than 75 countries with over US\$260 billion in investments, expected to reach over US\$6.7 trillion by the end of 2020.<sup>16</sup> This growth is expected to continue in both

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<sup>10</sup> Mr Mumtaz Hussain, Asghar Shahmoradi and Rima Turk, 'An overview of Islamic finance' (IMF Working Paper No WP/15/120, International Monetary Fund, June 2015 ).

<sup>11</sup> M Mansoor Khan and M Ishaq Bhatti, 'Islamic banking and finance: on its way to globalization' (2008) 34 (10) *Managerial finance* 708.

<sup>12</sup> Hussain, Shahmoradi and Turk, above n 11.

<sup>13</sup> Damak, above n 1.

<sup>14</sup> UN Comtrade, *International Trade Statistics Database (2016)* (2018) <<https://comtrade.un.org/>>.

<sup>15</sup> Mohamed Damak, 'Islamic Finance Outlook' (Working Paper, S&P Global Ratings 2019); Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing, 2019).

<sup>16</sup> Katarzyna Sidlo, *Islamic finance 2017: State of the art and outlook for the future*, K4D [530] (18-10-2017).

countries that already have established Islamic finance systems and those countries in which Islamic finance has a foothold (e.g., Australia).

Although the global value of the Islamic finance industry's total assets is relatively small compared to the conventional system, its market share has grown steadily over the last two decades.<sup>17</sup> This growth has seen the Islamic finance industry make inroads into western financial markets, such as the United Kingdom (UK), the main destination for the establishment of foreign shariah-compliant institutions, and Australia.<sup>18</sup> In response to strong demand for Islamic financial products for both domestic and international trade, IFIs and some conventional banks in these countries have started to provide Islamic financial services to carve out shares in this emerging niche market. Major players in international finance (e.g., Citigroup, HSBC and Deutsche Bank) have begun to provide diverse Islamic financial products including financial loans, securities and derivatives.<sup>19</sup>

While Islamic finance is well-established in the UK and elsewhere, the industry is still in its infancy in Australia and its expansion has been slow.<sup>20</sup> The Australian business and industry sectors lack knowledge about Islamic banking outside of those cases in which importer/exporters arrange shariah-compliant financing. Some jurisdictions—such as the state of Victoria—recognise Islamic financial products, but most Australian banks have minimal exposure to the Islamic banking industry. In the 1980s, ANZ became the first Australian bank to enter the Islamic banking market by providing consultative services to Pakistani banks about structuring Islamic financial products and opening an offshore Islamic banking window in 1989 for international transactions. Other banks have followed suit, with Westpac beginning to develop a wholesale Islamic financial instrument intended for the Islamic financial market and the National Australia Bank initiating an Islamic banking window in 2010.<sup>21</sup>

There are also a few fully-fledged IFIs in Australia, such as the Muslim Community Cooperative of Australia (MCCA), which opened in Melbourne in 1989; Amanah Finance, which opened in Melbourne in 2015, and Islamic Co-operative Finance Australia Ltd (ICFAL), which opened in Sydney and functions as co-operative in New South Wales.<sup>22</sup>

The operations of these Islamic institutions are limited to providing financing facilities to their customers and, unlike conventional financial institutions, they do not accept normal bank deposits.<sup>23</sup> These institutions, like

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<sup>17</sup> Mohamed Rosli et al, 'Financial Exclusion in Australia: Can Islamic Finance Minimise the Problem?' (2016) 10(3) *Australasian Accounting, Business and Finance Journal* 89.

<sup>18</sup> Thorsten Beck, Asli Demirgüç-Kunt and Ouarda Merrouche, 'Islamic versus Conventional Banking: Business Model, Efficiency and Stability' (2013) 37(2) *Journal of Banking and Finance* 433.

<sup>19</sup> Farrar, above n 7, 422.

<sup>20</sup> George Mickhail, 'Australia slow to capitalise on Islamic finance opportunities' No 815, University of Wollongong, (2015).

<sup>21</sup> Treasury material used 'as supplied, *Review of the Taxation Treatment of Islamic Finance : A Report to the Assistant Treasurer* (June 2011).

<sup>22</sup> MRM Sain, MM Rahman and R Khanam, 'Islamic Finance in Australia: History and Development' (Proceedings of the 3<sup>rd</sup> Malaysian Postgraduate Conference, 2013).

<sup>23</sup> Abu Umar Faruq Ahmad, above n 10.

their counterparts in the UK and Malaysia, overwhelmingly use *murabaha* for financing homes, motor vehicles and consumer goods. This has allowed Australian Muslims to own homes and purchase motor vehicles and other consumer goods without violating Islamic prescriptions on borrowing money on which interest is charged. Despite this, the Australian Islamic finance and banking system is not as robust as it is other countries due to legal challenges and an ineffective shariah regulatory and supervisory system.

Due to the absence of a comprehensive legal and shariah framework governing the Islamic banking industry in Australia, IFIs face numerous challenges. The following section provides an overview of Islamic finance theory and practice before discussing these challenges in more detail.

### 1.3 Islamic Finance Theory

Islamic law categorises economics, finance and all other matters related to the social life together as one dimension; Islamic finance and banking is a part of a broader Islamic economics—informed by shariah principles—that establishes a framework of permissible and impermissible behaviour in regards to financial transactions.<sup>24</sup> Islamic finance is based on cooperative participation in enterprise ventures between capital suppliers and workers and seeks to encourage good faith and honest behaviour between the contracting parties in financial transactions.<sup>25</sup> To this end, Islam prohibits *riba* (interest), *gharar* (extreme uncertainty) and all financial transactions that involve unethical or immoral activities (e.g., gambling, pornography and alcohol). Unlike the conventional banking system, in which financiers earn money by charging interest and fees for services, Islamic financiers earn their money by sharing profit and loss, trading, leasing and charging fees for services rendered. Profit is shared between financiers and entrepreneurs according to a predetermined ratio, while the loss is borne by the financier.<sup>26</sup> In contrast to the conventional banking system, in which most products involve loan transactions, Islamic banking products involve trade transactions and Islamic financiers share the risk and return with investors/borrowers rather than guaranteeing a return without incurring any risk.

#### 1.3.1 Definition of *Murabaha*

*Murabaha* is an Arabic word that refers to a simple sale contract in which the seller purchases a commodity and sells it to a customer at a cost plus an agreed mark-up, or profit margin, that is disclosed to the buyer.<sup>27</sup> The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) defines a *murabaha* contract as a transaction in which a customer promises to purchase an object from a seller (the financier) at an agreed price that includes an agreed profit margin that the customer pays either in a lump sum or by

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<sup>24</sup> Ali Adnan Ibrahim, 'The Rise of Customary Businesses in International Financial Markets: An Introduction to Islamic Finance and the Challenges of International Integration' (2011) 23(4) *American University International Law Review* 663, 671.

<sup>25</sup> Humayon Dar and Presley John, 'Islamic Finance: A Western Perspective' (1999) 1 *International Journal of Islamic Finance Services* 1, 5.

<sup>26</sup> Karim, above n 7.

<sup>27</sup> Usmani, above n 4.

instalment.<sup>28</sup> IFIs have further developed *murabaha* into a financial instrument, whereby a financial institution agrees to purchase goods desired by a buyer—ships, aircraft, vehicles or any other goods—with the promise of the buyer to purchase it from the bank, and sell the goods to the buyer for a deferred price at the original purchase price plus a negotiated profit that should be disclosed in advance.<sup>29</sup> In practice, *murabaha* becomes two sale contracts: a sale contract between the supplier and the bank and a sale contract between the bank and the buyer.

### 1.3.2 Legality of *Murabaha*

The Quran forbids usury but permits trade, and Islamic law permits the buying and selling of goods for a profit in the process of trade; thus, *murabaha* is a valid form of sale. *Murabaha* derives its legitimacy from the Quran, which states that ‘Allah has permitted trade and forbids *riba*’ and ‘it is no crime for you to seek the bounty of your Lord’. Islamic scholars agree that, because the Quran gives permission to trade, it is legitimate for the deferred *murabaha* price to be higher than the spot price.

In a *murabaha* sale contract, the financier agrees to purchase goods for the buyer, who promises to purchase it from them with the purchase price plus a mark-up. As such, financial institutions use *murabaha* sale contracts to serve customers who want to buy specific assets. The bank purchases the assets, possesses them and sells them to the buyer at a mark-up. Thus, *murabaha* contracts combine two promises: one from the buyer to buy from the bank and one from the bank to sell to the buyer with a mark-up, in which point the customer pays through instalment.<sup>30</sup>

While some jurists classify the mark-up in a *murabaha* sale as interest, most Islamic scholars disagree on the basis that the purchase price (including profit) is known in advance by all parties. What is prohibited is the increasing of loans or usury. For instance, the *riba*, it is a condition to increase the sale amount or the principal that divided into the parties of the future time and it will increase because of the increase of the time; conversely, the deferred sale price in a *murabaha* is predetermined and cannot be increased. In *murabaha*, the seller has no right to ask for instalments to be increased above the predetermined price. To be shariah-compliant, a *murabaha* contract must satisfy the following rules:<sup>31</sup>

- The subject of the sale must exist at the time of the sale and be known or identifiable.
- The subject of the sale must be in the ownership of the seller at the time of sale and the seller must assume any risk related to the commodity before selling it to the customer.
- The subject of the sale should be a property having value.

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<sup>28</sup> Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Shari'ah Standards for Islamic Financial Institutions* (AAOIFI, 2015).

<sup>29</sup> Wahbah Alzuhayli, *Islamic Contemporary Financial Transactions* (Dar Elfikri Almu'asir, 2002) vol 1.

<sup>30</sup> Ibid.

<sup>31</sup> Ibid; Usmani, above n 4.



- The subject of the sale must be permissible within Islamic law and should not include prohibited materials. IFIs cannot effect *murabaha* for any purpose that is either prohibited according to shariah or harmful to the moral health of society. They must not remain indifferent to the activity for which the subject is required.
- The delivery of the commodity to the buyer must be certain, absolute and unconditional and should not depend on a contingency or chance.
- The price of the *murabaha* sale, including the mark-up, must be certain and disclosed. The seller purchases the commodity required by the client, who assures the seller that they will purchase the commodity in turn. Unlike in conventional finance, no money is advanced by the Islamic financier—the seller creates real assets. The profit claimed by the seller is the reward for the risk they assume.
- Unlike the interest-bearing banking system, in which the amount to be repaid by the borrower increases over time, the selling price of the *murabaha* remains fixed. This means that when the buyer fails to pay on time, the seller cannot ask for a higher price—there is no concept of the time value of money in shariah law.

Although *murabaha* is not an ideal mode of Islamic financing and has been criticised for its similarities to interest-based financing in its net results, *murabaha* financing creates real assets and the financier becomes the owner of the asset before selling it to the customer. Further, the mark-up is not considered interest but instead a return that represents the difference between the original purchase price and the sale price. Moreover, IFIs use the *murabaha* financing mode for trade financing by structuring it into dual independent agreements that are intrinsically linked by an overarching economic function for short-term loans and remunerated by the mark-up. Because there is no unified standard for Islamic finance, IFIs appoint shariah supervisory boards (SSBs) to ensure their *murabaha* agreements comply with the principles of Islamic law.

### 1.3.3 Structure of *Murabaha* Contracts

In *murabaha* financing, the financier purchases an asset or goods from a supplier at the request of a customer and then sells them to the customer at the original sale price plus a profit margin. This transaction involves three parties—a vendor, a buyer and a bank—and two legally independent contracts.<sup>32</sup> The bank—as both a trader and as a financial intermediary—provides the client with a certain product, not with credit in the form of cash, as in a conventional bank. Further, in the case that the customer defaults upon payment of the loan, the financier is only entitled to the price of the commodity and cannot penalise the client with extra charges.<sup>33</sup>

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<sup>32</sup> Saida Daly and Mohamed Frikha, ‘Corporate Governance: What About Islamic Banks?’ (2014) 8(1) *International Journal of Financial Services Management* 18.

<sup>33</sup> Ahmad, above n 10.

Unlike conventional banks, Islamic banks cannot require the client to pay defaulting interest as compensation for the delay of payment.

Islamic Financial Institutions structured *murabaha* sale contracts into a debt-like financing instruments that is operable in the financial market. *Murabaha* transactions involve three parties: the vendor, the buyer and the bank. The bank acts as an intermediary to buy an asset from a supplier with the promise that the customer will then purchase it from the bank, then the bank sells the asset to the customer with a price that includes a mark-up. The mark-up can be a lump sum or a ratio based on the original price of the goods, but must be agreed by the mutual consent of both parties. When negotiating the mark-up, the financier can take into account all expenses that they will incur in the acquisition of the asset (e.g., custom duties and freight).<sup>34</sup>

Islamic banks and financial institutions developed *Murabaha* financing into several different forms: the standard *murabaha* structure, *tawarruq* (*murabaha* commodity), *bai al-inah* (sale and buyback transactions), *Bai' Bithaman Ajil* and treasury products such as *sukuk*.

### 1.3.3.1 *Murabaha* Standard Structure

IFIs use the standard *murabaha* structure for retail banking and financing of homes, cars and consumer goods. This form of *murabaha*, as shown in Figures 1 and 2, involves three parties: the vendor, the buyer and the bank. Instead of assuming only the role of financial intermediary, as in the case of conventional banking, an Islamic bank conducts trading activity through buying and selling according to the following steps:

- 1) Upon the request of a customer for the bank to finance certain goods, the customer promises to purchase the goods from the bank at the purchase price plus a mark-up after the bank purchases the goods from a vendor. The bank can assign its rights as seller under the first sales contract to the buyer as its agent; however, the agency contract must be independent from the *murabaha* agreement.<sup>35</sup>
- 2) The bank, after receiving the goods from the vendor and possessing them—directly or through the customer as its agent—sends a sale offer to the customer according to their previous promise.
- 3) The bank sells the goods to the customer at the original price plus the mark-up and discloses this to the buyer.<sup>36</sup>

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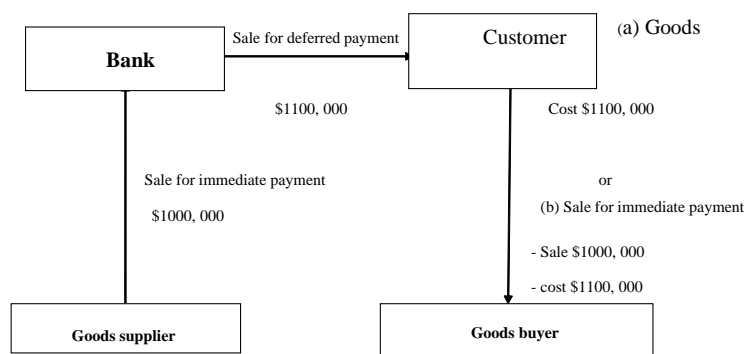
<sup>34</sup> Usmani, above n 4.

<sup>35</sup> Mahmoud El-Gamal, 'Interest and the Paradox of Contemporary Islamic Law and Finance' (2003) 27 *Fordham International Law Journal* 108.

<sup>36</sup> Ibid.

- 4) After the customer purchases the goods with a deferred sale contract, he repays the bank through deferred instalments.<sup>37</sup> Thus, Once the price is agreed and fixed, it cannot be increased or decreased and the client does not pay more than the agreed price, even if they delay the payment of the loan or instalments.

Figure 1: an example of a standard *murabaha* sale contract



The following steps begin with the request by the customer and their promise to purchase goods from the bank:

- The bank purchases the goods for AU\$100,000 from the supplier on behalf of the customer.
- As soon as the the bank pays the cost of the goods to the supplier and assumes the goods from the supplier, the contract becomes effective and binding to the customer and the bank sells the goods to the customer at AU\$110,000.
- The customer pays this amount by deferred instalments.

By contrast to conventional banking, which limits the responsibility of the bank to check whether the loan documents conform to the requirements of the loan contract, Islamic banks are required to deal with the financed goods by possessing them before selling them to the customer. The Islamic bank receives no interest, only a return, which is the difference between the original purchase price and the selling price (representing the assumption of the risk of owning the financed goods). Although the end result of a standard *murabaha* transaction could be similar to conventional financing, the *murabaha* transaction is shariah-compliant because it is backed by real assets.

### 1.3.3.2 *Tawarruq* (Murabaha Commodity)

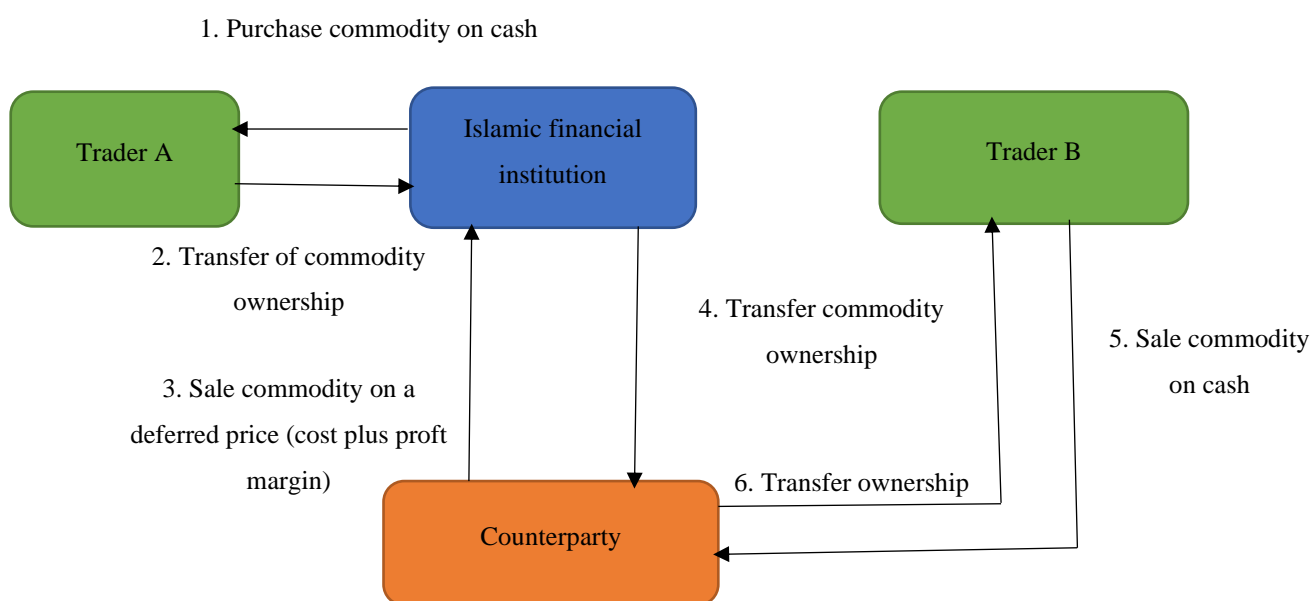
Islamic banks and financial institutions use *tawarruq*—a reverse *murabaha*—as a tool for managing liquidity. *Tawarruq* is similar to a standard *murabaha* structure, but with an extra component (see Figure 2). Under

<sup>37</sup> Ahmad, above n 10; Gary Bell, 'Harmonisation of Contract Law in Asia—Harmonising Regionally or Adopting Global Harmonisations—The Example of the CISG' (2005) *Singapore Journal of Legal Studies* 362; Visser, above n 1.

*tawarruq*, a financial institution seeking to provide working capital or cash to its customers, may sell an asset to a customer for a deferred payment. The asset is then sold by the customer (directly or with the financial institutions as their agent) to a third party for cash. In this type of transaction, the buyer basically has the cash needed to make the initial purchase. The buyer pays the loan, comprised of the cost plus mark-up, to the original seller—the bank—through instalments or in a lump sum. Most Muslim scholars have approved *tawarruq* as long as the transaction does not involve prior arrangement of the three parties involved.<sup>38</sup> As the buyer has a contract for a *murabaha* transaction, and later the same transaction is reversed, this transaction is also called a reverse murabaha.

Both transactions must be shariah-compliant. Islamic scholars consider them to be shariah-compliant if the three parties have not made a prior agreement; however, some scholars believe that the transactions are not shariah-compliant if the intention is not for the buyer to use or own the commodity, because the lack of real economic activities creates interest.

**Figure 2: Simple Mechanism in *Tawarruq* Financing**



In practice, the counterparty appoints the bank as its agent to sale the commodity to trader B.

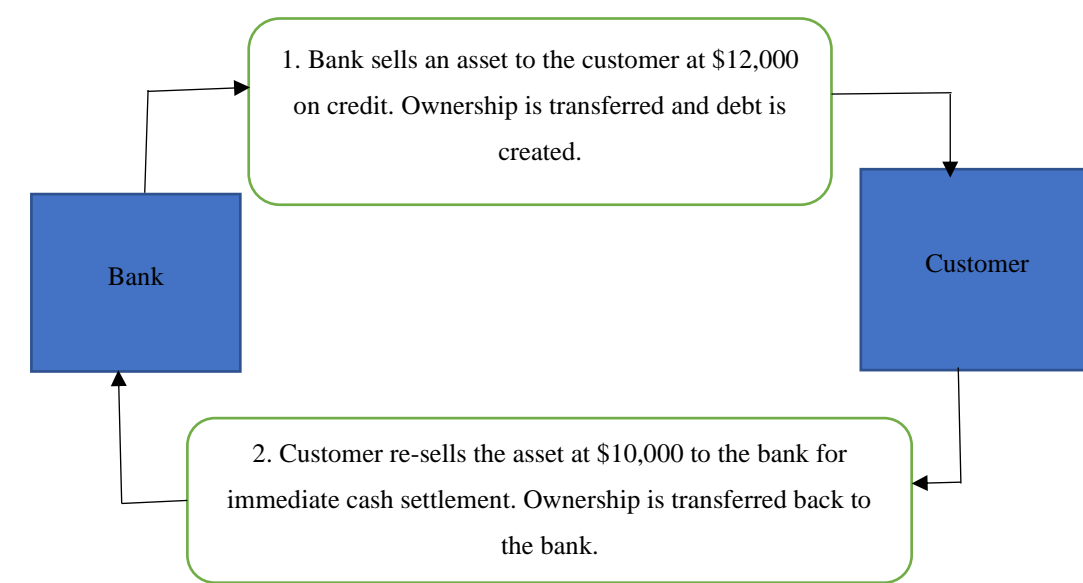
### 1.3.3.3 *Bai Al-inah* (Sale and Buyback Transaction)

In a similar fashion to *tawarruq*, Islamic banks and financial institutions use *bai al-inah* (sale and buyback transactions) to manage liquidity. As outlined in Figure 3, *bai al-inah* involves the sale and buyback of assets: the financier sells an asset to a buyer on a cash basis and later buys it back on a deferred payment basis at a

<sup>38</sup> Alzuhayli, above n 30; Usmani, above n 4.

higher price, or the customer sells an asset he owns to the bank at a spot price, and then immediately purchases back the asset from the bank for a higher price on a deferred payment basis.<sup>39</sup> The concept of *bai al-inah* has received fierce criticism from scholars on the basis that it is not a genuine *murabaha* sale transaction, but is constructed as bridge to get a loan through legal tricks that circumvent the prohibition of interest. Most Muslim jurists consider it not to be shariah-compliant and it has been rejected by international scholars, except in Malaysia.<sup>40</sup>

**Figure 3: Simple Mechanism in *Bai Al-inah* Financing**



#### 1.3.3.4 *Bai' Bithaman Ajil*

IFIs developed the *murabaha* structure into another instrument, *bai' bithaman ajil* (BBA), for financing and investment operations. As with the standard *murabaha* structure, IFIs use BBA as a financing instrument. In BBAs, a customer requests that a financial institution purchase an asset for them from a supplier; the financier purchases the goods and simultaneously sells it to the customer for a deferred payment equal to the cost of the goods plus a profit margin (see Figure 4).<sup>41</sup> As in the case of traditional *murabaha*, BBA is based on buying and selling activities: the customer, who wishes to be financed for the purchase of an asset, requests the bank purchase it for them and promises to purchase it from the bank at an agreed price, which they repay through deferred payments.<sup>42</sup> As with a traditional *murabaha* sale contract, the legal documentation and terms and conditions (e.g., the price, duties and the rights of all parties) must reflect the true nature of the sale contract.

<sup>39</sup> Khir, Gupta and Shanmugam, above n 39.

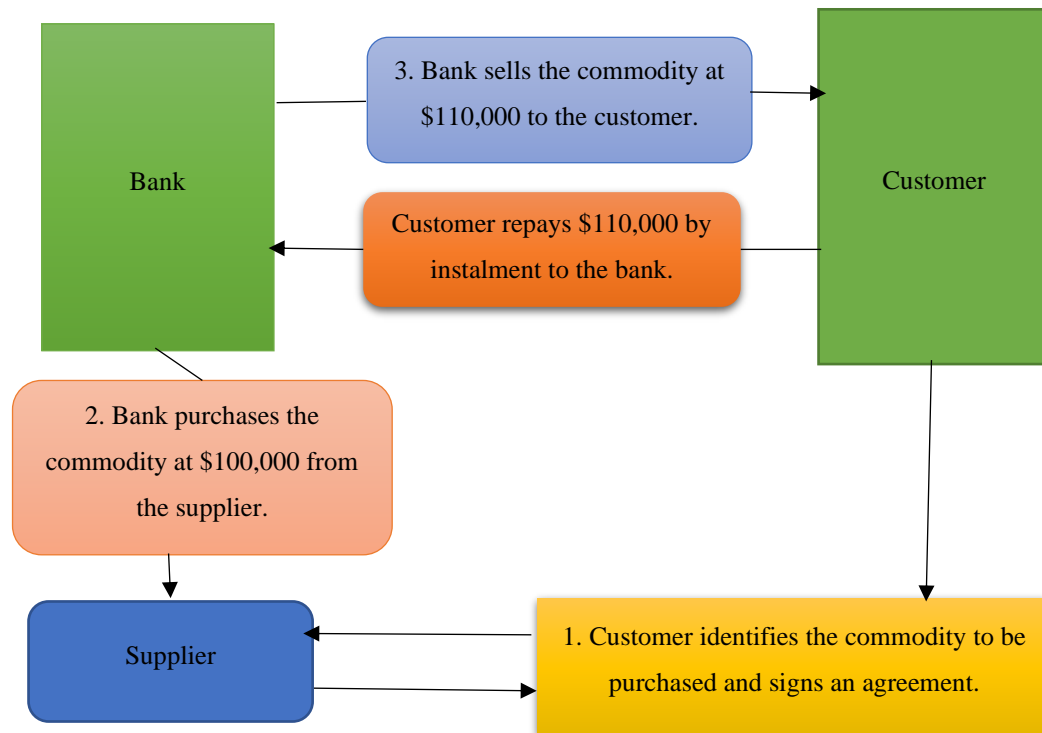
<sup>40</sup> Alzuhayli, above n 30.

<sup>41</sup> Kelly Holden, 'Islamic Finance: Legal Hypocrisy Moot Point, Problematic Future Bigger Concern' (2007) 25 *Boston University International Law Journal* 341; Usmani, above n 4.

<sup>42</sup> Khir, Gupta and Shanmugam, above n 39.

The structure of BBA contracts is the same as that of *murabaha* contracts, except that in *murabaha* profit must be disclosed to the buyer—in BBA contracts, it is not mandatory that the profit margin be disclosed to the buyer. Due to the similarities, and because BBAs are developed *murabaha* contracts, this study uses the term *murabaha* for both.

**Figure 4: Simple Mechanism in Bai' Bithaman Ajil Financing**



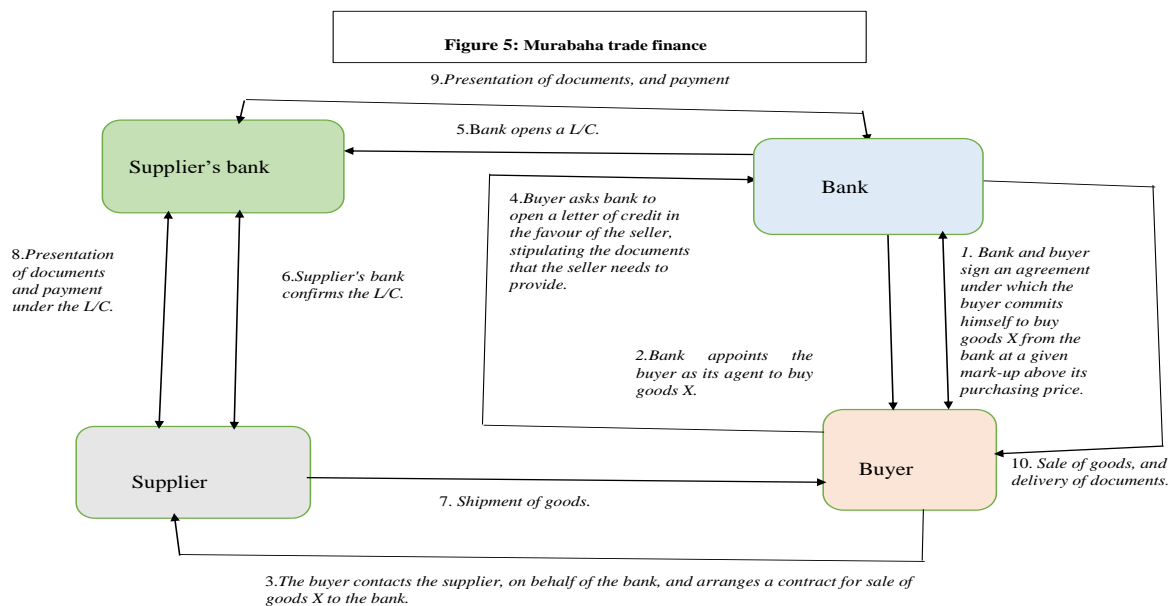
### 1.3.3.5 *Murabaha* Trade Finance

IFIs use *murabaha* in corporate banking for trade finance (see Figure 5) using a documentary credit system (e.g., imports, exports, letters of credit [LC], etc.) to cover the gap between payments to exporters and receipts from importers in different cultures and legal systems. For example, an importer from South East Asia or the Middle East may enter an agreement with an Australian supplier to purchase a commodity, or an Australian importer may enter an agreement with a Malaysian or Middle Eastern supplier and seek shariah-compliant finance from an Australian bank. As trade finance, *murabaha* sale contracts may be structured within the framework of the *UN Convention on Contracts for the International Sale of Goods (CISG)*, or as a credit contract under the latest version of the *Uniform Customs and Practice for Documentary Credits (UCP600)*. According to the AAOIFI, the conventional documentary credits governed by *UCP600* are shariah-compliant as long as they do not violate shariah principles (e.g., by including provisions that stipulate interest or allowing excessive uncertainty).<sup>43</sup>

<sup>43</sup> AAOIFI, above n 29.

International *murabaha* transactions proceed according to the following steps:<sup>44</sup>

- 1) An importer who wants a contract to be shariah-compliant signs a draft agreement with a foreign exporter to purchase specific goods. The importer normally acts as an agent for the bank when buying the goods from the supplier, although this is not necessarily disclosed to the supplier.
- 2) The importer requests that the issuing bank open a letter of credit in favour of the exporter, providing information pertinent to the goods.
- 3) The importer presents the contract documents of the contract to the bank requesting that it issue an irrevocable LC in favour of the foreign exporter.
- 4) After receiving the contract documents and satisfying the conditions of the contract, the bank issues an irrevocable LC on behalf of the importer in favour of the exporter.
- 5) The issuing bank sends the LC to a negotiating bank.
- 6) After receiving the shipment documents from the exporter and satisfying them, the negotiating bank pays the exporter and sends the documents to the issuing bank.
- 7) After receiving and checking the contract documents—including the shipment documents—the issuing bank passes them to the importer.
- 8) The importer collects the document from the issuing bank, takes possession of the goods and repays the cost of the goods to the issuing bank in instalments.
- 9) The issuing bank passes the payment from the importer and reimburses the negotiating bank after deducting its fees.



<sup>44</sup> Alice De Jonge, *Islamic Law and the Finance of International Trade* (Monash University, Faculty of Business and Economics, 1996); Kettell, above n 5.

### 1.3.3.6 Murabaha Sukuk

IFIs use *murabaha* for investing *sukuk*—certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services. *sukuk* is an alternative Islamic finance instrument for interest-paying bonds. *sukuk* represent the holder's ownership of underlying real assets. IFIs issue *sukuk* using *murabaha* contracts to collect funds from their owners for the purpose of integrating the finance sector with the real economic and investment sectors, away from dealing in cash for cash (see Figure 6). The collected funds are invested through shariah-compliant financing and investment contracts. Under Islamic law, IFIs can use *sukuk* to lease or sell real assets and distribute the resulting income in the form of profit on sale or rental income stream on the lease of assets to the *sukuk* holders.<sup>45</sup>

Figure 6: Simple Mechanism in *Murabaha Sukuk* Financing

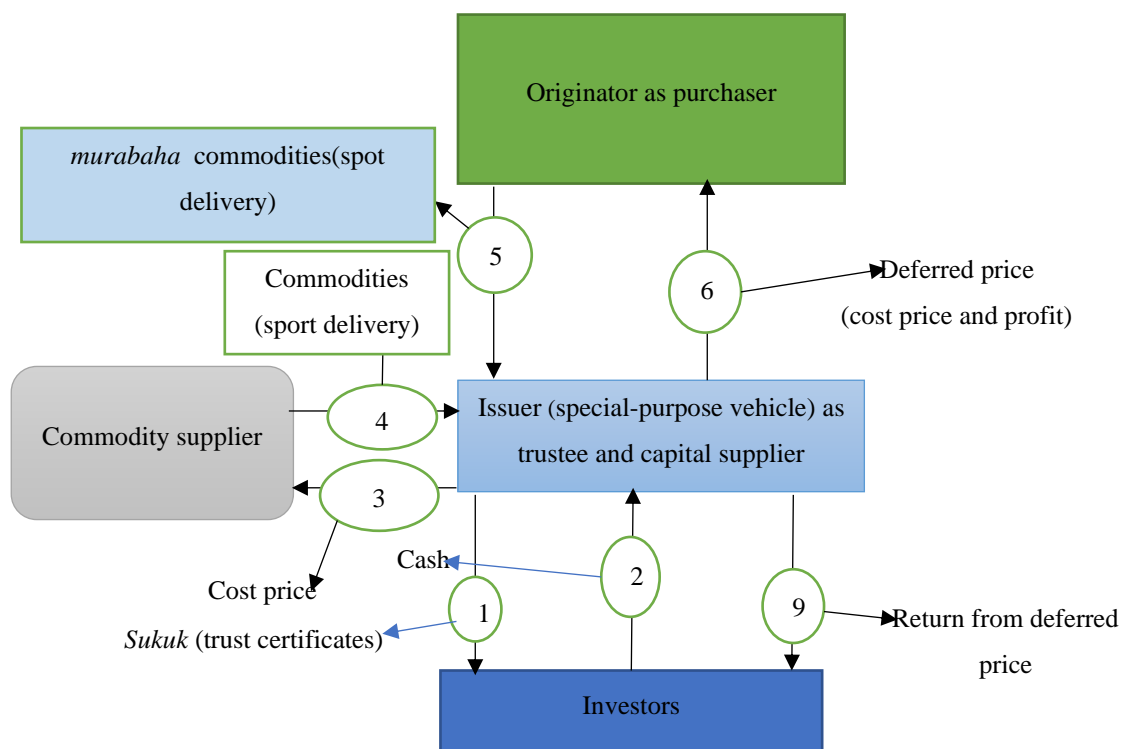


Figure 6 shows the structure of a *murabaha sukuk* transaction. In such a transaction, a special-purpose vehicle buys an asset that the borrower has identified, financing the purchase of the assets with the proceeds of a *sukuk* issuance. In the case of a *murabaha*, *sukuk* are issued on the basis of a *murabaha* contract, and the realised funds are used to finance the purchase of the *murabaha* assets for the purpose of selling the same to the party promising to buy them. The *murabaha sukuk* represent a common share in the ownership of these assets, after the purchase of *murabaha* assets and prior to their sale and delivery to the *murabaha* buyer. After their sale to the party promising to buy them, the *sukuk* represent a common share in the selling price of the *murabaha*

<sup>45</sup> Salman Shaikh and Shan Saeed, 'Sukuk Bond: The Global Islamic Financial Instrument' (2010).



assets;<sup>46</sup> thus, the returns from the *sukuk* originate from the difference between the selling and purchase prices of the *murabaha* assets.

## 1.4 Problem Statement

The Islamic financial system in Australia is still in its infancy and the Australian business community has little awareness of it. Australians tend to interact with Islamic finance only when importer/exporters arrange shariah-compliant financing. Some Australian jurisdictions, such as the state of Victoria, recognise Islamic financial products by exempting *murabaha* transactions that appear to be two sale contracts (one between the financier and the supplier and one between the financier and the customer) from double stamp duty on the basis that are actually one transaction.<sup>47</sup> Despite this, the Australian federal government has not produced any regulations or made any subsequent legal amendments concerning Islamic financial products in Australia. There are minimal regulations that specifically deal with the Islamic finance industry and its products and the ones that do exist only concern the basics of Islamic finance (e.g., defining some Islamic finance modes and their methods).<sup>48</sup> This minimal involvement of Australian banks with Islamic finance indicates that large parts of the Muslim community are financially excluded due to their abstinence from conventional financial practices—this community needs financial inclusion in the form of Islamic finance.<sup>49</sup>

Few studies have examined Islamic finance in Australia. Those that have investigated this issue did not investigate the feasibility of shariah-compliant *murabaha* financing under Australian law or whether legislative change is necessary to make *murabaha* both legally compliant and commercially desirable.<sup>50</sup> Ahmed's study of the practice of Islamic finance in Australia and the legal and regulatory impediments facing it recommended the introduction of a legal and regulatory system to create a level playing field in Australia for Islamic finance.<sup>51</sup> Following their examination of the legal and regulatory impediments facing Islamic finance in Australia, Sadiq and Black suggested both amendments to existing laws and exemption from the *National Credit Code* for shariah-compliant lending products to enhance their parity with conventional financial transactions.<sup>52</sup> Farrar's study discussed the advantages of Islamic finance as a niche market from which Australia can benefit through pursuing engagement with the Middle East and Asia-Pacific regions to

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<sup>46</sup> Nathif Adam and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in sukuk* (Euromoney Books, 2004).

<sup>47</sup> See, eg, the *Duties Act 2000* (Vic), which was amended to insert sss 17, 'Single Dutiable Transaction', and s 57A–57F, which provide that where land is sold to a financier and back to a natural person there is no duty on the second transfer of the land or the property.

<sup>48</sup> Reza Djojosegito, 'Mitigating Legal Risk in Islamic Banking Operations' (2008) 24(2) *Humanomics* 110, 112, 117.

<sup>49</sup> Rosli et al, above n 17, 89.

<sup>50</sup> Abu Umar Faruq Ahmad, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (PhD Thesis, University of Western Sydney, 2007); Maria Bhatti, 'Taxation Treatment of Islamic Finance Products in Australia' (2015) 20 *Deakin Legal Review* 263; Salim Farrar, above n 7, 413; Kerrie Sadiq and Ann Black, 'Embracing Sharia-Compliant Products Through Regulatory Amendment to Achieve Parity of Treatment' (2012) 34 *Sydney Law Review* 383.

<sup>51</sup> Ahmad, above n 10.

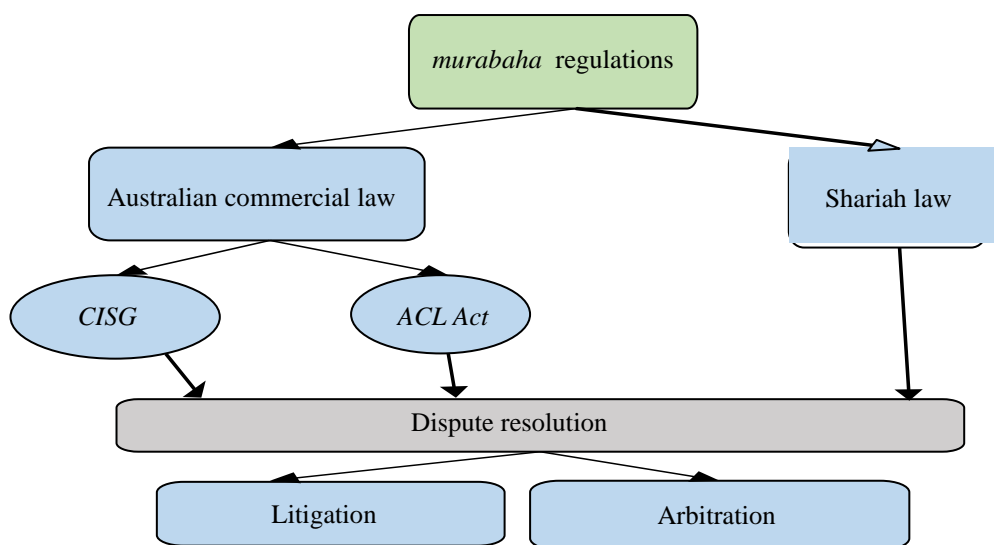
<sup>52</sup> Sadiq and Black, above n 52, 189.

prompt innovation in the Australian market.<sup>53</sup> He suggested that IFIs engineer and structure their financial products in a way that satisfy both domestic and Islamic laws.

*Murabaha* contracts can be classified both as sale contracts and credit contracts. If the *murabaha* is identified as a sale contract, the relationship between the financier and the customer may be that of a seller and a buyer; however, if it is identified as a credit contract, the relationship between the bank and the customer will be that of creditor and debtor.

#### Structure of *murabaha* contracts under shariah and common law.

Figure 7: Simple mechanism in *murabaha* regulations.



Note: CISG = *United Nations Convention on Contracts for the International Sale of Goods*.

As shown in Figure 7, when IFIs use *murabaha* sale contracts to facilitate trade finance, *murabaha* trade finance might be required to conform to the *CISG* principles and relevant UN convention that regulate the formation of the contract and the obligations of the parties involved. Conversely, *murabaha* contracts that are considered credit contracts may fall under the ambit of the *Australian National Consumer Credit Protection Act 2009* (Cth) (*‘Consumer Credit Protection Act’*) and *UCP600*, which regulate the validity and enforceability of the contract. If a *murabaha* is considered a sale contract, disputes related to remedies from loss or defects of the goods are subject to the rules established by the *CISG*, while if it is considered a credit contract, disputes related to defaulted payments are governed by the *Consumer Credit Protection Act* and *UCP 600*.

The parties in a *murabaha* agreement may choose to include a clause that refers to or incorporates Islamic law principles into the contract. In Islamic finance transactions, the choice of law is delicate as parties often opt for financial documents to be governed by Islamic law. This embedding of shariah principles is often drafted

<sup>53</sup> Farrar, above n 7, 440.

in such a way that the governing law will be used subject to shariah principles.<sup>54</sup> The unique structure of *murabaha* contracts and the requirement for *murabaha* transactions to simultaneously comply with these different legal systems can create potential conflicts of law and pose regulatory and financial risks.

This raises questions regarding the feasibility of using *murabaha* sale contracts for financing in the Australian legal context and the extent to which shariah principles can be applied in the law of the relevant jurisdiction.

## 1.5 Methodology

The methodological basis of this research is doctrinal and analytical. This study examines the conceptual basis of contemporary usage of *murabaha* financing contracts and the challenges facing it within the interest-based Australian banking system. This study uses an interpretative and qualitative critical case study method to explore the feasibility of using *murabaha* contracts for financing in the Australian legal context while also remaining shariah-compliant. This study also examines whether the requirement that *murabaha* contracts to simultaneously comply with these different legal systems creates additional legal or financial risk and what dispute resolution is best suited to *murabaha* contract disputes in Australia. Since there is no legal precedent relating to the courts and dispute resolutions in Islamic banking in Australia, the study draws on the courts and dispute resolution cases of the UK and Malaysia. These two countries have significant experience in regulating and governing the Islamic finance and banking industry. Additionally, as with Malaysian law, Australian common law is inherited from British common law and shares a historical background with the British legal system. Further, both Australian and Malaysian commercial law are by and large the same as UK commercial law.

To answer this main question, this thesis had several secondary objectives; thus, it:

- critically analyses the theory of Islamic finance and banking by examining the sources of Islamic law, Islamic contract law and the principles of Islamic finance and banking. It examines both the Islamic legal sources and the principles of Islamic finance to assess *murabaha* contracts in the context of their historical and cultural settings. To avoid personal selection of different opinions given by various Islamic schools and maintain consistency, the study adopted Islamic jurisprudence as a unified system. Likewise, to maintain objectivity, the AAOIFI—the most influential Islamic financial regulatory body—was chosen as a representative reference.
- analyses the Australian legal system in the context of the conditions of a shariah-compliant *murabaha* contract in practice to identify whether the divergent law systems create additional legal or financial risk in *murabaha* finance. In this regard, the study uses practical court cases to

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<sup>54</sup> This thesis uses both ‘Islamic law’ and ‘Shariah principles’ to refer to Islamic law.

understand the complexity of international *murabaha* trade financing within these different legal systems.

- examines two different aspects of *murabaha* dispute resolution—litigation and arbitration—to identify whether the *murabaha* dispute resolution mechanism is best suited to court litigation or an arbitral tribunal in the Australian context.
- provides recommendations and suggestions for improving the current *murabaha* financing system in Australia to enhance its effectiveness. These recommendations are intended to find common ground between these different legal systems, increasing the legal compliance and commercial desirability of *murabaha* financing.

In pursuit of these objectives, this thesis discusses six in-depth case studies; three from UK financial institutions that provide Islamic financial products and services and three cases from IFIs in Malaysia. Analysis of dispute cases from these two common law countries allows Islamic banking and *murabaha* to be contextualised and provides insight into the contemporary practices of Islamic banking in common law jurisdictions. The purpose of this analysis is to transfer the British and Malaysian experiences to Australia with modifications commensurate with the requirements of the Australian legal regime.

Exploring these issues may enable a synthesis between shariah principles and these regulations for *murabaha* transactions and allow for the establishment of an identifiable, unified and effective strategy to incorporate *murabaha* financing transactions into the Australian regulatory framework. It will also prompt assessment of how Australian common law legally and practically accommodates Islamic *murabaha* finance. These findings are essential steps in bridging the existing gap between the literatures of Islamic banking and finance.

For validity, the study used court cases to address the effects of overlapping legal systems on *murabaha* contracts as either sale or credit contracts. The reliability of this information was tested through the implementation of verification strategies and self-correction techniques. Additionally, all data was kept throughout the study and any variation from initial assumptions continuously checked and verified through comparison with the original and final entered data. When changes occurred in the settings of the research that affected the approach of the study, the researcher acted accordingly to ensure reliability. The researcher also used a peer debriefing technique to ensure reliability of the findings. Structural validation and referential material adequacy was also incorporated into the research process to develop a comprehensive framework for addressing *murabaha* financing in Australia.

## 1.6 Significance of the Study

Islamic trade finance has the potential to become an important financial sector in Australia and neighbouring regions, to facilitate further innovation and competition in the wholesale and retail banking market and to support Australian credit market diversification. Islamic finance is making inroads into the Australian financial market by targeting the Muslim community, estimated to be 365,000, or around two per cent of the Australian population, a large proportion of which has shown a keen interest in Islamic financial services.<sup>55</sup> Given Australia's strategic geographic location, political stability, proximity to the most populous Islamic country in the world (Indonesia) and Muslims making up 41 per cent of the South-East Asian population (600 million), Islamic finance is increasingly relevant to Australian financial markets. Further, strong trade links with South-East Asia and the Middle East could make Australia an operational centre for Islamic finance, facilitate innovation and competition in the banking sector and support credit market diversification. The growth of this industry not only increases the variety of financial products offered in Australia financial markets but also helps to bridge the gap between Australia and the Muslim world politically.

To achieve this goal and participate in the rapidly growing niche market, the Australian government formed a task force to assess the possibilities of Islamic finance as an alternative investment for private banking, securitisation and residential mortgage-backed securities in Australia. In 2010, the Department of Foreign Affairs and Trade formed a task force to assess and evaluate the tax treatment of Islamic finance to resolve the legal and regulatory impediments associated with it and to ensure Islamic financial products receive equal treatment in taxation law.<sup>56</sup>

The Australian government believes Islamic finance will substantially contribute to making Australia a global financial services centre for the region and also present opportunities for Australian financial institutions to develop shariah-compliant finance products locally and internationally. This would both enable Australian financial institutions to open Islamic banking windows—providing access to offshore investments—and enable Muslims to invest according to their faith. In sum, embracing Islamic finance in Australia with an appropriate regulatory system will have social, economic and political benefits. As such, it is important for Australian banks to understand both the characteristics and operational mechanisms of Islamic financial transactions and the dispute settlement system used in Islamic financial contracts.

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<sup>55</sup> Abu Umar Faruq Ahmad and Mohammad Kabir Hassan, 'Legal and Regulatory Issues of Islamic Finance in Australia' (2009) 2(4) *International Journal of Islamic and Middle Eastern Finance and Management* 305; Houssain Kettani, 'Muslim Population in Asia: 1950–2020' (2010) 1(2) *International Journal of Environmental Science and Development* 143.

<sup>56</sup> See <[https://trademinister.gov.au/releases/2010/sc\\_100212.html](https://trademinister.gov.au/releases/2010/sc_100212.html)>.

In practical terms, the findings of this thesis can be used to assist the Australian business community to better understand the Islamic financial system and products, particularly in terms of trade financing mechanisms. It also builds on existing knowledge in the field of Islamic banking and finance.

First, this study will help Australian financial institutions and the business community to understand the characteristics and dynamics of Islamic trade financing. Second, the findings from this study will inform Australian policymakers as they seek to understand the prospects and challenges of Islamic trade finance transactions and their legal and regulatory implications within the framework of international trade finance and Australian commercial law. Third, the findings of the thesis will contribute to the literature on Islamic banking and finance by providing Australian financial institutions and investors with insights about Islamic trade financing techniques and assisting them to understand *murabaha* contracts and conflict resolution in the Australian context. Fourth, by using the CISG framework, this thesis will increase awareness of these issues and how to address them among foreigner investors intending to make shariah-compliant investments in Australia. Fifth, as Australia strives to attract greater direct foreign investment inflows, the findings of this study will play an important role in guiding investors in and outside Australia. Sixth, this study will also help the Australian government and its relevant stakeholders reform and strengthen the local economy to become a friendlier investment destination. Seventh, the findings of this study will be useful to Australian companies with interests in the Middle East and North Africa. Eighth, it will be possible to use these findings in some trade projects, particularly in terms of the development of Islamic finance and products in Australia. Ninth, this thesis will be useful for teaching Islamic banking, traditional banking, world economics, international economic relations and international trade transactions in Australian universities, as well as in writing papers devoted to the Islamic financial system and its functioning in different countries.

## **1.7 Limitations of the Study**

The scope of this study extends only to *murabaha* financing transactions and the current practices of IFIs offering these products within the Australian legal system in terms of shariah principles. It examines how *murabaha* contracts operate under Australian law while also remaining shariah-compliant and the changes needed to make it both legally compliant and commercially desirable in Australia. For this reason, this study evaluates how regulation of *murabaha* can be improved under Australian commercial law by analysing whether the current practices of *murabaha* financing in Australian commercial law are compatible with shariah principles. However, this study is concerned only with IFIs operating in common law jurisdictions and with Sunni Islamic law schools. However, due to the lack of certain fundamental elements in the Australian Islamic banking system, such as a comprehensive legal and shariah framework, this study focuses on examining how lessons from the British and Malaysian experiences of Islamic banking and finance can be transferred to Australia. Further, in terms of Islamic financial regulatory bodies, it focuses solely on the AAOIFI.

## CHAPTER 2: SOURCES OF ISLAMIC LAW

### 2.1 Introduction

Shariah law is the rules and law originating from the Quran, as well as the body of practices and explanations based on the sayings, practices and approvals of the Prophet Muhammad (Peace Be Upon Him; ‘the Prophet’) and the *ijma* (consensus), *qiyas* (reasoning by analogy) and *ijtihad* (efforts) of Islamic scholars. The Quran—the revelation given to the Prophet by God—and the Sunnah—the Prophet’s deeds, sayings and approvals, which clarify and explain the issues that the Quran has not fully explained or has left unresolved—are the two main sources of shariah law. *Ijma* and *qiyas* through *ijtihad* are secondary sources for shariah law.<sup>57</sup> When the Quran does not provide an answer for a specific issue, Islamic jurists turn to the Sunnah to either confirm the law in the Quran and clarify ambiguous issues or to explain matters mentioned in general terms in the Quran. When both the Quran and the Sunnah are silent or do not provide adequate answers to contemporary issues, they turn to the *ijma*, *qiyas* or *ijtihad* to develop rules that can be applied to contemporary matters, such as financial transactions. Further, scholars have also developed other legal sources, such as *istihsan* (pursuit of the public good), *Maslaha* (public interest) and *‘urf* (custom) that supplement the primary and secondary legal sources. As the Quran and the Sunnah represent the principal sources of Islamic law, the rules of *fiqh* (jurisprudence) are derived from them through *usul al-fiqh* (the principles of jurisprudence): the methods of analogy, *istihsan* (juristic preferences) and *istishab* (presumption of continuity). *Maslaha* (public interest)

The central focus of Islamic finance is compliance with shariah. To ensure financial transactions are shariah-compliant, IFIs must establish advisory or supervisory boards to advise them. The opinions of these supervisory boards guide them towards shariah compliance. Financial institutions cannot claim to be conducting Islamic financial business unless they set up such a body consisting of qualified, reputable scholars who possess the necessary skills.

### 2.2 Primary Legal Sources for Islamic Law

#### 2.2.1 The Quran and the Sunnah

The Quran is the revelation given to the Prophet by God over 23 years through the angel Gabriel, given in the very words of God to enable believers to reflect on it and keep it in their memories. The Quran is the first and most authoritative source of Islamic law. It describes the relationship between human beings and their creator, human conduct and human relationships. Quranic verses are divided into two groups: decisive verses, which provide clear directions, and metaphorical verses.<sup>58</sup> In general, the Quran lays down guidelines and principles with few injunctions; for example, only 350 of its verses cover legal issues, and most of these either address

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<sup>57</sup> Ibrahim, above n 25, 661.

<sup>58</sup> Muhammad Taqi-ud-Din Al-Hilali and Muhammad Muhsin Khan, *Noble Quran* (King Fahd Complex for the Printing of the Holy Quran, 1996) 20.

the conduct of individuals or are responses to problems that arose at specific times. Conversely, the Sunnah, which represents the practice, sayings and approvals of the Prophet during his lifetime, is considered the second legal source for Islamic law. It is legal proof that either testifies to the authority of the Quran or clarifies issues the Quran has not sufficiently explained or has left unresolved.

### 2.2.2 *Ijma*

*Ijma* is the consensus of qualified Islamic scholars of a given generation on matters of Islamic law. The Quran refers it in the following verse:

*O ye who believe! Obey God, and obey the Apostle, and those charged with authority among you. If ye differ in anything among yourselves, refer it to God and His Prophet, if ye do believe in God and the Last Day, that is best and most suitable for final determination.*<sup>59</sup>

This suggests that when the Quran and the Sunnah do not provide guidance on a disputed matter, jurists can use the *ijma* methodology to seek agreement and resolution. *Ijma* is potentially the most important legal notion in Islamic law as it enabled Islamic societies to establish permanent legislative institutions. Nevertheless, in practice there have been very successful examples of *ijma* in relation to financial issues because of cultural differences between scholars and their affiliations with different schools of thought. As a result, the opinions of scholars in certain geographic areas or within certain schools of law can be accepted. To use *ijma* and understand the intentions and purpose of shariah law, scholars must have a deep knowledge of the Quran, the Sunnah, *usul al-fiqh* and the Arabic language.

### 2.2.3 *Qiyas*

*Qiyas*, the use of analogical reasoning, is considered a legal source of continuity in Islamic jurisprudence. According to this method, rulings may be extended to new problems on the basis that a precedent and a new case share the same operative or effective cause. For example, scholars may rule on the prohibition of drugs, even though they are not mentioned in the Quran, because their effects and consequences are similar to those of alcohol, which is prohibited by the Quran. *Qiyas* was originally a fluid concept of reasoning from prior sources to address contemporary issues and provide flexibility to the development of shariah law; however, over time, it was restricted to literal interpretation of the law. This led to the development of *istihsan*, *maslaha* and the use of custom to remedy these later restrictions by promoting the spirit and essential social side of the law, which is to assure the satisfaction of human interests.

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<sup>59</sup> Ibid.



#### 2.2.4 *Ijtihad*

*Ijtihad* refers to the use of scholars to discover or formulate new legal rules derived from the Quran or the Sunnah to find answers for contemporary social matters. *Ijtihad* is considered one of the most useful legal sources for ensuring that Islamic law is relevant. Muslim scholars have used it in various legal and religious situations.

According to one Hadith, the Prophet sent Mu'ad ibn Jabal to Yemen as the governor and judge and asked him how he would judge when a dispute was brought to him. Mu'ad replied that he would judge in accordance with the Quran. Then the Prophet asked him what he would do if he did not find any answer in the Quran that helped him resolve the dispute. He answered that he would seek guidance from the Sunnah. The Prophet then asked him what he would do if he did not find any guidance in either the Sunnah or the Quran. He replied that he would do his best to form an opinion to resolve the dispute.<sup>60</sup> On the basis of this Hadith, scholars make *ijtihad* relevant by employing analogy as a legal method—which they call the practice of inference—to reach a ruling.

### 2.3 Secondary Legal Sources for Islamic Law

#### 2.3.1 *Istihsan*

*Istihsan* can be translated as both 'juristic preference' and 'public interest'. It describes the process of selecting one acceptable solution over another because of its suitability for the situation at hand, even though it may be technically weaker than the rejected one. It also refers to the process of using *ijtihad* to select the best solution for the general public. It is considered the deepest dimension of shariah law.<sup>61</sup> Once it has been determined that *istihsan* does not contravene previous rulings, it is preferred as evidence over previously established rulings. Any departure from a previous ruling can be justified this way, regardless of whether the evidence it presents is textual and irrespective of whether the method used to establish the previous ruling was based on general evidence, jurisprudence rules or apparent clear analogy.<sup>62</sup>

This legal methodology enables judges and scholars some flexibility in interpreting the law and allows the spirit of the law to prevail over its wording. That said, it only applies to cases where there is no evidence available and it establishes the continuity of a fact that has already been proven to exist. Examples of this include the presumption that a missing person is still alive until their death is confirmed, the presumption that someone is innocent until proven guilty or the presumption that a marriage continues unless the end of the marriage can be proven. For these reasons, *istihsan* is sometimes called the 'hidden *qiyas*', as opposed to the 'apparent *qiyas*', the latter of which requires a strict application of the law.

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<sup>60</sup> al-Hajjaj, Hadith No 1569.

<sup>61</sup> Abu Tariq Hilal and Abu Esmail al-Beirawi, *Understanding Usul Al-Fiqh* (Revival Publications, 2007).

<sup>62</sup> Ibid 136.

### 2.3.2 *Maslaha*

*Maslaha* refers literally to Islamic peace, submission, justice and the well-being of society. It broadly describes the means by which the mission of liberation and salvation is pursued through a set of new moral values for social change.<sup>63</sup> In Islamic law, *maslaha* literally describes seeking benefits and repelling harm. Conversely, in the juristic definition, it refers to a consideration of the public interest and well-being of society that does not contradict the spirit and objectives of Islamic law. According to Al-Ghazali, a great Islamic scholar (1058–1111 CE), *maslaha* encompasses everything that is beneficial to people that protects and preserves the five essential Islamic objectives: the belief, the lives of people, wealth, intellect and the honour or the dignity of people.<sup>64</sup> Thus, *maslaha* can be used to select the best alternative solution for the contemporary matters.

### 2.3.3 *Urf*

*Urf* refers to the collective customs or knowledge of a given society. It is well-known by most people, whether in the form of words or practices. To be recognised in an Islamic society, *urf* must be compatible with shariah law. When applied, it can lead to the deprecation or inoperability of certain aspects of Islamic jurisprudence. Islamic jurisprudence recognises local customs as important sources of law even if they relate to non-Muslim society, so long as they do not contradict the shariah—at least in spirit.<sup>65</sup>

*Urf* can be defined as that which is practiced more often by people in a particular geographic area. Islam considers *urf* to be unwritten laws formed by practice over many generations and incorporated into the law through the procedures of judges, court judgements and *ijma*.<sup>66</sup> When a judge is unable to find an applicable text from the Quran or Sunnah and cannot find an *ijma* or *qiyas* relevant to a case, he will turn to the *urf* of the community to determine the issue. For example, if an agreement does not determine the commission in a sale contract, the judge will turn to the practices of the place where the contract was concluded and issue his judgement on that basis. *Urf* can serve as persuasive evidence or as the basis for legal presumption; however, when a case requires reference to local custom, judges rely on experts and notaries to indicate the acceptable form of the local customary practice.

## 2.4 Islamic Schools of Law

The first Islamic schools of jurisprudence were founded after the death of the Prophet and most of his companions in 632 CE. They were particularly important after Islam had spread into many parts of the world

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<sup>63</sup> Toha Jabir al-Alwani and Ushul al-Fiqh al-Islami, *Source Methodology in Islamic Jurisprudence: Methodology for Research and Knowledge* (International Institute of Islamic Thought, 1990).

<sup>64</sup> S Mohammad Ghazanfar and Abdul Azim Islahi, *Economic Thought of al-Ghazali* (Scientific Publishing Centre of King Abdul Aziz University, 1997).

<sup>65</sup> Mughal and Munir Ahmad, 'Islamic Jurisprudence' (Available at SSRN 1903980 No 278, Punjab University Law College; Superior Law College, 3 Aug 2011).

<sup>66</sup> Hilal and al-Beirawi, above n 63, 25.

and encountered new cultures with new issues for which the Quran and the Sunnah did not provide clear answers or gave vague answers that needed solutions.

The main schools of Islamic jurisprudence were established between the ninth and eleventh centuries by Imam Abu Hanifa (690–760), Imam Malik ibn Anas al-Maliki (711–795), Imam Muhammad ibn Idris al-Shafi'i (767–820), Ahmad ibn Hanbal (781–855) and Jafar al-Sadiq (700 or 702–765 CE). The first four of these schools are recognised by most Sunni countries and represent accepted Islamic jurisprudence in the Sunni Muslim world.<sup>67</sup> The founders of most of these schools did not initially intend to establish law schools. They sought only to define rules by discovering and comprehending the linguistic and historical backgrounds behind the revelation of the verses of the Quran and the sayings and practices of the Prophet.<sup>68</sup>

Even though these schools agree on the primary legal sources—the Quran and the Sunnah—they differ in their interpretations of the legal status of these sources.<sup>69</sup> For example, they agree that the Quran and the Sunnah are the two most important Islamic legal sources, but they diverge when it comes to the acceptance and usage of the secondary legal sources in matters that are not covered in the Quran and the Sunnah. Some schools give precedence to *ijtihad* and *qiyas* as the next major legal sources, while others include the use of the personal opinions. This often involves applying *istihsan* to adapt Islamic jurisprudence according to the changing needs of society with the intention of avoiding rigidity in Islamic law and unfairness in applying the literal meaning of the law.

These differences exist between the Sunni and Shiite schools, between individual Sunni schools themselves and even between individual jurists within each school. They stem from the different approaches the schools take to interpreting the legal sources of shariah law. These differences manifest in criteria for determining the authenticity of the Hadith, the importance given to *ijtihad* and the methodologies used for interpretation. These differences influence their stances on the formation of legal rules and lead each school to their own conclusions on the same matters, including financial issues.

## 2.5 Contracts in Islamic Law

Islam allows people the freedom to sell and purchase or exchange their properties and services; it only instructs that people should not take property from others in unfair ways. The parties to a contract have total autonomy to form the contract, specify conditions and determine its rights and obligations as long as they do not contravene the principles of shariah law.<sup>70</sup> By establishing the principle that the ‘contract is the law of

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<sup>67</sup> Ahmad, above n 52

<sup>68</sup> Khizr Muazzam Khan, ‘Juristic Classification of Islamic Law’ (1983) 6(23) *Houston Journal of International Law* 23, 33.

<sup>69</sup> Michael Lubetsky, ‘Financial Alchemy in Islamic, Talmudic and Western Law’ [234] (2010) 19(1) *Transnational Law and Contemporary Problems* 232; T S Twibell, ‘Implementation of the United Nations Convention on Contracts for the International Sale of Goods Under Islamic law: Will Article 78 of the CISG be Enforced When the Forum is in an Islamic State?’ (1997) 9(1–2) *International Legal Perspectives* 25, 62.

<sup>70</sup> Aisha Nadar, ‘Islamic Finance and Dispute Resolution: Part 1’ (2009) 26 *Arab Law Quarterly* 23.

contracting parties', shariah law gives the contracting parties the autonomy to create and define their rights and responsibilities within the contract.

Unlike other types of contract, sale contracts are specifically addressed in the Quran. Although Islamic jurists developed the principles of Islamic contract law, they did not develop a theory of contracts until the nineteenth century. Before then, Islamic jurists regarded contracts of sale as the model for all other contracts; any contracts with similar aspects were included within their scope.<sup>71</sup> The main reason for the lack of progress in Islamic legal systems in general, and particularly in terms of contract theory, was the dominance of English common law in the Muslim world for 600 years. During this time, Islamic law did not have the same opportunities to develop as common law.

Against this brief background, the following section discusses the definitions and essential elements of Islamic sale contracts.

### **2.5.1 The Definition of Contracts of Sale Under Islamic Law**

The Arabic word for contracts, 'aqd', involve exchanging one thing for another and literally means a tie or bond between two things. This definition seems to be deeper than the usual meaning of the word 'contract' in common law.<sup>72</sup> Islamic jurisprudence specifically defines a sale as the exchange of one property for another property (i.e., exchanging a commodity for another commodity or a commodity for a currency) and the transfer of its ownership from one party to another. It connects the offer and acceptance of the contracting parties, showing their consent and reflecting their intentions. Additionally, it represents a social bond that binds together the members of the community.<sup>73</sup> This definition positions contracts as legal arrangements intended to create legally binding obligations for all parties. Within this definition, there are three components to the sale contract: two parties, the seller and buyer; an object that is the subject of the contract; and a statement or expression from the seller and buyer that shows their intention to enter a contract of sale.

Sale contracts place some obligations on both the buyer and the seller (e.g., the seller must deliver the goods to the buyer or his agent and the buyer must pay the price).<sup>74</sup> By establishing certain obligations and rights of the parties through their own free will, the contract benefits both. Although the definition of a contract in Islamic law is similar to that of common law, Islamic law considers both the subject matter of the contract and

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<sup>71</sup> Md Jalil and Muhammad Khalilur Rahman, 'Islamic Law of Contract is Getting Momentum' (2010) 184 *International Journal of Business and Social Science* 1; Mahdi Zahraa and Shafaai M Mahmood, *Definition and Scope of the Islamic Concept of Sale of Goods* (2011) *Arab Law Quarterly* 216.

<sup>72</sup> *The Mejelle: Being an English Translation of Majallahel-ahkam-i-adliya and a Complete Code on Islamic Civil Law* (Charles Robert Tyser and D G Demetriades trans, Other Press, 1901).

<sup>73</sup> Mohammed Abu Zahra, *The Concept of Ownership and the Theory of Contract in Shariah Law* (Dar al-fikri Al-Arabi, 1976) vol 2; Jalil and Rahman, above n 73.

<sup>74</sup> Zahraa and Mahmood, above n 73, 215.

the private ownership of the goods to be usufruct on the basis that the real owner is God—the people involved are only trustees for God’s wealth.<sup>75</sup>

Shariah law divides contracts into two types: unilateral and bilateral contracts. Unilateral contracts, including some contracts that favour the recipient (e.g., gifts, loans or endowments), do not require the acceptance of the recipient. Conversely, bilateral contracts require the consent of both the seller and the buyer. There are six types of bilateral contracts: contracts of exchange, contracts regarding utilisation of usufruct, contracts of security, contracts of partnership, contracts pertaining to doing work and contracts of safe custody.<sup>76</sup>

The main types of contract are contracts of exchange, which cover most transactions, and usufruct contracts that presuppose the transfer of usufruct of property from one party to another (e.g., hire and lease). The other types of contract depend on these. Although this classification system may appear quite comprehensive, there may be other contracts that do not conflict with shariah principles. That said, the golden rule for ensuring the permissibility of a contract is for it to be free from uncertainty and lack of knowledge.

### **2.5.2 Essential Elements in Sale Contracts Under Islamic Law**

The essential elements of a shariah-compliant contract are equality, fairness and the fulfillment of obligations. Shariah law applies the principle that the ‘contract is the law of contracting parties’, which emphasises the freedom of the contracting parties to enter the contract of their own will and respects its conditions. Shariah law also denounces dishonest and fraudulent dealings in commercial transactions.<sup>77</sup> Thus, the contracting parties must agree to the contract of sale and the subject of sale must be lawful, ascertainable and deliverable. This presupposes the simultaneous transfer of the ownership of property or a commodity between the parties. Possessing the commodity before selling to the buyer and ensuring delivery to the buyer at the same time aims to avoid exposing the contract to *gharar* (risk; e.g., selling goods that are unowned, not present at the time of the contract or those for which the time of arrival is unknown or unsure)<sup>78</sup>. When the outcomes of a contract become uncertain or unknown to the buyer, it becomes proscribed by shariah law as *gharar*.

As the object of a contract is recognised as property that has value and gives rise to ownership and consideration, its transfer must be based on buying and selling activities such as a sale in cash or through deferred instalments. The price can be paid on the spot or in the future; however, it cannot be determined later or left for a third party to determine—to avoid uncertainty, shariah law requires the price to be fixed and

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<sup>75</sup> Hideyuki Shimizu, 'Philosophy of the Islamic law of contract: A comparative study of contractual Justice' (IMES Working Papers Series No 15, Institute of Middle Eastern Studies, International University of Japan Working papers series, 03-01-1989).

<sup>76</sup> Baker, above n, 49.

<sup>77</sup> The Quran (26:181) says the following on this topic: ‘Woe to the fraudulent dealers, who exact full measure from others, but give less than due to others in weight and measure, do they not know that they will be called to account, on a mighty day’.

<sup>78</sup> Wahbah Alzuhayli, *Islamic Contemporary Financial Transactions* (Dar Elfikri Almu’asir, 2002) vol 1.

known at the time of the contract. This price, according to Islamic law, is not limited only to money but can be in the form of another commodity.<sup>79</sup>

Within this context, the contract be valid is required to include the following elements: offer and acceptance, unity of the meeting and the option to cancel a contract, consideration in the contract, intention to create legal agreement, content of contract, legal capacity of the contracting parties and legality of the contract.

#### 2.5.2.1 Offer and Acceptance

The offer and acceptance that express the consent and intention of the parties to form the contract can be oral, in writing, given by an agent or given using modern communication tools (e.g., letters, emails, telephones or fax). Additionally, contracts are valid if the buyer takes goods from a seller and pays the price without oral or any other expression if this is considered acceptable according to *‘urf*.<sup>80</sup>

For a contract to be valid according to Islamic jurisprudence, the *ijab* (offer)—the expression of intention to sell property or goods to the purchaser—made by one party must connect the *qubul* (acceptance) of the other party with the subject matter and consideration. One party makes a proposal to obtain the consent of the other party to perform or abstain from doing something and the acceptance occurs when the buyer accepts this *ijab*.<sup>81</sup> When the *ijab* is accepted by the purchaser, the agreement is made between the parties and the contract becomes legally binding on both.

The *ijab* and *qubul* can be verbal, in writing or by conduct and circumstances that show the consent of the contracting parties. The *ijab* of the seller and the *qubul* of the purchaser must be free from other people’s influence and coercion. That said, the requirement that there be an *ijab* and a statement of *qubul* can be replaced by simply paying the price of the commodity and taking it without uttering a word where this is dictated by *‘urf*.

Although the *ijab* and *qubul*, given through a statement or an action according to customary practice is sufficient, both parties are also required to agree to the description, quality, quantity and price of the goods and the time of the agreement. For a contract to be valid, jurists require the *ijab* and *qubul* to fulfil the following conditions: the *ijab* and *qubul* must occur in the same session, the recipient of the *ijab* must not decline it and the one proposing the *ijab* must not withdraw it before it is accepted by the other party.<sup>82</sup>

Conversely, the *qubul* given by the purchaser is completed when it comes to the knowledge of the seller. This means that a contract is only formed when the seller becomes aware of the purchaser’s *qubul*. Classical Islamic

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<sup>79</sup> Mohd Daud Bakar, ‘Contracts in Islamic Commercial Law and their Application in Modern Islamic Financial System’ in Mohd Daud Bakar and Engku Rabiah Adawiah Engku Ali (eds), *Essential Readings in Islamic Finance* (CERT Publications, 2008) 47.

<sup>80</sup> Abdulrahman Aljasiiri, *Alfiqhi Ala-Almadahib al-Arbah* (Dar Elfikri Al-Arabiyaha, 2006) vol 2, 127.

<sup>81</sup> Ibid 130.

<sup>82</sup> Abu Zahra, above n 75, 200.

jurists hold the view that, to avoid contract disputes, the purchaser must hear the seller's *ijab* and the seller must hear the purchaser's *qubul*.<sup>83</sup> Nevertheless, when the *ijab* is made to a potential purchaser who is not present at the meeting with the seller, it will persist until the purchaser receives it and accepts or refuses it according to the practices and customs of the business.<sup>84</sup> In contemporary businesses, it is customary for the *ijab* and *qubul* to be conveyed by modern communications, such as email, fax or letter.

An *ijab* in writing can be made to a potential buyer who agrees to its terms. It is preferable for the *ijab* and *qubul* to be written in business dealings as they can be referred to in the case of disputes. This is why the Quran (2:282) emphasises that contracts should be in writing:

*O believers when you deal with each other in lending for a fixed period, put it in writing. Let scribe write it down with justice between the parties. The scribe, who is given the gift of literacy by Allah, should not refuse to write: he is under obligation to write. Let him who incurs the liability (debt) dictate, fearing Allah and not diminishing anything from the settlement. If the borrower is mentally unsound or weak or is unable to dictate himself, let the guardian of his interest dictate for him with justice.*<sup>85</sup>

With this in mind, most Islamic jurists consider that the writing of a contract shows the expression of the contracting parties and their mutual consent to its conditions and terms. If a contract is to take place in the future, they require the *ijab* and *qubul* to be in writing to avoid uncertainty. That said, an invitation to make an offer to buy something is considered an invitation; thus, as in common law, shariah law treats some acts—like displaying goods in a shop, publishing advertisements and giving notice of auctions or tenders—as merely invitations to treat.

#### **2.5.2.2 Unity of the Meeting and the Option to Cancel a Contract**

For a contract to be valid, the *ijab* and *qubul* must take place in the same session, which can be any natural place in which the parties conduct the agreement. The intention of this requirement is to create a time and place that unites the declarations of consent from both parties and their intentions. In this sense, unlike in other legal systems, Islamic law emphasises the importance of the *ijab* and *qubul* occurring in one session without there being a gap between the time of the *ijab* and the time of the *qubul*. That said, because modern businesspeople often need time to consider the possibility and viability of accepting offers, it may not be reasonable to expect that an immediate acceptance take place in the same session. This means a businessperson who is not present at the same place with the seller may send their *qubul* using modern communications (e.g., email, telephone or letter), which replaces the presence of the absent party in the session. This is acceptable within the contextual analysis of shariah.

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<sup>83</sup> Baker, above n, 5.

<sup>84</sup> Jalil and Rahman, above n 73, 175.

<sup>85</sup> Al-Hilali and Khan, above n 60, 171; Alzuhaili, above n 30, 20.

The unity of the meeting gives each party the right to withdraw or cancel the agreement before either of them leaves. This is explained in one Hadith, which states that the buyer and the seller have the option of cancelling their contract as long as they have not separated and left the place of the agreement.<sup>86</sup> As Islamic finance is mainly based on sales contracts, this Hadith indicates that the right to withdraw or cancel the contract is a very important element.

The right to withdraw or cancel the contract is provided only under the rules of option. In the option, each party can choose to have a cooling-off period during which they can cancel the contract, allowing them to ensure there is no problem with the object. The buyer also has the option to cancel the contract before acquiring the object if there is any defect in it, whether it existed before or after the sale. The option, in this case, is the option to see the object, which allows the buyer the opportunity to accept or refuse it upon seeing it.

### **2.5.2.3 Consideration in the Contract**

The object of sale in a contract must exist, be legally tradable, have legal value and be deliverable. Additionally, the object must be legally owned by the seller. Further, the contract has the consent and consideration of all parties—and is valid—if it is not affected by undue influence, fraud, coercion, misrepresentation or related legal ambiguities.<sup>87</sup> For example, if someone sells their car to another person for \$10,000 while the market value of the car is \$12,000 the contract is valid as long as they sell the car with free consent and without undue influence or coercion. As long as the contracting parties freely consent to the agreement and its conditions, there does not need to be any defined consideration to validate the contract.<sup>88</sup> Of course, if a gift offered by a friend to another according to social practice is deemed a valid contract and free from fraud, coercion or the like, it does not require consideration; therefore, as the consideration is not counted in the gift, the donor cannot request the gift be returned on the ground of lack of consideration.

Thus, although consideration is usually required, there are exceptions to this general rule in certain specific circumstances. Take the example of a husband who leaves his wife to stay in another country and promises to pay her \$2,000 every month for living expenses and their children's education. If the wife accepts, this promise would be enforceable against the husband if he failed to pay every month. According to the principles of shariah law, this *qubul* is valid without consideration and the husband has a legal duty to provide for the family while he is married.

### **2.5.2.4 Intention to Create Legal Agreement**

Under shariah law, it is important that there be an intention to create a legal agreement. A contract without the intention to create a legal relationship is considered void and unenforceable. This emphasises the the

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<sup>86</sup> Muhammad bin Ismail Abu Abdullah Al-Bukhari, *Sahih Al-Bukhari* (Muhammad Muhsin Khan trans, Darussalam, 1997) vol 1.

<sup>87</sup> Baker, above n 5.

<sup>88</sup> Jalil and Rahman, above n 73, 175.



importance of obtaining consent that reflects the intention of the contracting parties. Understanding the purpose of the financial transaction depends on knowing the intention of the parties. This is demonstrated in the Hadith, which say ‘*actions are but by intentions*’.<sup>89</sup> This demonstrates the prime importance of intention in the formation of a contract according. If one party claims there was no intention to create a legal relationship, that party is required to prove this beyond doubt.

#### **2.5.2.5 Content of Contract (‘urf)**

Contracts can be based on customs that people have used in their business dealings for a long time. This custom is treated the same as a contract formed through a verbal *ijab* and *qubul*. Based on this principle, when there is no clear guidance in Islamic law regarding problems arising from disputes between the parties to the contract, it will be referred to custom for an answer. For example, if a wholesaler displays a label clearly showing that a kilogram of sugar is \$2 and the buyer gives this amount to the seller without uttering a word and takes the kilogram of sugar, nonverbal communication has taken place between the two parties and the contract is considered complete according to the custom known to both parties. In this sense, custom can be used to interpret contracts.

This is relevant in the example of one Hadith about which jurists disagree: ‘*The Prophet forbade a sale and stipulation, the Prophet forbade a sale and a loan, the messenger of God forbade two sales in one sale*’.<sup>90</sup> In interpreting this Hadith, the Shafi and Hanfi schools restrict the stipulations in the contract to those that are socially acceptable, suit the contract’s purpose or are necessary for its operations. If the conditions of the contract are customarily unknown and benefit only one of the parties, it is considered an invalid stipulation, which invalidates the contract, as it benefits one party while excluding the other. Conversely, the Maliki and Hanbali schools reject the singularity of the contract and support instead the validity of the stipulations by stating that the invalid stipulations are the only exceptions. They argue that the avoidable stipulations are only those specifically mentioned in the Hadith. This implies that the a contract’s stipulations are valid unless they are specifically prohibited by shariah law or contradict the purpose or the intent of the parties.

#### **2.5.2.6 Legal Capacity of the Contracting Parties**

Conducting a valid sale contract requires mental capacity and the free choice and consent of the contracting parties. To be eligible to enter an agreement, both parties must reach the age of prudence and puberty that shows they have reached both mental and physical maturity. The competency of the contracting parties depends on their legal capacity to reach both physical and intellectual maturity, indicating the capacity for sound judgement in financial matters. In this sense, Islamic law emphasises the importance of the mental and

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<sup>89</sup> Bukhari, above n 89, 5.

<sup>90</sup> Ibid 328.

physical capacity of the contracting parties by requiring them to be adults who understand the contract in question<sup>91</sup>.

Concerning the legal capacity of the legal entity, which is one of the important elements in the common law concept of separation of the legal entity of a company once is incorporated, is considered a person. However, in Islamic law, there are different views concerning the legal entity of a company. The traditional view of the Islamic jurists is that the principle of separate legal entity does not exist in Islam, because a company that is regarded as a person is only an artificial person, and cannot hence engage in any commercial transaction.<sup>92</sup> Besides, if the company becomes insolvent, the creditors have only the rights over the assets of the company that registered under the fictitious person whereby if the assets are not enough to settle the debt amount, it is simply cannot be claimed from anyone and will be written off. Given this, the Islamic financial institutions in Malaysia incorporated under section 16(5) of Companies Act 1965 are treated as a separate legal entity, enabling them to enjoy the rights and liabilities of a legal person.<sup>93</sup> This conforms with the concept of *Urf* (customs) that accepts the practices of people in a particular geographical area or a country to be considered as unwritten laws that can be incorporated into the local laws. This implies the separation of the company from its owners and considering it an independent legal person that represented by its directors, is a contemporary custom that the Islamic law should accept it as part of the domestic law as far as it does not contravene with the principles of the Shariah law.

#### **2.5.2.7 Legality of the Contract**

To form a contract and accept its conditions and terms, the parties must be free from any undue influence, fraud or coercion, any of which would invalidate it. On this topic, the Quran (4:29) states, '*O ye, who believe, squander not your wealth among yourselves in worthless dealings, but let there be trade by mutual consent*'.<sup>94</sup> On this basis, it is forbidden to take other people's property without their consent. The emphasis the Quran and the Hadith place on the importance of mutual consent in trade and business transactions demonstrates that the consent of the parties to a contract by their own free will is fundamental to the principles of Islamic law. As a result, it is mandatory that contracts be consistent with public policy and mandatory rules that safeguard community interest; likewise, public policy cannot be violated by the agreement's terms and conditions. This means that under shariah law, any contract that includes terms and conditions that violate public policy is considered invalid. In this sense, the conduct of financial transactions cannot be separated from faith and the

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<sup>91</sup> Wahbah Alzuhayli, *Islamic Contemporary Financial Transactions* (Dar Elfikri Almu'asir, 2002) vol 1.

<sup>92</sup> Ibid.

<sup>93</sup> Zainal A Zuryati, Mohamed Yusoff and Ahmad N Azrae, 'Separate legal entity under Syariah law and its application on Islamic banking in Malaysia: A note' (2009) 6(2) *International Journal of Banking and Finance* 139.

<sup>94</sup> Muhammad Taqi-ud-Din Al-Hilali and Muhammad Muhsin Khan, *Noble Quran* (King Fahd Complex for the Printing of the Holy Quran, 1996).

general interest of the public. Any violation may contravene public policy and, by consequence, shariah principles.

### 2.5.3 Disputed Contracts

#### 2.5.3.1 Tawarruq

*Tawarruq*, as described previously, is the sale of an asset to a purchaser for a deferred payment, in which the purchaser then sells the asset to a third party on cash for a smaller price than the deferred price. The purpose of this transaction is to acquire cash. For example, a customer in need of cash might purchase certain commodities from a bank at a price higher than the spot price on a deferred payment basis; then, the customer asks the bank as their agent to sell the same asset to a third party at its spot price and receives the proceeds of the sale. Alternatively, the customer could sell the asset to a third party directly and receive the sale proceeds from the purchaser of the asset.<sup>95</sup> In another scenario, a bank—seeking to assist its customers to obtain needed liquidity—might buy a commodity from a supplier and then sell it to the customer at a price that includes the cost of the commodity plus a profit margin on a deferred basis. In return, the customer, with the bank as their agent, sells the commodity at the spot price and receives the cash they need.

*Tawarruq* contracts involve three parties; for example, the bank, the customer who purchases it from the bank on credit, and the one who purchases the commodity from the customer at the spot price for cash.<sup>96</sup> For example, a customer, who needs \$1000 cash today, they might buy a commodity from the bank for \$1200 on credit, payable after five months, and then instantly sell it to a shop in Werribee on spot for \$1000. In this transactions, the customer gets the \$1000 they need today and, after five months, pays the debt of \$1200 to the bank. In such a transaction, the customer has no intention of using or benefiting from the asset; they merely want to obtain cash.

Most Muslim scholars have approved *tawarruq* as long as it does not involve a prior arrangement by the parties and the resale of the object is to a third party—not a buyback arrangement with the original seller (as in *bai al-inah*). Ahmed bin Hanbal, the founder of the Hanbali school has allowed both *tawarruq* and *bai al-inah* as long as the customers involved are really in need of cash and the rich are reluctant to lend it. In these cases, needy people can acquire cash by putting higher prices on the deferred payment against the lower price in cash. The AAOIFI also maintains this stance. Shariah scholars and experts in Islamic finance advise that *tawarruq* may only be used where there is an unavoidable need for liquidity in the corporate sector.

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<sup>95</sup> Gholamreza Zandi, Noraini Mohd Ariffin and Alireza Shahabi, ‘Some Issues on *murabaha* Practices in Iran and Malaysian Islamic Banks’ (2012) 6(24) *African Journal of Business Management* 7066.

<sup>96</sup> Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons, 2007).

### 2.5.3.2 Bai Al-inah

*Bai al-inah*, as previously described, involves the sale of an asset that is later repurchased at a different price in which the deferred price is higher than the cash price. *Bai al-inah* transactions typically involve an agreement between a bank and a customer for the customer to sell assets or goods they own to the bank at a spot price and then immediately purchase back the asset from the bank on credit at a higher price. Alternatively, a bank might sell an asset to a customer on a deferred payment basis with a mark-up and then buy it back from the customer at a lower price for a cash payment.<sup>97</sup> In such a contract, the bank agrees to purchase an asset from the customer and simultaneously resell to the customer subject to the terms and conditions.<sup>98</sup> As in *tawarruq*, the objective of the customer in a *bai al-inah* transaction is merely to obtain cash.

For example, a customer who wants cash may sell their car to the bank on credit for one year for \$12,000 and then simultaneously purchase the same car back from the bank for \$10,000 cash. The customer receives \$10,000 immediately and has to pay \$12,000 after one year. Similarly, the bank extends \$10,000 to the customer immediately and receives \$12,000 back after one year, which makes the difference of \$2000 the interest on the loan extended by the bank to the customer. Alternatively, a customer might sell their car to the bank for \$10,000 and then buy it back from the bank on credit for \$12,000 payable after one year. In *bai al-inah* there is a simultaneous double sale of the same commodity between the bank and the customer and the original underlying commodity eventually returns to the original owner due to the buyback nature of the sale.

*Bai al-inah* is controversial and has been fiercely criticised by scholars as a sham and not a true *murabaha* transaction. *Bai al-inah* contracts are considered bridges constructed to obtain loans. Most Muslim jurists consider *bai al-inah* impermissible contracts aimed to obtain liquidity or cash money based on a contract of sale that is not a real sale contract, but instead of a legal ruse employed to circumvent the prohibition of *riba*.<sup>99</sup>

That said, some scholars, including abu Yusuf from the Hanafi school and some scholars of the Shafi school are of the opinion that this sale is permissible. Additionally, as described above, Ahmed bin Hanbal allows *bai al-inah* when people are really in need of cash and the rich are reluctant to lend it. In these cases, needy people can get cash by putting a higher price on the deferred payment against the lower price in cash.

### 2.5.3.3 Sale of Two Contracts

A sale of two contracts refers to a situation in which a contract is actually comprised of two, such as when someone offers to sell one of two items without specifying which. Because they cause uncertainty in the deal, these sale of two contracts are prohibited under Islamic law. These contracts are prohibited by the Quran and the Hadith. The Prophet clearly banned the incorporation of two contracts into one contract and two

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<sup>97</sup> Khir, Gupta and Shanmugam, above n 39.

<sup>98</sup> Ayub, above n 97.

<sup>99</sup> Alzuhayli, above n 30.

transactions into one transaction. According to Imam al-Shafi, they are forbidden because of the uncertainty they involve. He pointed out that if someone is willing to buy an asset for \$100 on the condition that he lends \$100 to the seller, then the actual price in the sale and purchase contract is a combination of the money and the lending benefits received by the seller.

These sales either involve two prices in one settlement or two contracts at a time. One example would be an offer to sell a commodity for \$1000 in cash or \$2000 in debt. This is prohibited according to shariah law because the actual price of the transaction is unknown, it has *gharar* elements and neither the benefits of the transaction nor its size are clear. But if the buyer chooses one of the two options—buying in cash or buying in debt—then the sale and purchase is permitted.

Islamic law also forbids the inclusion of multiple contracts in a contract when they have different legal provisions (e.g., in the sale contract and the purchase contract). An example of this would be a seller offering to sell an item for \$10,000 to someone already in their debt on the condition that the purchaser pay their debt of \$10,000. Similarly, someone might pay a debt and then buy something from the creditor at a higher price than the real value of the goods.<sup>100</sup> In another scenario, someone may give a few dollars of debt to the creditor and the debtor borrows something to the creditor then says, ‘If you cannot afford to pay the debt, then the goods are sold to me with a few dollars instead.’ In these examples, an element of *gharar* is introduced by the unknown price, uncertain payment method and the ambiguity regarding whether the goods are acquired after the sale in the first contract or after the second deal; as such, these transactions are prohibited by shariah law.

## 2.6 Financial Regulatory System

The effective regulation of IFIs is as necessary and desirable in Islamic banking as it is in the conventional banking system.<sup>101</sup> As the risks of Islamic banking are the same as in the conventional banking system, the goal of applying prudential regulation and supervision to financial activities is the same in both: to maintain financial stability by ensuring the safety and reliability of financial institutions. This prevents systemic consequences and ensures the stability of the financial system.

IFIs cannot claim to be providing shariah-compliant financial products or services unless they set up shariah boards or committees consisting of reputable, qualified scholars with the necessary skills. As such, IFIs are required to follow the standards set by shariah advisory or supervisory boards or rules established by Islamic financial regulatory bodies.

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<sup>100</sup> Syed Faiq Najeeb, ‘Trading in Islam: Shari’ah Rules and Contemporary Applications in Islamic Financial Transactions’ (2014) 2(2) *Journal of Emerging Economies & Islamic Research*.

<sup>101</sup> Errico and Farahbaksh (1998), 11.

The following section provides a general overview of the Islamic financial regulatory system. It gives an overview of the Islamic regulatory systems in three Islamic countries that are pioneers in Islamic finance and banking: Sudan, Iran and Malaysia. It then discusses international Islamic finance regulatory bodies and, lastly, SSBs.

### **2.6.1 Overview of the Islamic Financial Regulatory System**

The infrastructure of Islamic finance—including standards-setting and regulatory institutions—is in the process of catching up with the rapid growth of the Islamic financial industry. Over the last 30 years, various international standards-setting institutions have been established to guide the operations of the industry. The AAOIFI, based in Bahrain, started issuing accounting, auditing and shariah standards for financial reporting in 1991. In 2001, the Bahrain-based International Islamic Financial Market was mandated to develop guidelines for the issuance of IFIs and to encourage active secondary market trading. The Islamic Financial Services Board (IFSB), established in Malaysia in 2002, is also responsible for issuing supervisory and regulatory standards and guidelines. The IFSB also promotes the adoption of these standards and guidelines by relevant regulatory authorities. Most recently, in 2010, the Malaysia-based International Islamic Liquidity Management Corporation started issuing short-term shariah-compliant financial instruments to facilitate cross-border Islamic liquidity management.

Islamic financial products and IFIs must be approved by SSBs or regulatory bodies. Without approval, financial products cannot be marketed as shariah-compliant products. Approval requires financial institutions to follow the guidelines of the regulatory bodies and for specialised shariah scholars to ensure the compliance of their products.

#### **2.6.1.1 Sudan**

Sudan has a fully-fledged Islamic financial system. The Faisal Islamic Bank was established in Sudan in 1977, an event that was followed by the opening of another five Islamic banks in the 1980s: Al-Tadamum Islamic Bank, Sudanese Islamic Bank, Islamic Cooperative Bank, Al-Baraka Bank and the Islamic Bank of Western Sudan. However, the first effort to align Sudan's entire banking system with shariah principles began in 1984 and the country's financial system became fully shariah-compliant in the early 1990s, when the Bank of Sudan issued the *Banking Business (Organisation) Act 1991*. This Act stated that all banking finance transactions for all banks in Sudan to be must managed according to shariah principles. For this reason, the government established the Higher Shariah Control Commission in 1992 as a regulatory body that oversees the Islamic banking system and ensures the compliance of the financial industry with shariah principles.<sup>102</sup>

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<sup>102</sup> Hussain, Shahmoradi and Turk, above n 11.

The Sudanese government passed the *Supervision and Control Act 1992* for the supervision and control of the insurance sector, making it mandatory for all insurance operations in the country to comply with shariah principles and repealed the *Controller of Insurance Act 1960*. More detailed legislation was adopted in 2001, which was further expanded with the *Insurance and Takaful Act 2003*.<sup>103</sup> This Act was introduced to describe the scope, subjects and parties of insurance and *takaful* contracts to be used as a reference in the courts of law.

#### **2.6.1.2 Iran**

Iran also has a fully-fledged Islamic financial system. Iran has been a pioneer in both the theoretical and the operational aspects of Islamic banking. As in Sudan, there were three phases in the Islamisation of the Iranian banking system. The Central Bank of the Islamic Republic of Iran was established immediately after the 1979 Islamic revolution and its scope and responsibilities were defined in the *Monetary and Banking Law of Iran*. The period from 1979 to 1982 marked the first phase of the Islamisation process, during which the banking system was nationalised, restructured and reorganised. The second phase began in 1982 and lasted until 1986. The defining moment for Islamic banking in Iran in this period was the approval of the *Riba-Free Banking Act 1983* and its implementation in 1984.<sup>104</sup> The third phase began in 1986; however, Iranian government gave banks one year to convert their deposits to the new system and three years to convert all other operations.<sup>105</sup>

Through this process, Iran unified its banking and finance industry under shariah principles and based on *riba*-free practices. It mandates that all banks and financial institutions follow strict Islamic principles and considers all conventional banking to go against the teachings of the Quran.

#### **2.6.1.3 Malaysia**

Malaysia has the most comprehensive and progressive Islamic financial system in the world. It has a legislative framework consisting of mixed jurisdictions and mixed legal systems of both common law—which originated in England—and shariah law. Common law is applied in the civil courts and Islamic law is used in the shariah courts on issues pertaining to the family and inheritance. Thus, the *Malaysian Federal Constitution* puts Islamic banking and finance under the jurisdiction of the civil courts. It has been necessary for Malaysia to develop harmony between shariah law and common law to support the implementation of Islamic banking without compromising the ethical rulings stipulated in the Quran and the Sunnah or general Islamic principles pertaining to justice and equality in financial transactions.

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<sup>103</sup> Ibid.

<sup>104</sup> Farhad Nili, 'Islamic Banking and Finance' in Sasikala Thiagaraja et al (eds), *The Islamic Finance Handbook: A Practitioner's Guide to the Global Markets* (John Wiley & Sons, 2014) Ch 11, 175.

<sup>105</sup> Ahmad Alharbi, 'Development of the Islamic Banking System' (2015) 3(1) *Journal of Islamic Banking and Finance* 12.

This harmonisation strengthens the legal infrastructure of Islamic banking by ensuring the common law principles in contract law are in line with shariah principles. It also ensures that participants in the Islamic banking and finance industry comply with both shariah principles and common laws.<sup>106</sup>

In 1983, the Malaysian government introduced a dual banking system in which Islamic banking is practiced alongside the existing conventional banking system. Then, in 1993, the Central Bank of Malaysia introduced the Interest-Free Banking Scheme, a program that allowed conventional banks to offer Islamic banking products through Islamic windows.<sup>107</sup> This harmonisation is necessary for when disputes between two or more parties about Islamic financial transactions are brought to the court. This enables these disputes to be heard in the civil court according to the *Constitution*.

This development is facilitated and supported by legal infrastructure through several pieces of legislation and directives (e.g., the *Islamic Banking Act 1983*, the *Banking and Financial Institutions Act 1989* and the *Central Bank of Malaysia Act 2003*). The *Central Bank of Malaysia Act 2003* (CBA) outlined the framework for supervising and monitoring the implementation of Islamic banking. The CBA states that the national Shariah Advisory Council (SAC) should be the sole authorities to be referred by the civil courts for issues related to Islamic banking and finance.

## **2.6.2 Accounting and Auditing Organisation for Islamic Financial Institutions**

The AAOIFI presents itself as the leading regulatory and standards-setting body for Islamic financial products and services. It is based in Bahrain and after more than two decades is considered the oldest and most important Islamic financial regulatory body involved in standardising the accounting and auditing practices of IFIs.<sup>108</sup> The AAOIFI has been issuing accounting, auditing and shariah standards for the financial reporting of IFIs Since 1991.<sup>109</sup>

The AAOIFI's board is composed of members representing all major Islamic schools of thought and major geographic regions in the Islamic world (e.g., South-East Asia, South Asia and the Middle East). With this diverse representation, it provides an international perspective and rounded solutions for Islamic financial products. The AAOIFI reviews financial products and financial services provided by the IFIs for shariah compliance to ensure standardisation. It also offers training. The AAOIFI claims that almost all jurisdictions follow its accounting standards and about 16 jurisdictions follow or consult its other standards on overseeing shariah governance, compliance and supervision.

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<sup>106</sup> Mohammad Hashim Kamali, 'Shari'ah and civil law: Towards a methodology of harmonization' (2007) 14(3) *Islamic Law and Society* 391.

<sup>107</sup> Ahmad Ibrahim, 'Legal Framework of Islamic Banking' (1997) 1 *IKIM Law Journal* 23.

<sup>108</sup> Scott R Anderson, 'Forthcoming Changes in the Shari'ah Compliance Regime for Islamic Finance' (2010) 35 *The Yale Journal of International Law* 237.

<sup>109</sup> The AAOIFI has issued more than 88 accounting and governance standards for Islamic financial institutions.



The AAOIFI has issued 56 standards for financial accounting, auditing and other governance issues. Most IFIs follow its accounting and auditing standards or consult its other standards; however, these standards are not yet unified and IFIs take them only as guidelines for structuring their financial products. For example, although AAOIFI standards have been adopted in Bahrain, Jordan, Qatar, Sudan and Syria as well as by the IDB and the Dubai International Financial Centre, Malaysia and Pakistan have their own national accounting standards and take the AAOIFI standards only as guidance.

The goal of the AAOIFI to establish homogenous standard for Islamic financial products across a range of different geographical locations and Islamic markets has not yet been realised. This is because of different schools of thought and cultural differences between Islamic countries. Additionally, as these standards are only guides for IFIs, the AAOIFI has left room for every institution to develop its own products within this established framework.

### **2.6.3 Islamic Financial Services Board**

The IFSB was established in Malaysia in 2002 to issue supervisory and regulatory standards and guidelines for IFIs.<sup>110</sup> It is an international institution that designs and publishes shariah-compliant standards to enhance the health and stability of the Islamic financial services industry. These include guidelines for the banking, insurance and capital sectors.

The IFSB is also the leading body regarding the prudential conduct of IFIs and has developed prudential standards for the Islamic financial services industry regarding risk-management, capital adequacy, corporate governance and market discipline.<sup>111</sup> By issuing standards and guiding principles for the industry, which it broadly defines as including the banking, capital markets and insurance sectors, the IFSB aims to promote and enhance the Islamic financial services industry. It has also made pronouncements on risk-management, capital adequacy, corporate governance, supervisory review processes, transparency and market discipline, recognition of ratings on shariah-compliant financial instruments and the development of money markets. Further, the IFSB undertakes training programs for workers in IFIs, including central bank officials and financial experts.

The *IFSA* was a significant step away from the previous legal framework for Islamic finance. It introduced provisions regulating IFIs financial holding companies, made shariah-compliant risk-management a statutory duty, strengthened requirements for end-to-end shariah governance and increased customer protection. The consequences of breaches are severe and the *IFSA* grants wide powers of intervention to the Central Bank of Malaysia. The *IFSA* and the shariah and operational standards issued under it by the Central Bank of Malaysia provide clarity for the application of shariah-compliant financial contracts for Islamic financial products.

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<sup>110</sup> The IFSB has issued more than 17 regulatory and prudential standards and six guidelines.

<sup>111</sup> Bell, above n 38, 362.

There is a mandatory separation between deposit accounts, which guarantee customers' deposits and investment accounts, which do not. This requirement gave IFIs an expanded role in investment intermediation beyond their current role in credit intermediation. The increased focus on shariah-compliant contracts is also expected to spur product innovation and diversification. The *IFSA* also requires that *takaful* (Islamic insurance) operators that run dual *takaful* businesses split their operations into family and general *takaful* businesses. The segregation of family and general *takaful* licensing and businesses by 2018 was expected to strengthen the *takaful* sector. In supporting Malaysia's aspirations to establish itself as a regional leader in Islamic finance, the Securities Commission Malaysia also released the *Capital Market Masterplan 2001–2010* and the *Capital Market Master plan 2011–2020*<sup>112</sup>.

While the efforts undertaken by the IFSB have produced some fruit, its standards have not been widely accepted because IFIs tend to follow the *fatwas* (legal opinions) of their own regional shariah scholars. For instance, IFIs in the Gulf States follow scholars from that region, while South-East Asian IFIs follow their own shariah scholars. The different opinions of these shariah scholars yield different results for financial products. For example, Gulf State-based shariah scholars criticise some market-friendly financial products approved by their counterparts in South-East Asia. Given the disagreement among Islamic schools and the lack of a central regulatory body that governs and provides Islamic financing, the International Association of Islamic Banks (IAIB) requires its members to have their own SSBs that interpret shariah principles on contemporary Islamic financial contracts, intended to make this practice normative for all members.<sup>113</sup> Because of the lack of a central body, individual IFIs rely on their SSBs to verify the shariah compliance of their products.

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<sup>112</sup> Securities Commission, *Capital market masterplan 2001-2010*, Securities Commission: Kuala Lumpur, Malaysia.

<sup>113</sup> De Jonge, above n 46; Shaykh Yusuf Talal DeLorenzo, 'Shariah Compliance Risk' (2006) 17(2) *Chicago Journal of International Law* 397.

<sup>114</sup> The IFSB has issued more than 17 regulatory and prudential standards and six guidelines.

<sup>115</sup> Bell, above n 38, 362.

recognition of ratings on shariah-compliant financial instruments and the development of money markets. Further, the IFSB undertakes training programs for workers in IFIs, including central bank officials and financial experts.

The *IFSA* was a significant step away from the previous legal framework for Islamic finance. It introduced provisions regulating IFIs financial holding companies, made shariah-compliant risk-management a statutory duty, strengthened requirements for end-to-end shariah governance and increased customer protection. The consequences of breaches are severe and the *IFSA* grants wide powers of intervention to the Central Bank of Malaysia. The *IFSA* and the shariah and operational standards issued under it by the Central Bank of Malaysia provide clarity for the application of shariah-compliant financial contracts for Islamic financial products. There is a mandatory separation between deposit accounts, which guarantee customers' deposits and investment accounts, which do not. This requirement gave IFIs an expanded role in investment intermediation beyond their current role in credit intermediation. The increased focus on shariah-compliant contracts is also expected to spur product innovation and diversification. The *IFSA* also requires that *takaful* (Islamic insurance) operators that run dual *takaful* businesses split their operations into family and general *takaful* businesses. The segregation of family and general *takaful* licensing and businesses by 2018 was expected to strengthen the *takaful* sector. In supporting Malaysia's aspirations to establish itself as a regional leader in Islamic finance, the Securities Commission Malaysia also released the *Capital Market Masterplan 2001–2010* and the *Capital Market Master plan 2011–2020*.

While the efforts undertaken by the IFSB have produced some fruit, its standards have not been widely accepted because IFIs tend to follow the *fatwas* (legal opinions) of their own regional shariah scholars. For instance, IFIs in the Gulf States follow scholars from that region, while South-East Asian IFIs follow their own shariah scholars. The different opinions of these shariah scholars yield different results for financial products. For example, Gulf State-based shariah scholars criticise some market-friendly financial products approved by their counterparts in South-East Asia. Given the disagreement among Islamic schools and the lack of a central regulatory body that governs and provides Islamic financing, the International Association of Islamic Banks (IAIB) requires its members to have their own SSBs that interpret shariah principles on contemporary Islamic financial contracts, intended to make this practice normative for all members.<sup>116</sup> Because of the lack of a central body, individual IFIs rely on their SSBs to verify the shariah compliance of their products.

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<sup>116</sup> De Jonge, above n 46; Shaykh Yusuf Talal DeLorenzo, 'Shariah Compliance Risk' (2006) 17(2) *Chicago Journal of International Law* 397.

### 2.6.1 Shariah Supervisory Boards

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## 2.7 Concluding Remarks

Islamic law is the combination of a civil code represented by the Quran and Sunnah and a common law system created by jurists through *ijtihad*, *qiyas* and other supplementary legal sources. Islamic law stipulates the rights and obligations of parties to financial contracts through interpretation of the Quran and the Sunnah. Jurists have established a range of other legal principles for validating legal opinions on topics not addressed in either the Quran or the Sunnah. The opinions of these jurists represent a natural extension of human understanding of the Islamic legal sources. When the Quran or the Sunnah become silent or do not provide adequate answers on specific topics, Islamic jurists turn to *ijmah*, *qiyas* or *ijtihad* to develop rules that can be applied to contemporary matters, such as financial transactions. Scholars have also developed other supplementary legal sources, such as *istihsan*, *maslaha* and *urf* to provide support to the main legal sources.

Through recognition of these supplementary legal sources, shariah law has created a platform for the expression of diverse scholarly opinions, enabling them to be both flexible and responsive to the needs of and changes within society. The result of this diversity is that scholars have different opinions on the same issues; such differences stem from their different approaches to the interpretation of legal principles based on their membership in different schools of law and divergent cultural backgrounds. These differences prompted the formation of the Sunni and Shiite schools of law and four separate schools of law within the Sunni school. While the Sunni and Shiite schools share common grounds on the fundamentals of shariah law, they differ in their interpretations on some issues.

These differences have consequences for Islamic banking and finance because the validation of transactions depends on who they are interpreted by and in which environment this takes place, which may affect *murabaha* contracts and their operations in the financial market. Some Islamic jurists consider these differences to be

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<sup>119</sup> De Jonge, above n 46; Shaykh Yusuf Talal DeLorenzo, 'Shariah Compliance Risk' (2006) 17(2) *Chicago Journal of International Law* 397.

positive in the development of Islamic law, while others consider them to be sources of potential damage and, consequently, suggest the establishment of a framework that can synthesise and bridge these differences.

To be shariah-compliant, Islamic financial contracts and transactions must not contravene either the principles and objectives of Islamic finance or domestic laws. On this basis, an appropriate legal and regulatory framework for accommodating these dual legal systems is a basic requirement for establishing and operating sound IFIs and markets. As such, the discussion now turns to an examination of the theory and principles of Islamic finance.

## CHAPTER 3: THEORY OF ISLAMIC FINANCE

### 3.1 Introduction

Islamic financial theory is based on cooperative participation in enterprise and the establishment of equitable relationships between financiers and entrepreneurs through the unification of money and the real economy. It bridges financial activities and the real economy through cooperation between capital suppliers and customers and considers economics, finance and matters related to social life together.<sup>120</sup> On this basis, Islamic law prohibits charging interest on loans, receiving interest from deposits, any financial transactions that involve *gharar* and any business activities that are unlawful according to shariah principles. These elements represent the framework for permissibility and impermissibility in financial dealings with which IFIs are expected to comply.

This chapter discusses the principles that distinguish Islamic finance from conventional finance, issues of ownership in *murabaha* contracts, issues regarding promises to purchase in *murabaha* contracts, *gharar* and the main approaches within Islamic finance.

### 3.2 Principles of Islamic Finance

Islamic financing, which is a part of Islamic economics more broadly, is guided by the main tenets of shariah law to forbid *riba*, *gharar*, unethical activities and unlawful financial transactions. At its core is the principle of equity, which is the reason for the prohibition of *riba*—the weaker contracting party in any financial transaction should be protected. The principle of equity is also the basis for the prohibition of *gharar* as manifested by ambiguity in contracts or elusiveness regarding outcomes. The principles of equity and wealth distribution are the basis for the *zakat*—a 2.5 per cent levy on cash or in-kind wealth imposed by shariah law on all Muslims who meet specific minimum levels of income and wealth—which is intended to assist the less fortunate and foster social solidarity.

Although, Islamic finance is commonly known as interest-free financing, the prohibition of *riba* does not mean that capital is not to be rewarded. According to shariah principles, rewards—profit—come with risk-taking; consequently, return on investments has to be earned in tandem with risk-taking, not with the mere passage of time. By disallowing *riba*, Islamic law requires the capital supplier to share the risk and return with the borrower rather than guaranteeing a return without incurring any risk. Returns on capital are legitimised by risk-taking based on *ex post* asset performance or project productivity and the links between financing activities and real activities. This ensures that increases in wealth accrue from productive activities. Further, the principle of ownership and the shariah prohibition against selling things that the seller does not own mandate ownership of assets prior to the execution of contracts. For these reasons, Islamic finance is known

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<sup>120</sup> Dar and Presley, above n 26, 1.

as an asset-based financing system that links finance and the real economy. This chapter focuses on the underlying legal principles of Islamic finance that differentiate it from conventional finance.

### 3.2.1 The Prohibition of *Riba*

*Riba* describes any increase or growth from an original size, whether in quality or quantity. In the Quran, it refers to any prohibited earnings (e.g., receiving more than the principal loan amount against the time of a loan). The Quran specifically uses *riba* to describe illegal earnings, such as those from bribery, and usually refers to *riba* in the context of debt;<sup>121</sup> conversely, the Hadith refer to *riba* in the context of sales.<sup>122</sup> The Quran not only denounces *riba*, but also urges wealthy people to provide charity to needy people or lend to them without charging interest on loans. As such, borrowers are only required to pay back the principal amount without paying any *riba*. Although it was common practice in the early days of Islam for *riba* to be charged on loans when a borrower could not pay a debt on the due date and requested an extension, it was unknown for *riba* to be charged at the beginning of the contract. Later, using *qiyas*, Islamic jurists extended the scope of *riba* to prohibit any interest that was determined at the beginning of a contract.

In extending the scope of *riba*, Islamic jurists defined it to mean any increase or predetermined return over and above the principal amount of a loan, whether at the beginning or the end of the loan.<sup>123</sup> They also considered *riba* any unfair gain obtained through the exchange of specific homogeneous goods mentioned in the Hadiths of the Prophet, such as gold, silver, wheat, dates, salt and barley.<sup>124</sup>

To this end, jurists categorise *riba* one of two ways: *riba al-nasiah*, in which money is exchanged for money with deferment and which relates to debt on deferred payments, and *riba* would be lawful where money is exchanged for money hand-to-hand, but in different quantities and related to exchange of commodities through sale transactions.

#### 3.2.1.1 *Riba al-nasiah*

As Islam promotes justice, morality and the protection of less fortunate people, it prohibits *riba al-nasiah*—the form of interest that pre-Islamic Arabs used to charge on loans. The Quran usually refers to *riba* in the context of debt, which is akin to the contemporary banking practice of charging interest over the course of a loan. Before Islam, when a debt became due and the borrower was unable to pay it on time, the borrower would say to the lender, ‘*extend the time to pay the debt for me, and I will add an extra amount to your wealth*’.<sup>125</sup> This interest could be double the original amount of the loan depending on how many times it was

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<sup>121</sup> Translated by Abdullah Yusuf Ali, *The Holy Qur'an: Original Arabic Text with English Translation & Commentary* (Saba Islamic Media, 2000).

<sup>122</sup> Abu Abdullah Mohamed bin Ahmed bin Abi Bakar Al-Qurdubi, *Jami Ahkam Alquran* (Al-Resalah Publishers, 2006) vol 4.

<sup>123</sup> Aljasiiri, above n 83.

<sup>124</sup> Siddiqi, above n 12, 1.

<sup>125</sup> Al-Qurdubi, above n 122, 378.



extended. A Hadith narrated by Jabir ibn Abdullah mentioned that the Prophet in his last speech, at the farewell pilgrimage, said: ‘*all contracts of riba [before Islam] are null and void*’.<sup>126</sup> This Hadith suggests that the common practice before Islam was to charge interest on loans as a standard condition of a financial agreement. From the beginning, the Quran condemned the practice of *riba* and reminded Muslims of the prohibition of *riba* in previous scriptures (i.e., the Torah and the Bible).<sup>127</sup> The Quran also declared that those who charged interest would be punished: ‘*taking of usury despite its prohibition, and cheating others of their properties—we made many wholesome things unlawful which were formerly lawful for them. We have prepared a painful punishment for them*’.<sup>128</sup> Moreover, the Quran (3:130–132) warned about the practice of *riba* and its injustice towards needy and vulnerable people: ‘*O you who believe! Eat not riba, doubled and multiplied; but fear Allah, that you may be successful*’.<sup>129</sup>

As can be inferred from these verses, the determination of *riba* usually occurred when debts became due and debtors were unable to pay them on time, instead requesting extensions by promising to pay *riba* against the maturity of the loan. This indicates that creditors used to charge *riba* on the principal loan amount against the extension of the maturity of the loan—at the request of the borrower—doubling or redoubling the amount depending on how many times the maturity was extended. However, when the Quran prohibited *riba*, Arab traders argued that the return was the same whether it was predetermined at the beginning of the sale contract or interest was added to the loan principal at the completion of the transaction. In response to this argument, the Quran made a distinction between the profit from a normal sale contract through trade and the *riba* that comes from advancing a loan by prohibiting returns through *riba* and allowing returns from commercial activities (e.g., the sale and purchase process). With this distinction, the Quran warns those who compare *riba* to returns from sales and defiantly practice *riba* about severe punishment in the hereafter. On this basis, increases on loans and increases on the price of sales are considered different in Islamic jurisprudence. Increases on loans result from extensions to the time of said loans, whereas increases in the price of sales come from deferred payment of the sale price.<sup>130</sup> The benefit of *riba* is limited to the financier, while the returns from a sale through trade are mutually beneficial to both parties.

### 3.2.1.2 *Riba Al-Fadli*

*Riba al-fadli* (unequal exchange of commodities) is not mentioned in the Quran; however, it is condemned in the tradition of the Prophet. Unlike *riba al-nasiah*, which relates to interest on loans, *riba al-fadli* refers to interest on sales.<sup>131</sup> In the Hadith, the term *riba* is used in reference to specific barter transactions practiced by

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<sup>126</sup> Muslim ibn Al-Hajjaj, *Sahih Al-Muslims* (Abd-al-Hamid Siddiqui trans, Dar Tibah, 2009) 651.

<sup>127</sup> Ibid.

<sup>128</sup> Abdullah Yusef Ali, *The Quran* (Tahrike Tarsile Quran, 1997).

<sup>129</sup> Ibid; Al-Hilali and Khan, above n 60.

<sup>130</sup> Al-Qurdubi, above n 122; Al-Tabari; Wahbah Alzuhailli, *Almu, amalat Almaliyah Almu'asirah* (Dar Elfikri Almu'asir, 2002) vol 1.

<sup>131</sup> Siddiqi, above n 12.

pre-Islamic Arab societies and involving certain commodities. The most cited Hadith on this topic names six *riba* commodities:<sup>132</sup> ‘Exchanging gold with gold, silver with silver, wheat with wheat, barley with barley, dates with dates, salt with salt in equal quantities and spot, anyone who increases the quantity or asks for increase indulges in *riba*, the receiver and payer are equal in this’.<sup>133</sup> This Hadith specifically refers to interest or gains obtained unfairly in the exchange of specific homogenous commodities against each other. A modern analogy to the prohibition of *riba* in the exchange of these six commodities is the consideration in Islamic law that exchanging a certain amount of Australian currency for a higher amount of Australian currency to be *riba*; however, if the consideration is different to the subject matter—such as exchanging Australian dollars for Malaysian ringgit, *riba* would not be involved in the transaction as the exchange is made on the spot.

When people exchange the same commodities against each other, shariah law requires those commodities to be equal in quantity and weight. Further, *riba al-fadli* seems to constitute *riba*, especially when it involves unfair financial dealings (e.g., cheating an unsophisticated person who is unaware of the situation of the market and can be deceived through rigging prices). That said, because it is only explicitly prohibited in the Hadith, not the Quran, some Islamic jurists have questioned whether the prohibition of *riba al-fadli* is exclusive, or was only introduced to prevent backdoor interest dealings. Some have argued that its prohibition was intended to prevent backdoor interest.<sup>134</sup> Abdullah ibn Abbas, the Prophet’s cousin and one of the best-known Quran commentators, did not disapprove of *riba al-fadli*. There are reports that indicate he did accept the view of most jurists prohibiting *riba al-fadli* at one point, there is little evidence about how and when he changed his opinion.<sup>135</sup>

Ultimately, although the Quran does not mention *riba al-fadli*, a number of Islamic schools of law—including the four main Sunni schools—hold the stance that *riba al-fadli* is prohibited interest because of its similarities with *riba al-nasiah* in terms of exploiting the weaker side in financial dealings.<sup>136</sup> In line with this view, most Islamic financial regulators including the Islamic Fiqh Council of the OIC accept the legal ruling that the Hadith regarding *riba al-fadli* applies to contemporary financial transactions.<sup>137</sup>

Although there is no debate concerning the prohibition of *riba* in Islam, there has always been some disagreement between scholars about the concept and its scope because of the word’s various meanings in Arabic.<sup>138</sup> This disagreement highlights the insufficient descriptions of *riba* given in the Quran—an ambiguity

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<sup>132</sup> Al-Hajjaj, above n 126, 38.

<sup>133</sup> Al-Bukhari, above n 89, Hadith No 158, 647.

<sup>134</sup> Abdullah Saeed, ‘The Moral Context of the Prohibition of “Riba” in Islam Revisited’ (1995) 12(4) *American Journal of Islamic Social Sciences* 162.

<sup>135</sup> Aljasiiri, above n 83, 127.

<sup>136</sup> Ibid.

<sup>137</sup> Mahmoud Amin El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance* (Rice University, 2000).

<sup>138</sup> Hassan Abdullah Al Amin, *Shariah Ruling (Hukum) on Contemporary Banking Transactions with Interest* (Islamic Research and Training Institute, Islamic Development Bank, 2000).

that has opened the door to significant differences in opinion between Muslim scholars about whether it pertains to all forms of interest in contemporary financial transactions.

### 3.2.2 The Concept of *Riba*

Unlike the conventional financial system that considers interest an indispensable function of finance, Islamic law disallows any guaranteed fixed return, receipt or payment over and above the principal amount, replacing this with the PLS principle. Islamic finance distinguishes itself from conventional finance by its ostensible prohibition of charging interest on loans, whether the borrower is in dire need or is an entrepreneur seeking to start up a business.<sup>139</sup> Instead of allowing financiers to secure fixed returns without bearing any risk, Islamic banking and finance is based on loss-sharing arrangements between lenders and borrowers. By encouraging lenders and borrowers to share the risk of financing through the PLS financing principle, Islamic law aims to unify money with the real economy by ensuring that every financial transaction is asset-backed.

In Islamic financial theory, the logic behind the prohibition of interest—unlike in the interest-based financial system—is that money has no intrinsic value and is only a medium of exchange. Therefore, Islamic financial theory does not allow the creation of wealth by money alone without the injection of effort by the capital supplier.<sup>140</sup> Islamic law considers interest on money to represent an unjustified creation of direct property rights outside the legitimate framework of recognised property rights, because as soon as a contract for lending on interest is concluded a right to the borrower's property is created for the lender. As a result, Islamic law not only disapproves of interest-based loans on the basis of their adverse impact on society but also ensures that lenders and borrowers share the rewards and losses of financing.

Unlike the conventional banking system, in which interest is imposed as a penalty for delays in the payment of loans, Islamic banks use *murabaha* trade financing, and are only entitled to the price of the goods. Additionally, there is no penalty charged on the delay of payment unless the customer has deliberately delayed payment while they are actually in a good financial position.<sup>141</sup> Consequently, for *murabaha* sale contracts to earn legitimacy, they must conceptually and operationally comply with shariah principles by avoiding charging or receiving *riba*. Thus, the main reason that interest cannot be charged upon the default of a *murabaha* contract is that *murabaha* are considered sale contracts—once the price of the sale is fixed, it cannot be increased. This means that interest cannot be charged on the loan component of a *murabaha* contract when the buyer delays payment; instead, the seller is entitled only to the price of the goods, which cannot be increased once agreed.

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<sup>139</sup> Alzuhayli, above n 30, 318.

<sup>140</sup> Masudul Alam Choudhury, 'Islamic Venture Capital: A Critical Examination' (2001) 28(1) *Journal of Economic Studies* 14, 23.

<sup>141</sup> Amr Mohamed El Tiby Ahmed, *Islamic Banking: How to Manage Risk and Improve Profitability* (John Wiley & Sons, 2010) 640.

### 3.2.3 The Scope of *Riba*

As discussed previously, there has always been some disagreement among scholars about the scope of the prohibition of *riba*. Even though IFIs regularly obtain *fatwas* from their SSBs, these *fatwas* have not yet resolved the enduring differences on this topic.<sup>142</sup> As mentioned before, throughout Islamic history, these differences in opinion have generated vigorous debate among Islamic jurists and scholars regarding whether the *riba* prohibited in the Quran includes conventional banking interest. This disagreement, which goes back to early Islamic history, revolves around the question of what kind of *riba* the Quran really prohibited. Was the prohibited interest related only to the *riba al-nasiah* that concerns lending and borrowing, or did it mean both *riba al-nasiah* and *riba al-fadli*, the latter of which involves buying and selling transactions. One view holds that originally the prohibited *riba* was only the *riba al-nasiah* that was involved in loans for money and food and does not include *riba al-fadl*. According to this view, *riba al-fadli* is simply a consequence of *riba al-nasiah*, because money can always be transformed into commodities. However, another view holds that the prohibition of interest extends to both *riba al-nasiah* and *riba al-fadli*. In this regard, the Hadith concerned with interest and the explanations given by the jurists stand as amplifications and extensions of the basic Quranic concept of *riba*.<sup>143</sup>

Most Islamic scholars maintain that the interest charged on loans by conventional banks is synonymous with the *riba* prohibited in the Quran. They insist that Islamic law disallows charging of any predetermined return on a loan that is linked to its tenure. As Chapra persuasively argued, this view is consistent with the decisions of the main Islamic regulatory bodies (e.g., the Academy of Islamic Jurisprudence, the OIC and the Pakistan Council of Islamic Ideology), all of which hold the view that the term *riba* encompasses all forms of interest, whether it relates to loans for consumption or productive purposes.<sup>144</sup> Despite this, some jurists view *riba* as only applying to usury, in which there is an excessively high rate of return. For example, Mehmet Ebusuud Efendi, the mufti of Istanbul during the Ottoman Empire (1545–1574), and Sheikh Mohammed Sayyid Tantawi, grand sheikh of Al-Azhar in Egypt (1986–2010), attempted to reinterpret interest within the framework of contemporary financial transactions.<sup>145</sup> In their views, the Quran prohibited only the sort of usury that was practiced before Islam, not the sort of interest charged by contemporary banks.<sup>146</sup> In this view, the *riba* prohibited in the Quran is the pre-Islamic sort (i.e., when the debtor could not pay on time, the creditor would give an extension on the condition that the debtor pays interest);<sup>147</sup> modern interest differs because it is mainly used for long-term trade financing rather than personal consumption. According to this argument, the

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<sup>142</sup> Mohammad Omar Farooq, 'The Riba-Interest Equation and Islam: Reexamination of the Traditional Arguments' (2009) 6(2) *Global Journal of Finance and Economics* 99; Sadiq, above n; Saeed, *Reading the Qur'an in the Twenty-First Century: A Contextualist Approach*, above n 170.

<sup>143</sup> Ziaul Haque, *Riba: The Moral Economy of Usury, Interest and Profit* (S. Abdul Majeed & Company for Ikraq, 1995).

<sup>144</sup> Mohammad Umer. Chapra, 'The Nature of Riba in Islam' (2006) 2(1) *Journal of Islamic Economics and Finance* 7.

<sup>145</sup> Al-Azhar is the highest Islamic institution in the Sunni world. It is Egypt's oldest degree-granting university and was established in 970 CE.

<sup>146</sup> El-Gamal, above n 36, 108.

<sup>147</sup> Ibid; Feisal Khan, 'How "Islamic" is Islamic Banking?' (2010) 76(3) *Journal of Economic Behavior & Organization* 805.

fixed interest that capital suppliers receive from banks or that banks receive from borrowers represents a share of profit in investment.

Similarly, Zaman argued that the conflation of *riba* and interest would be acceptable only if the meaning of the word described an excess over the principal amount. He argued this on the basis that if the word *riba* cannot provide definite meaning, it is possible that it does not cover all forms of interest. This seems to reflect the meaning of the Quran (2:279): ‘*You shall be entitled to the return of your principal, and you will do no wrong, and neither will you be wronged*’. This provides the rationale for the prohibition of interest.<sup>148</sup> Abdullah Saeed concurred with this view, arguing that the pre-modern exegetical literature ignored the last part of 2:179—‘Do not commit injustice and no injustice will be committed against you’—by failing to link it to other parties, which obscures the intended meaning of the verse. Because of this presumed missing linkage, he suggested that pre-modern Islamic scholars had neither sufficiently elaborated the concept of *riba*, nor developed a well-established theoretical framework for Islamic finance.<sup>149</sup> These arguments suggest that the *riba* prohibited in the Quran is only the pre-Islamic form, not the contemporary type of interest that conventional banks charge on loans. Further, Timur Kuran contended that the prohibition of *riba* only extends to the pre-Islamic practice of doubling a debt when the borrower could not pay on time, thus pushing them into enslavement.<sup>150</sup>

These scholars have called for the concept of *riba* to be revisited by examining whether all forms of contemporary interest charged on loans constitutes prohibited interest in the Quran. So far, despite the call to exclude modern interest from prohibited *riba* and to limit the scope of *riba* to the pre-Islamic form, Islamic banks still hold the view, prevailing among most Islamic scholars, that all forms of interest are prohibited. As a result, they overwhelmingly conduct their operations under this legalist interpretation, in which all forms of contemporary interest are prohibited as *riba*.

Given this analysis, it is important to ask whether the prohibition of interest implies a denial of the concept of the time value—a concept that is rooted in time preference and is used for investment and financial decisions.

### 3.2.4 Time Value of Goods

The concept of TV is very important in financing, planning, managing and evaluating future projects. Generally, people prefer present consumption over future consumption unless influenced by other incentives. TVM is a basic element in conventional financial theory regarding buying goods, investing and evaluating future projects and it assumes a guaranteed positive time preference where the opportunity cost is both in terms

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<sup>148</sup> M Raquibuz Zaman, 'Usury (Riba) and the place of bank interest in Islamic banking and finance' (2008) 6(1) *International Journal of Banking and Finance* 1.

<sup>149</sup> Saeed, above n 143, 111.

<sup>150</sup> Timur Kuran, 'Islamic Economics and the Islamic Subeconomy' (1995) 9(4) *Journal of Economic Perspectives* 156.

of market and material. By contrast, the Islamic concept of TVG suggests that opportunity costs can be non-material and non-market. For example, a person might cease conducting business for a while (a material opportunity cost) to go and pray (a non-material and non-market cost), which represents a high opportunity cost.

Because production and consumption take time, the time value of goods (TVG) implies that present goods have a higher subjective value than future goods of like kind and number. People pay interest for both time preference and the prospect of increasing income in the future, and consequently, when people expect their income will increase in the future, they tend to borrow money to consume now and pay interest. The justification for charging interest is that lenders could otherwise invest their money to earn profit:<sup>151</sup> the increased deferred sale price of a commodity aims to compensate the lender the difference between its present and future values based on time preference—people prefer present satisfaction to future gratification because the future is uncertain and they may lose the purchasing power of their money in future or lose opportunities. Conventional financial theory bases the investment and financial decisions on TVM; hence, financial institutions are allowed to charge interest on money lent and pay interest on the money deposited by investors on a monthly or yearly basis. This enables people to buy, sell or speculate with the money.

By contrast, Islamic banking and financial theory positions money as an intermediary of exchange that becomes useful only when exchanged into real assets or used to buy services. Understood that way, money is not a commodity that people can sell, buy or speculate upon. As a result, Islamic law prohibits interest.

This raises another question: does the prohibition of interest suggest that Islamic law denies the time value? The next section discusses this issue in some detail.

### **3.2.5 Increasing the Prices of Sale on Credit**

Islamic law recognises the increment of the price of a deferred sale contract, rather than the spot price. An example of this is the way that *murabaha* contracts, rents and wages include a fixed and predetermined compensation for time.<sup>152</sup> This recognition in the deferred sale of a fixed and predetermined element as compensation for time demonstrates an acknowledgment of TV in Islamic law as long as it is not a predetermined value and is conditional on the contract. Deferment cannot be compensated with a fixed and predetermined incremental amount in isolation from the price of the transacted commodity, as in the case of a loan contract, where deferment alone is given monetary value without any association with a commodity.

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<sup>151</sup> Evon Bohm-Bawerk, 'Positive Theorie des Kapitals' (W M Smart trans, Macmillan, 1889).

<sup>152</sup> Abu Umar Faruq Ahmad and Mohamed Kabir Hassan, 'The Time Value of Money Concept in Islamic Finance' (2006) 23(1) *American Journal of Islamic Social Sciences* 66; Mohammed Fahim Khan, 'Time Value of Money and Discounting in Islamic Perspective' (1991) 1(2) *Review of Islamic Economics* 25.

Despite the acceptance of time value in Islamic law, the correlation of TV with an interest rate that constitutes rental or use of money for a certain period brings the legitimacy of time value into question. Take the example of someone who forgoes present consumption of an amount of money by lending it to someone else—the lender would deserve to receive the principal amount with a fixed incremental amount that sufficiently and reasonably compensates for the difference between its present and future value. It is necessary to consider which principles in Islamic law determine the value of time.

Islamic jurisprudence recognises that the concept of TVG is rooted in positive time preference and shares certain similarities with the conventional concept of TVM. A close examination of the opinions of Islamic schools of law reveals that the prohibition of *riba* does not equate to a denial of TV. For example, the approval of a credit price for a commodity that is higher than the spot price suggests recognition of time value based on time preference; however, although Islamic law recognises certain similarities between TVG and the conventional concept of TVM, it recognises them differently in both theory and practice. Despite denouncing the concept of time value on loans, Islamic jurisprudence recognises the time value on credit sales as long as it is not part of a predetermined lending relationship. For example, Ibn Abedeen of the Hanafi school argued that ‘the deferred and the spot price are not equal because the present value of [a] commodity is more valuable than the future value (loan) of [the] commodity’.<sup>153</sup>

Likewise, Shafi, the founder of the Shafi school, suggested that food received presently is more valuable than food that will be received some time in the future: ‘*One hundred bags of rice that is received now is more valuable than one hundred bags of food that will be received in the future*’.<sup>154</sup> Similarly, ibn Taymiyaha of the Hanbali school stated, ‘*deferment has a share in the price*’.<sup>155</sup> Based on these views, both the AAOIFI and the Islamic Fiqh Academy of the OIC recognise the validity of the deferred sale price being higher than the spot price.<sup>156</sup>

Most contemporary Islamic economists likewise view the permissibility of a contractual increment in a deferred sale that is greater than the spot price to constitute legal recognition of TVG; however, some of them do not accept that the relationship between TVG and time preference is the main reason for deciding whether to consume immediately or investment to earn more income in the future. For example, Zarqa rejected the use of TV to discount future projects to their present value by arguing that the positive time preference is neither a fixed, rational principle nor an empirically established predominant tendency among consumers. He asserted that the time preference is simply one of three tendencies of intertemporal choice—the others being zero or

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<sup>153</sup> Ibn Abedeen, ‘Hashiyat (Rad al-Mukhtar ala al-Dur al-Mukhtar) 4/88; Al-Kasani’ 5(67) Badai’ Al-Sanai 6.

<sup>154</sup> M I Al-Shafi’i, *Al-’Um* (2001) vol 4.

<sup>155</sup> Imam Taqi al-Din Ahmed Ibn Taymiyyah, *Majmu’ Fatawa Shaikh al-Islam ibn Taymiyyah* (Dar Ibn Hazm, 1328) vol 4.

<sup>156</sup> Islamic Development Bank, *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy (1985–2000)* (Islamic Research and Training Institute, 2000).

negative time preference—wherein each is rational and observable under its own conditions.<sup>157</sup> In addition, Siddiqui similarly argued that a preference for current over future consumption may not be based on pure time preference alone, because people are generally unmindful of future needs and thus prefer a promised future income rather than current consumption.<sup>158</sup> These arguments suggest that time preference is not the only factor that determines the preference of individuals to utilise their money immediately instead of deferring it to the future. This view, like the previous one, holds that preferences could be also based on other factors that induce individuals to receive present income.

Conversely, Khan argued that the positive time preference—or the realisation of TV—is acceptable only if TV is not claimed as a predetermined value. This means, for the credit sale to be higher than the spot price does not mean Islamic law allows a predetermined TV on the grounds of pure TV. He argued that the preference could be influenced by market forces, such as supply and demand, as in *murabaha* sales. In addition, the disapproval of Islamic law on financing leases based on return of an asset or time and its nominal value shows that Islamic law does not allow predetermined TV. Finally, the permissible profit margin on the financial transaction must be based on risk-bearing and not merely on TV. With these stipulations in mind, he argued that the discount rate for future projects should be based on the rate of return on the deposits of Islamic banks, instead of the interest rate.

Based on Khan's approach, any increase in the credit sale price over the spot sale price should depend on both time preferences and supply and demand conditions in the market. The implication of this argument is that if a consumer in the conventional financial system was given a choice between current and future consumption, they would prefer future consumption if the rate of return on future investment is equal to the interest rate. In this sense, investors use the interest rate to discount the cashflow of future projects and to compare them with their present value. That said, Khan is of the view that the expected rate of return on capital includes elements of risk not associated with time and that are assigned to compensate investors. The risk associated with the return is either related or unrelated to time, and only the portion of the expected rate of return assigned to compensate this risk will capture the time value, while the other portion assigned to the risk does not relate to time. However, unlike Zarqa, Khan argued that the rate of return on public projects should be based on pure time value, because their cost is distributed among a large number of taxpayers.

As interest is prohibited as a measure of time preference, investors should use the average rate of return on capital as a proxy for the expected TVG, not the interest rate.<sup>159</sup> It can be inferred, then, that the return based on actual return on capital—not the expected return—would be rewarded to investors. Although this argument has some weight, it does not clearly define how the proxy average return can be consistent with the principles

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<sup>157</sup> Muhammad Anas Zarqa, *An Islamic Perspective on the Economics of Discounting* (CERT Publications, 2005).

<sup>158</sup> Shamim Ahmad Siddiqui, 'The Controversy Over Time Value of Money Among Contemporary Muslim Economists' (2006) 2(2) *Journal of Management and Social Sciences* 144.

<sup>159</sup> Khan, above n 70, 3.



of shariah law and be different from the average return, the latter of which is heavily influenced by the interest rate and other economic variables.

Kahf contested Khan's view regarding the effect of time preference on present consumption. He argued that the time preference is based on investment rather than sheer preference of present consumption of money over its future utilisation. He also contended that, as the risk and uncertainty of time usually involves business and financial transactions, the concepts of justice and fairness should be related to the outcome of financial transactions.<sup>160</sup> This would suggest that the prohibition of interest in Islamic law does not mean a denial of TV, but instead aims to prevent injustice and unfairness in the evaluation of time value. On this basis, Kahf argued that as the returns, as compensation for time, are based on *ex post* of the investment rather than *ex ante*, the *actual* return from an investment can differ from the *expected* return due to the uncertainty of time. It can be concluded from this that people usually do not forgo present consumption unless they expect higher income in the future; however, forgoing consumption and simply putting money aside does not necessarily entail an increase in future income unless it is used in a productive manner. As such, the expected return of investable funds can be understood as compensation for saving today and this is the main source of time preference and TVM. Kahf further argued that risk-bearing alone is not a factor of production because risk does not create any value added to the capital; as a result, only those who contribute to production are entitled to a share of its returns.<sup>161</sup>

Because the value of money is an investment phenomenon and not related to abstinence from current consumption, time preference is a real factor for investable funds; however, as the valuation of time only takes place *ex post* and not *ex ante*, any investment has an implicit time value that enables investors to estimate the return on investment based on accumulated experience and mental calculation. Because predetermined returns are disallowed by Islamic law, the determination of any return on investable funds depends on the actual net profit, which represents a real increment in the transaction. According to Islamic financial theory, money does not have any function by itself and only serves as a facilitator for exchanging transactions—it only becomes capital when combined with other resources in productive activity, as in *mudarabah* and *musharakah*, in which the suppliers of funds share both profit and loss with the fund user.

Unlike Kahf, al-Misri accepted TV. He illustrated all justifications of interest and the concept of time preference with an argument based on the testimony of the Quranic verses discussed earlier and the views of the classical jurists, and convincingly proved the recognition of time value in Islamic law.<sup>162</sup> Al-Misri insisted that if two exchanges are the same in all aspects, people will choose current over future consumption because

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<sup>160</sup> Monzer Kahf, 'Time value of money and discounting in Islamic perspective: Re-visited' (1994) 3(2) *Review of Islamic Economics* 31.

<sup>161</sup> Ibid.

<sup>162</sup> Rafiq Al-Misri, *Bay' al-Taqsit: Tahlil Fiqhi wa Iqtisadi* (Dar al-Qalam, 1997).

the increase of one of the exchanges over the other—either in quantity or time—makes the present value higher than the future value when all other things are equal. Al-Misri cited a statement from the Quran (75: 20-21), ‘*Nay, but you love this fleeting life, and give no thought to the life to come*’, to argue the value of time is shown by the Quran’s encouragement for people to prefer the hereafter over worldly life because of the lasting life in the hereafter and the rewards awaiting them for doing good deeds in this life. He maintained that, if time has no value, the Quran has neither promised the giver more reward for lending money without interest nor allowed the increase of the deferred sale because of time.<sup>163</sup> That said, al-Misri did not differentiate between the preference of time due to current consumption from investment for future consumption.

This debate shows that Islamic jurists have considered TV and, as a result, have given approval for the price of a deferred sale being greater than the spot price. In their views, the prohibition of *riba* does not indicate a rejection of TV rooted in positive time preference. Islamic law disallows TV on loans where the return is predetermined and conditional. As such, if Islamic law failed to recognise TV, it would be difficult to calculate the present value of future projects. This helps the Islamic banking system to operate competitively within modern financial markets. That said, although the time value concept is considered in Islamic law when calculating the present value of a loan that will be paid in the future, there is an additional requirement for transactions to be shariah-compliant: the price over time must be determined at the beginning of the contract, because the price cannot be increased during the tenure of the loan or when the borrower defaults on payment.

### 3.3 Ownership of the Subject of Sale

Given that IFIs are not allowed to sell goods they do not own, they rely on promises made by customers to extend finance according to *murabaha* contracts.

Under Islamic law, sellers must possess the subject of sale at the time of sale.<sup>164</sup> This implies that sellers—financiers, in this case—can only sell commodities after acquiring them physically or constructively, and consequently, will be liable for the risk of loss, defects or damage of the goods between the time of the purchase from the supplier until the sale of the object to the client, or during transit before the buyer assumes ownership. Additionally, where a seller appoints someone else as an agent, the owner of the goods remains liable for the actions of the agent who purchases the goods from the supplier. Accordingly, if there are disputes about the condition of the goods that the exporter has sent to the importer or if there is a failure to comply with documents, the owner/seller bears the risk according to shariah law.<sup>165</sup> Additionally, when the bank designates

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<sup>163</sup> Al-Misri, above n 163, 100.

<sup>164</sup> Usmani, above n 4, 73.

<sup>165</sup> Jason Chuah, ‘Islamic Principles Governing International Trade Financing Instruments: A Study of the Morabaha in English Law’ (2010) 27(1) *Northwestern Journal of International Law & Business* 137; Usmani, above n 4.

an agent, it must make the agency contract separate and independent from the *murabaha* agreement itself. A contract for the sale of goods needs to meet the following conditions:<sup>166</sup>

- The subject of the sale must exist at the time of the sale.
- The subject of the sale must be owned by the seller at the time of sale.
- The sale must be absolute and instant.
- The subject of the sale must be valuable.
- The subject of the sale must not be unlawful in the view of shariah law (e.g., pig products, alcohol, pornography, weapons of mass destruction or any transaction that involves interest).
- The subject of the sale must be determinable and known to the buyer.
- The subject of the sale must be deliverable to the buyer.

### 3.4 Promises and *Murabaha*

There are two promises involved in *murabaha* contracts: a promise from the bank to sell goods or assets to a customer and a promise from the customer to purchase from the bank. Islamic scholars differ from one another regarding these promises and their significance. For example, the Hanafi and Shafi schools allow promises to sell or purchase. Conversely, while the Maliki school approves promises made to sell or purchase, it does not allow for promises made for the purpose of fixing tofit. Meanwhile, some scholars do not allow promises made for the purpose of selling or purchasing on the basis that the inclusion of promises in a sales contract resembles a *bai al-inah* transaction.

#### 3.4.1 Responsibilities of the Promiser from Religious and Legal Perspectives

Islamic scholars also have different views about the responsibilities of the promiser—the one who makes the promise in a transaction. The Shafi, Hanafi and Hanbali schools hold that that a promise made by one person to another is considered only a religious obligation that must be performed by the promiser and does not create a legal obligation. From this perspective, the promise is considered a voluntary contract and not binding; however, it is noble to fulfil such a promise.<sup>167</sup> On the basis that a customer has the right to refuse to purchase goods, this means that even if the seller—the bank, in this case—purchases the goods and incurs expenses as a result, the customer may choose not to honour their promise<sup>168</sup>. Additionally, Zarqa argued that a promise does not have a binding effect on the promiser and does not confer any right to the person towards whom the promise is made. Nevertheless, even if a promise is not legally binding, the promiser is still required to fulfil the promise; otherwise, he is considered a sinful person.

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<sup>166</sup> Usmani, above n 4, 67.

<sup>167</sup> Usmani, above n 4, 59.

<sup>168</sup> Munwar Iqbal, 'Advances in Islamic Economics and Finance' (Proceedings of 6th Conference on Islamic Economics and Finance, Islamic Research and Training Institute, 2007).

By contrast, the Maliki school holds the view that promises are legally and religiously binding. This school holds that promises are legally binding and that the promiser is obliged to fulfil their promise. Along similar lines, al-Qardawi agreed with the Maliki school about making promises both religiously and legally binding. His perspective was based on the rationale that promises can be made legally and religiously binding, especially in cases where it would be in the public interest to do so. This position was also supported by a resolution made by scholars of Islamic jurisprudence, which was held in Dubai in 1988. The resolution stated that promises are both religiously and legally binding, especially when they require the performance of specific acts as a result of legal obligations or commitments from the person to whom the promise is made.<sup>169</sup> As a promise to purchase from a bank is not considered binding by some Islamic jurists—which could incentivise bad customers to renege on their promises—some scholars ruled that promises are binding in the context of *murabaha* financing arrangements once the customer signs the promise to purchase goods from the bank.<sup>170</sup>

In line with the above, Scholars ruled that the promise is legally binding and the promiser is obligated to fulfil its conditions if it relates to the performance of certain act, or requires certain commitments from the promiser. However, in the normal situation, if the promise is made unilaterally, it is binding on the promiser religiously and not legally. Additionally, the bilateral promise is considered a legal ruse to practice *riba* (as in the case of *bai al-inah*). In the case where a sale and purchase contract cannot be enforced because the seller does not possess the goods but there is a public interest in ensuring that both parties perform their obligations by the general practice of a state's commercial dealings or by a provision of law (e.g., issuance of documentary credit for import), then binding bilateral promises are permitted either by virtue of law or by the agreement of the parties in the contract. Thus, such a promise will not take effect as a future or forward contract; consequently, there is no transfer of ownership between the seller and the purchaser and there is no debt or obligation created as a result of the promise. The sale and purchase will only be effective and enforceable at the time stipulated by the parties, as long as the *ijab* and *qubul* is considered concluded satisfactorily. Therefore, if one party breaks the promise, they are legally responsible for fulfilling the contract and are liable for any damages occurred as a result.

The Islamic Fiqh Academy elaborated on the final case by stating that such a promise would be binding when the following conditions are met:

- The promise is made by the buyer.
- The bank incurs costs in the course of acquiring goods according to instructions from the client and their promise to buy the goods.
- The goods are purchased for the buyer by the bank.

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<sup>169</sup> Organisation of Islamic Cooperation, *Majalah Majmah al-Fiqh al-Islami* 957.

<sup>170</sup> *Decision of Majlis Majma' Fiqh al-Islami al-Duwali*, Meeting No 17, 24–28 June 2006, decision no. 157 (17/6).

In support of this position, the AAOIFI requires customers to sign a form committing them to buy the item once the bank acquires it. This form can be prepared by the bank as a standard application form that is signed by the customers and will bind them once they sign it.<sup>171</sup> In this respect, the customer's signature assures the purchase of the goods once the bank acquires them for the client. This minimises risk in *murabaha* trade financing.

Despite this, given the binding of the promise does not happen in practice, Islamic banks often avoid offering finance on the basis of a standard *murabaha* contract and instead use *tawarruq* and *bai al-inah* for some of their financing activities. As previously discussed, most Muslim scholars approve of *tawarruq* as long as the transaction does not involve a prior arrangement between the three parties involved. *Bai al-inah* is considered impermissible on the grounds that it is not a genuine sale contract, and instead is constructed as a bridge to get a loan.<sup>172</sup> In both of these transactions, the customer has no intention of using or getting benefit from the asset, but merely wants to obtain cash.

### 3.5 *Gharar*

*Gharar* refers to uncertainty, speculation, lack of knowledge and doubtful transactions in which the subject of the sale, the price, time of payment or any other significant characteristics could result in an outcome detrimental to one party of the contract. Such a lack of knowledge may stem from misrepresentation, errors, fraud, duress or terms beyond the knowledge and control of one of the parties.

In terms of contracts, *gharar* may relate to ignorance about the type, species, attributes, quantity or specific identity of the object, ignorance about the time of payment in deferred sales, explicit or probable inability to deliver the object or the non-existence of the object.

The purpose of prohibiting *gharar* in financial agreements is to prevent the exploitation of the weaker party and to prevent zero-sum games in which party gains at the expense of the other. On the basis of *gharar*, shariah law recommends avoiding:

- the sale of things that do not exist or that may or may not come to be should be avoided (e.g., the sale of an unborn animal in its mother's womb, unripened fruit on the tree or fish and birds that have not yet been caught).<sup>173</sup>
- the sale of things that exist, but that the seller does not own or the availability of which is doubtful. *Gharar* becomes involved when the subject of the sale does not belong to the

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<sup>171</sup> AAOIFI, above n 29, 65.

<sup>172</sup> Alzuhayli, above n 30, 68.

<sup>173</sup> Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press, 2006).

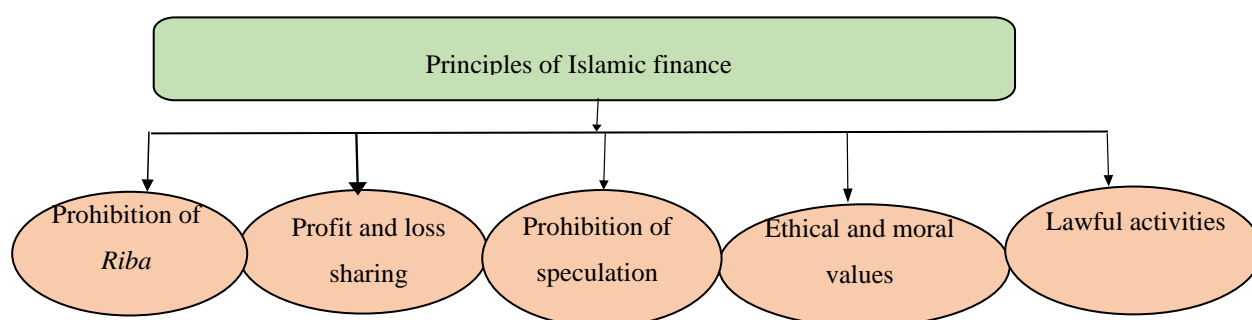
seller/owner or they own it but cannot deliver it practically to the buyer. This represents a risk according to a Hadith that says, ‘do not sell what you do not possess’.<sup>174</sup>

- the sale of goods that the seller cannot deliver, as this involves counterparty or settlement risk
- two sales in a single transaction, such as the sale of one article at different prices—one for cash and one for credit—or the sale of two different articles at the same price—one for immediate payment and the other for a deferred payment—as discussed previously.

The realisation of these goods is uncertain because the animal may not be born or be healthy, the fruit may never ripen and the birds and fish may never be caught. Because of this uncertainty, the Prophet has forbidden the purchase of unborn animals, unmeasured milk in the udder and what a diver may catch.<sup>175</sup> The Hadith from which this prohibition derives implies that an agreement with a diver to buy whatever is caught on the first dive is *gharar* under Islamic law. By contrast, Islamic jurists would permit an agreement in which someone hired a diver for a fixed price on the understanding that whatever the diver caught during a certain period would belong to the hirer because it eliminates ambiguity from the contract.

Unlike *riba*, which is determined according to a fixed formula, the determination of *gharar* is based on many factors because the parameters of knowledge and consent and the toleration of risk in a society are not fixed. Because no contract can ever totally avoid uncertainty or some degree of risk, the jurists have been more lenient in their prohibition of *gharar*. Jurists usually permit *gharar* if it is not excessive and set standards for identifying the level of risk at which a contract is invalidated.<sup>176</sup> Risk is permissible if the *gharar* is in the subsidiary part of the contract rather than the main contract or if the risk is unavoidable and the contract is in the public interest. Conversely, risk is not permissible if it could lead to a dispute or if it is not in the public interest. According to these principles, Islamic commercial law has accepted the distinction between major uncertainty, which should be avoided, and minor uncertainty, which is tolerated by society.

Figure 8: Principles of Islamic finance.



<sup>174</sup> Ismaeel Ibrahim Aljeriwi, *The Compatibility of Saudi Domestic Law with the Seller's Obligations under the Vienna Convention (CISG)* (PhD Thesis, Newcastle University, 2010).

<sup>175</sup> Muslim ibn al-Hajjaj, *Sahih al-Muslims* (1989) Hadith 1569.

<sup>176</sup> Ahmad Hidayat Bin Buang, *The Prohibition of 'Gharar' in Islamic Law of Contracts: A Conceptual Analysis with Special Reference to the Practice of Islamic Commercial Contracts in Malaysia* (University of London, 1996).

Within this context, Islamic scholars have outlined two different approaches to the conventional financing system within the shariah framework: the socioeconomic approach and the legalist approach.

### 3.6 Approaches to Islamic Finance

As previously discussed, Islamic banking and finance are based on shariah law in the form of the Quran, the Sunnah and the practice of jurisprudence. Within this framework, the pioneers of Islamic economics and finance promoted the creation of an Islamic banking system free from interest and based on social justice, fairness and equitable distribution of wealth. Two different approaches have emerged to identify the most effective and lawful platforms for offering Islamic financial and banking services within the conventional financial system: the socioeconomic approach and the legalist approach.

#### 3.6.1 Socioeconomic Approach

Advocates of the socioeconomic approach believe that the social, economic and spiritual dimensions of human society are considered inseparable from Islamic faith. They insist that all economic activities and financial transactions must be conducted entirely according to the principles of Islamic law. From this perspective,

which is considered the core theory of Islamic finance, there should be no profit without sharing risk and earning through economic ventures based on reward and risk-taking. This approach was first defined by Abu Al-ala Al-mowudi and other Islamic thinkers;<sup>177</sup> however, it was put into practice by Ahmed Al-Najjar, who founded the Mitt Ghamr Saving Bank in Egypt in 1963, and the founders of Tabung Hajj in Malaysia.<sup>178</sup>

Advocates of this approach maintain that Islamic finance is based on the principles of social justice, fairness and equity and cannot be separated from the ethics of shariah law.<sup>179</sup> By consequence, the Islamic financial system is required to promote welfare, social justice and equal access to credit, economic development and poverty alleviation—not mere commercial objectives—that it might replace the interest-based finance system that causes the unfair distribution of wealth and class struggles in society.

Within this framework, the Islamic economists of the socioeconomic approach have promoted the Islamic banking and finance system as a replacement for the conventional financing system. To this end, the main services of the Mitt Ghamr Saving Bank—the first experiment of this kind—included saving accounts, investment accounts, equity participation, social services and free loan accounts to encourage saving among low-income people without any financial reward. The bank's investment accounts were designed for PLS-based investment using *mudarabah* and *musharakah* contracts. Al-Najjar, the founder of the Mitt Ghamr

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<sup>177</sup> El-Gamal, above n 36, 108.

<sup>178</sup> Walid Hegazy, 'Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism' (2007) 7(2) *Chicago Journal of International Law* 581, 598.

<sup>179</sup> Alexey Arakcheev et al, 'Islamic Money Management: A Western View' (2010) 6 *Capital Markets Law Journal* 238, 242.

Saving Bank, believed that this system had the advantage of providing the capital supplier more control over the financed asset, as it gave them the power to retain full or partial ownership of it.<sup>180</sup>

Conducted according to this approach, Islamic finance encourages people to consciously perform their contractual duties when undertaking business activities and not only be concerned with their interests, but instead care about the interests of society. That said, as this approach involves risk and selection problems, IFIs have neglected to implement it in conventional financial markets. It does not protect capital owners by guaranteeing them either initial capital or fixed returns, which has resulted in fund users underreporting profits. Since the PLS principle is complicated by the moral hazards and adverse selection involved in this approach, IFIs have based their financial operations on a legalistic approach, opting instead for low levels of financial risk and similar economic effects to those found in conventional financial facilities.

### 3.6.2 Legalist Approach

As there have been difficulties implementing profit-sharing products in the conventional financial system, demand has grown for another approach that accommodates the requirements of the conventional financial and secular legal systems while remaining consistent with shariah principles. This legalist approach was pioneered by Mohammad Baqir Al-Sadr, an Iraqi scholar, and Sami Hamoudi, a Jordanian economist and banker, and focuses on structuring shariah-compliant financial products (e.g., *murabaha* financing). Hamoudi introduced the *murabaha* financing method using the deferred sale mechanism, in which customers can pay by instalment. This legalist approach mainly advocates for credit-financing methods that closely resemble conventional debt-financing methods while also complying with both the shariah and conventional legal regimes.

Al-Sadr divided the activities of financial institutions operating in conventional markets into two types: ideology-driven and objective-driven. He argued that the activities of the conventional financial system—such as collecting deposits from surplus holders and channelling them to investors—are common to every society regardless of ideology. He maintained that the current conventional financial tools and techniques are allowed as long as they do not conflict with shariah principles.<sup>181</sup> Concurring with this position, Abdul Halim Ismail, one of the pioneers of the Islamic banking in Malaysia, argued that Islamic banking has the same commercial objectives of conventional banking, the only difference being the shariah compliance of Islamic banking.<sup>182</sup> He contended that the primary objective of Islamic finance, aside from an emphasis on social welfare, is the maximisation of the wealth of the shareholders because the government fulfils the responsibilities for social welfare in the community. IFIs overwhelmingly conduct *murabaha* operations using this legalist approach.

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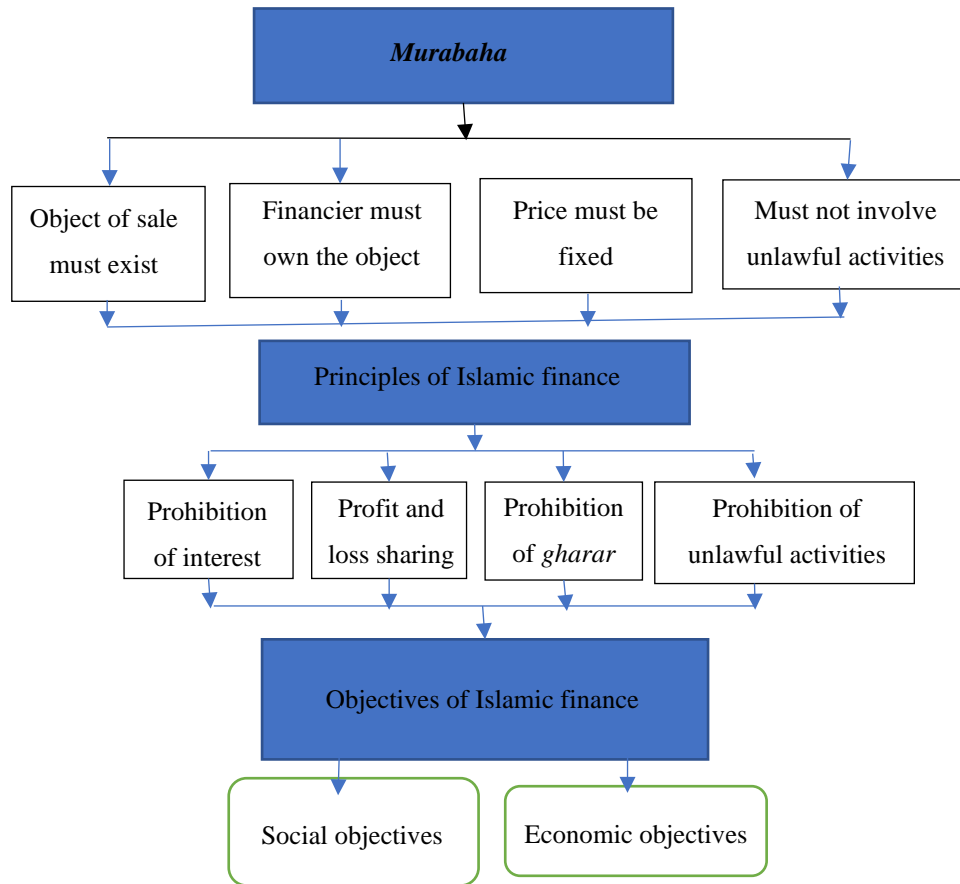
<sup>180</sup> Ibid.

<sup>181</sup> Hegazy, above n 180, 580.

<sup>182</sup> Asyraf Wajdi Dusuki, 'Understanding the Objectives of Islamic Banking: A Survey of Stakeholders' Perspectives' (2008) 1(2) *International Journal of Islamic and Middle Eastern Finance and Management* 132, 133.



Figure 9: Shariah-Compliant Structure of *Murabaha* Contracts



### 3.7 Concluding Remarks

As discussed in this chapter, the main characteristic that distinguishes Islamic finance from conventional finance is compliance with the principles of shariah law: the prohibition of *riba*, *gharar* and unlawful activities, the dependence of financial transactions on real assets and the broad objectives of Islamic finance (e.g., the promotion of social justice to protect the less fortunate within society). In sum, Islamic financial activities are based on a trade financing system focused on socioeconomic objectives and ethical activities. Islamic banks, unlike conventional banks, are not allowed to collect deposits from investors, rent money out for profit or extend finance with guaranteed returns. In contrast to the interest-based financial system, money has no intrinsic value in Islamic finance and is considered only as a medium of exchange.

The prohibition of *riba* refers to either the unequal exchange of two usurious commodities or the exchange of money for money with different qualities without simultaneous transfer. In this respect, any predetermined interest over and above the principal is prohibited whether the borrower is in dire need or is an entrepreneur seeking to start a business. Additionally, Islamic law forbids excessive *gharar* and gambling. Because Islamic banks are not allowed to offer interest to depositors or charge interest on loans, Islamic finance is asset-based—financiers cannot collect or pay interest on rented money as they can in the conventional banking system.

Although the prohibition of *riba* may suggest the rejection of TV, Islamic law recognises TV in terms of pricing assets, but not for adding to loans or debts. This implies that time valuation is possible only in the trade of goods and business and not in the exchange of monetary values or loans. As discussed previously, shariah law considers loans to be righteous acts and people discouraged from taking any benefit from them. This implies that no time value can be added to a loan's principal amount after the contract is created and the price is fixed. Disallowing the adding of interest to a loan's principal suggests that Islamic law does not allow money to have a fixed and predetermined time value.

Any financial transactions that do not comply with these principles risks noncompliance with shariah law, which renders them invalid. Noncompliance in transactions generates operational and financial risk—at least from the perspective of customers—whether or not it complies with domestic laws. As such, the discussion now turns to an examination of similarities and differences between shariah law and Australia law to evaluate the possibilities for reconciliation between them regarding *murabaha* contracts.

# CHAPTER 4: MURABAHA AS A SALE CONTRACT

## 4.1 Introduction

The sale of goods is at the heart of commercial transactions, and transfer of property in goods through sale is pivotal to economic activity. Thus, an appropriate legal and regulatory system is vital for establishing a sound financial institution and their markets. *murabaha* contract like other financial products needs legal and regulatory systems that enable it to effectively operate in the both domestic and international financial markets.

In Australia, all states and territories have Goods Acts, which are similar to the Victoria Goods Act 1958 (Vic), The Goods Act, which will be referred to as the ‘Act’ in this study, governs the contract of sale of Goods. When the sale of Goods contract involves a cross-border transaction it may be subjected to the rules of the Contract of International Sale of Goods (CISG) in addition to the Act.<sup>183</sup> Thus, *murabaha* as a domestic or a cross border sale contract may be required to comply with the Victoria Goods Act 1958 and Contract for International of Goods (CISG) that incorporated into the Australian common law system. In this, the parties of the *murabaha* contract may choose to incorporate Shariah law principles into the Goods Act and CISG as the governing law of the *murabaha* contract by using the principle of autonomy of the sale contract under article 3 of the Rome Convention.<sup>184</sup> Australian federal government ratified the CISG in 1987, and it came into force in 1989<sup>185</sup>, and Australia legal system gives it the supremacy over the legislation of the states and territories. Yet, the states and territories governments need to agree to the CISG Convention to implement it within their respective jurisdictions. Given this, this chapter examines how the *murabaha* as both domestic and cross border finance transactions can operate under Australian law, while also remaining Shariah compliant with particular reference to the CISG. It will discuss the differences and the similarities between the Act and CISG on one hand, and Shariah law on the other hand on the *murabaha*, as a sale contract.

## 4.2 Definition of Sale Contract under Australian Law

Under Australian contract law, a sale contract is a legally binding agreement that is reached by two or more parties, whereby one party makes an offer and the other accepts it, with the consideration of bargain and intention to create a binding contractual legal relationship. According to the Act 1958, a contract of sale is a

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<sup>183</sup> The CISG is one of the most modern sales law models for international trade transactions. CISG Convention came into force in Australia in 1988 and currently more than eighty countries have signed the convention and adopted it as part of their domestic laws, including some of the most influential trading nations such as the USA, EU countries, Australia, China, and some Muslim Arab countries such as Egypt, Syria, Iraq and Mauritania that have signed the convention. See [www.cisg.law.pace.edu/cisg/countries/cntries.html](http://www.cisg.law.pace.edu/cisg/countries/cntries.html)

<sup>184</sup> J Rinze, ‘The scope of party autonomy under the 1980 Rome Convention on the law applicable to contractual obligations’ (1994) 412 *Journal of Business Law*.

<sup>185</sup> Fariba. Aghili, ‘A Critical Analysis of the CISG as Australian Law.’ (2007) 21(4) *Quarterly: The Journal of the Commercial Law Association of Australia* 15; Benjamin Hayward, and Patricia Perlen, ‘The CISG in Australia-The Jigsaw Puzzle That Doesn’t Quite Fit’ (2011) 15(1) *Vindobona Journal of International Commercial Law and Arbitration* 119; Bruno. Zeller, ‘UN Convention on Contracts for the International Sale of Goods (CISG)-A Leap Forward towards Unified International Sales Law,’ (2000) 12 *Pace International Law Review* 79.

legal contract for exchanging goods, services or property from a seller to a buyer for an agreed value of money paid or promised to be paid in the future. Under section 2(7) of the Act, goods are any movable property other than actionable claims and money. Pursuant to section 3(1) of the Act, goods include all chattels, emblements and things attached to or forming part of the land, which are agreed to be severed before sale or under the contract of sale.<sup>186</sup> On the other hand, CISG rules, which take an eclectic approach rather than being a monolithic system to unify those laws, apply only to international commercial transactions between parties in signatory states.<sup>187</sup> It facilitates cross border commercial transactions by considering the different social, cultural, economic and legal systems of the signatory countries by removing the legal barriers from the transactions between international traders and establish trade transactions based on equality and mutual benefit of both the seller and buyer.<sup>188</sup> Thus, it aims to harmonise and unify international private commercial law and establish an effective dispute resolution system for international transactions through a coherent remedial scheme in international trade transactions to minimise the financial risk of international trade transactions.

However, because of political compromises of the signing states, some substantive issues such as the validity of the contract, security interests in goods, product liability such as personal injury, and the rules of evidence and statutes of limitation were excluded from the governing of the CISG Convention and left to domestic law.<sup>189</sup> According to article 4 of the CISG, the Convention governs only the formation of the contract of sale and the rights and obligations of the parties of the contract; therefore, the Act 1958 fills this gap. The Act sets out the rules for the performance of the contract between the seller and buyer and the remedies that arise from the breach of the contract. This denotes that the Act does not apply if the transaction cannot be characterised as a contract for sale of goods. Thus, the next section discusses the essential elements in the Sale Contract.

### 4.3 Essential Elements in the Sale Contract

The Act sets out the rules for the performance of the contract between the seller and buyer and the remedies that arise from the breach of the contract. The Act does not apply if the transaction cannot be characterised as a contract for the sale of goods.<sup>190</sup> The Act identifies seven essential elements for validity and enforceability of the sale contract such as offer, acceptance, consideration, intention to create a legal relationship, capacity to contract, and legality of the contract. Under the Australia law, contract is a promise for an agreement made

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<sup>186</sup> Victoria Goods Act 1958 (VIC) 201 Bakar, above n 53.

<sup>187</sup> According to article 2 of CISG, this Convention do not govern the sale contract when the purpose of the purchase of the goods is for personal, family or household use.

<sup>188</sup> Fatima Akaddaf, 'Application of the United Nations convention on Contracts for the International Sale of Goods (CISG) to Arab Islamic countries: Is the CISG compatible with Islamic law principles' [10] (2001) 13(1) *Pace International Law Review* 59; Twibell, above n 30.

<sup>189</sup> Karen H Cross, 'Parol Evidence Under the CISG: The "Homeward Trend" Reconsidered' (2007) 68 (133) *Ohio St. LJ*; Benjamin Hayward, and Patricia Perlen., 'The CISG in Australia-The Jigsaw Puzzle That Doesn't Quite Fit.' (2011) 15(1) *Vindobona Journal of International Commercial Law and Arbitration*.

<sup>190</sup> Simon Fisher Gail Pearson, Elisabeth Peden, GJ Tolhurs and G Pearson, *Commercial Law: Commentary & Materials* (Thomson Reuters, Australia, 3 ed, 2010).

volunatrily between two parties or more. It will only be legally enforced if it supported by consideration of at least one party of the agreement, the parties have legal capacity, they intend the contract to be legally binding to them and of the formalities of contract complied with. The consideration can be money, promise to undertake or not to undertake a particular act.

In comparison, the essential elements for the contract under Shariah law as discussed in chapter three mainly agree with the essential elements of the sale contract under the Australian common law. The Essential Elements in the sale contract that the Victorian Goods Act 1958 identifies, such as offer and acceptance, consideration, intention to create a legal relationship, capacity to contract, and legality of the contract agree with the position of the Islamic law. In addition, according to s13(1)(2) the parties of the contract of sale could determine the price or leave it to be fixed in the future in a manner that they agreed or determine by the course of dealing between them.<sup>191</sup> However, when the price is not determined according to the previous dealings, the buyer is expected to pay a reasonable price depending on the circumstances of the contract.

#### **4.3.1 Offer and Acceptance**

Under Australian contract law, the formation of a contract starts when an offeror (person offering the sale) makes a promise that identifies the terms of the contract to an offeree with the intention to create a legally binding contractual relationship. The promise can be in the form of doing or refraining from doing something for the offeree (the part to whom the offer is addressed); reciprocally the referee also promises doing or refraining from doing something for the offeror. This offer can be in writing, oral or implied from the conduct and the circumstances surrounding the agreement.<sup>192</sup> However, the offer is tentative until the offeree accepts the offer with the intention of creating a legally binding contractual relationship and communicates it with the offeror.<sup>193</sup> On the other hand, the acceptance of the offer would be achieved when the party to whom the offer was made accepts it either in writing, orally, or inferred from his/her conduct without addition or deletion of the terms of the contract.<sup>194</sup>

Albeit, the acceptance may be made or inferred from the words or the conduct of the buyer, it must be communicated to the offeror in a manner that is consistent with what the offeror expressly or implicitly requested. Consequently, the acceptance must contain words or acts that indicate the offeree has accepted the offer and expressly communicated with the offeror, because the acceptance cannot be inferred from silence. Same as the common law, under the Shariah law, the contract to be valid, the offer (*Ijab*) of one party must connect to the acceptance (*Qubul*) of the other party with the subject matter and consideration.<sup>195</sup> The offer

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<sup>191</sup> Goods Act 2000 (VIC).

<sup>192</sup> Stephen Graw, *An introduction to the law of contract* (Thomson Reuters 9 ed. 2012) 48.

<sup>193</sup> The offeror can withdraw at any time before the due date for the acceptance of the offer.

<sup>194</sup> Goods Act, above n 24.

<sup>195</sup> Aljasiiri, above n 29.

and the acceptance can be concluded either in writing or verbally or in any other way that shows the intention of the parties verbally or in writing. Similarly, under Australian contract law, the formation of a contract starts when an offeror makes a promise that specifies the conditions of the contract to an offeree with the intention to create a legally binding contractual relationship. The promise can be in the form of doing or refraining from doing something for the offeree (the part to whom the offer is addressed); on the other hand, the referee promises doing or refraining from doing something.

Even though, the writing of the contract is not mandatory under the Islamic law, Quran emphasises the importance of writing the agreement by explicitly stating that:

*O believers when you deal with each other in lending for a fixed period put it in writing. Let scribe write it down with justice between the parties. The scribe, who is given the gift of literacy by Allah, should not refuse to write: he is under obligation to write. Let him who incurs the liability (debt) dictate, fearing Allah his Rabb and not diminishing anything from the settlement. If the borrower [is] mentally unsound or weak or is unable to dictate himself, let the guardian of his interest dictate for him with justice.*<sup>196</sup>

Nonetheless, some Islamic scholars interpret the Quran's emphasis on a written contract to be only as a recommendation and guideline rather than mandatory for the contractual relationship of the parties. Thus, the agreement can be verbal, in writing, by conduct or trade usage that expresses the consent of the parties of the contract, as mentioned previously. According to article 2(4) (1) of the AAOIF Shariah Standards states, *"Documentation in writing is recommended by the Shariah law, whether such documentation is in the form of ordinary or official documents."*<sup>197</sup> This indicates the importance of writing the contracts of contemporary financial transactions, particularly the cross border financial contracts. In this regard, the Quran (2:282) explicitly encouraged the writing of debt contract by saying:

*You must not be averse to writing (the contract) for a future period, whether it is (the amount) small matter or big. This action is more just for you in the sight of Allah, because it establishes strong evidence and is the best way to remove all doubts; but if it is a common commercial transaction concluded on the spot among yourselves, there is no blame on you if you do not put it in writing.*<sup>198</sup>

This shows Islamic law consider the writing as elucidating the expression of the parties to the contract and their mutual consent about its conditions and terms. It recommends that the offer and acceptance to be in writing to support the oral testimonies of the contract because. In this respect, the Quran (2:283) discourage

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<sup>196</sup> Al-Hilali and Khan, above n 66.

<sup>197</sup> AAOIF, above n 126.

<sup>198</sup> Al-Hilali and Khan, above n 67.

interfering with or destroying anything that constitutes evidence of the contract by saying: *“Do not suppress evidence; one who suppresses it is a sinner at his heart; and God knows all that you do.”*<sup>199</sup>

The position of Islamic law on writing the contract agrees with section 42 of Victorian Goods Act that states the acceptance of the offer would be achieved when the party to whom the offer was made accepts it either in writing, orally, or inferred from his/her conduct without addition or deletion of the terms of the contract<sup>200</sup>. This implies Shariah law is in same position with the Australian common law (including CISG) in putting emphasis on testimonial evidence and emphasising the importance of the testimonial evidence to establish the existence of a contractual relationship by examining the conduct of the parties and the trade usages. It also shows as discussed, Shariah law principles and the Australian contract law seem to uphold the principle of the sacredness of the contract.

#### **4.3.2 Consideration**

Under Australia contract law, the consideration of a contract of sale should only be for money consideration, as exchange of goods with goods is not accepted to be a contract of sale of goods. According to section 6(1) of the Act, the contract of sale is formed when the seller transfers or agrees to transfer the property in goods to the buyer for a monetary consideration.<sup>201</sup> In this respect, barter or providing skills and labour as an alternative for paying money for the goods do not constitute a contract of sale. However, if the agreement involves both a money consideration and exchange of goods, such as a trade-in, the transaction would be a contract of sale of goods. On the other hand, if the price is not stated in the contract, the contract will still be valid and binding, whereby the buyer is required to pay a reasonable price on the condition that other requirements of the contract are met.<sup>202</sup> This indicates, the Act provides protection of implied terms to ascertain whether goods are of good quality and free from latent defects and reasonably fit for their intended purpose.

Similarly, under the Islamic law, the object of sale must exist, be legally tradeable, have legal value and be deliverable. In addition, it must be legally owned or authorised by the seller. What is more, the contract will only be valid with the consent and consideration of the parties if it is not affected by undue influence, fraud, coercion, misrepresentation, or related legal ambiguities.<sup>203</sup> In comparison, as discussed earlier, under Australia contract law, the contract of sale is formed when the seller transfers or agrees to transfer the property in goods to the buyer for a monetary consideration. Unlike the Islamic law that accepts the exchange of goods against or goods against money, under the Australia law, the consideration of a contract of sale should only

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<sup>199</sup> Ibid.

<sup>200</sup> Goods Act, above n 23

<sup>201</sup> Australia Government, Goods Act 1958 (Government 2011) vol 97.

<sup>202</sup> Ian Turley, Principles of Commercial Law (Cavendish Pub Limited, 2001).

<sup>203</sup> Bakar, above n 52.

be for money and goods exchange consideration, as exchange of goods with goods is not accepted to be a contract of sale of goods. In case the price is not mentioned in the contract, the contract still is considered valid and the buyer pays a reasonable price if other elements of the contract are fulfilled.

#### **4.3.3 Intention to create a legal relationship**

The essence of a contract is the promise made by the parties to create a legally binding contract. According to section 36 of the Act, the intention of the parties can be inferred from the wording that expressly or impliedly stated by the parties in the contract. Pursuant to section 30 of the Act, the seller is obliged to deliver the correct quantity and quality of the goods that meet the description and the terms in the contract that are agreed by the parties.<sup>204</sup> This can be gleaned from either the express or implied terms of the contract or the conduct of the parties and the circumstances surrounding it. In particular, if it is a commercial agreement, the parties are assumed to enter it with the intention to create a legally enforceable relationship. However, if the parties do not intend their agreement to have legal consequences, such as promises to pay pocket-money or house-keeping money, it cannot be considered a contract enforceable at law.<sup>205</sup> This suggests a social agreement does not indicate the parties intended to create a legally binding contract that attracts legal consequences. Consequently, at the dispute of the contract, the court would examine the subject matter of the agreement and the words that they used in addition to the circumstances surrounding the agreement to figure out whether the parties intended to enter a legally binding contractual relationship.

In comparison the intention to create a legal agreement is important under Shariah law because it indicates the purpose of the contract. In addition, the promise to make create legally binding contract it represents the essence of the contract. Intention part) As the discussion of the study has shown, Islamic law, same as the Act and the CISG put great emphasis on testimonial evidence to derive the intention of the parties and the usage of the goods. Finally, the position of Shariah law seems to be consistent with the requirements of the CISG which determine the intention of the parties of the contract by examining the circumstances of the agreement, such as the negotiations, practices, conduct of the parties and the trade usage. What is more, the concept of good faith in Islamic law is like the notion of good faith in article 7(1) of the CISG.

Islamic law emphasises honesty, acting in good faith and fulfilling the obligations of the contract fairly and reasonably and forbids trickery and falsification in a contract.<sup>206</sup> This indicates that, under Islamic jurisprudence, knowing the intention of the parties is essential for understanding the purpose of the financial

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<sup>204</sup> Turley, above n 112.

<sup>205</sup> Stephen Graw, *An introduction to the law of contract* (Thomson Reuters, 2012).

<sup>206</sup> Al-Hilali and Khan, above n 162. In this respect the Quran (5:89) says: “do not allow your oaths in the name of God [frequently and hastily pronounced to thus] become an obstacle to acts of virtue and righteousness and reconciliation of people; surely God is All hearing, All-knowing. God will not hold against you a slip in your oaths, but He will hold you responsible [only] for what your hearts have earned [intentionally] and God is All-forgiving, forbearing. God will not hold against you [an unintentional] slip in your oaths; but He will [only] hold you responsible for such oaths, which you have earnestly”.



transaction, and consequently, as discussed before, a contract without an intention to create a legal relationship is considered void and unenforceable. It further, demonstrates that the intention of the contracting parties is one of the most important elements in the contract according to Islamic jurisprudence. Therefore, if a party claims there is a lack of intention in the contract to create a legal relationship, that party is required to prove beyond doubt the absence of the intention in the agreement. This indicate the position of both the Islamic law and the common law on the intention of the contract commonly are similar.

#### **4.3.4 Contents of the contract**

In Australian contract law the contents of the contract must be identified and sufficiently certain to avoid the lack of clarity that leads to it being vague, incomplete or uncertain. This lack of clarity of the provisions of the contract may come from the nature of its statement which may fall into the classification of representation and not the essential content that is enforceable by law. This implies if a seller says to the buyer, ‘I will sell this beautiful house for \$500,000’, the phrase beautiful is not considered an essential term in the contract. However, if someone says: ‘this art was made by Goldsmith and the price is \$30,000’, this will be treated as part of the terms of the contract. Thus, to distinguish whether the issue is mere representation or part of the content of the contract, it should determine if it is reasonable to believe the parties of the agreement were certain about the statement; then the statement will be regarded as part of the content of the contract.

It is worth noting that the parties may enter into a contract based on custom and trade usage and expect this to be implied in the contract.<sup>207</sup> Notwithstanding, this may lead them to have different views about what has been agreed on the interpretation of the terms of the agreement because of their different views about the custom. Thus, to understand if the statement is part of the content of the contract, it is important to look at whether the term of the statement relates to its conditions or warranties.<sup>208</sup> This implies if the term relates to the conditions of the agreement it would be considered an essential part of the contract; however, if the term relates to the warranties it is not considered essential to its content. A contract conforms to its description when a seller describes goods to the buyer, and the buyer purchases them according to that description; the goods are considered to correspond impliedly with the description stated in the contract. In the implied description, a term will be implied only if non-conformity goes to the identity of the goods, instead of their quality.<sup>209</sup> On the other hand, according to Islamic law, the content of the contract must be known certain and identifiable. Also, the content of the contract can be based on a custom that people have approved for their business dealings for many years. The custom is treated the same as the contract that formed by an offer and acceptance verbally. Therefore, when there is no clear guidance in Islamic law on problems arising from disagreement of the parties to the contract, it will be referred to custom to find how the custom recognise the formation of the contract.

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<sup>207</sup> Nicholas Seddon, *Government Contracts: Federal, State and Local* (Federation Press 8 ed. 2009).

<sup>208</sup> Daniel Khoury and Yvonne Yamouni, *Understanding contract law* (Chatswood, N.S.W. : LexisNexis Butterworths, 7 ed, 2007).

<sup>209</sup> Andy Gibson, *Commercial Law: In Principle* (Homson Lawbook Co, 3 ed, 2005).

However, the content that referred to the custom and practices of the business should be those that are socially acceptable, suit the contract's purpose, or necessary for its operations and be fair to the parties of the contract

#### **4.3.5 Capacity to contract**

In common law there are certain classes of people in society who either have no mental capacity or are not sufficiently mature to fully understand the nature of the agreement they enter with other parties. Thus, the law restricts these people from entering into a contract because of their inability to assess its real meaning and the obligations and rights it creates.<sup>210</sup> This exclusion aims to protect these persons as a matter of public policy because of their immaturity, inability or inexperience to understand the nature of their acts and the consequences of the contract. Therefore, as this incapacity leads the contract to be unenforceable at law, these persons need protection from predatory persons until they have the capacity to understand the complexity of the contract. This incapacity may relate to persons, corporations, or any other legal entities recognised by law such as mentally ill persons, minors (under 18 years of age), and intoxicated persons. Therefore, as they may lack mental capacity that enables them to enter into a contract and fully understand the nature of their actions, public policy dictates they should not be bound by a legal contract.

Under Islamic law conducting a legal and binding contract requires mental capacity and free choice and consent of the parties of the contract.<sup>211</sup> Thus, the parties of the contract, to be eligible to enter an agreement, must be both their mentally and physically fit and reach the legal age as a matter of public policy.

In comparison, Australia law does not allow persons who either have no mental capacity or are not sufficiently mature to fully understand the nature and complexity of the agreement to enter a legal contract. The law restricts these people from entering into a contract because of their inability to fully assess the nature of the contract and understand the obligations it creates. This incapacity may relate to persons, corporations, or any other legal entities recognised by law such as mentally ill persons, minors (under 18 years of age), and intoxicated persons.

Provided this, apart from the age of the persons, which Islamic law considers 15 and Australia law 18, both Australian law and Islamic law are on same foot on this element of the sale contract. Even though, Islamic jurisprudence states the mature age to be 15 overwhelmingly in the Islamic countries (and of course Islamic financial institutions) the legal age of the person is 18 years. In addition, when it comes to the dispute of the corporations or legal entities, the legal capacity of the natural person representing them will be checked his legal age. Both Islamic law and the common law protect these legally ineligible persons to enter contract as a

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<sup>210</sup> Graw, above n 46.

<sup>211</sup> Aisha Nadar, 'Islamic Finance and Dispute Resolution: Part 1' (2009) 23(1) *Arab Law Quarterly* 1.

matter of public policy because of their immaturity, inability or inexperience to understand the complexity and the consequences of the contract.

#### 4.3.6 Legality of the contract

The legality of the contract is the last of the seven essential requirements for its formation, validity and enforceability under common law where, if it does something illegal or is for illegal purposes, it will be generally invalid and unenforceable.<sup>212</sup> Hence, a contract may involve conduct that is against the law or the public interest and as a result becomes illegal and unenforceable at law. The law invalidates expressly or impliedly any agreement that is prohibited by statute or poses a threat to the public interest. However, the law only makes other contracts that do not meet this description void but not illegal.<sup>213</sup> Thus, the agreement may become illegal and unenforceable if it is contrary to public policy, and the parties may be liable to a penalty for either making the agreement or attempting to carry it out. As a result, the court may intervene and invalidate a contract, because of mistakes, legal incapacity, duress, deceit, misrepresentation, illegality or undue influence on the weaker side.

Similarly, the autonomy to form a contract and to accept its conditions and terms warrants the parties being free from any form of undue influence, fraud or coercion that makes contracts invalid. In this regard, the Quran (4:29) states that “*O ye, who believe, squander not your wealth among yourselves in worthless dealings, but let there be trade by mutual consent.*”<sup>214</sup> This shows that taking other people’s property without their consent is forbidden. The emphasis in the Quran on the importance of mutual consent in trade and business transactions demonstrates that the consent of the parties to a contract by their own free will is fundamental to the principles of Islamic law.

It is mandatory that the contract is consistent with public policy. The definition of public policy by the Egyptian Supreme Islamic court in the 1950s was as follows.<sup>215</sup>

*According to the Islamic law, public policy does not permit that respect owed to religion be diminished by the violation of its rules and prescriptions formulated by a conclusive source which is acknowledged and admitted by the unanimity of spiritual leaders.*

These mandatory rules which safeguard community interest and public policy cannot be violated by the agreements and terms and conditions of contracts. This means that under Shariah law principles, any contract that involves terms and conditions that violate public policy is considered invalid. Thus, the practices of financial transactions cannot be separated from faith and the general interest of the public. Any violation may

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<sup>212</sup> Stephen Graw, *An introduction to the law of contract* (Thomson Reuters 9 ed. 2017).

<sup>213</sup> Yamouni, above n 380.

<sup>214</sup> Al-Hilali and Khan, above n 112.

<sup>215</sup> Id. at.

contravene public policy and as a result contradict Shariah principles. In this regard, Islamic schools of law (both Sunni and Shiite Schools) agree that the Quran and the Sunnah are the two most important Islamic legal principles. However, they differ in the acceptance and usage of secondary legal sources when there are matters not covered in the Quran and the Sunnah.

#### 4.4 Performance of the Contract of Sale

As the sale contract is a two-sided agreement that establishes mutual obligations between the seller and buyer, the seller is obliged to deliver the goods and transfer the property in goods to the buyer. In addition, the object that the seller is selling to the buyer must be lawful, ascertainable and deliverable. On the other hand, the buyer is expected to pay the price and receive the goods from the seller. Unless otherwise agreed, s35 of the Act 1958 assumes that the paying of the price of the goods and their delivery should be simultaneous. This implies the seller committed to give the possession of the goods to the seller in exchange for the price.<sup>216</sup> Thus, Australian law requires the seller to deliver the goods and the buyer to accept them and pay in accordance with the conditions of the contract. This entails the obligation of the parties is reciprocal and consequently the law requires both parties to perform their obligations in the contract. Therefore, under the common law, the parties must perform the obligations of the contract, whether these are about performing something or abstaining from doing something that contravenes the contract.

Likewise, under Shariah law, as with the Australian contract that incorporates CISG, obligations and rights of the parties of the contract are fundamental for the sale contract. Shariah law applies the principle of ‘contract is the law of the contracting parties’ by emphasising the freedom of the contracting parties to enter the contract by their own will as long as it does not conflict with the principles of Shariah law. The Quran emphasises fulfilling the obligation of the contract, saying: “*You must fulfil your agreement, for every agreement you are accountable.*”<sup>217</sup> Thus, Islamic law requires the parties to treat all contracts as a sacred law and abstain from dishonest and fraudulent dealings in commercial transactions, regardless of whether they are governed by domestic law or are under international treaties such as the CISG. On the other hand, it does not differentiate whether the parties of the contract are individuals, the public, Muslims or non-Muslims. Therefore, the contract of sale under Shariah law generally agrees with articles 46 to 62 that cover the rights and obligations of the seller and buyer.<sup>218</sup> According to the concept of sacredness of contract under Shariah law, all contractual obligations are required to be specifically performed personally by the parties. The concept of sacredness of the contract is deeply rooted in Islamic law; the Quran emphasises this sanctity. Therefore, under Shariah law a contract is divine in nature and obliges the parties to uphold their agreement. Equally, the tradition of the prophet stresses the importance of the specific performance of the obligations of the contract unless it

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<sup>216</sup> Australia Government, above n 19.

<sup>217</sup> Al-Hilali and Khan, above n 373.

<sup>218</sup> Akaddaf, above n 40.

contravenes Shariah principles regarding the code of conduct or public policy. Because of the sacredness of the contract in Islamic law, scholars consider breaching it as breaching the Islamic code of conduct and the violation of the rights of society.

#### **4.4.1 Seller's obligations**

Under Australian law, the seller is obliged to deliver the goods and transfer the property in goods to the buyer. In addition, the goods that the seller is selling to the buyer must be lawful, ascertainable and deliverable. Shariah law like the CISG requires the seller to perform their specific obligations, such as delivering the goods to the buyer in the time and place specified and after the buyer pays the price, he passes the title to him in accordance with the terms of the contract of sale. Thus, the seller is obliged to personally perform unless the contract allows him to arrange someone else to perform on his behalf. The object that the seller is selling to the buyer must be lawful, ascertainable and deliverable. Moreover, according to the Shariah law, the seller must possess the ownership of the commodity before selling it to the purchaser.<sup>219</sup> Requiring possession of the goods before selling to the buyer and ensuring delivery to the buyer avoids uncertainty and risk in the transaction. In contrast, under the CISG, upon the sale of goods the ownership and associated risk transfer to the purchaser. The Quran (5:1) says: *"You must fulfil your agreement, for every agreement you are accountable."*<sup>220</sup> What is more, according to the concept of al-Khiyar(option) in Islamic jurisprudence, the seller is required to allow the purchaser to examine the condition of the goods before and after the conclusion of the agreement. Given this, if it is discovered either before or after the agreement that the goods are defective, the purchaser has the right to either cancel or continue with the agreement.<sup>221</sup>

The above discussion shows that, Shariah principles regarding the sale contract are compatible with the provision of CISG that restricts the buyer's right to compel the seller to perform if the harm is greater than the benefit that the innocent party obtains from the performance. Shariah law is also compatible with article 46 of the CISG that gives the buyer the right to ask the seller to undertake specific performance, as mentioned earlier.

##### **4.4.1.1 Assuming ownership of the goods**

The contract of sale occurs when a seller transfers or agrees to transfer goods to a buyer in the future. Thus, the Act requires the goods that are subject to a contract of sale to be owned (or possessed) by the seller at the time of the contract or to be acquired in the future. Under the Australian commercial law, if the goods subject to the sale are agreed upon and identified at the time of the contract between the seller and buyer and both parties accept the terms of the contract, the risk of the goods, even if the goods subject to the sale are not

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<sup>219</sup> Alzuhaili, above n ; Baker, above n 49.

<sup>220</sup> Al-Hilali and Khan, above n 141.

<sup>221</sup> Sheikh Mohammad Towhidul Karim, 'Protection of Rights of Consumers in Business Transaction: A Comparative Approach with Special Reference to Islamic Law' (2016) 10 *IJUC Studies* 183.

ascertained, will be passed on to the buyer. Pursuant to section 5(1) of the Act, the goods that are subject to sale can either be in existence (or specific) when the contract is made or unascertained and will be acquired, manufactured or grown by the seller in the future.<sup>222</sup>

The contract of sale occurs when a seller transfers or agrees to transfer goods to a buyer in the future. Thus, the Act requires the goods that are subject to a contract of sale to be owned (or possessed) by the seller at the time of the contract or to be acquired in the future. Pursuant to section 5(1) of the Act, the goods that are subject to sale can either be in existence (or specific) when the contract is made or unascertained and will be acquired, manufactured or grown by the seller in the future.<sup>223</sup>

In this regard, the legislation divides the goods into the following categories:

- specific goods that are known and agreed between the parties at the time of the contract;
- goods that are to be manufactured or acquired by the seller in future;
- goods that are specific and exist at the time of the contract, but the seller does not necessarily have their title;
- unknown goods that are to be the subject of the sale contract but have not exactly been identified; and
- determined goods which are unascertained; however, have been identified in the contract. This means that Australian commercial law permits the sale contract to be on goods that are currently owned or would be owned by the seller in the future if both parties agree on the description of the goods.

On the other hand, under the Australian commercial law<sup>224</sup>, validity of the sale contract needs to meet the following conditions:

First, when the contract is executed, the seller is required to transfer or agree to transfer goods to the buyer.

Second, the goods must be in exchange for money. This means, an exchange of goods with goods is not accepted as a contract of sale of goods according to Australian commercial law.

Third, when the price is not stated in the contract, but all other requirements are met, the contract will still be binding, and the buyer is required to pay a reasonable price.

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<sup>222</sup> Lisa. Spagnolo, 'The Last Outpost: Automatic CISG Opt Outs, Misapplications and the Costs of Ignoring the Vienna Sales Convention for Australian Lawyers.' [1] (2009) 10(1) Melbourne Journal of International Law 1.

<sup>223</sup> Ibid.

<sup>224</sup> Andy Gibson, Sophie Rigby and Gary Tamsitt, *Commercial law in principle* (Lawbook Company, 2005).

Fourth, the goods subject to sale must exist and be owned by the seller at the time of the contract. That said Australian commercial law permits the sale contract to be on future goods that would be acquired or manufactured by the seller. For example, if the goods subject to the sale are agreed upon and identified at the time of the contract between the seller and buyer and both parties accept the terms of the contract, the risk of the goods will be passed on to the buyer. In addition, if the goods subject to the sale are not ascertained, the risk passes to the buyer.

Although Australian law fills the external gaps of the convention, it is sometimes difficult to determine if a gap is internal or external because of the competing policy objectives of the domestic legal system. In this sense, when the obligations and rights are not clear, or the meaning is ambiguous, the court or the tribunal may interpret the contract by employing the general principles of the convention according to article 8 on the usage of trade to determine the obligations and the rights of the parties.

Comparatively, as discussed earlier, under Islamic law, the seller must possess the subject of sale physically or constructively at the time of sale to the buyer. This implies the seller (financier) can only sell commodities after acquiring them physically or constructively and will be liable for the risk of loss, defects or damage of the goods. This is contrary to the Australia commercial law that allows the seller(financier) to pass the risk of the goods subject to finance to the buyer (borrower) if the goods are not ascertained. Unlike the Australian commercial law, Islamic law does not allow the sale contract to be on future goods that would be acquired or manufactured by the seller because this unknown or doubtful transactions with the subject of sale (Gharar). Because of the uncertainty involving with the subject of the sale, the seller may not able to deliver the goods to the buyer. This is the reason the Prophet disapproved selling for what a person does not yet possess<sup>225</sup>. Thus, the sale of goods contract mutsmeet conditions that discussed before.

Nevertheless, in some situations, Islamic jurisprudence permits the contract to involve with unknown; for example, if a person hires a diver for a fixed price and agrees with him that whatever he catches belongs to him, because it eliminates ambiguity from the contract.<sup>226</sup> Furthermore, where a seller appoints someone else as an agent, the owner of the goods is liable for the actions of the customer who acts as an agent for buying goods from the supplier. Accordingly, if there are disputes about the condition of the goods that the exporter has sent to the importer or not complying with the documents, the owner/seller bears this risk according to Shariah law.<sup>227</sup> In addition, when the seller (financier) makes the customer its agent, it must make the agency contract separate and independent from the murabaha agreement itself.

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<sup>225</sup> Usmani, above n 89.

<sup>226</sup> El-Gamal, above n 120.

<sup>227</sup> Usmani, above n ; Chuah, above n 140

The above discussed on both the Australian commercial law and the Islamic law show their commonality (generally) on the ownership of the subject for sale, except when the subject of the sale relates to goods that would be acquired or manufactured by the seller in the future. Islamic law prohibits this because of its connection with this unknown or doubtful event that the seller may not be able to deliver the goods to the buyer on the due date.

#### 4.4.1.2 Delivering the Goods

Both Act 1958 and CISG require the seller to deliver the goods and transfer the property in goods to the buyer and receive the price from the buyer. According to article 30 of the Act 1958, the seller must deliver the goods, provide the documents relate to them and transfer the property in the goods to the buyer, as required by the section 1 of CISG Convention.<sup>228</sup> The delivery can be proved by communication of the parties or invoices as copies for an export bill of lading. Nevertheless, if the parties to the contract do not agree on the time, they must obey the rules of article 53 that states the buyer must pay the price and possess the goods as required by both the conditions of the contract and the guidelines of the CISG Conventions.<sup>229</sup>

Although the obligation of the seller to transfer goods and the buyer to accept them is pivotal for the contract of sale, the transfer of ownership does not depend on physical control or the possession of the goods because the transfer of property in goods (title) is different from their possession. The Act requires the seller to deliver the goods and transfer the property in goods to the buyer, reciprocally the buyer is expected to pay the price and receive the goods from the seller.

In this regard, section 35 of Act states that:

*Unless otherwise agreed, delivery of the goods and payment of the price are concurrent conditions (that is to say) the seller must be ready and willing to give possession of the goods to the buyer in exchange for the price, and the buyer must be ready and willing to pay the price in exchange for possession of the goods.*<sup>230</sup>

This indicate, the transfer of property in goods (through ownership or title) occurs when the parties intend to pass the goods from the seller to the buyer. In particular, for the delivery of the goods, the Goods Act sets out five rules for the transfer of ownership (title) from the seller to the buyer:

first, when the sale contract is an unconditional contract of goods in a deliverable state, the property in goods (title) passes to the buyer regardless of the time of the payment or the delivery. As s25 of the Act states, the risk in goods passes with the property, regardless of their delivery to the buyer. Under the contract of sale, the

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<sup>228</sup> Australia Government, above n 66.

<sup>229</sup> United Nations, United Nations Convention on Contracts for the International Sale of Goods, New York, United Nations Comm, 54 mtg.30.

<sup>230</sup> Australia Government, above n 19.



delivery of goods by the seller to the buyer and payment for them by the buyer in exchange for their possession is considered simultaneous, unless agreed otherwise by the parties. Second, the title does not pass to the buyer when the contract is for specific goods and the seller is obliged to ensure the goods are in a deliverable state, unless the seller does this and notifies the buyer. Third, when a contract is for sale of specific goods in a deliverable state, the seller is bound to weigh, measure, test or do anything else that relates to the determination of the price, and the title does not pass to the buyer until the seller undertakes these tasks and the buyer approves of them. Fourth, when the contract for sale of goods is delivered to the buyer on the condition of approval or a sale and return arrangement, the title only passes to the buyer if he accepts or does not indicate any rejection.<sup>231</sup> This means the buyer is deemed to accept the offer after the expiration of a given period for acceptance or return of the goods, if he does not show anything that indicates his/her rejection of the purchase or a reasonable time has elapsed to consider acceptance of the offer according to the custom and practice of the trade. Five, where the goods subject to the sale are unascertained, their title passes to the buyer if the seller and buyer agree concurrently with the classification of the goods. However, if the seller delivers goods to the buyer, a carrier or a bailee (whether or not it has been named by the buyer) and the buyer does not reserve the right of removal, the seller is deemed to have unconditionally appropriated the goods to the contract.<sup>232</sup> But these obligations are not strict because, according to section 31 of the Act, the parties have the right to stipulate conditions other than those required by the Act. This provides flexibility to the buyer in accepting goods that do not meet these criteria, if they stipulate conditions in the contract.

In both the domestic and cross-border transaction, the seller is obliged to deliver the goods to the buyer in the time and place specified in the contract or pass the title onto him as stipulated in the contract.<sup>233</sup> According to article 1(1) (a), of the Act, the contract of sale will be international when the sale contract meets the following conditions:

when the contracting parties have their businesses in different states or live in different states that are both contracting states, regardless of whether or not they are aware the states in which their places of business are located are contracting states of the Convention. For example, if an exporter whose place of business in Malaysia sells goods to another business person in China, the convention will apply to the contract as both countries are contracting states. However, if the parties of the contract do not have a place of business in different countries, yet the private international law approves the application of the law of a contracting state, the convention governs it. But, if one party to the contract has a place of business in a signed state. The place of business is where it is registered. According to article 10(1), if the business is in several different places, the place of the business is the one that has the closest relationship to the performance place of the contract,

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<sup>231</sup> Ibid.; Austrade, Islamic finance., Australian Trade Commission No (2010).

<sup>232</sup> Peter Gillies, Business law. Annandale (NSW: Federation Press, 2004).

<sup>233</sup> Australia Government, above n 9.

taking into consideration the circumstances known to the parties at the time of the conclusion of the contract. However, if a party to the contract does not have a place of business, the place of business is their habitual residence.<sup>234</sup> Under article 4 of the Rome Convention, which is considered supplementary to the CISG Convention when there is no valid choice of law clause in the contract "the contract is most closely connected with the country where the party who is to affect the performance of the contract has at the time of the conclusion of the contract took place in the habitual residence, or in the case of a body corporate or incorporate, the residence is the central administration of the business."<sup>235</sup> For example, if the seller has a place of business in both Australia and the UAE, and the buyer has a place of business in the UAE, the performance of the sale contract is more closely related to the UAE than Australia.

On the other hand, Islamic law like the common law (including the CISG) requires the seller to deliver the goods to the buyer in the time and place specified in the contract. However, Islamic law demands the seller to possess the goods physically or constructively before selling to the buyer and ensure the delivery of the goods to the buyer. In this regard, the Quran (5:1) says: *"You must fulfil your agreement, for every agreement you are accountable."*<sup>236</sup> Furthermore, Islamic law requires the object of sale to be lawful, ascertainable and deliverable. Finally, Islamic law requires the seller to allow the purchaser to examine the condition of the goods before and after the conclusion of the agreement. In contrast, under the CISG, upon the sale of goods the ownership and associated risk transfer to the purchaser.

#### **4.4.1.3 Receiving the price of the Goods**

Under the Australian commercial law, the parties of the contract of sale could determine the price or leave it to be fixed in the future in a manner that they agreed or determine by the course of dealing between them. Unless otherwise agreed, s35 of the Act 1958 assumes that the paying of the price of the goods and their delivery to be simultaneous. This means, the buyer is prepared to pay the price of the goods to the seller in exchange for the possession of the goods, and the seller committed to give the possession of the goods to the seller in exchange for the price.<sup>237</sup> However, when the price is not determined according to the previous dealings, the buyer is expected to pay a reasonable price depending on the circumstances of the contract. On the other hand, according to article 6 of the CISG, the first obligation of the buyer is to pay the price at the agreed time and place and receive the goods. The place of the payment is usually the seller's place of business unless the agreement determines another place. So, failure to pay the price by the buyer constitutes

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<sup>234</sup> Sunil R Harjani, 'Convention on Contracts for the International Sale of Goods in United States Courts, The' (2000) 23 *Houston Journal of International Law* 49; Hayward, above n ; Md Zahidul Islam, 'Applicability of the Convention on Contracts for International Sale and Goods (CISG)' (2013) 14(13) *Journal of Humanities and Social Science* 4.

<sup>235</sup> Kilian Balz, 'Islamic Law as the Governing Law under the Rome Convention: Universalist Lex Mercatoria vs. the Regional Unification of Law' (2001) 8 *YB Islamic & Middle EL* 73; Louis F. Del Duca, and Patrick Del Duca. , 'Selected Topics Under the Convention on International Sale of Goods (CISG)' (2001) 106 *Dickinson Law Review* 205.

<sup>236</sup> Al-Hilali and Khan, above n 141.

<sup>237</sup> Ausralia Government, above n 19.

nonconformity, which can result in a judgment in favour of the seller. Nevertheless, if the parties do not agree about the time, they must obey the rules of article 53 that states that the buyer must pay the price and possess the goods according to the guidelines of the CISG convention. In addition, under article 55 of the CISG, if at the conclusion of contract, the prices of the goods is not expressly or implicitly determined, in the absence of any indication to the contrary, the price is considered to have implied to the price that generally charged at the time of the conclusion of the contract for goods sold that share common circumstances with this good.<sup>238</sup>

On the other hand, section 55 of the Goods Act states that if the seller delivers the property (the title) in the goods to the buyer; however, the buyer refuses or neglects to pay for the goods according to the terms of the contract, the seller is entitled to sue the buyer for the price of the goods.<sup>239</sup> According to section 51 of the Act, the seller can sue the buyer for the price of the goods when the property has passed to the buyer, regardless of whether the buyer has received it.

However, the seller may not resort to any remedy unless the buyer notifies him that he will not perform during the assigned period for the performance. In addition, the seller has the right to claim damages for the delay of the performance. Moreover, the seller may declare the contract void if the failure of the buyer to perform constitutes a fundamental breach of contract or, according to article 63, the buyer has not paid the price and taken the goods within the extended period that was given by the seller. Nonetheless, according to article 64 of the Act, the seller loses the right to declare the contract to be invalid if the buyer pays the price.

On the other hand, under (2) of s55 of the Act, if the payment is agreed by parties on a certain day regardless of the delivery of goods to the buyer and the buyer unlawfully neglects or refuses to pay the price of the goods as agreed in the contract, the seller is entitled to bring a claim for the price. Moreover, if the delivery is delayed because of the fault of the buyer, the buyer bears the risk of any consequential loss, regardless of whether or not the property in the goods has been transferred to the buyer. This means the seller sues the buyer for the price even though the property in goods (title) has not passed to the buyer and the goods have not been appropriated to the contract. In addition, pursuant to (1) s56 of the Act, the seller might sue the buyer for damages of non-acceptance if the buyer wrongly neglects or refuses to accept the goods and pay for them.<sup>240</sup>

In comparison, as discussed in chapter three, Islamic law, same as the Act, requires the buyer to pay the price for the goods and take delivery of the goods or obtain their title. However, same as the common law, before paying the price the buyer has the right according to the Islamic rule of al-Khiyar(option) to examine the condition of the goods. In addition, the above discussion shows that Islamic principles regarding the sale contract are in general compatible with the provision of the common law that restricts the buyer's right to

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<sup>238</sup> United Nations, New York, United Nations Comm, 54 mtg.

<sup>239</sup> Australia Government, above n 29.

<sup>240</sup> Ibid.

compel the seller to perform if the harm is greater than the benefit that the innocent party obtains from the performance. Furthermore, as the discussion of the study shows, Islamic principles regarding the sale contract are compatible with the provision of CISG that restricts the buyer's right to compel the seller to perform if the harm is greater than the benefit that the innocent party obtains from the performance.

#### **4.4.1.4 Charging interest for defaulting of the buyer**

Under Australian contract law, the buyer may pay interest for the default or delay of payment. According to s60 of the Act 1958, the aggrieved party in the contract is entitled to interest from the defaulting party.<sup>241</sup> According to this article nothing will affect the aggrieving party to recover interest where by law interest may be recoverable, or to recover money paid where the consideration for the payment of it has failed. In addition, according to article 70 of the CISG that explicitly imposes interest on the non-performing party by asserting that, *"If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it, without prejudice to any claim for damages recoverable under article 74."*<sup>242</sup> Under article 74, the grieving party is entitled to interest if the buyer fails to pay the price or any other sum that is in arrears without prejudice to any claim for damages recoverable under article

Although this article explicitly imposes interest on the non-performing party, it seems to be vague and does not precisely determine the rate of interest that will be given to the grieving party.

This provides room for a domestic court to determine the rate of interest through the principle of conflict of laws by using private international law (conflicts of law) principle.<sup>243</sup> This means when any dispute regarding defaulting on the price or payment is brought to the court it can interpret the contract according to the principles of the CISG to preserve the uniformity of the convention and keep its international character, and the court may impose interest by using article 7(1) that states the following reasons for paying interest:

first, interest is compensation to the grieving party to restore him to his previous position if the default of the payment had not happened. Second, interest is based on the presumption that money naturally produces interest over time. Third, interest is based on the time value of money and the lost opportunity to earn money due to default of funds. Fourth, the nominal rates protect the grieving party from inflation and currency depreciation during the period of the default and the date of the full payment. Fifth, the compensation is based on the cost that the creditor would incur in securing alternative finance as a substitute for money defaulted. Sixth, charging interest for the default prevents unfair enrichment of the debtor at the expense of the creditor

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<sup>241</sup> Ibid.

<sup>242</sup> United Nations, New York, United Nations Comm, 54 mtg.

<sup>243</sup> Luca Castellani, 'Promoting Uniform Law in Countries Influenced by Islamic Law: The Example of the United Nations Convention on Contracts for the International Sale of Goods' (2014) The Protection Project Journal of Human Rights and Civil Society 14.

and discourages him from delaying payment.<sup>244</sup> This implies that when the debtor delays the payment, he may benefit unfairly from the funds of the creditor during the defaulting period at the creditor's expense. Therefore, imposing interest on defaulters deters non-payment or delayed payment and makes them take precautions to avoid future litigation.

On the other hand, the issue of interest under the Shariah law, which means any unjustifiable increase of capital in sales or loans, as discussed in chapter 2, conflicts with both s60 of the Act 1958 that states that the buyer to pay interest for the default or the delay of payment as discussed earlier in this chapter, and article 78 of the CISG that mandates interest to be paid to the grieving party: "*If a party fails to pay the price or any other sum that is in arrears.*"<sup>245</sup> Thus, Islamic law principles regarding interest seem not only difficult to reconcile with article 78, but also raises the question of how the Islamic contracting parties, such as Islamic financial institutions that operate in western countries such as Australia, proscribe interest from being awarded to the grieving party. Some may argue that as far as the Islamic countries signed the CISG Convention without reservation, Islamic financial institutions and individuals are obliged to comply with article 78.<sup>246</sup> However, as accepting interest being awarded conflicts with the most important characteristic of Islamic finance (prohibition of interest) which triggers the transaction to be non Shariah compliant, someone may argue that this problem can be overcome by using the permission that article 1 of the Convention to the parties of international sale contract to exclude some provisions of the CISG, such as article 78, from the contract. Nonetheless, the problems may arise when although the exclusion of this article may satisfy the demand of Muslim clients, the non-Muslim contracting parties who may enter sale contracts with the belief that the remedies of default will be based on interest guaranteed by the article 78 may not accept this exclusion. This might jeopardise business relations between Muslims and non-Muslims. Therefore, this problem may be solved by using the penalty that some scholars suggested to be imposed on defaulters, particularly when they delay the payment without acceptable reasons. However, this penalty rate (as will be discussed in the following chapter) to be not resemble the conventional interest rate, should be based on the return rate *that a bank gives (or would have given) to Investment Account Depositors during the defaulting period.*<sup>247</sup> However, before penalising the defaulter the following conditions need to be met:

First, it should be proved that the debtor defaulted on the loan *deliberately* without acceptable reason. This implies that if the defaulter evades the payment because of poverty or hardship, no penalty will be charged. Instead, he will be given sufficient time to pay the debt. Second, the bank as a seller should give the defaulting client a reasonable grace period to pay the loan or the remaining part of the loan and if the buyer does not

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<sup>244</sup> Sze Lum Leung, A critical evaluation of methods for the calculation of interest rate under Article 78 of the United Nations Convention on Contracts for the International Sale of Goods ("CISG") (University of Hong Kong, 2014).

<sup>245</sup> United Nations, New York, United Nations Comm, 54 mtg.

<sup>246</sup> Twibell, above n 27.

<sup>247</sup> Usmani, above n 91.

make payment within the given period, the bank charges a penalty. This is consistent with both the Quran encouraging the creditor to give an extension or even waive the loan to the debtor as a charitable act when he cannot repay it, and the rationale behind the prohibition of interest. Third, the penalty should be imposed even if the investment accounts do not earn any profit during the defaulting period.

#### 4.4.1.5 Specific Performance

In section 58 of the Act, the court may order a party that breaches his contractual obligations to perform specific duties stipulated in the contract.<sup>248</sup> This Act requires specific performance from the breaching party when money alone is not adequate to compensate for the damages of the breach, because of the uniqueness of the subject matter of the contract, repair of the damages or anything that can be considered as fair compensation for the grieving party.

When financial compensation cannot be paid or is insufficient for compensation or damages to the seller, he is entitled to require specific performance from the buyer. In addition, when money is not an appropriate remedy and the common law is incapable of providing a solution, the court can use equity to ensure justice is served. However, if the loss is limited to the seller (creditor) and financial compensation can cover this loss, a special performance will not be required by the seller from the buyer.<sup>249</sup> The requirement of this article is compatible with the common law requirement of the breaching party to compensate the damages that they inflicted on the other party.

However, when financial compensation cannot be paid or is insufficient for compensation or damages to the seller, he is entitled to require specific performance from the buyer. the object of damages is to compensate the actual loss, and award damages to restore the aggrieved party to the position he would have occupied if the contract had been performed as agreed. However, as article 28 of the Act does not grant this right to the buyer if the local law does not require specific performance from the defaulting seller.<sup>250</sup>

In performing the specific performance of the commercial contracts, Islam law stresses morality, honesty and fairness, whether the contract is governed by a treaty convention, common law or Islamic law. In addition, it requires parties to disclose all the information about the contract such as defect of the goods, fraud, concealment in transactions and avoiding misrepresentation in the provisions of the contract to observe good faith. This is evident in the Hadith of the prophet that says: *“It is illegal for one to sell a thing if one knows that it has a defect, unless one informs the buyer of that defect.”*<sup>251</sup> This indicates that acting in good faith in

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<sup>248</sup> Australia Government, above n 30.

<sup>249</sup> Akaddaf, above n 40.

<sup>250</sup> Article 28 says: “If, in accordance with the provisions of this Convention, one party is entitled to require performance of any obligation by the other party, a court is not bound to enter a judgement for specific performance unless the court would do so under its own law in respect of similar contracts of sale not governed by this Convention”.

<sup>251</sup> Bukhari, above n 3,155.

commercial transactions is crucial according to Islamic law to avoid the contract being broken and to protect society from disputes. Moreover, under Shariah law, like the CISG, acting in good faith is presumed throughout the contract period, and therefore the parties are judged by their intention as expressed in the contract unless the contrary is proven.<sup>252</sup> Acting in good faith and fulfilling the conditions and terms of the contract is required by the Quran whether it is bilateral or multilateral as mentioned before.

In comparison, under Islamic law, the buyer must execute the specific performance personally if stated expressly or impliedly in the contract. What is more, it requires the breaching buyer to compensate for damages that they inflict on a seller. However, the specific performance will only be required from the buyer when financial compensation cannot be paid or is not sufficient for the compensation of the loss of the seller. This restriction, based on the principle of specific performance to be denied if it causes hardship and suffering that is greater than the benefit the injured party gains from the performance.<sup>253</sup> This principle, based on the concept of equity and equal bargaining, which means that neither the rights of parties of the contract can be abused, nor the contractual relationship should be harmed. Therefore, the specific performance required by Shariah law from the buyer seems to be compatible with the requirement of the Act 1958, Australian common law and CISG.

Nonetheless, when the requirements of specific performance and the issue of good faith appear to be an important step in achieving harmony between Shariah law and the CISG on the murabaha sale contract, there are still significant differences between the CISG and Shariah principles on the issue of interest which may make determining remedies for breaching the sale contract difficult.

#### **4.4.1.6 Remedies for the Seller**

In the Australian commercial law, the parties must perform the obligations of the contract, for either performing something or abstaining from doing something that breaches the contract. Section 40 of the Act states that when the contract of sale is executed and the seller has made the goods ready for delivery and notified the buyer to take them; however, the buyer fails to receive delivery without an acceptable excuse, the seller has the right to sue the buyer to recover any loss that arises from the buyer's failure to take the goods including the cost incurred for keeping them as inventory.<sup>254</sup> However, if the goods are destroyed before the property passes to the buyer without fault of either party or the seller's knowledge of their destruction at the time of the contract, the contract becomes void. Similarly, article 30 of the CISG obliges the seller to deliver

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<sup>252</sup> Aljeriwi, above n ; Gary F. Bell, 'Harmonisation of Contract Law in Asia-Harmonising Regionally or Adopting Global Harmonisations-The Example of the CISG' (2005) *Sing J. Legal Stud.* 362.

<sup>253</sup> Malik Bin Anas, Almuwada (Resalah Publishers, 2013).

<sup>254</sup> Australia Government, above n 22.

the possession of goods to the buyer and transfer any documents that relate to them as agreed in the contract, and the buyer is expected to receive the goods and pay their price to the seller.

Thus, at the breach of a contract the aggrieved party has the right to claim discharge from further performance and sue the breaching party for award if the contract provides this right or the seriousness of the breach justifies termination of the contract. The contract can be terminated, and each party released from obligation when (a) a party breaches the contract, (b) operation of the law because of frustration, (c) non-fulfilment of the contingent condition of performance, and (d) consent of the parties.

When the breach is fundamental, the grieving party is entitled to claim and treat the contract as discharged. However, when the breach is not fundamental, the aggrieved party is only entitled to claim damages<sup>255</sup>.

The remedy should compensate the actual loss, and award damages to restore the aggrieved party to the position he would have occupied if the contract had been performed as agreed. However, under the remedy, not only the innocent party is assured of recovering the loss but also the breaching party is assured it will not be liable over and above the actual loss that the innocent party suffered. Ideal damages (those awarded not to compensate loss but to punish or deter a wrongdoer who is guilty) are therefore not normally available in a contract, even if the breach being complained about was intentional or maliciously motivated.<sup>256</sup> This suggests that if the innocent party sues for any breach, substantial damages can only be recovered for substantial loss. It means if there has not been consequential loss, or where there is no evidence of what the plaintiff's loss was, all that can be recovered are the nominal damages which can be small sums of money awarded to the grieving party to acknowledge both the existence of a breach and disapproval of this kind of behaviour.

#### **4.4.2 Buyer's obligations**

In the Islamic law, the buyer (borrower) must execute the specific performance personally if stated expressly or impliedly in the contract. According to article 53 of the Act, the buyer is required to pay the price for the goods at the agreed time and take delivery of them.<sup>257</sup> In addition, according to articles 46 and 62 of the CISG, the buyer's obligations include: paying the price of the goods at the agreed time and place, receiving the goods, examining the conformity of the goods to the terms of the agreement and, in the case of non-conformity with the terms of the contract, notify the nonconformity to the seller within a reasonable period.

##### **4.4.2.1 Receiving the Goods and Paying the Price**

The buyer is entitled to claim remedy when the seller fails to perform his obligations in the contract. in the breach to deliver the goods to the buyer, the court if convinced of the case of the buyer, may order the seller

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<sup>255</sup>.Ibid.

<sup>256</sup> Akaddaf, above n 35.

<sup>257</sup> Ausralia Government, above n 19.



to deliver the goods to the buyer without giving the seller the option to obtain the goods on payment of damages.

According to article 58(3) of the Act, the buyer is not obliged to pay the price before receiving and examining the goods or arranging for someone else to examine them on his behalf to ensure their conformity and give notice of any nonconformity to the terms and conditions of the contract within a reasonable time (given the circumstances of the contract) to the seller.<sup>258</sup> However, when goods are delivered, their examination can be deferred until they reach their destination. However, when the goods are re-directed while in transit or the buyer returns them without having a reasonable time to examine them and the seller knew or ought to have known at the time of the conclusion of the contract the possibility of returning or re-directing the goods, the examination of the goods will take place after their arrival to the new destination. Thus, according to article 60 of the CISG, the buyer is bound to take all the necessary steps that enable the seller to make the delivery of the goods.

In comparison, Shariah law requires if the buyer breaches the contract to compensate for damages that he inflicts on the seller. This restriction, based on the principle of no harm “*la darara walaa diraara*”, which demands specific performance to be denied if it causes hardship and suffering that is greater than the benefit the injured party gains from the performance. This principle is based on the concept of equity and equal bargaining, which means that neither the rights of parties of the contract can be abused, nor the contractual relationship should be harmed. The specific performance required by Shariah law from the buyer seems to be compatible with the requirement of the Act 1958, Australian common law and CISG Convention. What is more, the concept of good faith in Islamic law is like the notion of good faith in article 7(1) of the CISG. Islamic law emphasises honesty, acting in good faith and fulfilling the obligations of the contract fairly and reasonably and forbids trickery and falsification in a contract as discussed earlier.

Islamic law describes the fulfilment of the conditions and terms of the contract as a characteristic of the believer and considers breaking the contract to be the characteristic of a hypocrite. It also the Quran (5:89) forbids dishonest and fraudulent dealings in commercial transactions, saying: “*Woe to the fraudulent dealers, who exact full measure from others, but give less than due to others in weight and measure, do they not know that they will be called to account, on a mighty day.*”<sup>259</sup> This is in line with the principle of “*la darara walaa diraara*” which literally means the harm of the specific performance to the performing party should not be more severe than what the grieving party has already suffered.

According to the sacredness of the contract under Shariah law, these verses and Hadiths demonstrate that the parties in the commercial contract are expected to be truthful, fulfil their obligations in good faith, or face the

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<sup>258</sup> Ibid.

<sup>259</sup> .Al-Hilali and Khan, above n 161.

consequences of acting dishonestly or fraudulently. Furthermore, article 2(4) (1) of the Shariah Standards of the AAOIF states that “*it is prohibited to forge documents or conceal their content or destroy them to bring about the loss of other peoples’ rights.*”<sup>260</sup> This emphasises the good faith and upholding honest behaviour for all contracts, Islamic law is in the same position as the CISG. This shows, in general, the obligations of the seller and the buyer under the Islamic law agrees with the Act 1958 and CISG Convention.

#### 4.4.2.2 Specific performance

Under section 57 of the Act, the buyer can sue the seller for damages because of non-delivery of the goods when: (1) the seller wrongfully neglects or refuses to deliver the goods to the buyer, (2) the damages are the result of the ordinary course of events because of the seller’s breach the contract; and (3) when the seller transfers goods by mistake to a third party, the buyer has the right to ask for the goods to be changed<sup>261</sup>. Nonetheless, if the seller fails to perform, the buyer can demand specific performance from the seller according and according to section 58 of the Act, the court may order to perform specific duties stipulated in the contract.<sup>262</sup>

On the other, The CISG gives the buyer the right to specific performance, such as the right to avoid the contract if there is a fundamental breach in it, the right to damages, the right to price reduction and the right to cure. For example, the buyer may be awarded a specific performance if the loss, destruction or the defects of the goods are unique. The specific performance might include payment of the price of the goods, performance or anything else that the court or tribunal considers to be fair compensation to the buyer. However, when these obligations and rights are not clear in the contract or the meaning is ambiguous, the court or the tribunal may interpret the contract by employing the general principles of the convention according to article 8 or the usage of trade to determine the obligations and rights of the parties. This concurs with article 46 of the CISG that provides the buyer with the right to ask the seller to undertake specific performance. However, this will only be required from the buyer when financial compensation cannot be paid or is not adequate for compensation to the aggrieved party.

Pursuant to article 39 of the Act, the buyer loses the right to claim specific performance on the ground of lack of conformity if he has not provided a notice to the seller within a reasonable time after he has discovered it or ought to have discovered it.<sup>263</sup> This article imposes a two-year limitation as a maximum period for notification of the lack of conformity of goods by the buyer, starting from the time of their delivery to the buyer. This implies that the buyer loses the right to apply specific performance if he does not submit the notice to the seller within a period of two years starting from the date on which the goods were delivered to the buyer,

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<sup>260</sup> AAOIF, above n 126.

<sup>261</sup> Gibson, above n 450.

<sup>262</sup> Australia Government, above n 30.

<sup>263</sup> Ibid.69.

unless this time is inconsistent with the contractual period of the guarantee. In this regard, article 68 of the Vienna Convention states that the risk of goods sold in transit passes to the buyer from the time of the conclusion of the contract.<sup>264</sup> However, if the circumstances indicate the risk is assumed by the buyer from the time the goods were handed over to the carrier who issued the documents embodying the contract of carriage, if at the time of the conclusion of the contract of sale the seller knew or ought to have known the goods had been lost or damaged and did not disclose this to the buyer, the loss or damage is at the risk of the seller. But it depends on whether the seller before presenting the shipping documents to the purchaser was aware the goods were defective; if so, this is fraud and as a result the contract cannot proceed.

On the other hand, it describes the fulfilment of the conditions and terms of the contract as a characteristic of the believer and considers breaking the contract to be the characteristic of a hypocrite. The Quran (5:89) states that: *“You must fulfil your agreement, for every agreement you are accountable”*. It also (5:89) forbids dishonest and fraudulent dealings in commercial transactions, saying: *“Woe to the fraudulent dealers, who exact full measure from others, but give less than due to others in weight and measure, do they not know that they will be called to account, on a mighty day.”*<sup>265</sup> This shows Islamic law stresses morality, honesty and fairness in commercial transactions and requires the contracting parties to fulfil their obligations according to these principles, whether the contract is governed by a treaty convention, common law or Islamic law. In addition, it requires parties to disclose all the information about the contract such as defect of the goods, fraud, concealment in transactions and avoiding misrepresentation in the provisions of the contract to observe good faith. This is evident in the Hadith of the prophet that says: *“It is illegal for one to sell a thing if one knows that it has a defect, unless one informs the buyer of that defect.”*<sup>266</sup> This indicates that acting in good faith in commercial transactions is crucial according to Islamic law to avoid the contract being broken and to protect society from disputes. Moreover, under Shariah law, like the CISG, acting in good faith is presumed throughout the contract period, and therefore the parties are judged by their intention as expressed in the contract unless the contrary is proven. Acting in good faith and fulfilling the conditions and terms of the contract is required by the Quran whether it is bilateral or multilateral. In this regard, the Quran says: *“O you who attained to faith! Fulfil your bonds (contracts).”*<sup>267</sup> Furthermore, to this effect the Quran (4:29) says: *“Do not devour your property among yourselves falsely except that it be trading by your mutual consent.”*<sup>268</sup> According to the sacredness of the contract under Shariah law, these verses and Hadiths demonstrate that the parties in the commercial contract are expected to be truthful, fulfil their obligations in good faith, or face the consequences of acting dishonestly or fraudulently. Furthermore, article 2(4) (1) of the Shariah Standards of

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<sup>264</sup> United Nations, New York, United Nations Comm, 54 mtg.

<sup>265</sup> Al-Hilali and Khan, above n 162.

<sup>266</sup> Bukhari, above n 3, 171

<sup>267</sup> (translated by Muhammad Muhsin Khan) Muhammad bin Ismail Abu Abdullah Al-Bukhari, Sahih Bukhari (Volume 3, Number 486) (2009) vol 1W.

<sup>268</sup> Al-Hilali and Khan, above n 112.

the AAOIF states that “it is prohibited to forge documents or conceal their content or destroy them to bring about the loss of other peoples’ rights.”<sup>269</sup> This emphasises the good faith and upholding honest behaviour for all contracts, Islamic law is in the same position as the CISG. Nevertheless, when the requirements of specific performance and the issue of good faith appear to be an important step in achieving harmony between Shariah law and the CISG on the murabaha sale contract, there are still significant differences between the CISG and Shariah principles on the issue of interest which may make determining remedies for breaching the sale contract difficult.

From this discussion, it can be concluded that the obligations of the seller and the buyer under the Islamic law agrees with Act 1958 and CISG.

#### **4.4.2.3 Remedies for the Buyer**

Under Australian commercial law, if the goods fail to conform despite the performance of the seller the buyer can demand, when certain requirements in article 46 are met, to repair the damages or re-delivery of the goods or undertaken specific performance.<sup>270</sup> In the breach to deliver the goods to the buyer, if the court accepts the argument of the buyer it may order the seller to deliver the goods to the buyer without giving the seller the option of obtaining the goods on payment of damages. However, when the aggrieved party cannot treat the contract as discharged or where he had the option to do so but decided not to, the contract remains valid and both parties are still required to perform their obligations and be liable to each other in the event of future breach.

According to section 59 of the Act, at the breach of the seller of the contract, the buyer is entitled to remedy by establishing that the seller breached the contractual obligations. However, when the aggrieved buyer cannot treat the contract as discharged or where he had the option to do so but decides not to, the contract remains valid and both parties are still required to perform their obligations and be liable to each other in the event of future breach. Nonetheless, the continuing contract will not be the same as the original version as it is not being performed as originally intended, and the innocent party is now getting less than was bargained for, which entitles them to be compensated for damages.<sup>271</sup> In addition, the loss results in the ordinary course of events from the breach of warranty. However, when the aggrieved buyer cannot treat the contract as discharged or where he had the option to do so but decides not to, the contract remains valid and both parties are still required to perform their obligations and be liable to each other in the event of future breach. Nonetheless, the continuing contract will not be the same as the original version as it is not being performed as originally intended, and the innocent party is now getting less than was bargained for, which entitles them to be

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<sup>269</sup> AAOIF, above n 126.

<sup>270</sup> Allison E. Butler, *A practical guide to CISG litigation: negotiations through litigation* (Chapter 2) (Aspen Publishers, 2007).

<sup>271</sup> Brendan J Sweeney, Jennifer N O'Reilly and Andrew Coleman, *Law in commerce* (LexisNexis Butterworths, 2007).

compensated for damages.<sup>272</sup> In addition, the loss results in the ordinary course of events from the breach of warranty.

This means, under the remedy, not only the innocent party is assured of recovering the loss but also the breaching party is assured it will not be liable over and above the actual loss that the innocent party suffered. However, if the buyer establishes that the breach of warranty decreased the payment, this does not prevent him from maintaining an action for the same breach of warranty if he suffers further damage. On the other hand, as the discussion of the study has shown, Islamic law, the Act and the CISG put great emphasis on testimonial evidence to derive the intention of the parties and the usage of the goods. Finally, the position of Shariah law seems to be consistent with the requirements of the CISG which determine the intention of the parties of the contract by examining the circumstances of the agreement, such as the negotiations, practices, conduct of the parties and the trade usage.

The above discussion shows that the contract law required for Islamic financial contracts in Australia is not different from those applicable to the conventional financial contacts. Therefore, the Australian regulatory regime can regulate Islamic financial transactions in parallel with the conventional financial transactions.

This makes the murabaha contract both operationally and commercially desirable in Australia. However, due to the explicit and distinctive features of Islamic finance in general and in particular the murabaha contract, such as, the issues of the prohibition of interest on defaulted payment and penalising interest to the breaching party in the contract, assuming the risk of finance and avoiding uncertainty in the financial transaction, amendments needed to be made to the Australian commercial law elements that pertain to the Shariah compliance requirement of the murabaha contract within Australian legal framework. This shows, without adequately addressing the specific legal and regulatory requirements of the Islamic financial transactions and particularly murabaha transactions, the operability of the murabaha and its commercial viability under the Australia law would be jeopardised.

## **4.5 Concluding Remarks**

As discussed in this chapter, Islamic law and common law share common principles as, generally, the legal foundations of both systems are based on precedents. However, Islamic law offers its own framework for the commercial and financial contracts and transactions. Islamic scholars developed legal rules by using the guidelines of the Quran and the Sunnah (the sayings, approves and practices of Prophet Mohamed). These legal rules, which represent a natural extension of human understanding of these two main Islamic legal sources, has same characteristics (to some extent) as the common law.

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<sup>272</sup> Ibid.

The two systems generally agree on the essential elements that are necessary for the validity and enforceability of a sale contract. Australian contract law and CISG which incorporated into Australian law appear to be no different from the position of Islamic contract law on the requirements of the specific performance of the parties to fulfil their contractual obligations. The position of Australian contract law on the issue of assuming ownership of the goods before selling them to the buyer is almost same as the position of the Islamic law. In general, they require the goods that are subject to a contract of sale to be owned (or possessed) by the seller at the time of the contract or to be acquired by the seller in the future. However, while the Islamic law generally does not allow the seller (financier) to sale what he does not own yet as this is considered uncertainty (Gharar) that is not allowed, Australia law permits selling what will be owned or manufactured in the future. Moreover, while Islamic law requires the seller(financier) to assume the risk of the goods subject to sale(finance), Australia law allow the seller(financier) to transfer the risk to the buyer (borrower).

Notwithstanding, while Shariah law and the Australian contract law agree on most essential elements of the sale contract, they differ on the issues of charging interest on the breaching party in the contract, assuming the risk of finance and avoiding excessive uncertainty in financial transactions. In contrast to the Shariah law, under Australian contract law, nothing will affect the right of the aggrieved party to recover interest when by law the interest is recoverable. Moreover, CISG imposes interest when the buyer fails to pay the price or any other sum that is in arrears. Furthermore, both Australian and Shariah law agree on the requirement of delivering the sold goods to the buyer either physically or providing the title at the nominated place in the contract. Finally, under both legal systems, the remedy not only the innocent party is assured of recovering the loss but also the breaching party is assured it will not be liable over and above the actual loss that the innocent party suffered.

Nevertheless, due to the explicit and distinctive features of Islamic finance in general and the murabaha contract in particular, amendments needed to be made to the Australian commercial law elements that pertain to the Shariah compliance requirement of the murabaha contract within Australian legal framework. Without adequately addressing the specific legal and regulatory requirements of the murabaha transactions, the operability of the murabaha and being commercially viability under the Australia law would be jeopardised. This implies murabaha would be vulnerable for the risk of non-Shariah compliance despite its compliance with the Australian common law unless amendments are made in the Australian commercial law to accommodate Islamic law elements pertaining to the murabaha contract within Australian legal framework, it will be exposed to the risk of non-Shariah compliant, which jeopardises its legitimacy and commercial viability in Australia. This may defeat the very purpose of the existence of the Islamic financing under the murabaha sale contract.

However, as incorporating murabaha as a sale contract into the Australia common law framework seems to be achievable if some amendments are made to the Australia law to accommodate Islamic finance, the

discussion now turns into the examination of the practice of the murabaha as a credit contract to see whether it is operationally and commercially viable product under the common law jurisdiction, while also remaining Shariah compliant.

# CHAPTER 5: MURABAHA AS A CREDIT CONTRACT

## 5.1 Introduction

As the Islamic financial system becomes increasingly global, IFIs and their customers in a variety of jurisdictions have taken the opportunity to gather their resources and form associations for joint participation in international business. As shariah principles provide the foundations for Islamic financial transactions, these principles are being integrated into international commercial agreements and non-Islamic legal environments, which are not necessarily bound to Islamic principles—at least where commercial agreements are concerned.

Islamic financial products and services represent elements of a broad process of financial innovation and diversification in the financial landscape. Islamic financial institutions offer various financial products as alternatives to conventional interest-bearing financial products for financing trade, working capital, issuance of letters of credit, consumer durables, equipment, raw materials and machinery. They mainly use a structured *murabaha* sale contract as an alternative financing instrument to the lending practices of conventional banks in the common law jurisdiction that under the Consumer Credit Code (the Code) considers any contract if there is a credit is advanced if there is a charge for the credit regardless if the charge is in the form of interest or not.<sup>273</sup> This contract, the *murabaha* sale by instalment that Islamic financial institutions claim they do not charge for the credit advanced under it. Within this, the first part of the chapter discusses the practices of Islamic financial institutions in Britain, Malaysia and Australia to understand the extent of Shariah compliance with the practices of *murabaha* financing. The second part discusses how Islamic financial institutions manage the financial risk of the *murabaha* transaction within common law jurisdictions, while also remaining Shariah compliant.<sup>274</sup>

## 5.2 Part One: Practice of Islamic Financial Institutions

### 5.2.1 The Issue of Ownership for the Financed Asset

Under the *murabaha* financing arrangement, Islamic financial institution provides credit by way of selling goods by instalment. In this financing arrangement, the customer purchases goods/ commodities from a supplier and the finance for the purchase is provided by the customer entering into a contract of sale with the financier, under which the customer pays the purchase price of the goods by instalment and the ownership of the goods will pass to him at the payment of the last instalment of the purchase price. Thus, the transaction to be Shariah compliant, a customer of an Islamic bank first agrees with a supplier to purchase goods (commodity), then approaches a financial institution for financing the goods with a promise to purchase them back from it for a price that comprises the purchase price plus a mark-up that is known and agreed to by both

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<sup>273</sup> Trade Practices Amendment (Australian Consumer Law) Act 2010 (No. 2) 38.

<sup>274</sup> As the Islamic financial institutions secure their finance and manage the Gharar (excessive uncertainty) by using conventional risk management techniques, thus the Gharar element *per se* will not be discussed separately in this chapter.



the bank and the buyer. The transaction involves two promises: a promise by the customer to purchase the object from the bank and a promise by the bank to sell the goods simultaneously to the customer either for cash or deferred payment.

Second, the bank purchases the goods directly from the seller or appoints the customer as its agent to purchase the asset on its behalf directly from the seller. Under this agency contract, which must be separate and independent from the *murabaha* agreement, the bank assigns its rights as seller under the first sale contract to the buyer as its agent.

Third, the customer provides invoices and other documents related to the purchase agreement to the bank for processing of the payment to the seller. Fourth, the customer receives the commodity from the seller as an agent for the bank, while at the same time the bank oversees the process of the customer acquiring the physical possession of the asset on its behalf.

Fifth, as required by Shariah law, the bank assumes both the ownership of the goods (physically or constructively) and the risk associated with the ownership as discussed before. This implies the seller cannot sell the commodity before acquiring it physically or constructively, because the validity of the *murabaha* sale contract depends on the seller (financier) possessing the ownership of the asset physically or constructively and bearing the risk associated with the ownership of the financed asset.<sup>275</sup>

Sixth, the bank transfers the ownership of the commodity and the risk associated with it to the customer who starts paying the agreed selling price either as a lump sum or through instalments. AAOIFI requires ownership and assumption of risk even for a short period before a seller (financier) sells goods to a customer. Unlike conventional banks that make payments against the documents of the contract, Islamic banks need to act both as financial intermediaries and traders that deal with the goods financed.

However, despite the requirement of ownership and assuming the risk associated with the financed commodities, in practice Islamic banks neither observe the requirement of ownership of the commodities nor assume the associated risk with them. Even when they acquire possession of commodities, the actual time they expose themselves to the risk of ownership is minimal. To avoid this risk at least physically, the banks pass financed commodities onto the buyers immediately after signing the contract and obtaining a guarantee of payment from customers, as the following discussion about the practice of Islamic financial institutions show. This provides the context for next section, which discusses how Islamic financial institutions comply with Islamic requirements regarding possessing the goods and assuming the risk associated with the ownership.

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<sup>275</sup> AAOIF, above n 126.

### 5.2.1.1 Britian Islamic Financial Institutions

#### a) Islamic Investment Company v Symphony Gems

The Islamic Investment Company of the Gulf (Bahamas) Ltd. (IICG) versus Symphony Gems in 2002 was the first case of an Islamic financing facility being brought before an English court.<sup>276</sup> In this case, IICG, a Saudi financial institution incorporated under the law of the Bahamas, and Symphony Gems, a Belgium company, entered a *murabaha* financing agreement. Under this *murabaha* financing arrangement, firstly, Symphony Gems agreed with Precious HK Ltd. (a seller of diamonds based in Hong Kong) on the price and other terms of the contract, and then approached IICG along with the necessary supporting documents for the contract. Secondly, after IICG agreed to advance finance to Symphony Gems through a revolving *murabaha* finance facility, it appointed Symphony Gems, as its agent, to buy the diamonds on behalf of it directly from the supplier to avoid dealing with the goods and exposing itself to financial risk in the transaction. Thirdly, Symphony Gems, as the undisclosed agent for the financier, negotiated and agreed the price and the terms of contract with Precious HK Ltd. without the involvement of IICG.

Fourthly, IICG demanded that Symphony Gems to make payments unconditionally and irrevocably to the bank without linking payments to the delivery of the supplies. Thus, as the delivery of the goods was not a prerequisite for payment of the loan by the customer, Symphony assumed the risk of non-delivery of the goods, same as the conventional banking system. This means, the responsibility of IICG was limited only to the payment of the loan to the supplier after checking it conformed to the terms and conditions of the contract.

It appears that the *murabaha* transaction in question did not involve a real buying and selling transaction; IICG played a traditional financial intermediary role by paying the loan to the supplier against the contract documents instead of against the goods. It also excluded the liability of any risk related to the financed commodity (e.g., defects, loss or damages during transit) from itself by passing the risk to the debtor.

Again, the appointment of IICG Symphony Gems to be its agent for purchasing diamonds and obtaining a commitment to purchase the diamond simultaneously from it to avoid being exposed to the risk associated with the ownership of the financed commodity reinforces this notion. This suggests the intention of both parties was merely a credit facility aimed at extending the loan to Symphony Gems and not engaging in a genuine sale contract that requires a transfer of ownership of the commodities from one party to another.

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<sup>276</sup> Kilian Balz, 'a *murabaha* transaction in an English court' [18] (2002) 11 *Islamic Law and Society* 17; Zulkifli Bin Hasan, and Mehmet Asutay, 'An analysis of the courts' decisions on islamic finance disputes' [41] (2011) 3(2) *ISRA International Journal of Islamic Finance* 41; Umar F Moghul and Arshad A Ahmed, 'Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems NV & (and) Ors.: A First Impression of Islamic Finance' (2003) 27(1) *Fordham International Law Journal* 150; Arthur Hartkamp Hugh Beale, Hein Kotz and Denis Tallon, *Contract Law* (Oxford and Potland, Oregon, 2002); Julie Clarke and Madine Courmadias Philip Clarke, *Contract Law* (Reed International Books Australia Pty Limited, 2005).

This shows IICG did not strictly comply with the requirements of this murabaha financing arrangement because of the risk involved with assuming the risk of the ownership of the financed goods during the tenure of the contract and passing the goods/ commodities only at the end of the payment of the last instalment. Thus, as murabaha contract is closely resembled the conventional financing mechanism, IICG did not incur any extra financial risk within the British common law jurisdiction.

#### **b) Shamil Bank versus Beximco Group**

The second *murabaha* trading financing case was between Shamil Bank, which is incorporated under the laws of Bahrain and licensed to act as a bank by the Ministry of Commerce and the Bahrain Monetary Agency, and Beximco, a Bangladesh group of companies involved in manufacturing, exporting and importing pharmaceuticals, entered into a financing agreement under a murabaha contract. Shamil Bank extended funds to Beximco under a reverse murabaha (Tawarruq) financing agreement for a working capital facility that Beximco required for its operations.<sup>277</sup> As Shariah law does not allow interest on loans, Shamil Bank stepped in by purchasing (nominally) through Beximco as its agent, certain goods from a specified seller and then immediately sold the goods to Beximco at the purchase price plus a specified profit margin calculated according to the market rate.

Like the previous example, this transaction does not seem to involve real buying and selling because the bank avoided exposing itself to the risk associated with ownership and limited its responsibility to the role of financial intermediary between the buyer and supplier. The main purpose of this transaction was to provide a cash loan (working capital) to Beximco and was not an actual sale as Shariah law requires for the murabaha contract. It appears that Shamil Bank used this contract as a bridge to provide a loan to the client to disguise an interest-bearing loan and easily accommodates a hidden interest rate. In addition, the evidences of the case show that both the bank and client appeared to be fully aware of the commercial realities and happy to dress up the loan transaction as a murabaha sale.<sup>278</sup> In fact, the transaction involved one credit sale and one cash sale, through reverse murabaha, which is fundamentally different from the theory of Islamic banking discussed in chapter two. It is evident that the bank purchased goods from the customer in cash at the spot price and then immediately sold them back to the customer at a higher price than the purchase price without possessing their ownership and assuming the risk. This not only indicates that the agreement did not involve any real buying and selling transaction but also suggests the real intention of the bank and customer was not a sale contract but a loan of working capital to the client. This practice not only makes the murabaha transaction same as the interestbearing loans, but also entitles the financier to receive the same protection as

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<sup>277</sup> Chuah, above n ; Hasan, above n ; Aisha Nadar, 'Islamic Finance and Dispute Resolution: Part 1' [26] (2009) 23(1) Arab Law Quarterly 1.

<sup>278</sup> Umar F Moghul and Arshad A Ahmed, 'Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems NV & (and) Ors.: A First Impression of Islamic Finance' (2003) 27 *Fordham Int'l LJ* 150.

conventional credit facilities. Therefore, it does not attract extra financial risk within the conventional financial markets, which makes financial markets and other stakeholders feel comfortable with murabaha financing operations in common law jurisdictions.

Although, according to the practice of Islamic financial institutions, the murabaha financing contract can operate under Australian law without attracting extra financial risk, their practice suggests that the Shariah compliance of the murabaha is questionable, which may question its Shariah compliance and legitimacy in the eyes of the customers of the Islamic finance. This paradox between the practice of the Islamic financial institutions and the theory of Islamic finance is because of the non-existence of commercial and banking laws appropriate for Islamic banking and financial contracts do not exist in many countries.

### **c) Investment Dar and Blom Developments**

Bloom Developments was incorporated in Lebanon and the Investment Dar was registered as an investment company in Kuwait. They entered a Wakalah (agency) financing agreement in which Investment Dar received funds from Blom Developments to invest on its behalf and guarantee a fixed return. This agreement was certified by the Shariah supervisory board of the bank to be Shariah compliant. However, same as the previous cases, it did not involve either a selling transaction or ownership and assumption of the risk of finance, which appears to be a clear violation of the principles of Shariah law on investment.

This case, like other above discussed cases indicate that modern Islamic banks do not expose themselves to the risks associated with ownership of the financed commodities, such as loss, damage, and deterioration of goods prior to delivery, and contractually transfers these risks to buyers. This practice shows the paradox that where Islamic financial institutions mimic conventional practices, they appear to contradict the principles of Islamic law, which may lead murabaha transactions to risk being non-Shariah compliant, which may jeopardise their legitimacy in the eyes of the target group.

#### **5.2.1.2 Malaysian Financial Institutions**

Islamic banks in Malaysia, like those in the UK, avoid assuming the risks associated with ownership of physical financed assets. By using a Bai-Bithaman Ajil facility (deferred murabaha sale), which works like a murabaha contract, but with payment generally made on a deferred basis as discussed before. In addition, Islamic Malaysian banks use commodity *murabaha* (Tawarruq) or *Bay Al-inah*. Under the Tawarruq, customers that seeking cash purchases certain commodity from a bank with deferred payment, and then instantly sale the same commodity by himself or through the bank as his agent, to a third party on cash and then obtain the proceeds of the sale at spot price and receives the proceeds of the sale.<sup>279</sup> As discussed in chapter

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<sup>279</sup> Mohamed Ariff and Saiful Azhar Rosly, 'Islamic banking in Malaysia: Unchartered waters' (2011) 6(2) *Asian Economic Policy Review* 301.

three, the majority of Muslim scholars have approved Tawarruq as long as the transaction involves three parties and not be pre-arranged.

On the other hand, Bai Al-inah involves an agreement between a bank and a customer, where the customer sells commodity he owns to a bank at a spot price, and then immediately purchase it back from the bank on credit at a price that higher than the selling price. Alternatively, the bank sells to the customer a certain asset/commodity on deferred payment basis with a mark-up and then purchase it back from the customer at a lower price on cash payments basis.

This kind of sale transaction has received a fierce criticism from scholars for being a sham and not a true murabaha sale transaction. Consequently, as this contract seems to be not a true murabaha sale transaction, but a contract constructed as bridge to get a loan, the majority of Muslim scholars have disapproved it as discussed in chapter three.

Under this transaction the banks transfer responsibility for finance to customers by requiring them to comply with the following conditions<sup>280</sup>:

- execute a registerable charge in favour of the bank and secure payment of the sale price;
- Indemnify the bank against losses that might be brought by the vendor;
- pay rates, taxes or other charges imposed by government or other authorities; and
- customer may pay other fees, expenses and charges connected to the financed asset.

**a) Bank Islam Malaysia v Adnan bin Omar**

In the Bank Islam Malaysia and Adnan bin Omar case (1994), when Adnan bin Omar sought to obtain a cash loan from the bank through Bai Al-inah, he sold a piece of land owned by him to the bank for cash, and after receiving the cash he simultaneously purchased it back from the bank at a lower price than the selling price on credit, through instalment. This denotes the bank firstly purchased the property from the customer nominally and immediately disbursed the purchase amount to the customer. Secondly, the bank sold it back to the customer at a price that contained the purchase price plus a profit margin. Thirdly, the customer agreed to settle the payment by instalment on an agreed disbursement schedule.<sup>281</sup>

Like the previous examples in Britain banks, ostensibly there was no transfer of property to the bank from the customer, as the bank neither assumed the ownership of the property nor the risks associated with ownership.

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<sup>280</sup> Kamal Khir, Lokesh Gupta and Bala Shanmugam, *Islamic banking: A practical perspective* (Pearson Malaysia 2008).

<sup>281</sup> Zulkifli Bin Hasan and Mehmet Asutay, 'An analysis of the courts' decisions on Islamic finance disputes' (2011).

This transaction appears simply to be a cash loan dressed up as a murabaha contract by using legal tricks in order to circumvent the prohibition of interest, and consequently seems to be contradicting with the Shariah principles.

**b) Haji Nik Mahmud v Bank Islam Malaysia**

In the case of Haji Nik Mahmud and Bank Islam Malaysia, the parties entered a property purchase agreement and sale agreement simultaneously. To extend a loan to the customer, the bank purchased a piece of land from the customer for RM520, 000 at spot price, and contemporaneously resold it to the customer for RM629, 200 on a deferred basis, charging the land as security for the loan.<sup>282</sup> This financing arrangement, like the previous one, shows that the bank did not assume either ownership or the risk associated with ownership. In addition, there was no transfer of property because the land remained in the possession of the customer. Secondly, there was no evidence of a change in the registered proprietorship of the land. Thirdly, when the parties signed the property purchase sale, the agreement was about a nominal registrable interest not a formal registrable interest that entitles the transfer of the title to the buyer to become the registered proprietor.

**c) Islamic Bank Berhand versus Veheng Global Trader**

In the case of Islamic Bank Berhand versus Veheng Global Trader, when the customer sought finance from the bank, he sold his property nominally to the bank on a cash basis and the bank instantly sold it back to him on a deferred basis through an instalment. By purchasing the property nominally in cash from Veheng Global Trader, the bank intended to extend the loan amount to the customer under a reverse murabaha facility (Bay'al-aynah) and charged a profit margin benchmarked with the market rate.<sup>283</sup> As the bank did not in fact acquire the property, the purpose of this contract was merely to provide a cash loan to the customer. Thus, like the previous example, the bank neither assumed the ownership of the property nor the risk associated with it.

**d) Kuwait Finance House (KFH)**

Similar to other Malaysian Islamic banks, Kuwait Finance House (KFH) in Malaysia avoided the risk of financing by not assuming ownership of the financed assets. It included in its financing agreement with customers (borrowers) a provision that excluded its liability for damage to the goods while in transit.<sup>284</sup> KFH relies on a fatwa issued by its Shariah supervisory board which transfers liability for defects of the goods to borrowers when products are explained to them in a way that does not leave room for suspicion about their real condition. KFH considers that without this limitation on liability, its operation might not be commercially viable and competitive in conventional markets because the competitive advantage of any bank depends on how it manages its financial risk.<sup>285</sup> Consequently, as KFH does not acquire possession of the financed assets

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<sup>282</sup> Ibid.

<sup>283</sup> Ibid.

<sup>284</sup> De Jonge, above n 17.

<sup>285</sup> Chuah, above n 7.

and include the limitation and exclusion clause in the murabaha contract, it makes this practice akin to techniques adopted in conventional financial institutions. For instance, KFH like other financial institutions appointed its customer as agent to purchase the goods from the supplier on its behalf to avoid the risk involved in ownership. It paid the cost of the goods to suppliers at sight or at the maturity of the credit term and immediately sold them back to customers at the purchase price plus a profit margin on deferred payment.

Again, by deploying these legal tricks to circumvent the prohibition of interest and dressing up the contract as a murabaha contract compliant with Shariah principles, these banks did not own the financed properties or assume their risks. This is the same as the conventional credit contract under the Consumer Credit Code (the Code) that mentioned earlier. This practice reveals although murabaha transaction receive same treatment and legal protection as conventional financial transaction, it seems not to be strictly complying with Shariah requirements in Malaysia. This similarity with the conventional financial instruments entitles murabaha to receive the same legal protection and subsequently not to attract extra financial risk within the Malaysian common law jurisdiction.

#### **5.2.1.3 Islamic Financial Institutions in Australia**

In Australia, financial institutions that provide Islamic financial products and services are non-bank financiers that base their operations on the Islamic finance system that recognises and meets the religious needs of the Muslim community. However, none of the approved foreign banks, including the Arab Bank and HSBC, and Australian high street banks offer Islamic finance windows.<sup>286</sup> The most well-known financial institutions that provide Islamic financial products and services are: (a) the Muslim Community Co-operative Australia Limited (MCCA); (b) Amanah Finance Ltd; and (c) Islamic Co-operative Finance Australia Limited (ICFAL).

Like Islamic financial institutions in common law countries, Australian Islamic financial institutions use the murabaha financing mode for providing finance their customers. They adopt murabaha as the main financial products because of its economic effect on conventional financial instruments and its manageable risk. They use it for financing homes, motor vehicles and consumer goods, like their UK and Malaysia counterparties.<sup>287</sup> But these financial institutions do not strictly adhere to Shariah requirements for assuming ownership of financed assets and the associated risk between the time the asset is purchased from the supplier and the time the financial institution sells it to customers. Thus, these financial institutions employ similar processes to those in the UK and Malaysia when it comes to avoiding the risk associated with the ownership of financed assets. They require customers to meet the following conditions to obtain finance:

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<sup>286</sup> Farrar, 'Accommodating Islamic banking and finance in Australia', above n 10.

<sup>287</sup> Ahmad, Theory and practice of modern Islamic finance: the case analysis *from Australia*, above n 13.

- a) purchase financed assets (whether it is a car or home) as agents for the financial institutions and acquire them on their behalf;
- b) take responsibility for registering proprietorial interest of the financed assets and hold them in custody on behalf of the financiers;
- c) keep assets in their possession and incur the costs associated with them during the term of the finance;
- d) insure assets at their cost and acquire their beneficial interest as mortgage managers; and
- e) Agree that upon default, financiers reserve the right to sell the security assets to recover their funds.

Amanah, like MCCA and ICFAL, stipulates in the contract the customer as purchaser and custody agent for the financier should be registered as proprietor of the financed asset and responsible for paying the costs related to the<sup>288</sup>:

- acquisition of the financed assets and the legal and other expenses linked to the proprietorial interest in the assets, and stamp duty and other expenses related to the acquisition of the financed assets;
- using the proprietorial interest in the financed properties as if they were their legal and beneficial owner, including any taxes and duties payable in respect of ownership (such as land tax), levies and rates, and maintenance;
- any liabilities and claims that arise from the proprietorial interest in the financed property or its use;
- The customer having no recourse to Amanah whatsoever in respect of any such costs, expenses and liabilities and if Amanah incurs costs, expenses and liabilities (including but not limited to legal costs) in connection with any of the above, the customer will indemnify Amanah; and
- The customer makes payments in accordance with the agreement and acknowledges that those payments are set at a level which allows them to also pay all amounts for which the customer is responsible, as specified in the Financing Agreement.

In this practice by Australian Islamic financial institutions to avoid finance risk, they do not acquire the possession of the financed assets. Even when the banks assume the risk of finance, the actual period during which they are exposed to ownership-risk is insignificant. It appears to be no different from the practice of Australian conventional financial institutions and contradicts the AAOIFI Standard No. 8 (3) that states

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<sup>288</sup> See <http://www.mcca.com.au/home-finance-payments>



financial institutions are prohibited from selling any item in a *murabaha* transaction before having acquired the possession of the item either physically or constructively.

This discussion shows that the practices of Islamic financial institutions in common law countries that provide finance under a *murabaha* is very similar to conventional financial instruments. As the discussion of this chapter demonstrated, they do not expose themselves to the risks associated with ownership of the financed assets and same as the conventional financial institutions transfer the risk of finance to customers. This similarity entitles *murabaha* transactions to receive same legal protection as the conventional financial products and as a result not to attract any extra financial risk in the Australian common law jurisdiction. That said even though, *murabaha* can operate effectively and be commercially viable in Australia, its close resemblance to the interest-bearing financial practice, as mentioned before may question its Shariah compliance, which in return jeopardise its legitimacy and commercial viability in Australia.

### **5.2.2 *Murabaha* Profit Margin (Mark-up)**

As discussed in chapter one, traditionally the *murabaha* contract refers to a trust sale contract of an asset at a purchase price plus an agreed mark-up (profit margin). However, Islamic financial institutions structured and developed it into a debt-like financing instrument operable in conventional financial markets. Thus, under *murabaha* financing arrangement, Islamic financial institutions buy assets sought by customers and then concomitantly sell them for the purchase price plus a predetermined profit margin.<sup>289</sup> However, once this sale price (including the purchase price and profit margin) is fixed upfront by mutual consent of both parties it cannot be increased, as discussed earlier. This aims to make it distinguishable from conventional interest that increases alongside with the increase of the interest rate or the tenure of the loan.

Nevertheless, the practice of Islamic financial institutions show that they explicitly benchmark the profit margin of the *murabaha* contract on prevailing commercial interest rates, such as London Interbank Borrowing Rate (LIBOR) or Base Lending Rate (BLR), to check the market parameters of loans with similar characteristics.<sup>290</sup> This benchmarking allows Islamic financial institutions to guarantee returns on finance similar to conventional loans. Thus it seems that Islamic financial institutions use *murabaha* contract to easily accommodate a hidden interest rate in the Australia law that obliged financial institutions to mention the word ‘interest’ in the financial contracts, which seems to be contrary to the principles of the Islamic law pertaining to the *murabaha* contract because lending for profit is prohibited-even if the rate charged was implied in terms of a penalty lending for profit. For example, UK financial institutions, as discussed earlier in the chapter, benchmarked *murabaha* profit margin with commercial interest rates. In addition, they obtained a guarantee from customers to reimburse the price of the commodities sold on a deferred basis without linking the payment

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<sup>289</sup> El-Gamal, ‘Interest and the paradox of contemporary Islamic law and finance’, above n 122.

<sup>290</sup> Ibid.

to delivery of the goods. As shown in the case of Shamil bank and Beximco, the transaction involved one credit sale and one cash sale through reverse murabaha, which appears to be indistinguishable from conventional practice. Moreover, in the case of Blom Developments Bank (Blom) and Investment Dar, the latter guaranteed to pay the investor an agreed profit that benchmarked market interest at the end of each quarter. By guaranteeing a fixed return these financial institutions seemed to act only as financial intermediaries by connecting between suppliers and customers with the aim to securing credit facility.

Correspondingly, Malaysian banks sold assets to customers at the purchase price plus an added profit margin that benchmarked the prevailing interest rate. However, unlike conventional loans that are adjusted with the increase or decrease of interest rates to reflect the cost to fund, the price of murabaha could not be adjusted to reflect changes in interest rates.<sup>291</sup> As a regulated financial institution, Islamic banks in Malaysia generally cannot increase the *murabaha* profit margin to reflect the increase in the interest rate and hence increase the price of the murabaha as this violates the principles of the Islamic law. However, central bank of Malaysia introduced in 2003 a variable rate for financing product under the concept of bai' bithaman ajil (deferred payment sale) to diversify the financing portfolio of the Islamic financial institutions from over-reliance on fixed-rate financing and to mitigate the risk associated with funding mismatch.<sup>292</sup> This will not only enable the banks to raise the financing rate when there is a rise in market rate, but also enable them to give better returns to their depositors. It also enable banks to set a high ceiling profit rate to buffer any rise in the market rate. However, the effective profit rate will remain at the ceiling rate if market rate rises more than 12% per annum. Unless the market is expected to be volatile, the rates are subject to a ceiling profit rate of four percentage point above the market's Base Lending Rate (BLR) This mode of financing is applicable to house, property and term financing only and would be extended to other types of financing in the future. In addition, Bank Negara has allowed rescheduling or extending the financing if the effective profit rate rises, on the condition that the financing agreement contains a rescheduling clause and the total repayments are not in excess of the original selling price. The floating rate allow financial institutions to be protected from exposure to fluctuations in the financing rate.

On the other hand, Australian Islamic financial institutions that provide Islamic financial products under a *murabaha* contract, like Britain and Malaysian Islamic banks, benchmark their profit margin with commercial interest. For instance, when a customer wants to purchase a car or property under the *murabaha* financing scheme approaches at MCCA or ICFAL for financing. Then the financier appoints the customer as its agent to negotiate with the supplier and agree the price with him. Then subsequently the financier sells it to the customer at a fixed price that is based on the original price plus a fixed profit margin. Normally these institutions ask the customer (particularly if he is self-employed) to make a small down payment, such as 20%

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<sup>291</sup> Khir, Gupta and Shanmugam, above n 210.

<sup>292</sup> Ariff and Rosly, above n

of the amount to be financed, as an initial deposit. Then the financier and customer agree to the terms of payment on a deferred basis and regular monthly instalments.

Thus, as the practice of these institutions fall under the Consumer Credit Code (the Code) that states a credit is advanced, whether charging is in the form of interest or not, the problems arose from the lending structure of the *murabaha*. The Code assumes that most credit is advanced in return for an annual percentage rate of interest. Therefore, where credit contract involves profit (in the form of interest), but this profit cannot bear an 'interest' label, this arises compliance problems for both the Code and Islamic financial institutions providing finance under the *murabaha* contract. Because of this problems MCCA has lobbied the Victorian Government to accommodate Islamic financial contracts under which if interest charged cannot be Shariah compliant, whereby also maintaining consumer protection under the Code.<sup>293</sup> Thus, the Victorian Government has accommodated Islamic financial contracts like *murabaha* by allowing IFIs to record their profits as returns instead of interest and—when reporting to the Australian Taxation Office—to record them as interest. *murabaha* contracts are recognised in Victorian legislation as single contracts that attract stamp duty only once even though they take the form of two contracts (i.e., a contract between the financier and the supplier and a contract between the financier and the customer).

Again, as this discussion shows, *murabaha* appears to function merely as a credit facility that resembles commercial interest-bearing financial practices. As outlined previously, the parties of the contract do not engage in genuine sale contracts that show a transfer of ownership of commodities from one party to another. Consequently, this close resemblance of the *murabaha* mark-up with the interest-based conventional financing system where the characteristics and identity of Islamic financing are lost, has led to fierce criticism from Islamic finance by different quarters branding it non-Sharaih compliant. For example, El-Gamal, one of the critiques of the Islamic finance, maintains that the practice of Islamic banks is paradoxical because on the one hand Islamic financial institutions claim to provide interest free financing and on the other hand they closely approximate conventional financing mechanisms by closely benchmarking with commercial interest rates and not exposing themselves to the risk associated with the ownership of the financed commodities.<sup>294</sup> In concurring with El-Gamal, Balza, Junius and Bell argue that the *murabaha* financing mode as an alternative financing system should not just mimic interest-bearing financing practice and instead must retain characteristics.<sup>295</sup>

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<sup>293</sup> See *the Report of the Consumer Credit Review: Part B, Four Areas of Focus*. 2006. Melbourne: Consumer Affairs Victoria. p.160.

<sup>294</sup> El-Gamal, above n 126.

<sup>295</sup> Balz, 'a *murabaha* transaction in an English court', above n ; Bell, above n ; Andreas Junius, 'Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law under German Conflict of Laws Principles' [538] (2006) 7 *Chicago Journal of International Law* 537.

Due to this problem, Mufti Taqi Usmani recommends *murabaha* to be used as a financing instrument only when the profit and loss-sharing methods (Mudarabah and Musharakah) become unworkable with the full observance of the conditions prescribed by Islamic law. He asserts that if *murabaha* financing is to be legitimate, according to Islamic finance theory, it should move away from conventional financial practice and maintain its characteristics.<sup>296</sup>

Thus, by referring to the question of how the *murabaha* contract operates under Australian law while also remaining Shariah compliant, it seems *murabaha* still is the most operable Islamic financial product in the common law jurisdictions despite its criticism. It is commercially viable and if it discontinued by Islamic financial institutions as financing vehicle this might create frustration among the customers of Islamic finance industry and may lead them to switch to conventional banking system. Notwithstanding, the practice of Islamic financial institutions show that the Shariah compliance of the *murabaha* is questionable particularly when it comes on the issues of mark-up and the assuming the risk of the financed assets.

This illustrates the dilemma *murabaha* faces because on the one hand, if Islamic financial institutions do not benchmark *murabaha* transactions with commercial practice they may not be competitive within the well-established conventional financial system. On the other hand, if they closely resemble the conventional financing system the transaction may risk being non-Shariah compliant.

Due to this quandary that Islamic finance industry faces, Islamic financial institutions seem to not have choice other than to closely resemble conventional financial products because of the following reasons:

- 1) *murabaha* financing to be Shariah compliant does not mean to be wholly different and outside the framework of conventional financing. *murabaha* may resemble conventional financial products, have the same economic effect as interest-bearing financial transactions and still be Shariah compliant as far as it meets the Shariah law requirements(at least in form), and keeps its characteristics such as being asset based or asset backed.
- 2) Islamic finance is in transition stage and still in its infancy and do not have a central banking system or unified legal system to support it. Therefore, it is necessary to use the instruments and risk management techniques of conventional banks on the grounds of the Shariah principle of necessity.
- 3) Benchmarking the returns of *murabaha* financing with conventional interest will enable Islamic banks to enjoy similar economic advantage to conventional financial institutions and attract Islamic investors, who only familiar with the conventional financial system. This will enable Islamic financial

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<sup>296</sup> Usmani, above n 12.

institutions to provide the same rate of return to their customers as conventional financing instruments, while also not neglecting the requirements of Shariah law.

- 4) Employing conventional financial contracts allows Islamic financial institutions to use traditional collateral security systems with the condition of not violating Shariah principles.

In light of the above discussion, it could be argued that the permission of the deferred price to be higher than the spot price indicates that the *murabaha* profit margin can be benchmarked with conventional finance practices that takes into account the time value, inflation and supply and demand. Ibn Abedeen from the Hanafi schools says that “*the deferred and the spot price are not equal because the present value of a commodity is more valuable than the future value of the commodity*”.<sup>297</sup> Similarly, Al-Kasani from the Hanafi school asserts that “*the deferred price can be increased because of the deferment*”.<sup>298</sup> In addition, Abu Ishaq Al-Syatibi from the Maliki School states that “the deferral of one of the exchanges (money or goods) requires it to be increased in line with the time of the payment.”<sup>299</sup> This means the price of goods that are identical in every respect can be different because of time of the deferred payment of the sale price, as the Ibn Taymiyaha of the Hanbali School of Law asserts, deferment has a share in the price. Along these lines, both the AAOIFI and the Islamic Fiqh Academy of the Organisation of the Islamic Conference (OIC) adopted this position. However, as discussed in chapter three, once the price of the *murabaha* price is determined it cannot be increased in the future because of the time unless another new contract is made between the parties.

This denotes that benchmarking of the *murabaha* mark-up with commercial interest rates do not make the *murabaha* profit margin unlawful as far as it has not been increased once it is determined inline with the time. This similarity with conventional interest-bearing transactions entitles *murabaha* transactions to receive the same legal protection as conventional credit facilities, which entitle it not to attract extra financial and legal risk. Notwithstanding, any slight departure from its requirements that differentiate it from interest based conventional financing products can lead it into the territory of prohibited interest. Therefore, Islamic financial institutions are required to pay due diligence to observe the Shariah compliance of the *murabaha* transactions.

### 5.2.3 Risk Management Techniques under *Murabaha*

As the selling price of the *murabaha* contract is payable later, banks insure the payment to be paid on due date. So, they normally ask the customer to furnish security for risk mitigation; however, this security can be required when assets are sold to a customer, its price is determined, and the debt is incurred by the customer

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<sup>297</sup> Abedeen, above n 89.

<sup>298</sup> al-Kasani, above n 100.

<sup>299</sup> Abu Ishaq Al-Syatibi, ‘Almuwafaqat fi Ushul Al-Syari’ah’ [41] (2003) 4 *Jilid I, Cet. III, Bayrut: Dar Kutub al-’Ilmiyyah*.

through a credit contract. However, as the rate charged may be couched in terms of a penalty, this may be unlawful again in the view of the Islamic law.

### 5.2.3.1 Defaulting

When the customer signs the *murabaha* contract with an Islamic bank, the selling price becomes a receivable debt for the bank. However, as the *murabaha* is considered a sale price (regardless of whether it is a sale contract or a credit facility) that is determined at the beginning of the contract, the bank cannot increase it by charging interest or other fees if the customer delays payment. Unlike the conventional banking system that imposes interest on the default of the loan, Islamic financial institutions that extend finance under *murabaha* generally are not allowed to penalise customers for delay in payment. They are only entitled to claim the price of the financed assets and cannot impose any charges on the customer because of a delay in payment, as any charge on top of the selling price is considered a *riba*. This can make risk management of default on payment challenging to Islamic financial institutions in common law jurisdictions and may encourage dishonest customers to default on payment of loans knowing that it will not attract penalties or extra payments. In addition, the loaned money may remain unproductive during the defaulting period and as a result a bank investor may miss the opportunity to earn money on the defaulted amount.<sup>300</sup> Moreover, inflation can erode the defaulted amount which leads the bank to receive a depreciated amount of money, which would be unfair to the financier.

This problem has led some contemporary Islamic scholars to attempt to find solutions within the contemporary financial environment by citing a Hadith reported to be from the prophet that says: “*The well-off person who delays the payment of his debt, subjects himself to punishment and disgrace*”.<sup>301</sup> However, as this punishment is broad, the question that comes to mind is what kind of punishment a bank can impose on the defaulter. Some suggest that banks can charge a penalty on defaulting customers and then pay the amount to charities as a disincentive to defaulting customers to delay payments. However, others take the view that the punishment mentioned in the Hadith implies the banks can impose a monetary penalty to both deter the defaulter and compensate the financier. However, there are two views on the penalty paid by the defaulter. One holds that the penalty payment is compensation for both lost income and damage to the bank because of the delayed payment. The other holds that the penalty is only compensation for damages and not lost income<sup>302</sup>, and suggests the financier impose on the defaulter an amount equal to the return that the bank gives or would have given to investment account depositors during the defaulting period. For example, if the bank has given 6 percent return to these depositors, the bank charges the defaulter 6 percent as a compensation for the profit that the bank would have earned during this period. In this regard, Mufti Taqi Usmani highlights the following

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<sup>300</sup> Hennie Van Greuning and Zamir Iqbal, *Risk analysis for Islamic banks* (World Bank Publications, 2008).

<sup>301</sup> Bukhari, above n Vol14, Hadith 2400.

<sup>302</sup> Kelly Holden, ‘Islamic finance: legal hypocrisy moot point, problematic future bigger concern’ [9] (2007) 25 Boston University International Law Journal 28.

conditions that need to be met before the banks charges the client.<sup>303</sup> First, the bank must give the defaulting client a reasonable grace period starting from the maturity of the debt to pay the price or the remaining part of the price, after which the bank gives him warning notices that if he does not make payment during this time, he will pay a penalty to the bank as compensation. Second, it needs to be proved beyond doubt that the debtor defaulted on the loan without acceptable reason. This means, if the customer defaults on the payment because of poverty or hardship, no penalty would be charged to him, and instead the financier would give him enough time to pay the debt. Third, the client will be asked for compensation only when the bank's investment accounts holders have earned or could have earned a profit during the defaulting period. Hence, if a profit is not earned in the investment accounts during the defaulting period, a penalty would not be charged on the debtor as compensation for the bank<sup>304</sup> However, another view holds that compensation should be paid by the client even if the investment account holders do not earn any profits during the defaulting period, provided that the default is proven to be without a valid reason<sup>305</sup>.

On the other hand, an opposing view argues that linking the payment of compensation with the profitability of the deposit of investment accounts holders resembles compensation based on the concept of opportunity cost and time value of money, contrary to the theory of Islamic finance, as demonstrated in chapter two. Taqi Usmani, one of the pioneers of Islamic banking, contends that this compensation neither conforms to Shariah principles nor solves the problem of defaulting on murabaha financing. He maintains that ordering a client who cannot pay the debt at the due date to pay compensation, on top of the price of the financed goods, constitutes interest by the backdoor. He compares this compensation to the interest that pre-Islamic Arab lenders used to request from their debtors by saying: *"Either you pay off the debt or you increase the payable loan amount"*, as the prophet reported.<sup>306</sup>

Notwithstanding, comparing the opinion of Taqi Usmani with the view of other Islamic scholars that holds charging a penalty equal to what investment account holders would have earned during the defaulting period seems to be consistent with the objectives of Shariah law that observe justice, equity and the public interest. They further argue unless some sort of penalties is imposed on dishonest debtors, bad customers will take advantage of Shariah principles that prevent charging penalties on defaulters and exploit Islamic banking under murabaha and may put it in a disadvantageous position in conventional markets. In addition, Islamic banks will not get competitive edge compared to their conventional counterparts. Therefore, it seems to be necessary to impose penalties on defaulters who delay payment without a valid excuse, such as hardship or poverty.

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<sup>303</sup> Usmani, above n 73.

<sup>304</sup> Ibid.

<sup>305</sup> Ibid.

<sup>306</sup> Ibid.

In light of the above, it is worth noting that even in the case of non-payment due to hardship or poverty, it is difficult to verify the genuineness of the claim because of the followings:

- a) every defaulter might claim poverty or hardship without providing solid evidence.
- b) another problem is that unlike conventional banks that presume every client can make payment unless otherwise declared bankrupt by the court, it can be a daunting task for Islamic banks to prove if the client is bankrupt. This suggests that Islamic financial institutions need to adopt conventional risk management techniques to discover if claims of poverty or hardship are genuine. This seems to be the reason that Malaysia Nagara Bank allows Islamic banks to impose on defaulting customers a percentage of the actual loss or the outstanding amount (without compounding) as compensation for default.
- c) recognition in Islamic jurisprudence of the concept of time value of money may reinforce the view that banks should impose penalties on defaulters as compensation for loss.
- d) as Islamic schools implicitly recognise the time value of money by accepting the deferred sale price as higher than the spot price as discussed earlier, this indicates recognition of the value of time in the concept of time preference. This shows that Islamic jurists' acceptance of the deferred sale price being higher than the spot price entails recognition of the time value of money on which the conventional financial industry bases its returns and interest. This view helps the Islamic banking system to operate competitively within modern financial markets and demonstrates that unless some sort of penalty is imposed on dishonest debtors, bad customers take advantage of not being charged penalties on defaults and exploit the Islamic banking system.

#### **5.2.3.2 Rebate in the *Murabaha* loans**

Defaulters are classified into solvent and insolvent. If it is proven that the defaulter is insolvent, then he will be given respite, in which if still cannot pay, the debt will be written off (Quran 2:280). However, if the defaulter is solvent, but the default is because of his negligence or because of circumstance beyond control. In the case of his negligence, a penalty will be imposed on him in addition to compensation if the creditor incurs losses; however, if the default is because of circumstance beyond control of the defaulter, he will be given respite to pay.

As the *murabaha* is considered a sale contract, full payment of instalments of the deferred sale price will fall due if the buyer defaults without acceptable excuse, according to the Hadith of the prophet that says: “*Muslims are bound by the conditions that they made*”.<sup>307</sup>

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<sup>307</sup>. Al-Hajjaj, above n 1570



Under this view, as the buyer entered the deferred sale contract freely, he is committed to pay the full price either on a lump sum or through instalment by the due date. This indicates that Islamic financial institutions are not obliged to give discounts or rebates (refund) for early settlement of loans because the portion of the undue profit margin of the loan is considered part of the selling price and the financier is still entitled to claim the price unearned, including the deferred portion of the profit margin for the remaining period. Unlike the conventional banking system, the client of an Islamic bank cannot obtain a discount if he pays off the loan well before the due date.

For this reason, the *murabaha* contract always creates problems between financiers and customers when customers make early settlement of the loan (selling price). For example, a bank may extend finance of \$100,000 with an 8 percent of mark-up (interest) annually for three years to a customer. Like conventional banking practice, the monthly instalment is \$3,133.64, which is consistent with conventional banking's basic formula of calculation ( $\$3,133.64 \times 36 \text{ months} \times 3 \text{ years}$ ), that makes the total payment \$112,810.92 at the maturity of the loan. However, unlike the conventional banking system, the customer of Islamic bank pays this amount regardless if he settles the loan well before the due date or pays it at the due date. The difference between Islamic and conventional banks, in conventional banking system, the customer pays the principal amount outstanding, which is \$69,286.41. However, Islamic banks ask their customers to pay off the outstanding selling price of \$75,207.28 which includes unearned profits of \$5,920.87 for the financing. Notwithstanding, Islamic banks have the discretion to waive the unearned profits from the customer. This means the bank voluntarily can wipe out the unearned profit of \$5,920.87 and asks the customer to pay only \$69,286.41, which makes it at equivalent to the financing of the conventional banks

In light of this, AAOIFI endorses Islamic banks giving a rebate to customers in the case of early payment. However, this rebate is only allowed if the bank pays it voluntarily and was not a condition stipulated in the contract for the early payment.<sup>308</sup> In addition, in the light of this, both the Negara Bank requires Malaysian Islamic banks to provide a mandatory rebate (*Ibra*) when customers make early settlement for the whole loan amount and waive (do not claim) the unearned portion of the profit margin from the financing.<sup>309</sup> This implies the financier can offer a rebate for early payment of the loan to encourage the customer to settle his loans earlier. This provides justice for both customers and financiers and gives Islamic financial institutions a competitive position compared to their conventional counterparts.

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<sup>308</sup> AAOIF, above n 230. See Hadith No 2400(Bukhari, Vol 14) that says "The basis for the permissibility of discount or rebate for earlier payment is because discount for early payment is a form of settlement between the creditor and the debtor to pay less than the amount of the debt. This is among the settlements that are endorsed by Shariah as stated in the case of Ubay Ibn ka'b may and his debtor, where the Prophet peace be upon him suggested to him in words: write off a portion of your debt".

<sup>309</sup> Abdul Hamid Mohamad and Adnan Trakic, 'Application and development of *Ibra*' in Islamic banking in Malaysia' (2013) 2013 The Law Review 26.

The above discussion suggests that Islamic financial institutions are required to make rebates when the rebate arises from (a) an early settlement, refinancing, restructuring of the contract or defaulting on settlement; or (b) a discount that may be given for the difference between the price calculated against the benchmark incurred, based on certain events, and the maximum selling price. For instance, if a sale price is based on a profit rate of 9%, but the financier (seller) agrees to offer a discount of 3% on the sale price based on a good payment record, or low funding cost when the customer only pays 6% instead of 9%. However, when the ceiling profit rate is, for example, 12% annually, but the effective profit rate is 8 % annually, the customer will only pay 8%, and the bank rebates the differential 4% to the customer. The rebate (*ibra'*) is required to be granted at every instalment to reduce the monthly instalments to match that of the current market level. Although, Islamic banks are not obliged to promise a discount, they are encouraged to voluntarily offer a discount / rebate to their clients as a gesture of goodwill by foregoing their right to claim the remaining deferred profit portion due to early settlement of the loan by customers. This is not only in line with the objectives and the principles of the Islamic law that promotes fairness in financial dealings but also makes Islamic financial institutions competitive in the financial markets.

### 5.2.3.3 Collateral Security in *Murabaha* Finance

As the *murabaha* is a deferred sale price, Islamic banks insure the risk of non-payment of *murabaha* finance by taking the financed assets as collateral through a Rahn (Collateral Security) contract. However, according to article 3 of the AAOIF, the bank is not entitled to security unless a credit contract is created between the bank and the client, and hence the client incurs a debt. In addition, according to Shariah Standard number (3) of the AAOIF, this collateralisation entitles the bank to apply for the sale of any asset pledged as collateral for the loan. Thus, banks usually stipulate in the contract a condition that gives them the right to sell the asset if the customer defaults, to recover their money without recourse to the court.<sup>310</sup> In this security technique, assets can be used for collateral when one or two different persons or institutions offer or make a pledge for a loan. In addition, once the pledge has been approved the pledgee cannot revoke the demand for repayment of the debt by the creditor and upon default or refusal of payment, the creditor can ask the court to force the sale of the asset to recover the debt.<sup>311</sup>

Although, security will be furnished only when the contractual relationship between the creditor and debtor is created, some scholars suggest that the client could furnish a security to the bank even before the actual sale contract takes place, if the *murabaha* price is determined in advance.<sup>312</sup> Nonetheless, in this case the goods will remain a risk for the bank if it possesses the goods furnished for security. Consequently, if these goods vanished while under the possession of the bank, it would either pay the market price of the goods to the client

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<sup>310</sup> AAOIF, above n 322.

<sup>311</sup> Zamir Iqbal and Abbas Mirakhor, *An introduction to Islamic finance: Theory and practice* (John Wiley & Sons, 2011) vol 687.82.

<sup>312</sup> Usmani, above n 88.

and cancel the *murabaha* contract or sell the goods requested by the customer on the market. However, in this case, the bank deducts the market price of the furnished asset from the price of the sold goods. Alternatively, the bank can keep the sold commodity physically or constructively as security and then return it back to the financier as security. This means it is not compulsory for the purchaser to take delivery of the sold commodity before giving it to the financier as security<sup>313</sup>, suggesting the only requirement is to distinguish between the time of selling the commodity and the time it has been assigned as security.

When the transactions relate to international trade, this security can be in the form of a lien or charge. Article 3 of the AAOIFI Shariah Standard states that: “*It is permissible to secure international transactions by using documentary credit provided that the secured transactions do not violate the Shariah principles*”.<sup>314</sup> For example, in the IITFC and PT Angles Products case, one of the most well-known *murabaha* trade financing contract cases, the financier used collateral security for finance. In this financing arrangement, the IITFC provided finance under *murabaha* to PT Angles products to purchase raw sugar from the Czarnikow Group headquartered in London. Although the contract parties did not mention what kind of documentary credit they used, it appears from the structure of the contract and the parties involved that they used UCP. After agreeing to finance the purchase of the importer, the ITFC firstly requested the importer to put 20 percent of the price of the commodity (raw sugar) into ITFC’s collection account before the bank paid the supplier of the commodity to ensure the commitment of the purchaser. Secondly, after the goods were shipped to the designated warehouse by the ITFC and documents were adduced, the ITFC paid the seller. The purpose of delivering the raw sugar to the warehouse was to put it under the control of the ITFC as the owner to check and verify the quality and quantity of the goods. For instance, PT Angles purchased the amount of raw sugar it needed for refining, and the ITFC issued invoices for the amount it purchased for the refining. Fourth, once the payment of the portion that the PT Angles purchased had been received, the ITFC instructed the collateral manager to release the quantity of raw sugar purchased to the buyer with the corresponding mark-up and management fee as well.<sup>315</sup> This practice seems to be consistent with Islamic jurisprudence; instead of securing the payment due by demanding a line of credit, the parties to the contract were allowed to use the goods as collateral for the finance.

This structured *murabaha* trade financing shows that the ITFC implemented a well-designed risk mitigation system and issued warehouse receipts under the ITFC’s name as evidence of the ownership of the commodity to satisfy Shariah principles. This insurance covered the commodity both during the shipment and in the warehouse, while the ITFC was chosen as the loss payee.<sup>316</sup> Moreover, the ITFC obtained 20 percent of the

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<sup>313</sup> Ibid.

<sup>314</sup> AAOIF, above n 391.

<sup>315</sup> Hossein Askari, Zamir Iqbal and Abbas Mirakhor, *New Issues in Islamic Finance and Economics: Progress and Challenges* (John Wiley & Sons, 2011) vol 753.

<sup>316</sup> Oseni, above n 11.

value of the commodity from the buyer, which provided a 125 percent collateral margin and safety against the finance. This shows that although theoretically the bank is liable for the financial risk, in fact the risk is borne by the client who reimburses the bank for the insurance and resembles the practice of conventional banking.

In the Australia context, the case would not have been different from the above example. For instance, an Australian exporter may sell wool to an importer from Malaysia for \$5,000,000 on the 1st of July 2018, while the Australian exporter requires the Malaysian importer to provide security for the payment on the due date, which coincides with the 30th of December 2018. At the request of the exporter, the importer without taking the goods, offered the wool as security. Thus, if the wool vanished before the 2nd of July, the sale contract would be cancelled, and the importer would make no payment; however, if the goods vanished after the 2nd of July, the sale would still exist but would be subject to the rules prescribed for the destruction of security assets. To this end, some scholars such as the Hanafi School of law suggest that the seller will bear the loss of the goods to the extent of the agreed sale price or the market price, whichever is lesser.<sup>317</sup> For example, if the price of the wool falls to \$5,800,000, the seller (financier) will be entitled only to the remaining amount of the agreed sale price of \$5, 000,000. On the other hand, if the market price of the wool remains at the agreed sale price (\$5,000,000), or has risen above this price, the importer cannot claim anything more than this price. Scholars from the Shafi and Hanbali Schools claim that if the destruction of the wool results from negligence or any fault of the exporter, the purchaser will bear the loss and pay the full price, and exporter will not be liable for anything. This indicates that Islamic financial institutions adopt the same risk mitigation techniques as conventional banks when it comes to collateralising *murabaha* finance, and hence they do not incur extra financial risk by providing finance under a *murabaha* contract within the Australian financial market.

#### **5.2.3.4 Guaranteeing *Murabaha* Finance**

As the *murabaha* payment is payable in the future and the customer may default or his payment capacity may deteriorate, the financier may ask the customer to provide a guarantor for payment of the loan.<sup>318</sup> Islamic financial institutions usually use Kafalah (guarantee) and rahn (collateral security) to guarantee *murabaha* loans. Under this strategy, Islamic banks like conventional banks may ask borrowers to furnish a guarantee from a third party to recover its money upon the client defaulting when the guarantor will be liable for the payment. But the financier cannot ask for any guarantee unless a credit contract is created between the bank and the client.

However, traditional Islamic jurisprudence holds the view that the guarantee should be voluntary, not mandatory. Thus, the guarantor cannot charge fees for the guarantee. While this view holds the guarantee to be free of charge, it allows the bank to charge fees for expenses that the guarantor incurs in offering the

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<sup>317</sup> Usmani, above n 89.

<sup>318</sup> Ibid.

guarantee. The reason for prohibiting fees to be charged on the guarantee is that Shariah law does not allow someone who only undertakes to pay a certain amount on behalf of the debtor upon his default, to charge fees on this voluntary service. This view argues that charging fee for the guarantee should be subjected to the same rules as prohibition of interest.<sup>319</sup> For example, a purchaser may borrow \$1,000,000 from a bank and asks an insurance company to be his guarantor; however, a financial institution may step in and pay off this amount immediately and ask the borrower to pay back \$1,100,000 within four years. According to Islamic finance theory, this \$100,000 extra from the principal loan amount constitutes interest. In another scenario, a purchaser might request a guarantee for payment of the sale price, and an insurer might be guarantor for the payment of the sale price (\$1,000,000); but the insurer asks the purchaser to pay 10 percent of the loan for the guarantee service. In these examples, although the approach is different the result is same because both the financial institution and the insurer charge 10 percent which constitutes interest according to traditional Islamic jurisprudence. Consequently, as Islamic law considers the guarantee to be voluntary, the question that arises is how Islamic banks provide guarantee services under a *murabaha* contract without charging fees like conventional banks.

In modern commercial transactions where the exporter and importer do not know each other, and it is difficult to find someone who offers a guarantee service without payment in international trade, it will be necessary to find an intermediary that provides a guarantee for both payment of the purchaser and delivery to the seller. However, under these circumstances no financial institution would provide a guarantee service without charging a fee. Hence, some contemporary Islamic scholars suggest banks should be allowed to charge fees for a guarantee by arguing that the prohibition of a fee is not based on any specific injunction in the Quran or the Sunnah but has been deduced from the prohibition of *riba* as one of the ancillary consequences. They maintain that the prohibition of fees on today's complicated commercial transactions operating in different legal systems has no basis in the Quran or the Sunnah of the Prophet<sup>320</sup> especially where the parties of trade transactions do not normally know each other without an intermediary financial institution. This is reinforced by article 2(1) of the AAOIF that states providing a guarantee is permissible under the contract of sale as far as it does not affect the validity of the original contract. This guarantee is intended to secure debts from being uncollectible or in default; such guarantees may take the form of written documents, guarantee, pledges, attestations, promissory notes, or cheques.<sup>321</sup>

Islamic financial institutions usually use *Kafalah* (guarantee) and *Rahn* (collateral security) to guarantee payments and provide security for loans. Under this mechanism, the bank could recourse the default of the

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<sup>319</sup> Ibid.

<sup>320</sup> Ibid.

<sup>321</sup> AAOIF, above n 109.

importer by utilising the Kafalah as a security for the loan according to Shariah principles.<sup>322</sup> This makes the Kafalah (guarantee) a very important tool for international trade transactions where the bank is asked to guarantee the delivery of goods to the customer.<sup>323</sup> However, the Islamic Fiqh Academy ruled that the Kafalah is a benevolent contract in which the bank cannot charge a fee for issuing a letter of credit because the payment of the guaranteed amount resembles interest on a loan. This implies that when the customer defaults and the guarantor pay the guaranteed amount, the customer will be liable to pay back this amount in addition to the fee to the bank, which resembles the prohibited interest in Shariah law. For this reason, the Islamic Fiqh Academy bans banks from charging fees for issuing a letter of credit. Notwithstanding, according to article 7(1) (2) of the AAOIF, charging administrative expenses for issuing a letter of guarantee is permissible on condition that the fees are the same as the administrative expenses charged on similar services.<sup>324</sup>

According to Islamic law, upon the default of the client the bank may sell the goods to a third party and use the proceeds to pay the exporter. However, if the proceeds exceed the amount owed by the importer, the bank refunds the extra amount to the importer after deducting any expenses that it may incur in selling the goods, or fees it may charge. On the other hand, if the proceeds fall short of the amount that the importer owed the seller, the bank pays the balance utilising its fund and then claims it from the importer. Alternatively, the bank can purchase the goods from the importer and assume their ownership and then sell them to a third party and keep the proceeds and the profits to the exclusion of others.

Referring to the question of how *murabaha* contract can operate under Australian law, while also remaining Shariah compliant and be commercially desirable in Australia, the current risk management practice of the Islamic financial institutions makes *murabaha* operationally and commercially viable in the conventional financial markets. This practice that resembles the conventional financial practice entitles *murabaha* transactions to receive same legal treatment as the conventional financial transactions. It appears that, although shariah principles are the cornerstone of Islamic financial transactions, IFIs often choose civil legal systems as the governing law for their *murabaha* transactions—particularly for international commercial agreements. This provides more certainty regarding their rights and obligations. Therefore, *murabaha* as credit contracts have become the most popular Islamic financing product among IFIs. This gives financial institutions and financial markets confidence in *murabaha* financing operations in common law jurisdictions.

Even *murabaha* transactions that comply with common law provisions may still violate shariah principles. This risk of noncompliance with shariah law may jeopardise not only their legitimacy, but also their commercial viability in common law jurisdictions.

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<sup>322</sup> Michael JT McMillen, 'Contractual Enforceability Issues: *sukuk* and Capital Markets Development' [427] (2007) 7(2) *Chicago Journal of International Law* 427.

<sup>323</sup> De Jonge, above n 31.

<sup>324</sup> AAOIF, above n 92.

### 5.3 Concluding Remarks

The discussion about the practice of Islamic financial institutions has revealed that *murabaha* as a credit contracts to be similar to the conventional credit facilities disguised as a *murabaha* sale contracts through traditional *murabaha* terminology to circumvent the prohibition of interest. In practice, Islamic financial institutions that provide finance under *murabaha* contract do not strictly comply with the conditions laid down by the Sharaih law for the permissibility of the *murabaha* financing contract, such as assuming the risks associated with the ownership of the financed goods. Instead, they transfer the risks associated with the ownership of the financed goods to customers, once they guarantee a return that closely resembled with the commercial interest rates from customers. This makes difficult to distinguish between the profit margin of the *murabaha* and the secured debt-based interests. This resemblance with the conventional financial practice, has entitled *murabaha* contract finance to receive not only same legal treatment as the conventional financial products but also not to incur any extra financial risks compared to the conventional financial products in the common law jurisdictions. This has made financial markets and other stakeholders in the common law jurisdiction to feel comfortable with the efficiency and commercial viability of the *murabaha* financing in the conventional financial markets; therefore, IFIs prefer to structure *murabaha* transactions as credit contracts because of their applicability in non-Islamic legal jurisdictions, such as in Australia.

Although IFIs opt to apply shariah principles on *murabaha* transactions in non-Islamic legal jurisdictions, which are not bound to Islamic law, in practice these IFIs tend to choose English law as the governing law for *murabaha* transactions. Beyond even the issues raised by the divergence between the use of *murabaha* as credit contracts and the theory of Islamic finance, this exposes *murabaha* transactions to the risk of noncompliance with shariah law. *Murabaha* credit contracts must comply not only with the common legal system but also with the principles of Islamic law if they are to be commercially viable in conventional markets and earn legitimacy from Islamic customers, upon who the survival of the Islamic finance system depends.

Having assessed the practices employed by IFIs when using *murabaha* as credit contracts, the next chapter will discuss *murabaha* disputes under litigation by analysing *murabaha* courts cases to understand the nature of *murabaha* credit contract under the common law jurisdiction and how the common law courts deal with the disputes of *murabaha* transactions.

## CHAPTER 6: MURABAHA UNDER LITIGATION

### 6.1 Introduction

The preceding chapter revealed that the practice of *murabaha* contract in the common law jurisdiction is not that different from conventional financial transactions. The chapter concluded that the resemblance of the *murabaha* contract with the conventional financial practice entitle it to receive same legal treatment as the conventional financial products and not to incur extra financial risks in the common law jurisdiction. Yet, as Islamic financial institutions do not seem to be satisfying the conditions laid down by the Islamic law for the *murabaha* financing, this may lead *murabaha* transactions to the risk of non-Shariah compliant. This risk is particularly evident when considering that Islamic finance is becoming increasingly global and financial participants from a variety of jurisdictions are adopting shariah principles into international commercial agreements and non-Islamic legal jurisdictions, none of which are bound to Islamic principles.

With this in mind, this chapter explores whether *murabaha* practice have diverged from the principles of the Islamic law by examining dispute resolution in cross-border *murabaha* transactions through litigation by examining *murabaha* dispute cases between Islamic banks and their customers in both Britain and Malaysia. By drawing on the Malaysian and British experiences, this chapter elucidates the extent of Shariah compliance of *murabaha* transactions and whether in the common law jurisdiction they create any extra legal and financial risk. Within this context, the chapter examines the validity and enforceability of *murabaha* transactions in the common law jurisdiction by examining and comparing British and Malaysian court cases (and any other relevant cases). In analysing these courts cases, the study aims to understand how Shariah law principles governing *murabaha* transactions and common law interplay in the contractual structure of the *murabaha* financing mode, and to examine whether the litigation system is best suited for *murabaha* transaction disputes.

### 6.2 *Murabaha* Enforceability in British Common Law Jurisdictions

The absence of unified legal systems for Islamic finance in the English common law has led the Islamic finance industry to prefer British common law for governing financial transactions because of the sacredness of the contract in common law and its reliability in enforcing financial agreements.<sup>325</sup> This is the business strategy adopted by many Islamic financial institutions in commercial financial transactions and trade. Yet, Islamic financial institutions that provide finance under a *murabaha* contract as a credit facility face legal risks due to its requirement to comply with both Islamic law and domestic common law which may not recognise Islamic law principles that the parties choose as the governing law in the *murabaha* contract. on the one hand on the one hand, Shariah principles pertaining to aspects of a *murabaha* agreement may clash with common law provisions, on the other hand, it raises the question of the validity and enforceability of the *murabaha*

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<sup>325</sup> Aida Maita, 'Arbitration of Islamic Financial Disputes' [35] (2014) 20(1) *Annual Survey of International & Comparative Law* 39.



transaction in secular common law jurisdictions. This may lead to a legal and regulatory predicament that creates further legal risk in *murabaha* trade financing.

Within this paradigm, the next section examines the decisions and interpretations of Britain and Malaysian court cases (and any other relevant cases) in *murabaha* financing transactions within the common law legal system to examine how *murabaha* contract can operate under Australian law while also remaining Shariah compliant and what changes to Australian law are necessary to make Mubarak both legally compliant and commercially desirable in Australia. It also examines whether these different legal system of *murabaha* transactions creates additional legal risk.

London has become one of the most important international financial centres and at the forefront of the Islamic finance industry in common law countries because of the reliability and enforceability of financial agreements within the British common law jurisdiction. It is common knowledge that parties in international trade transactions who come from different legal and cultural backgrounds usually choose the documentation and legal procedures of their financial agreements to be based on English common law which has become popular among Islamic financial institutions operating in Britain. For this reason, these financial institutions see no commercial imprudence in choosing common law for litigation of financial disputes due to the commercial and legal certainty it offers for financial contracts. Therefore, as London has become the forum for international Islamic financial transactions, English courts have been involved with Islamic financial disputes, particularly *murabaha* cross border contracts.<sup>326</sup> The most well-known cases in English courts are: *Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems in 2002*, *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Limited in 2004*, and *Investment Dar and Blom Developments*. These cases represent a watershed for Islamic transactions in the common law jurisdiction because they provide practical examples of how both common law and Shariah law interplay in the contractual structure of the *murabaha* financing agreement.

### **6.2.1 Islamic Investment Company of the Gulf v Symphony Gems**

Islamic Investment Company of the Gulf (Bahamas) Ltd (IICG) versus Symphony Gems in 2002 was the first case pertaining to an Islamic financing facility to be brought before an English court. In this case IICG, which is a Saudi financial institution incorporated under the law of Bahamas, entered a *murabaha* financing agreement with Symphony, a Belgian company.<sup>327</sup> Under this financing agreement, IICG agreed to advance finance to Symphony Gems through a revolving *murabaha* facility whereby Symphony Gems as a purchaser

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<sup>326</sup> Chuah, above n ; Hasan, above n ; Aisha Nadar, 'Islamic finance and dispute resolution: Part 2' (2009) 23(2) Arab Law Quarterly 181.

<sup>327</sup> Balz, 'a *murabaha* transaction in an English court', above n ; Hasan, above n ; Moghul and Ahmed, 'Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems NV & (and) Ors.: A First Impression of Islamic Finance', above n 153.

requested that IICG finance Gems Diamonds from a supplier (Precious HK Ltd, a diamond dealer based in Hong Kong) through a *murabaha* contract.<sup>328</sup> However, to avoid dealing with the goods directly and exposing itself to financial risk in the transaction, IICG appointed Symphony Gems as its agent to deal with the supplier regarding the price, terms and conditions of the contract. Thus, as the undisclosed agent for the financier (IICG) Symphony Gems negotiated and agreed the price and terms of the contract with the supplier without the involvement of IICG. Then Symphony Gems applied to IICG to finance the commodity (diamonds) under the *murabaha* financing method.

However, IICG before providing finance to Symphony Gems demanded it fulfil the following conditions. First, Symphony had to commit to make payment unconditionally and irrevocably without linking it to the delivery of the goods or the transfer of the title to it as the eventual buyer. This means the delivery of the goods to its destination was not a prerequisite for payment of the loan by the purchaser. This infers that the bank transferred the goods directly to the client who assumed the risk of non-delivery of the goods would be the same as for conventional banking. Second, to avoid the risk associated with the ownership of the financed goods, IICG instructed the supplier to transfer the goods directly to Symphony Gems. Third, IICG limited its responsibility to payment of the loan to the supplier after checking that the documents confirmed the terms and conditions of the contract. This means the contract excluded IICG from liability for defects, loss or damages of the goods caused during the transit. Finally, the parties to the agreement agreed that the contract should be governed by and construed in accordance with the common law. Consequently, after IICG not only negotiated these conditions but also obtained a guarantee from Symphony Gems to reimburse the price of the diamonds on a deferred basis without linking it with the delivery of the goods, IICG paid the supplier (Precious HK Ltd) the price of the goods on behalf of Symphony Gems.<sup>329</sup>

Within this financing arrangement, a dispute arose when Symphony Gems defaulted on payment of the loan, which led IICG to apply for a summary judgment at the English High Court against Symphony Gems to recover its funds.

#### **6.2.1.1 The Ruling of the Court**

In this financial dispute in the English High Court, Symphony Gems put forward several arguments about the invalidity and unenforceability of the *murabaha* agreement according to Shariah law principles, for the following reasons: (1) the nature of the *murabaha* is a sale agreement under which the seller is obliged to deliver the goods before payment is made. Thus, as the agreement did not link the payment to the delivery of goods to their destination, it violated Shariah principles, and accordingly made the agreement invalid and

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<sup>328</sup> Moghul and Ahmed, 'Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems NV & (and) Ors.: A First Impression of Islamic Finance', above n 150.

<sup>329</sup> Chuah, above n ; Moghul and Ahmed, 'Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. v. Symphony Gems NV & (and) Ors.: A First Impression of Islamic Finance', above n 155.

enforceable; (2) pursuant to Shariah law, the bank as the seller is required to possess the goods and assume the risk associated with ownership; however, as possession of the goods never took place and the financier had never borne the risk of financing them, this violated Shariah principles; (3) this financing arrangement was a conventional interest-based loan dressed up as a *murabaha* sale contract, which contradicted Shariah principles; and (4) the agreement was unenforceable because it was illegal under Saudi Arabian law which is grounded in Islamic law, and contrary to the doctrine of *ultra vires* because it resembled an interest-bearing loan.<sup>330</sup>

In interpreting its articles of association, the bank should not engage in any activities that violate Shariah principles and therefore the contract is invalid and unenforceable in a court. Thus, according to the doctrine of *ultra-vires* (under common law which the Bahamas law incorporated), the bank had no authority to enter an agreement that contradicted Saudi law which is based on Shariah law that prohibits interest.

#### **6.2.1.2 The Structure of the Agreement**

This contract illustrated the interplay of Islamic law with common law in the *murabaha* contract. The contention of this case related to both the contractual structure of the *murabaha* agreement and the enforceability of Shariah law relating to the *murabaha* contract within the common law jurisdiction. This issue raised the question of whether the *murabaha* is a sale contract in which the bank as a seller is obliged to deliver the goods or a credit contract that does not oblige the seller to deliver the goods to the buyer. It also raised the question of the enforceability of the agreement because of its illegality under the law of another country which is based on Shariah law, and how the doctrine of *ultra vires* could be accommodated in the *murabaha* contract within the common law jurisdiction.

As the dispute related to the contractual approach and the validity of the agreement according to Shariah law, the structure of the *murabaha* financing agreement was the first matter considered by the Court. For this reason, the court appointed two Islamic law experts, Professor Martin Lau of the School of Oriental and African Studies, University of London, and Yahya Al-Samaan of the Saudi law firm of Salah Al-Hejailan for advice. The experts, after examining the agreement under traditional Shariah law principles, declared that the *murabaha* contract in question did not have the essential characteristics of such a contract according to Islamic jurisprudence.<sup>331</sup>

In spite of receiving the opinions of experts, the courts put aside and analysed the contract according to the classical common law interpretation. In this respect, the court first examined the terms, conditions and the

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<sup>330</sup> Balz, 'a *murabaha* transaction in an English court', above n ; Chuah, above n 117.f

<sup>331</sup> Balz, 'a *murabaha* transaction in an English court', above n 124.

commercial purpose of the contract and concluded that the contract was a credit facility in accordance with English common law. In this regard, the judge made the following remarks after the decision:

*There cannot be two governing laws in respect of the contract as provided by the Rome convention which made clear that a contract shall be governed by a national law of a state chosen by the parties not by a non-national system of law such as shariah.*<sup>332</sup>

Second, the court stated that Shariah law is not a state law but a religious principle which made it unlikely that a secular court would be involved with matters related to religious belief that fell under the responsibility of the bank's supervisory board, and therefore the court rightly remarked that:

*It is improbable in the extreme, that the parties were truly asking this court to get into matters of Islamic religion and orthodoxy. This is especially so when the bank has its own religious board to monitor the compliance of the bank with the board's own perception of Islamic principles of law in an international banking context.*

Third, the court stated that even if it examined Shariah law matters pertaining to financial matters, there were some areas of considerable controversy in Shariah law due to the different opinions of Islamic schools, which made it difficult for a secular court to interpret in modern law. The judge commented on this matter by stating that:

*it was the evidence of both parties' experts that there are indeed areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself in any given case before reaching a conclusion upon the principle or rule in dispute.*<sup>333</sup>

In this note the court noted that there was no suggestion that the borrowers had been in any way concerned about the principles of Shariah either at the time the agreements were made or at any time before the proceedings were started and in the court's opinion, the Shariah defence was a lawyer's construct.

Fourth, the court held that Shariah principles could not be applied to the agreement and consequently dismissed its relevance to the contract claiming it was neither a national law nor a universally recognised body of law capable of governing and providing sufficient interpretation to this contract. Hence, by rejecting the argument of the defendants on the applicability of Shariah law to the agreement, the court ordered the defendant to pay the outstanding balance of the loan, inclusive of the principal and profit margin.

On appeal, the appeal court agreed with the High Court and dismissed the argument that shariah principles should be used to resolve Islamic finance transactions.<sup>334</sup> The Supreme Court did not recognise that the

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<sup>332</sup> Islamic Investment Company of the Gulf (Bahamas) Ltd v. Symphony Gems NV and Others, 2002 All E.R. (D) 171 (2002). (2002) [13 Feb 2002] All E.R. (D (High Court)).

<sup>333</sup> Ibid.

<sup>334</sup> Kilian Bälz, 'A Murābaha Transaction in An English Court—The London High Court of 13th February 2002 in Islamic Investment Company of the Gulf (Bahamas) Ltd. V. Symphony Gems NV & Ors' (2004) 11(1) *Islamic Law and Society* 117.

provisions of shariah law could govern commercial and trade transactions in the UK. By dismissing the relevance of Islamic law, the court considered *murabaha* to be a credit facility like conventional financial instruments, meaning that it is governed by and construed in accordance with English law; thus, *murabaha* transactions receive the same legal protection as conventional financial products under the common law.

Despite this decision, the court still seemed open to the concept of incorporating some provisions of a foreign law into English contracts, but only if the parties had sufficiently identified specific provisions of a foreign law or an international code or set of rules. In this case, the general reference to shariah principles in the governing law clause did not specifically identify those aspects of shariah that were intended to be incorporated into the contract. This may mean that, had there been clear and specific shariah provisions in the contract—such as a unified shariah standard for *murabaha* contracts—the borrowers might have succeeded in their application.

Similarly, although there have been no Islamic financial disputes in Australian courts, the Australian courts would likely have taken same approach as their English counterparts because of the commonalities between the two legal systems and their shared historical background. Australian private international law generally gives effect to the commonsense principle that contracting parties may choose the system of law by which their contract is governed.<sup>335</sup> According to the Hague principles on choice of law in international commercial contracts, the parties to a contract may generally choose a governing law with a clause in the agreement.<sup>336</sup> In this, the parties are not required to explicitly choose an applicable law; however, every contract has an applicable law, because a contract is unable to exist in a legal vacuum.<sup>337</sup> The law chosen by the parties of the agreement may be ‘rules of law’ that are generally accepted on an international or regional level, such as laws promulgated by intergovernmental organisations (e.g., the UNIDROIT Principles of International Commercial Contracts) or laws based on religion (e.g., shariah law). That said, neither Australian law nor English law allow non-state law (i.e., shariah) to govern contracts, which means the principles of non-state laws may only be incorporated as terms of a contract while Australian law remains the governing law.<sup>338</sup> On this basis, Australian courts would have taken the same position as the English courts regarding the non-recognition of shariah principles as law appropriate for governing *murabaha* contracts, and would have treated *murabaha* contracts as normal credit contract that are entitled to receive the same legal protection as conventional financial credit contracts.

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<sup>335</sup> Michael Douglas and Nicholas Loadsman, ‘The Impact of the Hague Principles on Choice of Law in International Commercial Contracts’ (2018) 19 *Melbourne Journal of International Law* 1.

<sup>336</sup> *Continental Bank NA v Aeakos Compania Naviera SA* (1994) 1994 WLR 1 588.

<sup>337</sup> *Amin Rasheed Shipping Corp v Kuwait Insurance Co* (1984) 1984 AC 50.

<sup>338</sup> Douglas and Loadsman, above n 334.

### 6.2.1.3 The issue of non-delivery of the goods

In the issue of non-delivery of the goods the court examined the terms, conditions and commercial purpose of the agreement and firstly held that the contract was a financing arrangement and not an orthodox sale contract. Second, the payment was payable by the purchaser through instalment without being linked to the delivery of the goods to him; the reimbursement of the loan was autonomous and did not depend on the delivery of the goods to their destination. Third, according to the terms of this agreement, Symphony Gems was not only obliged to pay the bank regardless of delivery of the goods, but it also accepted the risk of non-delivery of the goods as in conventional practices. Hence, the court noted that the non-delivery was the result of negligence of Gems Symphony which did not make the necessary arrangements. Fourth, as the communication between the bank and customers demonstrated, both sides were fully aware that the payment of the loan was independent of delivery of the commodity and the defendants did not raise the issue of non-delivery of the goods before the dispute. The court noted that the defendants had not shown any concern about the compliance of the agreement with Shariah principles. Fifth, the court concluded that given the economic structure of the agreement and using the word “facility agreement” in the contract showed that the transaction was for a credit facility with autonomous payment obligations that was not a prerequisite for delivery of the commodity to the purchaser.

Consequently, the court stressed that the Shariah defence was merely a lawyer’s construct and concluded that the contract was not a genuine *murabaha* sale contract.<sup>339</sup>

Thereupon, the court dismissed the argument of noncompliance of the contract based on non-delivery of the goods as the *murabaha* is a sale agreement, and instead held that it was about a credit facility because of the following reasons:<sup>340</sup> (a), the lack of involvement by the financier in the choice of supplier, selection of the commodity and negotiation of its price showed that the transaction was a credit contract; (b) IICG’s rejection of any liability for defects, loss or damages of the goods in transit indicated that the transaction was no different from conventional interest-bearing loans; (c), the deferred payment of the transaction confirmed the contract was a credit facility; and (d) the risk of finance was solely borne by the purchaser as stipulated in the agreement.

All these factors made it self-evident that the transaction was a credit facility, and as a result the *murabaha* financing contract received the same treatment and protection as conventional credit facilities. In the Australian context, the courts would have taken the same approach in deciding this issue as this contract falls under the Australian regulator regime under the Uniform Consumer Credit Code (UCCC). Therefore,

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<sup>339</sup> Maita, above n 46.

<sup>340</sup> Balz, ‘a *murabaha* transaction in an English court’, above n 131.

*murabaha* trade financing does not face either legal or financial risk within the British common law jurisdiction.

#### 6.2.1.4 Foreign Illegality and the doctrine of *ultra vires*

In the argument of the foreign illegality of the agreement under Saudi law, the court examined how the English court could deal with an international financial transaction if the law of the country where the performance of contract takes its jurisdiction does not allow the payment of interest according to article 10(2) of the Rome convention.<sup>341</sup> In the international agreement, the autonomy of the parties is fundamental where, pursuant to article 3.1 of the Rome convention 1980, the law chosen by the parties of the agreement would govern the contract. According to article 1 of the Rome regulation, this convention does not preclude parties of international contracts incorporating the contract as a non-State body of law or international convention. Given this view, the freedom of choice may provide the parties with the right to include a governing law clause that refers to a national or non-national law in the agreement.<sup>342</sup>

It is necessary to examine whether shariah law can be considered by English law as the chosen law according to the *Rome Convention*, which allows the parties to a sale contract to choose a foreign law to govern contracts, and to discuss the argument made by the defendants that the agreement was invalid according to the *ultra vires* doctrine. The defendants argued that—as this doctrine enunciated the activities of the company beyond the scope of its articles of association—it was invalid because they were not within the authority of the company<sup>343</sup> Because the company’s articles of association included a statement that does not allow it to undertake any business or transaction that is inconsistent with the principles of shariah law, the transaction violated the principle of *ultra vires* because the company went beyond its legal capacity and consequently the contract was unenforceable.<sup>344</sup> This meant the capacity of the company was limited to the law that created it as an entity and thereafter if the company entered an agreement beyond its authority it become unenforceable.

Therefore, the court first dismissed the argument of Symphony Gem’s claim about the applicability of the common law doctrine of *ultra vires* based on incorporating the company under the law of Bahamas by noting that the bank was not subject to the principles of *ultra vires* in this case. The court stated that the *ultra vires* doctrine was irrelevant in this case and, as a result, the court rejected the argument of the unenforceability of the *murabaha* based on the *ultra vires* doctrine and the foreign illegality argument.<sup>345</sup> Thus, the court

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<sup>341</sup> Chuah, above n 138.

<sup>342</sup> Anowar Zahid and Hasani Mohd Ali, ‘Shari’ah as a Choice of Law in International Islamic Financial Cotntracts: Shamil Bank of Bahrain Case Revisited’ (2013) 10 *US-China L. Rev.* 27.

<sup>343</sup> Bälz, ‘A Murabaha Transaction in an English Court’, above n 129.

<sup>344</sup> Ibid.; Chuah, above n 153.

<sup>345</sup> Balz, ‘a *murabaha* transaction in an English court’, above n 142.

dismissed the argument of the unenforceability of the *murabaha* based on the *ultra vires* doctrine and its foreign illegality and held that the contract was only governed by English law.

Second, in addressing the argument of illegality of the agreement because it contained elements that were perceived as illegal in Saudi Arabian law based on Shariah law, the court stated that Shariah law was not a state law according to the Rome Convention, but a religious principle. Consequently, it rejected the defence arguments on the grounds of the invalidity and unenforceability of the contract due to its illegality in law in another country whose legal system is based on Shariah law.<sup>346</sup>

Third, in ruling on whether or not Islamic law was the chosen law according to articles 8 and 10 of the Rome Convention, the appeal court hinted at the possibility of enforceability of foreign illegality of the contract when it was unenforceable under a foreign law. In this respect, the court could adopt the tradition of the English law principle that states: a contract would be illegal under English law if the contractual arrangement includes unlawful elements in the view of the foreign law. Even though, the English court considered foreign illegality under international transactions, it did not recognise foreign illegality of a contract when it contravened English public policy on the grounds of morality.<sup>347</sup> In this regard, the court examined what constituted the illegality of the contract and which actions rendered its performance in the foreign country or made its performance impossible by noting that the offer and acceptance of the contract to and from the headquarters of the company in Saudi Arabia were minimal, and that did not warrant the English courts considering the issue of foreign illegality.<sup>348</sup>

The generalisation of Shariah law principles without specifying provisions of the law that is intended to govern the agreement may have contributed to the court's conclusion to ignore the relevance to the agreement. Consequently, the court did not recognise this as a sale contract, and instead ruled it to be a credit contract and ordered Symphony Gems to pay the outstanding loan amount including the principal and compensation for the delayed payment to IICG.

This means any financial institution that provides finance under the *murabaha* mode can be treated as a credit facility and receive the same protection in common law as conventional financial institutions. The ruling shows the consistency of practice of the English legal system that interprets commercial agreements according to their literal meaning. What is more, it reflects the intention of the English court to protect both public policy and the common interest of the business community by making international trade contracts binding on contracting parties. Notwithstanding, someone may argue that if the parties of the agreement specified aspects of Shariah law that particularly related to the *murabaha* contract, such as the rules established by the AAOIFI

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<sup>346</sup> Chuah, above n 154.

<sup>347</sup> Ibid.

<sup>348</sup> Ibid.



and the IFSB without ambiguity for incorporating it into the agreement, the contention of non-compliance of Symphony Gems may have succeeded.

Albeit, the ruling suggests that had the court referred to Shariah law instead of British common law as the governing law of the agreement, it was likely that the *murabaha* agreement would have been ruled non-compliant. This might have jeopardised the *murabaha* as a financing instrument and forced Islamic financial institutions to consider another way of doing business. This means, if the court applied Shariah rules related to *murabaha* financing and accordingly ruled the agreement to be a sale contract rather than a credit facility, it might have made the contract null and void and endangered the *murabaha* as a financing instrument and compelled Islamic financial institutions to change offering finance under *murabaha*.

### **6.2.2 Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Limited**

The second *murabaha* trading financing case was between the Shamil Bank of Bahrain vs Beximco Pharmaceuticals Ltd, a Bangladesh group of companies involved in the manufacture, export and import of pharmaceuticals, under which Shamil Bank extended funds to the Mexico group of companies using a *murabaha* financing contract.

Shamil Bank and Beximco entered into a financing agreement in which the Bank extended funds to Beximco under a *murabaha* Tawarruq (Monetization of some commodity) financing agreement; the funds were for a working capital facility that Beximco needed for their operations. However, as Shariah law does not allow interest on loans, Shamil bank through reverse *murabaha* (Bay al-inah) sold the goods to Beximco on a deferred basis and purchased them back immediately from Beximco on a spot price that was less than the selling price.<sup>349</sup> This means that by selling the goods back to Shamil bank Beximco received the necessary working capital and committed itself to pay back this deferred sale price that included the principal amount plus a profit margin by instalment.

After Beximco and other borrowers defaulted on the payment under the *murabaha* agreement, Shamil Bank following a series of termination events brought the case to the court. The bank argued that Beximco and others failed to fulfil their obligations under the financing agreement and applied to recover the loan and receive compensation for the delay. However, Shamil Bank did not challenge the argument about Shariah non-compliance of the *murabaha* contract by the customer and instead argued the compliance of the agreement with English common law.<sup>350</sup> Beximco defended itself by arguing that: (1) by incorporating the governing law clause regarding Shariah law principles into the agreement, the parties intended that the contract would be governed by Shariah law as well as common law. Thus, the obligations and rights of the agreement would

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<sup>349</sup> Ibid.; Hasan, above n 54.

<sup>350</sup> Jason CT Chuah, 'Islamic principles governing international trade financing instruments: A study of the morabaha in English law' (2006) 27 Northwestern Journal of International Law & Business. 137.

only be binding if the agreement conformed to the principles of both Shariah and English Common law<sup>351</sup>; (2) the transaction was not compliant with Shariah principles because it was an interest-based loan disguised as a sale contract to circumvent the prohibited interest, and therefore rendered the contract invalid and unenforceable; and (3) as the contract was invalid because of its violation of Shariah principles, guarantors should be relieved from their obligation because they signed the agreement believing it complied with Shariah principles.<sup>352</sup>

Beximco contention about non-compliance of the agreement was surprising because the bank's Shariah Supervisory Board approved the *murabaha* financing agreement as Shariah compliant and it was consequently agreed by both parties of the contract. This indicates the paradox that Islamic financial institutions face in providing finance under the *murabaha* financing mode within the common law jurisdiction.

#### 6.2.2.1 High Court Decision

In examining this dispute, the issues that came to the attention of the High Court were the construction of the agreement, the governing law clause, and the statutes of English law. The *murabaha* agreement contained the following governing clause that states: '*Subject to the principles of the Glorious Shariah law, the agreement shall be governed by and construed in accordance with the laws of England*'. In addressing the governing law clause, the Court examined whether it indicated the intention of the parties to require English law to adopt Shariah law principles when applying English law to the contract. The court found the governing clause was inadequate to fulfil the objective of incorporating Shariah principles into the agreement and accordingly it held that the governing law of the contract was English law. It stated that the reference to shariah law principles embedded in the governing law clause stood unqualified to be the governing law in the contract.<sup>353</sup> This is firstly because shariah is not the law of a state, but a set of religious principles, and secondly, because the parties had not provided a unified shariah standard for Islamic finance in general (and the *murabaha* contract in particular).

After examining the elements of the *murabaha* contract in the light of common law principles and the principle of conflict of laws, the High Court dismissed the argument that shariah law was the governing law. It declared that two different and competing legal systems cannot govern a financial contract within the UK jurisdiction. It also indicated that the governing law clause referring to shariah principles was general, less genuine and

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<sup>351</sup> Jason Chuah, 'Islamic principles governing International trade: A Study of the Morabaha in English Law' (2006) 27 Northwestern Journal of International Law & Business 136; Hasan, above n 55.

<sup>352</sup> Chuah, 'Islamic Principles Governing International Trade Financing Instruments: A Study of the Morabaha in English Law', above n ; Hasan, above n 55.

<sup>353</sup> *Shamil Bank of Bahrain v Beximco Pharmaceuticals Limited and Others*, (2004) EWCA Civ 19, 1 (The Supreme Court of Judicature Courts of Appeal [Civil Division]). In this respect, Potter LJ made these remarks: 'The general reference to principles of Sharia in this case affords no reference to, or identification of, those aspects of Sharia law which are intended to be incorporated into the contract, let alone the terms in which they are framed. It is plainly insufficient for the defendants to contend that the basic rules of the Sharia applicable in this case are not controversial'.

uncertain, and the real intention of the parties of the agreement was that the contract be governed by English law. In addition, it maintained the governing law clause was intended to make bank customers believe that it was striving to conduct its operations according to Shariah principles.<sup>354</sup> The Court further noted that even if the court tried to apply Islamic law (even though it is not appropriate for a secular court to involve with matters related to religious issues) and tries to interpret it to reach an inclusion about the dispute, there are areas of considerable differences among the Islamic schools of thought that will not allow the court to translate into propositions of modern law texts.<sup>355</sup>

Therefore, the court dismissed the defendants' argument based on the invalidity and unenforceability of the contract on the grounds of its non-Shariah compliance and ruled that the agreement was solely governed and construed by British common law. However, upon their dissatisfaction on the decision of the court, the defendants then appealed the High Court decision arguing that it overlooked the governing law clause that stated Shariah law principles intended to govern the contract were incorporated into English law. In this case the court, unlike the case of *Investment Company of the Gulf and Symphony Gems*, allowed the defendants to take it to the Appeal Court.

#### **6.2.2.2 Appeal Court**

The Appeal Court in applying the principle of contract construction analysed the purpose of the commercial transaction, its genesis, the environment in which it took place and the market that the parties of the agreement were operating in to understand the intent of the parties to the contract. In this respect, the court analysed the wording of the agreement by using the reasoning of English commercial law that assumes the contracting parties intended what they had written in the document by highlighting the followings.<sup>356</sup>

Firstly, two legal systems cannot govern financing agreements in Britain and held that the common law agreement solely governed the contract in accordance with English common law.

Secondly, it dismissed Shariah law as the governing law on the contract by affirming that it is not a law of a specific country according to the Rome Convention, and indicated that the parties of the contract had chosen it only as religious principles. By examining whether the governing law clause sufficiently incorporated the principles of Shariah law into the agreement, the court declared that the choice of law clause referring to the principles in the agreement was ambiguous and did not identify if the Shariah law principles were incorporated into English law substantively or interpretatively.

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<sup>354</sup> Maita, above n 44.

<sup>355</sup> *Shamil Bank of Bahrain v. Beximco Pharmaceuticals Limited and Others*, (2004) EWCA Civ 19, 1 (The Supreme Court of Judicature Courts of Appeal (Civil Division) ).

<sup>356</sup> Chuah, 'Islamic principles governing International trade: A Study of the Morabaha in English Law', above n 146.

The court pointed out that the statement that says '*Subject to the principles of glorious Shariah*' in the governing law clause, was merely a marketing strategy intended to make customers believe that the bank was operating according to the Shariah principles and was not intended to surpass English law as the governing law of the agreement.<sup>357</sup>

In highlighting the ambiguity of the governing law clause referring to Shariah principles in the Shamil Bank and Beximco agreement, the Appeal Court stressed that the reference was not sufficient to warrant Shariah law principles qualifying to be incorporated into the English legal system. In particular, the contract did not identify the aspects of Sharia law which are intended to be incorporated into the contract with the framework of the British common law. Therefore, the reference to the Shariah law in the contract stand unqualified as a reference to the body of Sharia law generally.

Third, the court went further by asserting that even if it tried to examine the issue of Shariah law principles governing the agreement, there were areas of considerable controversy in its principles that are difficult to apply to financial matters. In this respect the courts noted that there are areas of considerable controversy because of the existence of a different of schools of law (thought) with which the court may have to concern itself in any given case before reaching a conclusion on the Islamic financial disputes. This problem will hinder the need to translate Shariah law principles pertaining to the Islamic financial contracts into propositions of modern law texts.<sup>358</sup>

Fourth, it pointed out that the parties would not have expected English secular courts to apply religious rules to the agreement which are not only controversial, because of the different views of Islamic schools of law, but are also not a national law<sup>359</sup>. Consequently, like the High Court, the Appeal Court insisted that the reference to Shariah law in the contract was too uncertain, and that the parties only intended this reference to express the bank's efforts to adhere to the principles of its operations. In this respect, the court declared that the English secular court was not in a position to resolve contractual disputes through Shariah law principles on which even Islamic jurists have different views.

In relation to the Rome Convention, the court referred to article 1 to decide if Shariah law meets the criteria for choice between the laws of different countries for commercial agreements. According to article 1.1 of the Rome Convention, the parties to a contract can incorporate some specified and clearly identified provisions of a foreign law or international convention into a contract that occurs in Britain. However, the Court rejected the Shariah principle as a foreign national law according to the Rome Convention, and consequently

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<sup>357</sup> Shamil Bank of Bahrain v. Beximco Pharmaceuticals Limited and Others, (2004) EWCA Civ 19, 1 (The Supreme Court of Judicature Courts of Appeal (Civil Division) ).

<sup>358</sup> Ibid.

<sup>359</sup> Ibid.

disregarded its enforceability within the British common law jurisdiction<sup>360</sup>. According to the Article 2 Rome Convention, the right of the parties to choose the governing law for contracts is limited to state law, and does not extend to a non-national law, such as Shariah law because it is considered religious principles.<sup>361</sup> Thus, the court understood that both sides of the dispute were under no illusion the contract was in fact a cash loan intended for working capital dressed up as *murabaha* sale contract and the words of the Shariah law in the contract were intended only to reflect the bank holds itself out as doing business according to the Islamic law. This means the parties of the contract did not intend the Shariah law to be applied in determining the rights the liabilities of the parties under the terms of the agreement.

Moreover, the court explicitly rejected Beximco argument based on the invalidity and unenforceability of the agreement on the grounds of non-Shariah compliance of the agreement in British common law jurisdiction. It held that this contract was a credit facility disguised as a *murabaha* sale contract, using traditional *murabaha* jargon to circumvent the prohibition of interest. Consequently, it did not allow debtors to avoid paying the loan or delay its payment merely on the grounds of religious belief within the common law jurisdiction. Therefore, both the High Court and Appeal Court dismissed the relevance of Shariah law principles to the validity and enforceability of the agreements. They upheld common law to prevail when it conflicts with Shariah law principles pertaining to matters of banking and finance. As there was no guarantee of enforceability of the agreement under Shariah law, referring to Shariah principles in the agreement was fruitless. This shows that resolving *murabaha* financing disputes through litigation does not serve the purpose of the Islamic finance industry and defeats the commercial purpose of Islamic finance.

To sum up, as the interpretation of the courts in these two cases demonstrate, *murabaha* financing is largely like conventional financing. As shown in this case, financial institutions that provide finance under sale-based financing contracts do not acquire financed goods physically because they avoid the risk associated with ownership. As a result, they do not bear the risk of loss, defect or the damage of the object and so these contracts do not appear to be genuine *murabaha* sale contracts and instead are like conventional interest-based financial facilities.

The ruling of these UK courts indicates that secular common law courts are not yet ready to accept the incorporation of Shariah law principles into their substantive or interpretative legal system. Shariah law is subject to varying interpretations, and there is considerable controversy among Shariah schools of law which might lead to different interpretations of Shariah principles pertaining to financial matters. In the view of the courts, Shariah law seems to be an unsophisticated, obscure and defective legal system that does not qualify

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<sup>360</sup> Chuah, 'Islamic principles governing International trade: A Study of the Morabaha in English Law', above n 141.

<sup>361</sup> Jonathan Hill, 'Choice of law in contract under the Rome Convention: the approach of the UK courts' (2004) 53(2) *International & Comparative Law Quarterly* 325; Chuah, 'Islamic principles governing International trade: A Study of the Morabaha in English Law', above n 146.

to be translated into propositions of modern law. In addition, the courts considered Shariah law principles to be neither a national law (codified law) nor a universally recognised body of law capable of governing and providing satisfactory interpretation in disputes of commercial transactions. Therefore, the Courts explicitly denied Shariah law to be applicable in solving disputes in *murabaha* agreements which appeared to be constructed as conventional commercial instruments.

Having said that, it can be understood from the concluding remarks of the Court that generalising Shariah law principles in the contract without specifying provisions of Shariah law that governed the agreement, may have contributed to the court rejecting the relevance of Shariah principles to the agreement. It seems the court implicitly signalled the possibility of recognising Shariah law if the parties clearly stated the provisions of Shariah law that related to the agreement and incorporated them into English law.<sup>362</sup> This means if the stipulation of the Shariah law elements pertaining to the *murabaha* contract were sufficiently incorporated into the agreement the defendants, who argued the non-Shariah compliance of the contract, would have been likely to succeed.

This suggests that if the agreement had been structured under rules established by Islamic financial regulators such as the AAOIFI and IFSB, which could be admitted by common law courts as a system of principles capable of governing Islamic finance agreements instead of referring the Shariah principles in general terms, the ruling of the Appeal Court might have been different. However, the problem would have been that if the Courts interpreted these *murabaha* transactions according to Shariah law principles, such as those established by the AAOIFI, the courts would have ruled these transactions to be non-Shariah compliant and might have jeopardised the validity of *murabaha* as a viable financing instrument in conventional markets. As the court ruled the contract to be a credit facility that receives the same treatment and protection as conventional financial instruments, its decision defeated this assumption.

These debt-like financing cases have become a precedent for Islamic finance governing law and for subsequent cases such as Investment Dar and Blom Developments which was an investment agreement under agency contract in 2009.

### **6.2.3 Investment Dar and Blom Developments**

As discussed above, the IICG versus Symphony Gems and Shamil Bank versus Beximco cases became a precedent for other cases. Blom Developments was incorporated in Lebanon and the Investment Dar was a registered investment company in Kuwait. They entered a Wakalah (agency) financing agreement, in which Investment Dar received funds from Blom Developments to invest on its behalf and guaranteed a fixed return.

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<sup>362</sup> Chuah, 'Islamic Principles Governing International Trade Financing Instruments: A Study of the Morabaha in English Law', above n 139.

This agreement was certified by the Shariah Supervisory Board of the bank to be Shariah compliant and both parties agreed that English law would govern the contract.

However, Investment Dar could not keep its promise to pay the agreed fixed return to Blom Developments and defaulted on payment. This prompted Blom Developments to apply for a summary judgment against Investment Dar because of defaulting the payment of the funds deposited. However, Investment Dar defended itself for not paying the agreed fixed return under the Wakalah agreement on the grounds of *ultra vires*. It argued that this agreement was non-Shariah compliant because it guaranteed a return, which is contrary to Shariah principles and to the constitution of the company that disallowed any activities that do not comply with Shariah principles.<sup>363</sup>

In ruling on this dispute, the court ignored the argument of Shariah compliance of the defendant and interpreted the contract according to English common law principles. As a result, it ruled the dispute in favour of the financier and ordered the defendant to pay both the principal and compensation for the delay of payment.<sup>364</sup> As in the two previous *murabaha* cases, this ruling shows the consistency of the English courts in dismissing Shariah law as governing contractual financing agreements and construing the agreement according to the English law.

The above discussion shows these financing cases involved the validity and enforceability of transactions from the Shariah law perspective within the British common law jurisdiction. Most of these financing dispute cases - whether they were raised by customers who failed to honour the contractual obligation, such as IICG v Symphony Gems or Shamil Bank v Beximco, or Investment Dar v Blom Development that failed to pay the agreed investment rate of return to the investor - the contention was based on non-Shariah compliance of the transactions. This call into question the ethicality of the practice of the Investment Dar by arguing that the contract was non-Shariah compliant. This would make customers wary about dealing with the financial institutions, which may argue the non-Shariah compliance of the financial services they offer to their customers.

Aida has listed the main problems that the Islamic finance industry faces under the litigation system which have led common law courts not to apply the principles of Islamic law in financial disputes.<sup>365</sup> First, Islamic law is not a law of a specific country. Second, it is not a universally accepted body of law. Third, different schools of law lead to different interpretations of aspects of Islamic finance due to their varying opinions on the same Islamic financial issues. Legal opinion can differ from earlier decisions reached by scholars and courts, because the courts are not bound by precedent and previous legal opinions. Four, there is no unified

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<sup>363</sup> Hasan and Asutay, above n 55.

<sup>364</sup> Ibid.

<sup>365</sup> Aida Maita, 'Arbitration of Islamic Financial Disputes' [35] (2014) 20 *Annual Survey of International & Comparative Law* 71.

standard for the governing clause of the agreement. Five, the decisions of Shariah supervisory bodies are always questionable when things go wrong due to their flexibility in defining the criteria of Shariah compliance of the products. This leads to varying interpretations of Shariah compliance of financial transactions which may cause uncertainty in Islamic financial transactions. Due to this complexity involved with Islamic financial disputes, the principles of Islamic law embedded in Islamic financial documents can be questioned as the cases have demonstrated. These cases show that shariah law does not apply in the UK and English law does not recognise shariah as a system of law capable of governing a contract. As shariah seems to be a relatively stateless body of law, the English courts did not consider it a national law belonging to a specific country according to the *Rome Convention 1980*, which entitles parties to a contract the right to choose the governing law of the agreement. As a result, the courts applied the ordinary principles of English law and avoided commenting on the compliance of the agreement with shariah as shown in *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd*.

Therefore, as Shariah is not a national system of law and there is no one standard codified Islamic law to be used as guidance and reference, English courts were consistent in dismissing Shariah law principles as applicable to the agreements. This means that the parties to a *murabaha* agreement cannot merely adopt Islamic law as the governing law without making reference to the law of a particular jurisdiction, because the national law system is often used as the governing law to provide more certainty on the rights and obligations of the transacting parties.

As the case of Shamil Bank and Beximco demonstrated, the court explicitly rejected Shariah law as either national governing law or an international legal system according to the Rome Convention. These rulings show the consistency of the English legal system in interpreting commercial agreements according to their literal meaning. In addition, these decisions reflect the intention of the English court to protect both the public policy and interest of the business community by making international trade contracts certain and binding on the parties. Thus, the courts by solely applying and construing the contract according to common law, validated and enforced the agreements as conventional interest based financial transactions and decided not to be bound by the Shariah principles pertaining to the *murabaha* agreement.

By ruling *murabaha* transactions to be similar to conventional interest-bearing transactions, the courts have given them the same protection as conventional financial transactions and made both customers of Islamic banks and financial markets feel comfortable with *murabaha* financing operations.

Although the Australian courts held that parties to a contract governed generally or specifically by Australian law can choose to incorporate provisions of another system of law as provisions of the contract, Australia does not yet seem ready to accept Islamic law as a governing law for contracts or to incorporate it into the Australian



legal system.<sup>366</sup> This encourages parties to *murabaha* contracts to opt for arbitration as the dispute resolution forum for relevant disputes. These may take advantage of the arbitration rule that obliges arbitral tribunals to apply the agreement by either the national law chosen by the parties or any other agreed considerations, such as shariah principles.

### 6.3 *Murabaha* Enforceability in Malaysia

Since the establishment of the Lembaga Tabunga Haji program in 1960s and the opening of the first Islamic bank in 1983, the Islamic finance industry has developed significantly. As a result, many disputes pertaining to Islamic finance's compliance to the principles of Shariah have been heard in the Malaysian jurisdiction. This has led to the development of a legal and regulatory framework based on Shariah law tenets for Islamic banking and finance, in parallel with the conventional banking and financial system.

According to the Malaysian constitution, the federal government has the power to regulate the Islamic financial system.<sup>367</sup> However, the Malaysian constitution also delegates to states to establish Shariah courts, stating that:

*except the matters included in the Federal List, the constitution, organisation and procedure of Shariah courts will have jurisdiction only over persons professing the religion of Islam. However, they do not have jurisdiction in respect of offences except in as 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 and Malay custom.*<sup>368</sup>

The Malaysian government introduced both an Islamic Banking Act 1983 and Banking and Financial Institutions Act 1989 for the regulation of the Islamic finance industry. According to the definition of these Acts, the meaning of Islamic finance applies to any financial transaction whose aim and operations are consistent with Shariah principles. In addition, the Central Bank of Malaysia (BNM) issues licences for both Islamic banks and non-Islamic banks that offer Islamic financial services using the existing infrastructure and regulates and supervises Islamic banking activities.<sup>369</sup>

Since the start of Islamic banking in Malaysia in 1983, Islamic financial institutions have overwhelmingly used the BaiBithaman Ajil facility (BBA), which is *murabaha* contract financing based on deferred payment. Hence, there is no surprise that litigations involving BBA transactions are outnumbered by cases involving other Islamic financial products in Malaysia. These cases involving litigation of the financing mode contract have undergone three stages. Examining the pattern of legal suites involved with these financial transactions

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<sup>366</sup> *Engel v Adelaide Hebrew Congregation Inc* (2007) 98 SASR 402.

<sup>367</sup> Mondher and Masood Bellalah, *Omar Islamic Banking and Finance* (Cambridge Scholars Publishing 2013).

<sup>368</sup> Abdul Razak Abdullah Baginda and Peter Schier, *Is Malaysia an Islamic State?: secularism and theocracy, a study of the Malaysian constitution* (Malaysian Strategic Research Centre, 2003) vol 1.

<sup>369</sup> Mohd Halim Kadri, *A study of Selection of Islamic Financing Products in Australia* Regional Convention on Islamic Studies, Melaka.

enables us to understand their impact on regulatory change and market development in Islamic financial transactions. In the first stage, the contentions of the disputes involved loan schemes similar to the conventional banking system and accordingly the court was asked to rule on the non-compliance of contracts with common law, because the amount of interest claimed for foreclosure proceedings violates procedural law requirements. Thus, the disputes were based on the invalidity of the contract due to the violation of state laws. In this stage, the courts applied the classical common law approach to *murabaha* transactions. In the second stage, disputes of this contract involved its validity and enforceability on the grounds of both technical defects in the existing law and its substantive construction. In this stage the courts went beyond the classic common law approach and examined the *murabaha* agreements from both the legal and Shariah perspective. Finally, in the third stage, the courts were mandatorily required to refer any matters pertinent to Islamic banking and finance to the Shariah Advisory Council (SAC).

The cases involving the Bai Bithaman Ajil facility have had a great impact on the regulatory development of Islamic banking and finance in Malaysia that has had to find its own survival path in the well-established conventional banking and financial systems. This has led the *murabaha* financing mode to face some legal problems, as the cases in the following sections reveal. Thus, similar to Islamic financial institutions in the UK, this section will examine the practice of Malaysian Islamic financial institutions that offer finance under the *murabaha* financing mode.

#### **6.3.1 Stage One: Applying the Common law**

In this stage, disputes arose when customers default on payments and subsequently banks requested that they immediately pay the entire sale price, which included both the principal and the amount of the mark-up, upon default of the payment. However, customers have disputed the genuineness of the BBA as a deferred sale contract according to Shariah principles and have argued that the balance of the loan and the interest that lenders requested from borrowers included unstated rebates that violated the procedural law requirement. Therefore, as the disputes were based on the invalidity of the contract due to the violation of the procedural law, the courts were requested to rule on whether the non-compliance of the unstated rebates with the procedural law should receive the same treatment as the other credit facilities. By applying the classical common law approach and not considering the Shariah compliance issue, the courts handled these cases in a conventional manner (emphasising the civil and technical aspects), and as a result decided in favour of the banks.

### 6.3.1.1 Bank Islam Malaysia as plaintiff and Adnan bin Omar (1994)

The Bank Islam Malaysia and Adnan bin Omar case was one of the first *murabaha* financing contracts that developed into a Bai Bithaman Ajil (BBA) case and was dealt with by the Malaysian court.<sup>370</sup> In this case, considered a landmark for Islamic finance in Malaysia, Adnan bin Omar, who needed a cash amount of RM 265,000, sold a piece of land to Bank Islam for RM 265,000 cash. However, after receiving this amount from the proceeds of the sale, he simultaneously purchased back this piece of land from the bank for RM583000 that included the principal loan amount plus a profit margin of RM 318 000 on credit, and he committed to pay this price back to the bank by instalment over 15 years. This profit margin suggests it was calculated similar to the conventional banking system. In addition, the bank charged the land as security for the RM583000 facility loan amount.

However, after the customer defaulted, the bank applied a summary judgment against the borrower requesting the payment of the full sale price of RM583000, as stipulated in the BBA contract. The bank firstly argued that as the contract was a sale contract regardless of the method of payment and the duration of the loan and the customer was aware of this, the bank was entitled to the full amount of the facility in the event of default. Secondly, the bank contended that Islamic law permits imposing a high price on the deferred sale, and henceforth the principal and profit margin combined constitute the sale price. In contrast, Adnan argued that the contract was a loan scheme and, as a result, the claim of the bank of unstated interest and the uncertain amount in the balance of the loan violated procedural law order 83 of the rules of the High Court that unstated interest on an uncertain amount of the balance of the loan was subject to rebate.

As this was the first Islamic finance case in a Malaysian court, the court faced the problem of solving *murabaha* /BBA contract (deferred sale contract) disputes that involved procedural and technical defects of the common law. The main issue that perplexed the court was determining the nature of the contract and deciding if the unstated claim of interest was subject to a rebate against the claim of the bank for payment of the full amount of the facility on the grounds of the transaction being a sale contract. The disputes were dealt with in the civil court on the principles applicable to common law for contract of sale, such as the Contract Act 1950, the Hire Purchase Act 1967, the National Land Code 1956 and the Companies Act 1965. The High Court held that the contract was a scheme for an Islamic facility which is unique in Islamic finance and works in its own sphere of the Shariah law. Accordingly, the court ruled that the bank was entitled to claim the full amount of the facility that included both the unstated interest and the uncertain amount in the balance of the loan (being a sale price) due to the default of the buyer. Furthermore, the court noted that the parties to the contract entered the agreement and signed it with full knowledge of its nature regardless of the calculation of the price and its payment method. Accordingly, it ordered the customer to pay the full amount of the facility that included

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<sup>370</sup> Apnizan Abdullah and Hakimah Yaacob, *The trend of legal suits involving Islamic financial transactions in Malaysia: evidence from the reported cases*.

principal loan plus the profit margin and dismissed the demand for the rebate of the unstated claim of interest from the bank, similar to conventional banks. This ruling appeared to be more burdensome to the customer than the practices of conventional interest-bearing loans, because the customer was required to pay 120 percent as a profit margin that included unstated interest.

In conventional banking systems, when the borrower pays the loan before the due date, the bank usually deducts the unearned interest from the balance amount of the loan. This means when the borrower defaults on payment he only pays the outstanding loan amount plus the earned interest and not the unstated interest calculated for the tenure of the loan. However, in this case the customer of an Islamic bank pays the outstanding full loan amount that includes the outstanding principal amount plus the mark-up (interest) calculated in tandem with the tenure of the loan. Although, this contract can be a sale contract as far as the parties are aware and they willingly agree to its terms and conditions, it should not be a burden to the customer paying the unstated portion of the profit margin (interest), which makes the contract more abhorrent than the conventional interest-based financing systems it intends to replace.

#### **6.3.1.2 Haji Nik Mahmud bin Daud versus Bank Islam Malaysia Bhd**

In the Haji Nik Mahmud and Bank Islam Malaysia financing arrangement case, the parties entered a property purchase and sale agreement under the BBA facility. The bank purchased land from the customer at RM520,000 in cash and contemporaneously resold it to the customer for RM629,200 on a deferred basis, while charging the land as security for the loan granted to the customer. However, after a dispute arose between the bank and the borrower in this financing arrangement the customer argued the following.<sup>371</sup>

1. the transaction included elements of interest and consequently *was ultra vires* according to the bank's articles of association that prohibit accepting and charging interest on loans;
2. The customer contended noncompliance of the contract with the procedural law that related to the charge secured for the BBA loan according to section 256(3) of the National Land Code (1965) and order 83 of RHC 1980, due to the unstated amount of interest claimed by the bank;
3. the customer argued that the contract defeats the very purpose of the Kelantan Malay Reservation Enactment 1930, which prohibits non-Malays entering agreements that involve Malay reserve land in Kelantan;
4. He argued that the purchase of the property by the bank and charging documents on the loan contravened section 7 of the Enactment that prohibits transfer or vesting any rights or interest of Malay

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<sup>371</sup> Nor Asiah Mohamad, *Looking into adequacy of Waqf protection in the national land code 1965: Towards sustainability of Waqf land*, Proceedings of the International Conference on Waqf 2015 (ICW2015), Universiti Sultan Zainal Abidin (UniSZA).

land to non-Malays. Based on this argument, the customer requested the court to rule both the property purchase and sale contracts to be *ultra vires* and invalid; and

5. the customer through his lawyer argued that the terms of the transaction infringed both the enactment and section 340 of the Code, because the bank was neither Malay nor a native Kelantan.

However, the bank disputed the argument of the customer according to both the interpretation of the Enactment and s340 of the Code (Malayan Law Journal 1996). In this respect, the lawyer for the bank put counter arguments challenging the indefensibility of the contract under both article 340 of the Code and interpretation of the Enactment *visa-a-visa* BBA transactions and applicability of equitable principles to the case.

Given these opposing arguments, the court's task was to determine the nature of the Bai Bithaman Ajil that involved the purchase of land by the defendant (the bank) for cash and then reselling it simultaneously to the plaintiff (customer) on a deferred sale price that was higher than the first purchase price.

In determining the transaction of the contract under the Enactment and the Code the court noted the following:

- 1) it recognised the contract was in accordance with Shariah principles. Nevertheless, it decided Islamic financial disputes fall under the ambit of civil law, and henceforth the proper law that would govern them was civil law;
- 2) it examined whether the purchase agreement transferred or conferred the rights or the interests of the land to the bank. In this respect, it stated that in a normal purchase sale the seller transfers the property together with the title to the buyer and only then will the purchaser be the registered proprietor. This means that after registration the title is vested in the purchaser and will have the indefensibility effect that the code confers. Nonetheless, in this case when the bank purchased the property, it only entitled beneficial ownership (and not actual ownership) and reselling the property to the customer immediately reinforced this position;
- 3) as the execution of the property purchase agreement did not show evidence of the change in registered proprietorship of the land, the court was convinced that no transfer of property took place because the land was still in the possession of the plaintiff;
- 4) it pointed out that both the property purchase and the sale agreements signed simultaneously by the parties were a procedure unique to the Islamic banking system that enabled the bank to avail the customer of financial facilities under the BBA financing mode;
- 5) the agreement was still at the executory stage and did not form a registrable interest, which was what both parties bargained for in the transaction;
- 6) the purchase agreement transaction did not transgress the Enactment because there were no dealings that showed the lands were transferred to the bank; and

- 7) it that although section 7 (i) of the Enactment did not allow any rights of the reserved lands to be transferred or conferred from Malays to non-Malays, the purchase agreement was neither fully executed nor lands transferred to the bank. For example, when the parties signed the property purchase sale, the agreement was about a registrable interest and not a formal registrable interest which entitles the transfer of the title of the land to the defendant. This indicates that only after a formal registrable interest transfers the title of the land to the defendant, does the defendant become the registered proprietor and only then would the argument of the indefeasibility be successful.

Thus, in the early phase of Islamic banking in Malaysia, the courts handled the cases in a conventional common law manner. In addition, by adopting the classic common law approach, the courts ruled in favour of the banks and did not consider the issue of Shariah law compliance of the contract. However, as the industry expanded the importance of Shariah compliance became important for customers and led the courts to further examine whether the practice of banks followed Shariah principles.

### **6.3.2 Second Stage: Examining the underlying Principles**

As the Islamic banking and finance industry continued to grow and financial disputes on Shariah compliance of transactions increased, the Malaysian government scrutinised the infrastructure of Islamic financial transactions. Accordingly, Malaysian authorities established the Shariah Advisory Council (SAC) to assist courts and arbitration tribunals on Shariah principles pertaining to financial transactions.

At this stage, the courts dealt with financial disputes regarding validity and enforceability of the BBA contract, on the grounds of contracts being legal tricks designed to obtain loans on interest and not genuine sale contracts as the Islamic law requires. This has led courts to determine whether or not BBA contracts were genuine sale contracts or cash loans on interest by examining the principles underlying Islamic financing contracts. Thus, the courts went beyond the interpretational approach of classic common law that courts applied in the first phase. As the advice of the SAC was not mandatory to the courts at this stage, they had the right to accept or reject this advice in their rulings on Islamic financial disputes by applying the doctrine of court independence and its discretion.<sup>372</sup>

In some cases, such as *Arab-Malaysian Merchant Bank Berhad versus Silver Concept Sdn Bhd* and *Affin Bank Bhd versus Zulkifli*, the courts declared that referral of Shariah issues relating to Islamic financial disputes to the SAC was advisable but not mandatory for the courts.

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<sup>372</sup> Apniza Abdullah and Hakimah Yaakob, 'The trend of legal suits involving Islamic financial transactions in Malaysia: evidence from the reported cases' (2012) 48 ISRA International Journal of Islamic Finance 78.

To understand how Malaysian courts dealt with the complexity involved in Islamic financial transactions in the second stage, the following section discusses two cases that demonstrate how Malaysian courts dealt with the issues of validity and enforceability of the *murabaha* contract.

#### **6.3.2.1 Islam Malaysia Berhad and Arab Malaysian Finance Berhad**

In the BBA contract between Bank Islam Malaysia Berhad and Arab Malaysian Finance Berhad, the problem related to issues of determining if the BBA contract was a genuine sale contract or a loan on interest. In this case, the defendant argued that the contract was a loan scheme tainted with elements of interest (*riba*) which contradicted the theory of Islamic banking. On the other hand, the bank argued that the BBA contract was a fixed sale price, regardless of whether the customer paid it through instalments or as a lump sum.

Following a close examination of the nature of this transaction that comprised a sale and buyback agreement between the customer and the bank, the court stated that the contract involved an element of interest which is against Shariah principles and the Islamic Banking Act 1983.<sup>373</sup> Consequently, it ruled that the bank was only entitled to the outstanding principal amount and earned profit and was not entitled to the unearned profit. However, the courts excluded the unearned profit for the time remaining on the life of the loan. This means the court found that as the transaction was in violation of Shariah principles and similar to the conventional banking system, the customer would not pay the unearned profit.

In this respect, he paid less than he would have paid if he had held the loan until the end of its tenure. But the bank as plaintiff became unhappy with the ruling of the High Court and took the case to the Appeal Court. The Appeal Court revoked the decision made by High Court, and despite the contract appearing to be a cash loan that used legal tricks to circumvent the prohibition of interest in Shariah law, held that it was a sale contract (*Bay Bithaman Ajil*) according to Shariah principles regardless of the way it was calculated and the method of payment. Hence, the court ruled the bank was entitled to the outstanding balance of the loan that included both the balance and the stated profit margin (whether earned or unearned).

The Appeal Court stressed that the High Court should not have ruled on matters of Shariah principles, which should be decided by Shariah judges or religious authorities such as the SAC that regulate Islamic banking and finance.

This case demonstrates that the BBA financing operation appears to be similar to its conventional counterparts, and the only difference is the use of the Islamic label.

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<sup>373</sup> .Kamilah Wati binti Mohd et al, 'Sustainability of Islamic finance Industry: Arbitration as Forum for Dispute Resolution' (Paper presented at the Syariah and Law Discourse issue, KL, Malaysia).

### 6.3.2.2 Affin Bank Bhd versus Zulkifli

In this case Zulkifli Abdullah obtained a secured loan of RM394,172.06 from Affin Bank through the BBA financing method in 1997. The bank put a profit margin on top of the principal loan amount that made the full sale price amount RM958, 909.21; however, after paying RM 33,454.19 of the loan, he stopped paying it. This led the bank to request recovery of the outstanding balance of the loan, including the unearned profit. Zulkifli Abdullah disputed the amount of the unearned profit being much higher than the original loan. Given the arguments put forward by both parties, the High Court, unlike the Bank Islam Malaysia and Arab Malaysian Finance case, noted the following issues before its verdict:

- a) The customer of an Islamic bank should not be worse off under the BBA financing arrangement than with a conventional loan facility. This implies the payment obligation under a BBA facility should not be different from the customer's conventional loan obligation that includes the earned interest and principal amount;
- b) As the profit margin of the loan is consistent with its and the borrower is required to pay the loan by instalment each month until the end of the loan period, equally the borrower has the right to take the benefit of the full tenure of the loan. In contrast, this contract allowed the bank to earn the profit margin from the unexpired period of the loan which entitled it to earn twice from the same amount and at the same time. In addition, it required the customer to pay the full amount of the loan in advance, whereby denying his right to benefit from the full tenure of the loan. It seemed to be contrary to the equity principle, to be unfair to the customer and obviously violated Shariah principles;
- c) The profit margin that related to the unexpired periods of the loan was not actually a profit. Consequently, as the profit was unearned it contradicted the principle of deferred sale price which ties the profit margin to the tenure of the loan. Thus, the profit not yet earned was not in fact a profit, and consequently the financier was not entitled to claim it according to the BBA contract;
- d) When the secured loan was certain, the financier was entitled to request the sale of the asset to recover his debt; and
- e) The total amount due at the verdict of the case was RM616, 080.99; however, as the debtor had already paid RM33, 454.19, the balance not yet paid was RM582, 626.80. The court stated that the original sale price was RM394, 172.06, where the profit margin rate was 9 percent annually, which was calculated according to the tenure of the loan, making the amount RM 35,475.49 per annum or RM2, 956.29 monthly (or RM98.54 per day) for 20 years. This made the period of the loan until 29 December 2005, which was equal to 74 months less two days. The court ruled that the defendant had to pay the principal amount plus the profit margin on these 74 months less the 2 remaining days plus RM 3,141.44 as a penalty for the default. The court awarded the plaintiff RM616, 080.99 and credited RM33,



454.199 to the account of the debtor. Thus, after crediting the debtor the payments that he paid, the balance due became RM 582,626.80.

The court examined these agreements from both the legal and Shariah perspectives. In addition, before drawing its conclusion, it examined both the substance of the contract and the intention of the parties.<sup>374</sup> Moreover, it considered whether or not these contracts conformed to Shariah principles as well as the common law. Hence, the court inferring from the analysis of the contracts concluded that the *murabaha* transaction was akin to conventional interest-bearing loans and consequently denied the bank from claiming the unearned returns because this contradicted Shariah principles. After examining these facts, the court in applying section 66 of the Contract Act of 1950 that states the obligation of the person who has accepted advantage under a contract that becomes void or invalid, declared that the financier was only entitled to recover the principal amount that it lent to the borrower and the earned profit margin.<sup>375</sup> This suggests the original facility amount was RM346000; however, after the extension of the term of the contract, the bank increased the facility amount of RM992, 363, which included an extra profit margin. Despite this, the bank argued that this amount was a selling price agreed by the client and was therefore binding on him. Contrary to the principles of Islamic law, it seemed the period of this *murabaha* contract was increased and the mark-up was also increased in tandem with the tenure of the finance, making the markup distinguishable from conventional interest that goes with the tenure of the loan.

In solving the complexity of this financing contract, the court by applying the concept of equity and fairness found that the contract was about a credit facility in which the liability was far higher than for a conventional loan, which shows the transaction was not a genuine sale contract. Despite the court rejecting the bank's claim for the unearned returns because of their resemblance to conventional interest calculation, it did not question the legality and validity of the profits derived from this financing facility from the Shariah perspective.<sup>376</sup>

In summation, in both the cases of *Bank Islam Malaysia v Adnan bin Omar* and *Affin Bank v Zulkifli*, the courts held that the contracts were interest-bearing loan schemes even when compared to conventional banking loans, and their charges were more excessive than conventional interest, which denoted they clearly violated Shariah principles and objectives.

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<sup>374</sup> Zulkifli Bin Hasan and Mehmet Asutay, 'An analysis of the courts' decisions on Islamic finance disputes' (2011).

<sup>375</sup> Hasan and Asutay, above n 47.

<sup>376</sup> Ibid.

### 6.3.3 Third Stage: Going Beyond the Facade of the Contract

As the growth of Islamic financial operations in Malaysia increased and the legal infrastructure was the key area to create both market certainty for Islamic finance and public confidence in it, the Malaysian government in 2009 made the advice of the SAC mandatory for financial institutions offering Islamic financial services.<sup>377</sup>

Thus, the courts have become more proactive in resolving challenges of customers to the validity of BBA transactions. However, the court's position is complicated by article 74 of the Malaysian constitution which put matters related to banking and finance activities under the ambit of the federal jurisdiction; issues related to Islamic banking and finance fall under the jurisdiction of the civil courts, while matters related to Islamic religion fall under the jurisdiction of state Shariah courts (Malay Law Journal). In addition, both the Islamic Banking Act 1983 and the Banking and Financial Institutions Act 1989, do not identify which standard or Islamic school of law courts should adopt when interpreting matters relating to Islamic banking and finance. Nevertheless, as the Acts neither provide a comprehensive legal system for Islamic banking and finance nor suggest any specific standard of Islamic law for Islamic banking matters, this put the courts in a difficult position in resolving matters related to Islamic financial transactions. Moreover, as Islamic law combines all Islamic schools, the courts face the challenge of not discriminating among the Islamic schools of law or ignoring the position of any of them in their interpretation of Islamic financial transactions.<sup>378</sup> Finally, the complexity of Islamic financial documentation based on a copy and paste approach from the conventional financial system, and divergent approaches and interpretations of courts in Islamic financial transactions have increased their legal risk.<sup>379</sup> Due to this legal and regulatory uncertainty in Islamic financial transactions, the Malaysian government introduced the Central Bank of Malaysia Act (CBA), which provides a legal framework for matters pertaining to Islamic finance. The CBA established the Shariah Authority Council (SAC) as the highest authority to oversee and provide advice to the courts on matters relating to Islamic banking and finance.<sup>380</sup> The CBA's role in Islamic financial transactions is to ensure Shariah compliance of financial matters referred to it by the concerned parties and provide advice to Islamic financial institutions.

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<sup>377</sup> The Shariah Advisory Council for the Central Bank of Malaysia (Bank Negara Malaysia) and the Securities Commission of Malaysia generally permits compensation), across the financial industry, where late penalties are agreed at the time of contracting, set at rates no greater than 1 per cent of arrears and not compounded: Shariah Advisory Council, Resolutions of the Securities Commission Shariah Advisory Council (2007) Securities Commission of Malaysia, 125

<sup>378</sup> Najahudin Lateh et al, 'The legal framework of the Islamic Financial System: A study on the cases in Malaysia' (2010) 9 Malaysian Accounting Review 85.

<sup>379</sup> Hakimah Yaacob and Apnizan Abdullah, 'Standards Issuance for Islamic Finance in International Trade: Current Issues and Challenges Ahead' [33] (2012) 65 Procedia-Social and Behavioral Sciences 492.

<sup>380</sup> Zulkifli Bin Hasan and Mehmet Asutay, 'An analysis of the courts' decisions on Islamic finance disputes' [48] (2011) 3(2) ISRA International Journal of Islamic Finance 33.

#### **6.3.3.1 Mohd Alias v Rhb Bank Bhd & anor**

The case of Mohd Alias in 2011 challenged the unconstitutionality of sections 56 and 57 of the Central Bank of Malaysia (CBM).<sup>381</sup> He argued the illegality of transferring judicial powers of the court to the SAC on the grounds it was not a court recognised by the constitution. He argued that the SAC or any other regulatory body had no jurisdiction to hear disputes related to Islamic financial contracts as they are under the purview of the federal authorities, and accordingly fall under the ambit of the civil courts. In addition, he contended that referring the case to the SAC denied his right for natural justice. He also argued the retroactive effect of sections 56 and 57 of CBA which denied his right to get an expert witness for the case.

Responding to this argument the court firstly stated that both sections 56 and 57 were relevant and acceptable because they referred issues pertaining to Islamic finance to the SAC for advice only, and therefore the role of the SAC was limited to ascertaining the Shariah compliance of the transactions and not determining the facts of the case in the courts.

Consequently, referring matters related to Islamic finance to the SAC for advice did not delegate the court's judiciary powers or undermine its authority. Hence, the role of the SAC was limited to ensuring Shariah compliance on financial matters referred to it by the parties and providing advice to financial institutions on Shariah matters relating to Islamic financial transactions.<sup>382</sup> Secondly, in the argument about deprivation of the customer's right, the court noted that the customer prematurely raised this issue because the SAC had not put in place any procedure to ascertain Shariah principles pertaining to Islamic financial transactions referred by the concerned parties. Finally, in relation to the argument about backdating the effect of sections 56 and 57 of the CBM, the court stated that retrospectivity was acceptable as long as the substantive rights of the customers had not been violated.

The court had taken a proactive approach. First, it pointed out the federal constitution and governing bodies of Islamic finance did not indicate which Islamic School the court should follow in the event of different views on the same matter. Second, it recognised that the contract of BBA was a *bona fide* sale contract, and accordingly referred its interpretation to the case of Affin Bank Bhd versus Zulkifli Abdullah that applied the equitable interpretation concept. Therefore, by using the principle of equity, the court ordered the defendants to pay an amount equivalent to the market price of a similar asset to the financier.

#### **6.3.3.2 Tan Sri Abdul Khalid bin Ibrahim v Bank Islam Malaysia**

Tan Sri Abdul Khalid bin Ibrahim requested finance from Bank Islam Malaysia to provide finance under the Bai Bithaman Ajil financing mode. However, shortly afterwards he defaulted and challenged the contract as

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<sup>381</sup> Hasan, above n 47.

<sup>382</sup> Lateh et al, above n 90.

violating Shariah principles and therefore was null and void. However, the bank argued that the contract complied with both Shariah principles and civil law and the agreement was valid and binding on the customer. Thus, the bank applied for a summary judgment against the customer to recover the debt.<sup>383</sup>

The High Court accepted the summary judgment and ordered the defendant to pay the debt to the bank. However, before ruling on the case, the court sought the advice of the SAC, whose ruling is binding according to section 56 of the Central Bank of Malaysia Act 2009. But the customer rejected the ruling of the SAC to the court by virtue of section 56, arguing there had not been a prior reference to SAC at the summary judgment stage which made sections 56 and 57 not retrospective and contrary to the constitution. He also argued it was not appropriate for the court to refer Shariah principles pertaining to Islamic finance to the SAC.

The court first analysed whether the BBA contract was Sharia compliant. Second, it examined whether the bank was permitted to use the shares pledged by the customer as security without the consent of the customer. Third, it probed if the non-Shariah compliance of the transaction ended the customer's obligation to settle the debt. Fourth, it examined if there were two independent contracts and if so, were there any violations with their independence. Finally, it examined the permissibility of purchasing shares pledged to the bank that already sold. Therefore, the court stated that as the summary judgment had been overruled, the argument of the plaintiff that referring the case to the SAC at the summary stage could not stand, and therefore the hearing was still open. The court had the right to refer the case to the SAC for advice before reaching a decision. In addition, the argument of the plaintiff that the execution of the BBA contract and consolidation of the suites before the Act came into force meant that amendment of purely procedural statutes should be given retrospective effect and amendments that changed substantial rights should be given prospective rights.

#### **6.3.3.3 Islamic Bank Berhad versus Veheng Global Trader**

In this case, Islamic Bank Berhad as a plaintiff applied for a summary judgment against Veheng Global Trader as a defendant for the outstanding amount of RM25, 914.12 under a *murabaha* facility at 2.44 percent annually on a loan facility of RM25, 000,000, calculated from August 2010 until the settlement day as compensation. On the sixth of April 2009, the bank agreed to refinance the existing RM30, 000,000 *murabaha* facilities into a commodity *murabaha* Tawarruq.<sup>384</sup> However, in this contract the customer was not interested in acquiring the commodity; he only used the contract to obtain a cash loan from the bank. After the customer asked to refinance this amount, the bank agreed to restructure the existing debt of RM30m into *murabaha* revolving credit that the bank paid in two stages and charged RM522, 914 as a profit margin. In the first stage, the bank agreed to pay RM 5m and in the second stage the remaining RM25m. The customer accepted the offer on 20th April 2009. Then, both the financier and the customer signed a master agreement Commodity *murabaha*

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<sup>383</sup> Hasan, above n 49.

<sup>384</sup> Ibid.

overdraft-i facility on 23rd June 2009. The customer settled the RM5m facility, while failing to pay the balance of RM25, 522,914 on the due date, the 10th of August 2010.

The previous divergence of the court's dealing in Islamic financial disputes caused both market uncertainty and legal risk for financial transactions. Its reluctance to make referrals to the SAC mandatory caused legal risk for financial transactions. Therefore, the Malaysian government introduced the Central Bank of Malaysia Act (CBA) in 2009, to provide both certainty and stability to the Islamic finance market and made it mandatory for the court to refer issues related to Islamic finance to the SAC for advice.<sup>385</sup>

The approach of the Malaysian High court in ordering courts and regulators to refer Islamic finance matters to the SAC shows that Islamic finance in Malaysia has taken a proper legislative and legal approach that clearly provides guidance for the courts to resolve matters pertaining to Islamic financial transactions.<sup>386</sup> Without this approach, Islamic financial institutions might have faced the risk of non-Shariah compliance that may have defeated the purpose of Islamic finance. Even if the SAC contradicts some well-established positions of traditional Islamic jurisprudence and Islamic scholars, the courts will consider its view to represent Shariah law and consequently its opinion is binding.

## 6.4 Concluding Remarks

This chapter discussed *murabaha* finance cases, demonstrating the complexity of *murabaha* transactions. Parties to these transactions naturally want to opt for Islamic law as the governing law of the financial documents in common law jurisdictions. Despite this, some disputes about Islamic financial agreements have been challenged as noncompliant with shariah law (by both customers and financiers); further, non-Islamic jurisdictions have not recognised the relevance of shariah law as it pertains to the governance of *murabaha* transactions.

In Malaysia, the first phase of Islamic banking, the courts have handled *murabaha* financial disputes in a manner that similar to the conventional financial disputes. However, as the Islamic finance developed and questions were raised on the Shariah compliance of the *murabaha* transactions, Malaysian government have developed a proper legislative and legal framework that provided guidance and reference to the Courts and Tribunals to resolve Islamic financial transaction disputes according to the Islamic law principles. The government instructed the courts and regulators to refer Islamic finance matters to Shariah Authority Council (SAC) for advice in Islamic financial matters. Thus, Islamic finance in Malaysia has taken a proper legislative and legal approach. Without this approach, Islamic financial institutions in Malaysia might have faced the risk

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<sup>385</sup> Abdullah and Yaacob.11.

<sup>386</sup> Bellalah, above n 10.

of non-Shariah compliance, which may have defeated the very purpose of the existence of the Islamic finance in Malaysia.

On the other hand, the cases in Britain have shown that English courts did recognise shariah as a system of law capable of governing *murabaha* contracts and justiciable in the English courts. The English courts applied the ordinary principles of English law in *murabaha* disputes and refrained from ruling on the shariah compliance of *murabaha* agreements. In this sense, the courts treated *murabaha* contracts as credit facilities disguised as *murabaha* sale contracts using traditional *murabaha* terminology to circumvent the prohibition of *riba*. Accordingly, they provided *murabaha* transactions the same legal protection as conventional financial transactions. This has made *murabaha* finance both operationally and economically viable in the UK and, as a result, has given both financial institutions and financial markets confidence in *murabaha* financing operations in common law jurisdictions.

This demonstrates that although the parties in an Islamic financial agreement may opt for Islamic law as the governing law of the transaction, the application of shariah principles to financial transactions in jurisdictions that are not bound to these principles—at least when it comes to the commercial agreements—is not effective. The main reasons for this are that shariah law lacks the characteristics of a national system of law and there are no standard codified bodies of Islamic law to use as guides or references. Participants in *murabaha* agreements feel more comfortable choosing national law systems as the governing law that because they provide more certainty regarding their rights and obligations.

Similarly, the Australian legal system would likely have followed the English position and dismissed the relevance of shariah as a system of law capable of governing a contract. Even though, *murabaha* contract in the Australia jurisdiction—same as Britain—can receive the same legal protection as conventional financial contracts, it is still vulnerable to the risk of being non-Shariah compliant. The risk of non-Shariah compliance leads it to lose legitimacy from the point of view of customers of the Islamic industry, whom its survival depends on. This defeats the very purpose of the existence of the Islamic finance. Hence, *murabaha* to be legitimate and commercially viable in Australia it must comply with both Islamic law principles and Australian law. This requires Australia government to incorporate Islamic financial transactions and insure their parity with the conventional financial products. This incorporation will not only provide a level-playing field for the *murabaha* transactions with the conventional financial markets and enable it to be both operationally and commercially viable in Australia and allow Australia to be Islamic financial hub in the Asia-Pacific region, but will also help the Muslim community achieve financial inclusion in Australia.

Although Australia does not recognise shariah as a system of law capable of governing a contract and does not seem ready to incorporate Islamic financial products into its legal system, the Islamic finance industry may seek arbitration as an alternative dispute resolution system (ADRS). The arbitration law obliges arbitration

tribunals to assess transaction disputes either on the basis of the national law chosen by the parties or any other agreed considerations, such as shariah principles.

In light of these legal impediment, the next chapter discusses arbitration law as an ADRS for murabaha transactions and examines whether it is more appropriate to arbitrate murabaha disputes than it is to rely on court litigation.

# CHAPTER 7: MURABAHA ARBITRATION

## 7.1 Introduction

This chapter discusses the suitability and practicality of arbitration as an ADRS over litigation of *murabaha* disputes within the Australian common law jurisdiction. The arbitration system allows parties to an agreement to opt for arbitration as an ADRS with reference to either a national law chosen by the parties or any other agreed considerations (including shariah principles). From this starting point, this chapter examines the possibility of harmonising Islamic finance arbitration systems with international commercial arbitration standards such as the UNCITRAL rules and the New York Convention that the Australian International Arbitration Act 2010 (IAA) gives the effect of law. It will *first* provide an overview of the international commercial arbitration system in the Australian context. *Second*, it will discuss Islamic arbitration and examine the similarities and differences between international commercial arbitration law and Shariah principles pertaining to the *murabaha* financial agreement. For the objectivity of the study, the chapter (when necessary) compares the AAOIFI Shariah Standard No. 32 on Arbitration, and the KLRCA i-Arbitration Rules within the United Nations Commission on International Trade Law (UNCITRAL Model Law) and the New York Convention that the Australian International Arbitration Act 2010 (IAA) give the effect of law. It then attempts to find a common ground between Sharia rules pertaining to the *murabaha* agreement and international commercial arbitration law provisions within the Australian international commercial law framework.

## 7.2 Overview of Australian Arbitration Law

International commercial arbitration is a preferred private dispute resolution system between contract parties of different legal jurisdictions because of its autonomy, freedom, flexibility and impartial arbitrators who have the credentials and expertise that best suit the needs of the parties to a dispute.<sup>387</sup> Because of its advantage over litigation in providing confidentiality, privacy, the expertise and impartiality of arbitrators, minimising costs, flexibility, speed and preservation of business relationships between the disputing parties, businesses prefer arbitration over litigation for resolving disputes. Thus, arbitration aims not only to reduce the differences in national arbitration laws but also to close the gap between national arbitration laws to harmonise the methods of the international commercial dispute system.

Within this context, the chapter discusses (1) a brief history of arbitration, (2) the nature of arbitration, (3) the scope of arbitration, (4) the rules and regulations regarding arbitration, (5) the choice of law, and (6) the scope of judicial review and enforcement.

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<sup>387</sup> Faisal Kutty, 'The Shari'a factor in international commercial arbitration' (2006) 28 *Loyola Los Angless International and Comparative law Review* 565.



### 7.2.1 History of Arbitration

Although the history of arbitration to resolve disputes between parties to a contract goes back to medieval Europe, its popularity has increased following the growth of cross-border commercial activities in modern times. In this respect, the New York Convention 1958 and UNCITRAL Model Law 1985 were set up for the arbitration of international trade disputes. The general objective of the New York Convention's provisions on recognition and enforcement of awards is to limit their judicial review to achieve dispute resolution of international commercial arbitration. On the other hand, the UNICTRAL Model Law as a procedural arbitration law aims to maximise the autonomy of parties and minimise judicial intervention in the process of arbitration.<sup>388</sup>

In Australia, the International Arbitration Act (IAA) was first enacted in 1974 and has given the effect of law to both the New York Convention 1958 on the recognition and enforcement of foreign arbitral awards and the UNCITRAL Model Law 1985, as arbitral procedure law for international commercial arbitration, as a supplement to the New York Convention. IAA aims to unify international commercial arbitration in Australia and provide certainty in law to arbitration agreements in international commercial disputes.

Australian commercial arbitration is based on the Australian legal system that derived from English common law based on precedents developed by judges. The Australian legal system like English law is a complex interaction of common law and statute law; however, unlike the English legal system, it does not provide comprehensive rules that govern all aspects of arbitration. Instead, Australian legislation provides outlines and references to common law principles that establish the rules that manage the framework for commencement, conduct and court supervision in the arbitration system.<sup>389</sup> Although Australian international commercial arbitration is an independent dispute resolution system, it is still attached to the domestic legal system and Australian public policy.

### 7.2.2 Nature of Arbitration

The aim of arbitration is to settle disputes between the parties to a contract and enforce arbitral awards. According to article 7 of the UNICTRAL Model Law, the term 'arbitration agreement' refers to agreement of parties to arbitrate disputes that relate to a defined contractual or non-contractual relationship in international commercial agreements concerning subject matter that can be settled by arbitration. Under the UNICTRAL Model Law, the arbitration agreement will be in writing, regardless of whether the contract has been concluded orally, by conduct, by any other means, or through communication in the form of a data message, such as

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<sup>388</sup> United Nations *UNCITRAL Model Law on International Commercial Arbitration 1985 with amendments as adopted in 2006* (UN, 2006).

<sup>389</sup> Richard Garnett, 'International Arbitration Law: Progress Towards Harmonisation' [1] (2002) 3 Melbourne Journal of International Law 14.

electronic mail, telegram, telecopy or telex that shows the occurrence of an agreement.<sup>390</sup> Likewise, under the New York Convention arbitration generally implies an agreement that includes both an arbitral clause in a written contract or is signed by both parties through letters or electronic communication.<sup>391</sup>

By leaving the content and form of the arbitration agreement in the hands of the parties, arbitration provides them with the freedom to control the proceedings of the dispute, such as choosing (a) the place of arbitration, (b) composition of the bench, (c) flexibility, (d) the choice of governing law, (e) choice of language for arbitration, and (f) the enforcement of arbitral awards. In particular, 2d of part 1 of the IAA, states that its objectives are.<sup>392</sup>

1. To facilitate international commercial transactions through encouraging businesses to use arbitration to settle their commercial transaction disputes;
2. To recognise and enforce arbitral awards on the disputes of international commercial transactions and trade;
3. To give effect to the foreign arbitral awards approved by the UNCITRAL Model Law on international commercial arbitration; and
4. To provide to the Conventions on the Settlement of Investment Disputes between States and nationals of other states that Australia signed in 2010 (IAA).

### **7.2.3 Scope of arbitration**

The International Arbitration Act 1974 (as amended in 2010) provides the effect and force of law to both the New York Convention and UNCITRAL Model Law applying to international commercial arbitration disputes in Australia. Pursuant to article 1 of the New York Convention, its provisions apply to the recognition and enforcement of foreign arbitral awards made in the territory of a state other than the state in which the recognition and enforcement of the awards are sought.<sup>393</sup> By providing effect to domestic law of both the UNCITRAL Model Law and New York Convention, the IAA does not allow any scope for excluding them in international commercial arbitration in Australia. Thus, it requires state courts to refer disputes brought before them to arbitration to enforce a foreign award if the breaching party does not voluntarily comply with it.

Within this context, the amended section 1(1) of Australian Arbitration Act 2010 has defined the scope of the applicability of UNCITRAL Arbitration Rules on the Arbitration Agreement by stating that when parties agree that disputes between them will be referred to arbitration under the UNCITRAL Arbitration Rules, such

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<sup>390</sup> United Nations above n 16.

<sup>391</sup> Albert Jan Van den Berg, *The New York Arbitration Convention of 1958: towards a uniform judicial interpretation* (Kluwer law and taxation, 1981).

<sup>392</sup> International Arbitration Act 2010.

<sup>393</sup> United Nations above n 13.

disputes shall be settled in accordance with the rules of the Model Law. According to article 1 of the Model Law, arbitration will be international for the following situations:

- a) When the places of business of the parties are in different countries at the time of the conclusion of the agreement. This means one party might have its place of business in Australia, while another party's place of business might be Malaysia;
- b) When either the place of arbitration or the place of the performance of a substantial part of the contractual obligation is located outside the country where the parties have their place of business; and
- c) When the parties to the dispute have explicitly agreed that the subject matter of arbitration has connection with more than one country.<sup>394</sup> For instance, the parties may choose the place of arbitration to be outside their countries and their place of business; the two parties may have Malaysia as their place of business but agree that Australia should be the place of arbitration.

Although, the parties to the arbitration agreement determine the jurisdiction of the arbitral tribunal, and normally this does not extend to other than these parties, there is an exception when a subsidiary or another controlling entity enters into an arbitration agreement with another party and the parent company is bound by this arbitration agreement. Although Australian courts have been unenthusiastic in acknowledging this principle, it has been recognised by Australian authorities, as the *Qintex Australia Finance Limited v Schrodgers Australia limited* case has shown. This suggests Australian authorities accept that a non-signatory party should be bound to the arbitration agreement in the case of fraud or when entering into an arbitration agreement if the company structure used was fake, or the motivation for incorporating the company (subsidiary) was to cover up the real purpose of the parent company, as the *Sharrment Pty Ltd v Official Trustee in Bankruptcy* and *Brewarrana Pty Ltd v Commissioner of Highways* cases have demonstrated.<sup>395</sup> Thus, if the dispute relates to international commercial arbitration, the court adopts a broader interpretation in determining the matter. For example, in the *Comandate Marine Corp v Pan Australia Shipping Pty Ltd* case in 2006 the Federal court interpreted arbitration broadly to encourage the parties to choose arbitration instead of courts.<sup>396</sup> This approach, which vindicated the autonomy, certainty and efficiency of dispute resolution, was also encouraged by the House of Lords for its ruling in the *Premium Nafta* case.<sup>397</sup> For this reason, Australian courts hold the parties liable to the consequences of their bargain even if it means they will be deprived of their rights under Australian statutory law, such as Australian Consumer Law. This entails that Australian courts avoid different

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<sup>394</sup> Ibid.

<sup>395</sup> Ian Ramsay and David B Noakes, 'Piercing the corporate veil in Australia' [250] (2001) 19 *Company and Securities Law Journal* 250.

<sup>396</sup> Sam Luttrell, 'Comandate Marine Corp v. Pan Australia Shipping Pty Ltd [2006] FCAFC 192' (2007) 21 *Austl. & NZ Mar. LJ* 92.

<sup>397</sup> Richard Garnett and Luke Nottage, '2010 Amendments to the International Arbitration Act: A New Dawn for Australia, The' (2011) 7 *Asian International Arbitration Journal* 29.

proceedings in domestic arbitration and use their discretionary powers to determine whether all elements of disputes should be referred to the arbitral tribunal. This aims to limit the scope of parties to the arbitration agreement avoiding their contractual obligations.

#### **7.2.4 Choice of the Governing Law**

Under article 28 of the UNCITRAL Model Law, the arbitral tribunal is required to decide the disputed agreement pursuant to the law chosen by the parties and confer to the provisions of the contract the custom and usage of the trade applicable to the agreement. In this respect, article 28 states that the parties have freedom to choose the law applicable to the arbitration agreement, particularly when national law does not expressly recognise this right. That said, the Model Law widens the options available for the parties by referring to ‘rules of law’ to allow parties to agree on any rules of law, regardless of whether they have been incorporated into any national legal system. From this perspective, the choice of the parties dictates that the arbitral tribunal will decide the dispute according to the provisions of the laws chosen by them. This means that the law chosen by the parties to govern their agreement will prevail.

However, when there is no express or implied choice of law by the parties to the arbitration agreement, the arbitral tribunal by using the principle of conflict of laws will determine the applicable law at the seat of arbitration. For instance, if the parties have not chosen which law will apply in the dispute, the arbitrators will use their own discretion to apply the closest and most real connected law to the dispute, such as the law applicable to the formation and validity of the agreement. Thus, the tribunal may regard any designated law or a legal system of a certain State, unless otherwise expressed clearly, to be directly referring to the substantive law of that State.

#### **7.2.5 Proceedings of the Arbitration**

In Australia, the procedural law for arbitration emphasises the conduct of arbitration instead of the nature of the parties’ substantive dispute. Arbitration legislation in Australia generally is not mandatory and is subject to the judgment of the parties to the agreement, since there is no restriction on which procedural rules they may choose. Thus, the parties are free to tailor the rules of procedure to their needs in tandem with the requirements of equality and fairness principles, such as those treating the parties equally and giving them equal opportunity according to article 18 of the Model Law.<sup>398</sup>

Section 8 of the IAA provides for enforcement of foreign arbitral awards that article 5 of the Convention covers. It obliges Australian courts to stay local court proceedings for disputes that relate to the breach of an arbitration agreement, when the place of arbitration is in a state that is a member of the New York Convention

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<sup>398</sup> United Nations above n 26.

or a party to the arbitration agreement is incorporated or has its principal place of business in such a country. Thus, according to the IAA, section 7 of article 2 of the New York Convention makes it mandatory for Australian courts to stay judicial proceedings that are brought to local courts on the breach of an arbitration agreement, whereby the place of arbitration is located in a member state of the Convention or the arbitration agreement is incorporated or has its principal business place in such a country (IAA). In particular, section 7 of the IAA 1974 states that (a) the procedure to arbitration of an arbitration agreement is regulated when the parties express the terms of the agreement or the law of a Convention country states it; or (b) it has been expressly specified by the law of a Convention country, whereas a party to the agreement is in Australia or a state, or the person was an Australian resident when the agreement was executed.<sup>399</sup> Furthermore, section 7 makes mandatory the stay procedure and does not allow parties to rely on the argument of convenience to avoid arbitration where this contrasts with a foreign jurisdiction or choice, except in three situations:

- (1) a party can argue that the subject matter of the dispute cannot be settled by arbitration because of the public interest that necessitates it to be heard in a court;
- (2) a party can argue that the dispute should not be settled by arbitration because the arbitration clause does not encompass the party's claim as a matter of contractual construction, such as section 18 of the Australian Consumer Law 2010.
- (3) A party may argue that the dispute cannot be referred to arbitration because of its violation of a mandatory statute that prohibits the arbitration of certain disputes, such section 11(2) of the Carriage of Goods by Sea Act, 1991.<sup>400</sup>

Australian courts may refuse to stay proceedings on the grounds of bankruptcy, insolvency or competition matters when they see the matters as not arbitrable or the scope of the arbitration agreement does not extend to them. This can be evidenced in *Alstom Power Ltd v Eraring Energy and Hi-Fert Pty Ltd v Kiukiang Maritime Carriers*, which under the Trade Practices Act 1974 (Cth), the Australian consumer and protection and competition legislation, the courts did not agree in their approach to the arbitrability of disputes under the states.<sup>401</sup>

#### **7.2.6 Selection of Arbitrators**

The parties to the arbitration agreement are free to appoint and determine the number of arbitrators and set out the procedure to be followed for their appointment. In addition, the parties have the right to require arbitrators to possess specific qualifications. According to article 11(3) of the Model Law, each party can appoint one

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<sup>399</sup> International Arbitration Act 2010.

<sup>400</sup> Australian Government, *Carriage of goods by sea* (Pearson Education, 1991).

<sup>401</sup> James Morrison, 'Drawing a line in the sand: Defining the scope of arbitrable disputes in Australia' (2005) 22(5) *Journal of International Arbitration* 395.

arbitrator and the two arbitrators can appoint a third arbitrator. However, if the parties fail to reach agreement on the number of arbitrators, the number becomes three by virtue of this article. Subject to paragraphs (4) and (5) of this article, the parties have the right to agree on the procedure for appointing the arbitrator/arbitrators. However, according to article 11(1) no person can be excluded from acting as an arbitrator because of his nationality unless the parties agree otherwise.<sup>402</sup> This means that if the parties fail to appoint arbitrators, or the two appointed arbitrators fail to appoint the third arbitrator within the time given by law, the court appoints an arbitrator or a third arbitrator upon the request of the other party.

### **7.2.7 The Seat of the Arbitration**

The seat of arbitration (also called place of arbitration) refers to the legal rather than physical location of arbitration and should be in a country that is a part to the New York Convention. Thus, arbitration awards decided in a country that is not a signatory to the New York Convention might not be enforceable in other countries. While hearings may physically take place in the seat country, sometimes the parties and arbitral tribunal may find it convenient to hold the hearings somewhere else. Thus, when applying the Model Law on international commercial arbitration in Australia, it should first recognise the state or territory in which the arbitration agreement takes place. Second, it should check whether the seat of the arbitration agreement (place of arbitration), has taken place in a state or territory that is different from where the agreement has taken place. Third, it should examine whether the agreement was entered before or after amendment of Australian arbitration law on the 6<sup>th</sup> July 2010.<sup>403</sup>

Although arbitration takes place outside courts and their role is limited, they play an important role in the process of arbitration. For example, the courts can supervise arbitration seated with their jurisdiction and undertake certain functions to support the arbitral process to intervene in arbitration when the relevant arbitration legislation allows that.<sup>404</sup> For example, a court on the application of one party stays the proceedings if one side of the agreement has a connection to Australia or a country that signed the Convention, unless the court considers the arbitration agreement to be invalid or incapable of being performed.<sup>405</sup> Article 16 of the Model Law not only gives the arbitral tribunal the competency to regulate in its own jurisdiction according to the principles of competence, but also gives each party the right to request that the court decide the dispute after the arbitral tribunal rules the preliminary matter of jurisdiction.

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<sup>402</sup> United Nations above n 6.

<sup>403</sup> Australia Government, above n 4.

<sup>404</sup> Ibid.

<sup>405</sup> Ibid. 419 Ibid.

### 7.2.8 Law Governing the Contract

As mentioned earlier, the Australian International Arbitration Act 2010 gives effect and force of law to the UNCITRAL Model Law on international commercial arbitration in Australia. According to section 21 of the Act, the parties to the arbitration agreement are not allowed to exclude the UNCITRAL Model Law from international commercial arbitration in Australia.<sup>419</sup> This implies all commercial disputes can be referred to arbitration, except certain matters that fall under section 18 of the Australian Consumer law 2010 and section 11 of Carriage of Goods by Sea Act 1991 which states that any arbitration agreement relating to a bill of lading (or comparable documents) for the international carriage of goods from or to Australia is invalid if not referred to arbitration.<sup>406</sup>

The amended section 1(1) of the Australian Arbitration Act in 2010 expressly states that when parties agree the dispute is to be referred to arbitration under the UNCITRAL Arbitration Rules, the dispute will be settled in accordance with these rules unless the parties seek to make some modification. In this regard, the parties are presumed to have referred to the rules on the date of commencement of the arbitration, unless they have agreed to apply a particular version. The purpose of this article is to determine which rules would apply when the parties have neither clearly identified which law will apply in the arbitration, nor expressed their intention clearly. This indicates the importance of understanding the intent of the parties, because the rules themselves cannot be determinative in factual changes to be enforced.

### 7.2.9 Enforcement of Arbitral Awards

In general, international commercial arbitration is considered a voluntary mechanism whose main objective is to insulate the arbitration process and ensure the enforceability of the arbitral awards that bind the parties to the dispute. According to section 8 of the IAA a foreign arbitral award is enforceable in Australia if it was made in a New York Convention country or any other country if the party seeking enforcement is incorporated in or has its principal place of business in a Convention country (including Australia).

Therefore, the decision of the tribunal is assumed to be binding according to section 8(2) of the IAA.<sup>407</sup> This means a foreign award that meets the conditions stated earlier will be enforced as if it were a judgment of an Australian court. This enforceability enhances the certainty of foreign awards in Australia. According to subsection 8(4) of the IAA, which is derived from subsections (1) and (2) of article 36 of the Model Law, Australian courts have limited grounds to refuse to enforce both domestic or foreign awards; they can only refuse to enforce awards that meet the conditions mentioned in subsections (5) and (7) of the Act.<sup>408</sup> Pursuant

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<sup>406</sup> John F Wilson, *Carriage of goods by sea* (Pearson Education, 2008).

<sup>407</sup> Australia Government, above n 7.

<sup>408</sup> Richard Garnett and Luke R Nottage, 'What law (if any) now applies to international commercial arbitration in Australia?' [953] (2012) 35(3) 26.

to articles 35 and 36 of the Model Law, the courts should recognise the arbitral award to be binding on the application of the parties in writing, irrespective of the country in which the agreement was made. In this regard, according to subsection 35(2), the party applying for enforcement of the arbitral award should present the original award or copy of it. The court may request the translation of the verdict of the award if it was made in a language other than the official language of the state.

However, under subsection 8(5), the court at the request of the party against whom the agreement was invoked has the authority to refuse to enforce the award if a party provides the following evidence:

1. The party to whom the award was made according to the law applicable to the arbitration was incapacitated at the time the agreement was entered between the two parties;
2. the arbitration agreement becomes invalid under the chosen applicable law and when the arbitration agreement becomes invalid under the law of the country that the award was made;
3. A proper notice about the arbitrator and time of the proceedings was given to the party; nonetheless he has been unable to present his case in the arbitration proceedings;
4. The award contains a decision on a matter outside the scope of the submission to arbitration, or does not fall within its terms;
5. the composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties or, failing such agreement, was not in accordance with the law of the country where the arbitration took place; and
6. the award has not yet become binding on the parties of the arbitration agreement or has been set aside or suspended by a competent authority of the country, or under the law where the award was made.

However, there is not any provision in the IAA that particularly vests jurisdiction in any court for the enforcement of a non-foreign award made in international commercial arbitration under both the IAA and the Model Law, if an award is made by an arbitral tribunal in international commercial arbitration in Australia, as opposed to a country other than Australia. According to section 16 of the IAA that gives effect to article 34 (2) of the Model Law, a foreign award is vested in the Australian Federal Court. Then again, pursuant to section 18 of the IAA, the Supreme Court of each State or Territory sets aside the foreign award when the place of arbitration is in its respective State or Territory.<sup>409</sup> Thus, pursuant to section 7 of the IAA which incorporates article 7 of the Model Law, Australian courts assist the arbitration process by referring disputes to arbitration and recognise and enforce the decisions issued by arbitral tribunals.

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<sup>409</sup> John Goldring, 'Unification and Harmonisation of the Rules of Law' (1978) 9 Fed. L. Rev. 284.



### 7.2.10 The Issue of Interest

Even though both the New York Convention and UNICTRAL Model Law do not contain any provisions for charging interest to the defaulting party, section 25 of the IAA authorises an arbitral tribunal when determining an award for payment of money to charge reasonable interest on the whole or part of the claimed principal amount, between the date on which the course of action took place and the date on which the decision of the award was made by the arbitral tribunal.<sup>410</sup> This implies that the arbitral tribunal has the power to determine a reasonable rate of interest on any unpaid amount unless the parties agree otherwise. According to section 25, this interest should be paid immediately from the day following the due date of the unpaid amount. Moreover, according to section 27(1) of the IAA, the court can use its discretion to decide any costs or fees claimed to be recovered by one party, unless the parties agree otherwise. Therefore, the award will be enforced in the Federal Court of Australia as if it were a judgment or order of a domestic court.

## 7.3 Part Two: Arbitration under Islamic Law

As the litigation of Islamic financial disputes under common law jurisdictions has presented challenges for Islamic finance due to the conflict between Shariah principles and the common law legal system, the Islamic finance industry needs an alternative dispute resolution system that suits the unique nature of its financial transactions. When the dispute involves an unacceptable element under Shariah law, such as imposition of interest in financial transactions, which is the main motive of conventional banking, its prohibition underpins the legitimacy of Islamic finance transactions. Thus, to examine if the arbitration dispute resolution system is more suitable than litigation for *murabaha* disputes, the next section discusses: (a) the concept of arbitration under Islamic law; (b) the scope of Islamic arbitration; (c) the applicable law on arbitration; and (d) the enforcement of the arbitral award.

### 7.3.1 The Concept of arbitration

In Islamic jurisprudence, arbitration means an amicable dispute resolution mechanism based on good faith that entrusts adjudication through arbitration to resolve disputes and create a friendship between the hostile parties.<sup>411</sup> The concept of arbitration dispute resolution (Tahkim) is as old as Islam itself, and has been the most practiced dispute resolution system for civil, political and commercial matters throughout Islamic history. It goes back to the early 6th century CE, where Arab communities before Islam used an arbitration system for civil and commercial disputes which were administered by tribal chiefs. However, the enforceability of arbitral awards during this period was not legally binding because it depended on the moral authority of the arbitrator.

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<sup>410</sup> International Arbitration Act 1974(No 136) 17.

<sup>411</sup> Umar Aimhanosi Oseni, 'Dispute resolution in Islamic banking and finance: current trends and future perspectives' (2009).

Notwithstanding, when Islam came, it excluded the pagan elements that existed in pre-Islam and validated it as an alternative dispute resolution system.<sup>412</sup>

The Quran and the Sunnah have some guidelines for it and the Prophet personally served as an arbitrator for a dispute that arose among the tribes of Macca about the replacement of the Black Stone of the Kaaba, after it was rebuilt. In this dispute, each tribe wanted the honour of putting the Black Stone back in its original position. Thus, to solve this problem, the Prophet put the Stone in the middle of a garment and requested a representative from each tribe to hold the edge of the garment and together they lifted the garment at the same time. Then, the Prophet stepped in and picked up the Stone and put it back in its original position.<sup>413</sup> This averted an imminent fight among the tribes of Macca. Moreover, by following his steps, the Prophet's companions deployed arbitration to settle disputes in the Muslim community. For example, they attempted to resolve the political rift between Ali ibn Talib (fourth Caliphate) and Muawiya who refused to accept Ali as a Caliphate after the death of the third Caliphate. Thus, by deriving legal instructions from both the Quran that explicitly outlined arbitration in marital disputes and the practice of the Prophet, they nominated two arbitrators: one from each side to settle the dispute.<sup>414</sup> Furthermore, Islamic jurists by following these legal precedents have developed the arbitration dispute resolution method and extended it into financial matters.

More recently the AAIFO issued Shariah Standard No 32 for Islamic finance dispute arbitration. This standard defines arbitration to be an agreement between two or more parties who nominate an external party to resolve their dispute through issuing a binding decision in conformity with the principles of Islamic law.<sup>415</sup> Similarly, the Kuala Lumpur Regional Centre Rules (KLRC i-Arbitration) issued regulations for the arbitration of Islamic financial disputes based on the UNCITRAL Arbitration Rules with some modifications to satisfy Shariah principles.<sup>416</sup>

Both the AAOIFI and KLRC i-Arbitration are generally in conformity with the rules of the UNCITRAL Model Law and the IAA that recognise and enforce arbitral awards of disputes on international commercial transactions and trade. They are consistent with article 7 of the UNCITRAL Model Law that expressly refers the term 'arbitration agreement' to parties arbitrating disputes that relate to a defined contractual or non-contractual relationship of international commercial agreements that can be settled by arbitration.

In the same way the AAOIFI and KLRC i-Arbitration state that the arbitration agreement should be in writing, regardless of whether the contract has been concluded orally, by conduct, or by any other means such

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<sup>412</sup> MA Ghazali, 'Fiqh-us-Seerah: Understanding the life of Prophet Muhammad' (1999) *Riyadh, Saudi Arabia*.

<sup>413</sup> *Ibid*.

<sup>414</sup> Abdul Azeez Olayemi and Bandar Khalid al-Zabyani, 'Arbitration Clause in Islamic Banking Contracts: A Contractual Necessity' (2014).

<sup>415</sup> AAOIF, above n 712.

<sup>416</sup> Umar A Oseni and Abu Umar Faruq Ahmad, 'Dispute resolution in Islamic finance: A case analysis of Malaysia' (2015) 125 *Ethics, Governance and Regulation in Islamic Finance* 18.

as electronic mail, telegram, telecopy or telex that show the occurrence of an agreement. Likewise, the New York Convention arbitration generally implies an agreement that includes both an arbitral clause in a written contract or signed by both parties through letters or electronic communication.<sup>417</sup> Therefore, by leaving the content and the form of the arbitration agreement in the hands of the parties, international commercial arbitration gives them (a) the freedom to choose the place of arbitration, (b) choice of arbitrators, (c) the choice of the governing law, and (d) the enforcement of arbitral awards. This choice and flexibility seem to enable the harmonisation of Shariah law principles in the *murabaha* contract and the international commercial arbitration system, making the arbitration system the most suitable dispute resolution mechanism for *murabaha* disputes in Australia.

### 7.3.2 Scope of the Arbitration

In Islamic law, arbitration is permissible for resolving disputes between parties unless it makes what is lawful unlawful.<sup>418</sup> The Quran (4:35.) explicitly outlines the process for resolving marital disputes:

*If you fear a breach between them twain (the man and his wife), appoint (two) arbitrators, one from his family and the other from her (family); if they both wish for peace, Allah will cause their reconciliation. Indeed, Allah is Ever All-Knower, Well-Acquainted with all things.*<sup>419</sup>

To resolve the marital conflict between the couple, the Quran orders the nomination of two righteous persons: one from the family of the husband and the other from the family of the wife. These arbitrators examine the cause of the dispute and the evidence of both sides and then make an arbitral award, as long as it does not make what is lawful unlawful or unlawful lawful. Within this context of Islamic jurisprudence derived from the Quran and the practice of the Prophet, the AAOIF and Rule 4 of KLCA i-arbitration introduced regulations for the arbitration of Islamic financial institutions. For example, the AAOIFI introduced Shariah Standard No 32(2) for disputes in financial transactions between institutions and their clients or other parties, whether inside or outside the host country.<sup>420</sup> Similarly, Rule 4 of KLCA i-the international commercial arbitration applies to the agreement when.<sup>421</sup>

- (1) one party has its place of business in another country other than Malaysia;
- (2) when the place of business is in Malaysia; however, one party to the contract is in another country. In this respect, like article 1 of the Model Law, this rule entails that if a party has a place of business in more than one country, the most closely connected country to the dispute will be considered the place of business;

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<sup>417</sup> Van den Berg, above n 47.

<sup>418</sup> See Sahih al-Bukhari 52, and Sahih Muslim 1599.

<sup>419</sup> Al-Hilali and Khan, above n 113.

<sup>420</sup> AAOIF, above n 794.

<sup>421</sup> Ibid.

- (3) the parties specifically agree that the subject matter of the agreement is related to more than a one country;  
and
- (4) if a party has no place of business, its habitual residence will be considered the place of business.

Both the AAOIFI and KLCA i-Arbitration rules appear to be no different from the position of the UNCITRAL Model Law. Their definition about the scope of arbitration conforms to the position of the International Arbitration Act that gives effect and force of law to both the New York Convention and UNCITRAL Model Law and exclusively applies to international commercial arbitration disputes in Australia. This implies that by offering the effect of law to both the Model Law and the New York Convention, the Act does not allow any scope for excluding them from international commercial arbitration in Australia. Consequently, Shariah law principles pertinent to the *murabaha* contract can be reconciled with international commercial arbitration. Someone may argue that Australian courts, as in *Comandate Marine Corp v Pan Australia Shipping Pty Ltd* in 2006, should accommodate Shariah principles that govern the *murabaha* contract by interpreting *murabaha* arbitration broadly. This encourages parties in a *murabaha* dispute to choose arbitration over courts because of its suitability to the nature of the *murabaha* contract in Australia.

### 7.3.3 Procedure of Arbitration

Arbitration has been practiced throughout Islamic history for resolving civil and commercial disputes. Even though Islamic scholars permit Islamic financial institutions to adopt rules to govern their disputes provided they do not make what is lawful unlawful or unlawful lawful, there has not been a procedure or standard for arbitration<sup>422</sup>. Islamic law generally gives the parties freedom to choose the rules of procedure tailored to their needs consistent with equality and fairness, such as treating them equally and giving them equal opportunity to present their case at the arbitral tribunal.

Section 7(2) (b) of the IAA mandates the court to stay its proceedings when a dispute relates to termination of a matter that can be settled by arbitration. However, sometimes Australian courts may refuse to stay proceedings on the grounds of bankruptcy, insolvency or competition. This suggests that when courts consider these matters not to be arbitrable, the scope of the arbitration agreement does not extend to them. This can be evidenced in *Alstom Power Ltd v Eraring Energy* and *Hi-Fert Pty Ltd v Kiukiang Maritime Carriers*, where under the Trade Practices Act 9174 (Cth), the court did not agree that disputes under the states could be arbitrated.<sup>423</sup> By analogising this case, the Australian legal system could accommodate Islamic finance by using a broader interpretation when determining disputes relating to *murabaha* crossborder transactions. This is reinforced by section 7 of part II of the IAA that obliges Australian courts to stay local court proceedings when the place of arbitration is in a country that is a member of the New York Convention, or a party of the

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<sup>422</sup> Faisal Kutty, 'Shari'a Factor in International Commercial Arbitration', [565] (2006) 28 *Loyola of Los Angeles International and Comparative Law Review* 624.

<sup>423</sup> Morrison, above n 398.

arbitration agreement is incorporated, or its place of business is in this country.<sup>424</sup> In this regard section 7 states that (a) the procedure for arbitration is regulated when the parties express the terms of agreement, or the law of a Convention country states that; or (b) it has been expressly stated by the law of a Convention country as not being Australia, whereas a party to the agreement is Australian or a State or a person who was an Australian resident when the agreement was executed. Although, the parties determine the jurisdiction of the arbitral tribunal, there is an exception when a subsidiary or a controlling entity enters into an arbitration agreement with another party and the parent company is bound by this arbitration agreement.<sup>425</sup>

Therefore, Australian courts should accept *murabaha* arbitration disputes and accommodate the Shariah law principles that govern the contract because the principles governing *murabaha* transactions can be reasonably reconciled with the international commercial arbitration system. This not only encourages the Islamic finance industry to choose arbitration in Australia but also enables Australia to become a hub for the Islamic banking and finance in South East Asia.

#### **7.3.4 Selection of Arbitrator**

In Islamic law the appointment of arbitrators is considered as important as the appointment of judges. Like court judges, arbitrators require certain qualifications to ensure their ability to undertake proper arbitral proceedings. In this regard, Shariah Standard 32 allows each party to the contract to appoint one arbitrator, and the two appointed arbitrators to appoint a third arbitrator if they have been given this authority by the parties. The standard recommends the number of arbitrators should be an odd number; if the number becomes even the parties have the right to appoint a chairman from the arbitrators' panel to give the chairman a casting vote where the votes become equal. But, if the parties disagree or fail to determine the number of arbitrators, the arbitral tribunal is entitled to determine the arbitrators by: (a) appointing three arbitrators when the dispute involves international arbitration; or (b) nominate a sole arbitrator when the case is domestic arbitration. Similarly, rule 4 of KLRCA i- arbitration states that when the parties fail to appoint the number of arbitrators, the tribunal appoints three arbitrators if the dispute involves international arbitration, or a sole arbitrator if the dispute is domestic arbitration.<sup>426</sup>

Shariah Standard No 32 and KLRCA i- arbitration derive from Shariah law that requires the following.<sup>427</sup>

First, under Shariah law the arbitrator is required to understand the concept of justice, the nature of fairness, and public policy in Islam. Although, traditional Islamic jurisprudence requires that the arbitrator is Muslim,

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<sup>424</sup> Australia Government, above n 3.

<sup>425</sup> Ramsay and Noakes, above n 8.

<sup>426</sup> Umar A Oseni and Abu Umar Faruq Ahmad, 'Dispute resolution in Islamic finance: A case analysis of Malaysia' (2015) 125-134 *Ethics, Governance and Regulation in Islamic Finance*.

<sup>427</sup> AAOIF, above n 795.

Shariah Standard No 32 accepts the arbitrator/arbitrators being non-Muslim, on condition that his decision is consistent with the principles of Shariah law. In comparison, in the Malaysian arbitration system there is no requirement for the arbitrator to be Muslim or male. In fact, the arbitration regulations of some Muslim countries, such as Saudi Arabia and the UAE do not require these conditions;<sup>428</sup>

Second, although according to jurists such as Maliki, Hanbali and Shafie the arbitrator must be male, this condition has been contested by Hanafi jurists who argue that women are the same as men and can be appointed as arbitrators for civil and commercial disputes as long as they are competent and have full legal capacity;

Third, the arbitrator must be mature. This means a child cannot be nominated as an arbitrator and his arbitral decision cannot be approved even if he bases his decision on the precedence of a competent arbitrator in a similar circumstance;

Fourth, the arbitrator must have both mental capacity (sanity) and legal capacity to evaluate matters brought in front of him. This means the insane person or one who lacks legal capacity will not be eligible to be an arbitrator, even if he is simply following set guidelines. Thus, if a person is known for his unwise disposition, or may be under the guardianship of another person because of legal incapacity, he is not qualified to be appointed as an arbitrator;

Fifth, the arbitrator must have all senses, such as sight, hearing, smell, touch and taste. In this respect, scholars emphasize the importance of the sense of sight and hearing for examining the evidence of the disputes and verifying them;

Sixth, the arbitrator must possess high moral correctness, integrity, and trustworthiness;

*Seventh*, most Muslim jurists, such as Shafie, Maliki and Hanbali, require the arbitrator to be expert in both the subject matter of the arbitration and aspects of Islamic law pertaining to the matter of the dispute; and

Eighth, the parties have the right to impose any limitation on the arbitrators as far as this limitation is permissible by Islamic law, such as stipulating in the arbitration agreement that the chosen law is the view of certain Islamic schools of law.

Thus, according to Standard 32 (10)(3), the arbitrator is not obliged to follow the procedural rules of the judiciary and other laws unless such law is part of the public order. Arbitrator/arbitrators can refer the dispute to Shariah experts (such as the Malaysian Shariah Supervisory Council) to express their opinion about Shariah compliance of the issue at hand. Both Shariah Standard 32 and KLRCA i- arbitration concur with article 11(3) of the Model Law that requires each party to appoint one arbitrator and the two arbitrators to appoint a third

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<sup>428</sup> Maita, above n 55. 443 Aljasiiri, above n 135 444 Maita, above n 36.

arbitrator. However, if the parties fail to reach an agreement on the number of the arbitrators, the number becomes three by virtue of this article. This infers that both AAOIFI Shariah Standard 3 and KLRCA i-arbitration adopt the position of article 11 of the Model Law in relation to the number of arbitrators and, not excluding any person from acting as an arbitrator because of his nationality and religion unless the parties agree otherwise. This position reflects the need to make the mandatory requirements of Islamic financial contracts consistent with international commercial practices because of the increasing commercial interaction between Muslim and non-Muslim nations.

### 7.3.5 The Applicable Law

Under Shariah law, the arbitrator is expected to apply its principles in the dispute. However, if the parties request a certain law be applied, the arbitral tribunal can apply the chosen law as long as it does not violate the Shariah principles of not making what is unlawful lawful. This is within the framework of article 28 of the UNCITRAL Model Law that requires the arbitral tribunal to decide the disputed agreement pursuant to the law chosen by the parties. Under this article, the parties have the freedom to choose the applicable law to the arbitration agreement, regardless of whether or not it has been incorporated into any national legal system. Article 28(1) of the Model Law<sup>429</sup> requires an arbitral tribunal to decide disputes in accordance with the law chosen by the parties, which suggests this could apply to Shariah law as the choice of law for the agreement. This view is consistent with section 1(1) of the Australian Arbitration Act in 2010 that states the dispute of the parties should be referred to UNCITRAL Arbitration Rules which give them the right to make some modifications to its provisions. According to the IAA the parties to an arbitration agreement should have referred to the rules on the date of commencement of the arbitration, unless they have agreed to apply a particular version of the rules.<sup>430</sup> This means the agreement of the parties will be assumed to be governed by the rules of IAA 2010 if they entered the arbitration agreement after the commencement of the new rules but only referred to them loosely. That naming any law or a legal system of a certain state in the agreement should be regarded to be directly referring to the substantive law of that state, unless expressly stated to the contrary. This means the law chosen by the parties to govern their agreement, which could be Shariah law, will prevail. However, if the parties have not chosen which law will apply in a dispute, the arbitrators have discretion to apply the closely connected law to the agreement according to the Act, as mentioned above. Therefore, it could be argued that if Shariah law, on which laws in most Islamic countries are based, governs the agreement the arbitration tribunal should apply Shariah law provisions pertaining to the *murabaha* agreement in the dispute if the parties stipulated this in the contract.

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<sup>429</sup> United Nations above n 17.

<sup>430</sup> Ibid.

### 7.3.6 Arbitration Enforcement

Arbitration is required to comply with Islamic law principles. However, there has been a debate among schools of Islamic jurisprudence on whether or not arbitration is binding or is simply conciliation, as the tone of verse 35 of chapter 4 of the Quran that mentioned above suggests. The opinions of the four schools of Sunni Islam have divided evenly on this issue. For example, while Hanafi and Shafi schools view arbitration to be conciliation and not binding unless both parties agree, the Maliki and Hanbali schools hold the view that arbitration is binding if it does not cause deliberate injustice or violate Shariah principles. This indicates the award will be binding on the parties according to most modern Islamic scholars. Thus, Islamic arbitration could be harmonised with international arbitration laws such as the UNCITRAL rules and the New York Model Law and could be enforceable within the Australian common law jurisdiction. For example, subsections 8(2)(3) of the International Arbitration Act 2010 that states a foreign award will be forced in the Federal court and in both State or Territory courts if the award was decided by that court, seems to accommodate *murabaha* disputes. According to subsection 8(4), of the IAA which are drawn from subsections (1) and (2) of article 36 of the Model Law, Australian courts have limited grounds to refuse to enforce a domestic or foreign award; it states that the courts can only refuse to enforce awards that meet the circumstances mentioned in subsections (5) and (7).<sup>431</sup>

This harmonisation will enable the parties to incorporate the principles of Shariah law pertinent to financial transactions into the governing law clause in accordance with the specifics of the disputed agreement and the needs of the parties. This proposes that the parties in an Islamic finance agreement could be decided according to Shariah principles within the framework of international commercial arbitration law. Similarly, it gives them the right to nominate arbitrators whom they are satisfied have knowledge of Islamic finance and Shariah law. However, unlike litigation, the arbitrator is not obliged to have knowledge of either Islamic finance or Shariah law under the arbitration system. In addition, the parties have the freedom to design the rules of their arbitration to fit their needs and the dispute. Moreover, the arbitral award can be easily decided by the arbitrator and enforced in another jurisdiction. A further advantage is that the dispute can be settled in a venue closer to the home of the parties regardless of whether the governing law in the agreement is in another country. For instance, the governing law might be Australian law, while the parties of the dispute might be in Malaysia or another Muslim State. This generally suggests the arbitration dispute resolution system is the most suitable for the *murabaha* contract in Australia.

However, although harmonisation between Islamic law and international arbitration laws can be achieved by ensuring the arbitration rules do not violate Islamic law principles, the question that arises is how Islamic law and international commercial arbitration law can be reconciled in a *murabaha* dispute without compromising

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<sup>431</sup> International Arbitration Amendment Act 2010 (Australia).



the principles of Islamic law in Australia. The following section discusses how disputes about Islamic finance and arbitration clauses in Islamic financial contracts are dealt with in Malaysia and the UK.

## 7.4 British Common Law Jurisdiction

The UK legal system accommodates arbitration as an Alternative Dispute Resolution method for both civil and commercial disputes within the framework of the English legal system. Section 4(2) of the UK Arbitration Act 1996, states that “*the parties to make their own agreements but provides rules which apply in the absence of such agreement*”.<sup>432</sup> This indicates that any law determined by the parties of the agreement to be the applicable law, or in the absence of their express or implied choice the governing law, will be treated as the law chosen by the parties. Thus, harmonization can be achieved by ensuring international commercial arbitration law does not violate the principles of Shariah law that govern the agreement and the arbitration proceedings on which the contracting parties agreed.

This argument can be supported by the *Jivraj v Haswani* case in which the UK Supreme Court accepted the right of parties in the arbitration agreement to request an arbitrator from a particular religious background, indicating that the parties can request the arbitrator to be a Muslim or at least the Islamic law to be the basis for arbitration. The court stated that (at para 61) the most important feature for the arbitration mechanism over the court is the ability of the arbitrator to structure the process of dispute resolution and the freedom and discretion given to the parties. Section 1 of the 1996 Arbitration Act states that the parties have the freedom to agree on how the dispute can be resolved provided that the contract does not infringe the public policy of the country. This can be supported by section 46(1) (6) of the English Arbitration Act 1996 that authorises the arbitral tribunal to decide the dispute in accordance with the law chosen by the parties<sup>433</sup>, which can be Shariah law. This view was strengthened by the *Sanghi Polyesters Ltd (India) v. the International Investor KCSC (Kuwait)* case<sup>434</sup>, where the parties to the agreement chose arbitration and London to be the place of the arbitration. The governing clause of the agreement stipulated that if any dispute arose from the contract it would be governed by the laws of England except where it may violate Shariah principles. Consequently, the arbitrator awarded the bank the principal and profit that had been agreed between the parties but did not award the damages to which the bank claimed it was entitled because this conflicted with the principles of Islamic law. But, when the losing party was unhappy with this ruling, it appealed against the verdict. The appeal court after ascertaining that the ruling of the arbitrator did not conflict with English law and the agreement did not violate Islamic law, upheld the decision of the arbitrator.<sup>435</sup> Thus, providing Shariah compliance of financial

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<sup>432</sup> Andrew Tweeddale and Keren Tweeddale, *Arbitration of commercial disputes: international and English law and practice* (Oxford University Press, 2005).

<sup>433</sup> Arif A Jamal, ‘ADR and Islamic law: the cases of the UK and Singapore’ (2015).

<sup>434</sup> *Sanghi Polyesters Ltd (India) v. The International Investor KCSC (Kuwait)* (2000) 2000 Lloyd 1.

<sup>435</sup> Maita, above n 52.

commercial transactions within the common law jurisdiction makes common law the forum of choice for Islamic international commercial transactions, except to the extent it may violate Shariah principles.

Analogically, Australia may adopt this approach and form an Islamic Finance Advisory Council (IFAC) that enable arbitral tribunals to refer any issue related to Islamic finance to it for advice before reaching a decision on disputes. This makes *murabaha* arbitration disputes in Australia to be resolved while in Shariah compliance. This will enable it to be both operationally and commercially viable under the Australian common law jurisdiction.

#### **7.4.1 The Issue of Interest**

The issue of interest which is considered a cornerstone of the modern economy and the main motive for banking business, has been an ethical dilemma for the Islamic finance industry, and has created a gap between Shariah law and international commercial arbitration within the common law legal system. Although the UNCITRAL Model Law and the New York Convention do not contain any provision that explicitly mentions awarding interest, section 25 of the International Australian Act permits an arbitral tribunal to award a reasonable interest or part of the claimed principal amount to compensate the successful party. Pursuant to section 26 of the IAA, the arbitral tribunal may order a defaulting party to pay interest on any unpaid portion between the date on which the course of action took place and the date on which the decision of the award was made (IAA). Moreover, section 27(1) of the IAA states that where any costs or fees are claimed to be recovered by one party, the arbitral tribunal (with its discretion) may decide the matter unless the parties agreed otherwise. This award may be enforced in the Federal Court of Australia with the leave of that court as if the award was a judgment or order of that court.<sup>436</sup> This means the arbitral tribunal has the power to determine the interest to be charged on any unpaid amount on or before the due date. However, the arbitral tribunal is required to determine a reasonable rate of interest unless the parties agreed otherwise.

On the other hand, the AAOIF does not allow awarding interest to the successful party under arbitration. For instance, AAOIF Shariah Standard number (3) states that banks are not allowed to stipulate in the contract any financial compensation or penalty, in cash or in other consideration. However, rule 12(8) of the KLRCA i-Arbitration states that unless the arbitration parties have agreed otherwise, the arbitral tribunal may order an award to be paid overall or in any part between the date on which the course of action arose and the date of realisation of the award. This can be either (a) compensation for the actual loss because of the late payment to the successful party; or (b) any other charges that the arbitral tribunal considers appropriate, including interest. Although giving an award to the successful party is not against Shariah law, the position of KLRCA i-Arbitration in allowing interest to be charged seems to contradict the prevailing view that shariah law prohibits all forms of interest from being paid or received, as discussed in chapter three. It appears that KLRCA derives

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<sup>436</sup> Australia Government, above n 2.

its ruling perhaps from the opinion of minority jurists who have narrowed the scope of the *riba* to usury (excessively high rate of return) and excluded banking interest from prohibited interest, as discussed in chapter two. The view of this minority claims that the Quran prohibits only the usury practiced in pre-Islam, and not the interest of contemporary banking.<sup>437</sup> They argue that the main reason the Quran prohibits the *riba* is because of the injustice and exploitation inflicted on poor debtors on whom lenders imposed extra interest against the increased loan tenure because of their inability to pay debts on the due date. As most jurists defined the *riba* as any unjustified increase in capital, whether through loans or sales that are predetermined, conventional banking interest falls into the definition of prohibited *riba*. Equally, as discussed in chapter three, modern Islamic economists and Islamic financial institutions have adopted this position.

#### **7.4.1.1 Midland International Trade Services Ltd v Al-Sudairy**

Midland International Trade Services Ltd V. Al-Sudairy and others, entered a financing agreement under Shariah law which expressly identified that the contract was to be governed and construed in accordance with English law and the UK was to be the jurisdiction forum.<sup>438</sup> However, after a dispute arose between the parties, the claimant took the dispute to the Settlement of Negotiable Instrument Disputes in Riyadh. But when interest was not awarded to the financier by the arbitral tribunal, the bank took the case to an English court which, after examining the agreement, awarded interest to the bank.<sup>439</sup> Although, generally interest is prohibited in Saudi Arabia and arbitration bodies do not award interest, as demonstrated in this case, in practice this prohibition is not enforceable in Saudi Arabia if parties do not bring the dispute to the court or arbitral tribunal. However, in one notable case a Saudi arbitral tribunal refused to enforce an arbitral award made in Bahrain because it entitled one of the parties to receive interest. On the other hand, the tribunal accepted the enforcement of the part of the contract that complied with Shariah law and ordered the losing party to repay the principal amount without interest.<sup>440</sup> Therefore, to avoid the lack of enforcement of awards by local Islamic courts, Islamic financial institutions usually (a) draft agreements in a way that does not allow local law that based on Shariah to be the applicable law of the contract; (b) the jurisdiction forum to be in the common law jurisdiction; or (b) incorporate the banking business outside its country of origin.

#### **7.4.1.2 Sanghi Polyesters Ltd (India) v. the International Investor KCSC**

Sanghi Polyesters Ltd and the International Investor KCSC entered a *murabaha* financing contract under which they agreed to be governed by the laws of England except to the extent they may violate Shariah

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<sup>437</sup> Farooq, above n ; Sadiq, above n ; Saeed, Reading the Qur'an in the Twenty-first Century: A Contextualist Approach, above n 85.

<sup>438</sup> Abdulrahman Yahya Baamir, Shari'a Law in Commercial and Banking Arbitration: Law and Practice in Saudi Arabia (Routledge, 2 ed, 2016).

<sup>439</sup> Ibid.

<sup>440</sup> Ibid.54.

principles which would prevail.<sup>441</sup> Thus, the arbitral tribunal, according to this agreement clause, awarded the bank the principal and profit that had been agreed between the parties, but denied awarding interest as damage to which it argued it was entitled. The tribunal made the interest void, while enforcing the other parts of the contract. This position can be reconciled with article 36 of the UNCITRAL Model Law that states the recognition and enforcement of an arbitral award may be refused (a) if the court finds that the subject matter of the dispute would not be settled by arbitration under national law, or (b) the recognition or enforcement of the award would be contrary to the public policy of the national law.

The essential elements of the contract under Shariah law are equality, fairness and fulfilling the obligations of the contract. In addition, Shariah law applies the principle of “contract is the law of contracting parties”, like the Pacta Sunt Servanda principle, which emphasises respect for the contract if it does not conflict with the principles of Shariah law. While paying or receiving interest is not allowed in Islamic law, it considers not fulfilling the conditions of an agreement a violation of the Islamic law. This is way Quran (17:34) states that “*You must fulfil your agreement, for every agreement you are accountable*”.<sup>442</sup> This entails the parties to the agreement being required to treat the contract as a sacred law, showing good faith and abstaining from dishonest and fraudulent dealings. Scholars therefore consider breaching the obligations of the contract as breaching the Islamic code of conduct and violating the rights of society and does not differentiate between the parties of the contract being individuals, the public, Muslim or non-Muslims because according to the concept of sacredness of contract under Shariah law contractual obligations are required to be specifically performed by them.

This seems to be a paradox because on the one hand Islamic law prohibits interest being charged on defaulters and on the other hand encourages the terms of the contract (which could include paying interest) to be fulfilled and appears to create a predicament for Islamic financial institutions. However, this paradox can be resolved by making the element of interest in the contract void, while other parts of the contract will be enforced to comply with the Islamic law concept that makes contracts legal as far as they do not violate Shariah principles. It seems unfair not to penalise defaulters when they delay payment without acceptable reasons and may take advantage of creditor loans for their own purpose. Therefore, an arbitral tribunal can impose a penalty based on the expected rate of return or the rate the bank would have given to investment account holders (IAHs) during the defaulting period. The reason for benchmarking with the expected return of the IAHs is to avoid resembling commercial interest rates that conventional banks impose on their clients.

Imposing penalties on defaulters is supported by the Hadith of the Prophet that says: “*The well-off person who delays the payment of his debt, subjects himself to punishment and disgrace*”.<sup>443</sup> This implies the arbitral

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<sup>441</sup> Sanghi Polyesters Ltd (*India*) v. *The International Investor KCSC (Kuwait)* (2000) 2000 Lloyd 1.

<sup>442</sup> Al-Hilali and Khan, above n 373.

<sup>443</sup> Sahih Al-Bukhari, hadith no. 2400, with Fath al-Bari, 5:62.

tribunal could impose a monetary penalty on the defaulter as both a deterrent for defaulting and as compensation for both lost income and damages that the financier suffered because of the delay in payment. This position is also reinforced by rule 12(8) of the KLRCA i-Arbitration that states the defaulter must either pay (a) a compensation for the actual loss, because of the late payment, to the successful party; or (b) any other charges that the arbitral tribunal considers appropriate as far as they are not conflicting with the theory of Islamic banking. This penalty should be imposed even if the investment account holders do not earn any profits during the defaulting period, if the non-payment is proven to be without a valid reason that has been verified using conventional risk management techniques. Unless some sort of penalty is imposed on the defaulting customer, bad customers may put Islamic banking under *murabaha* transactions at a disadvantaged position compared to conventional products. Therefore, it seems necessary, some sort of penalty should be imposed on the defaulter this penalty can be as Rule 12(8) of the *KLRCA i-Arbitration Rules* states that unless the arbitration parties have agreed otherwise, the penalty should cover the actual loss because of the default and any other charges that the arbitral tribunal considers appropriate.

## 7.5 Concluding Remarks

As the existing financial regulatory system in Australia is set up for the conventional banking and finance system and Australian government has shown its unwillingness to amend the existing laws to incorporate Islamic finance into the Australian legal system, arbitration over litigation seems to be the most appropriate system for the *murabaha* disputes. This view is reinforced by the current climate that associates Islam and the Shariah law with terrorism, which may not encourage the government to bring Islamic finance to the floor of the Australian Parliament. In addition, the inaction of the government to amend the existing laws to accommodate Islamic finance may be encouraged by the decision of the British courts that treated *murabaha* transactions in Britain same as the conventional transactions.

The arbitration dispute resolution system not only solves the legal complexity involved with the litigation that threatens the very purpose of the *murabaha* finance, but also there is no substantial difference between Shariah law and international commercial arbitration law on the *murabaha* transaction in the Australian common law jurisdiction. Islamic law systems share similar common principles with the international commercial arbitration law. This will enable Islamic law principles pertaining to the *murabaha* contract and the international commercial arbitration system to be harmonised in resolving *murabaha* disputes in Australia while keeping *murabaha* in Shariah compliant.

The main issues that the Islamic law and Arbitration law conflicts is the issue of interest on loan that does not allow imposing a penalty on defaulters of *murabaha* payment. However, this will be resolved by allowing Islamic financial institutions to impose a penalty to defaulters without acceptable reasons. The arbitral tribunal

can impose charges on defaulting customers after ascertaining the reason of the default. Nonetheless, to avoid resembling the conventional interest and being distinguished from conventional finance, the penalty rate should be based on the return that the Investment Account Holders (IAHs) of the financier or similar bank have earned or would have earned during the defaulting period. This is not only be fair to the lender and reflects the objectives and the principles of Islamic finance but also becomes deterrent to the defaulters and bad customers to delay payment of the loan without accepted reason.

Therefore, under the Arbitration system, there is no necessity to change Australian laws to accommodate *murabaha* finance. However, in the absence of any legislation or regulatory system for the Islamic finance, Islamic finance industry needs to structure *murabaha* contract in a way that make it to comply with the domestic laws, while also remaining Shariah compliant. This may require forming Islamic Finance Advisory Council from Shariah scholars, Islamic finance and Australian legal experts, who can establish one standard codified system of Islamic finance to be used as guidance and reference. This makes *murabaha* arbitration disputes in Australia to be resolved in a way that satisfies both the Australia law and Islamic law principles. This will enable *murabaha* finance to operate under Australian law while also remaining Shariah compliant and makes *murabaha* both legally compliant and commercially desirable. This not only closes the gap between Shariah principles and international commercial arbitration in *murabaha* commercial agreements but also creates stability and certainty in the international commercial relationships. Finally, the harmonisation of Islamic law principles with the international commercial arbitration system allow financial institutions to provide Islamic financial products that are both operationally and commercially viable in the conventional financial market.

# CHAPTER 8: CONCLUSIONS AND RECOMMENDATIONS

## 8.1 Introduction

This thesis explored the legal feasibility of using *murabaha* sale contracts for financing in Australia, while remaining shariah-compliant. It discussed whether the dual legal system creates additional legal or financial risk for *murabaha* transactions in jurisdictions that are not bound to Islamic principles regarding commercial agreements. Through an examination of *murabaha* financial disputes, this thesis also analysed whether either litigation or arbitration forums were the most appropriate method of dispute resolution for *murabaha* transactions. Considering that *murabaha* is not implemented in Australia, this study drew on the Malaysia and British experiences, discussing *murabaha* disputes in both jurisdictions to transfer their lessons to the Australian context.

To facilitate analysis of these issues, this thesis discussed Islamic law, its sources and the principles of the Islamic finance. By examining *murabaha* as sale contracts as well as credit contracts, it evaluated whether the requirement for *murabaha* contracts to simultaneously comply with different legal systems creates additional legal or financial risk. In addition to comparing litigation and arbitration, this thesis also considered whether changes are necessary to Australian law to make *murabaha* transactions both legally compliant and commercially desirable. In the course of answering these main questions, this thesis examined the theory of Islamic finance by examining the Islamic law, its sources and the principles of Islamic finance. In addition, it discussed the practice of Islamic financial institutions to see the extent of *shariah* compliance of the *Murabaha* transactions. Additionally, the thesis discussed whether the different legal systems that govern *murabaha* contracts create additional legal or financial risk to these transactions through analysing practical court cases from Malaysia and the UK. The study drew on the experiences of these countries because of their significant histories of regulating and governing Islamic finance and banking. Furthermore, it examined the different approaches to *murabaha* dispute resolution (i.e., litigation and arbitration) to identify which mechanism is best suited to *murabaha* disputes in Australia.

In practical terms, the study purpose was to synthesise between shariah principles pertaining to the *Murabaha* transactions and the Australian common law and to incorporate *murabaha* financing transactions into the Australian regulatory framework to establish a unified Islamic regulatory system for the Islamic finance. It also aimed to provide Australian financial institutions and investors with insight into Islamic financing techniques to assist them to understand the nature of *murabaha* transactions and the most appropriate methods of resolution for related disputes. It sought to inform Australian policymakers and regulators to understand the prospects and challenges for Islamic finance transactions and their legal and regulatory implications within the framework of international trade finance and Australian commercial law.

The following sections briefly outline the main findings from each of the eight chapters.

## 8.2 Chapter 1: Introduction

Chapter 1 laid out the background of the thesis and provided an overview of the Islamic finance system. It introduced and described the characteristics of Islamic finance that most distinguish it from conventional finance and banking and discussed Islamic financial products. This chapter also introduced the problem and the rationale of this thesis: In *murabaha* financing contracts, the question of law is delicate because parties typically choose Islamic law as the governing law of the contract within a common law jurisdiction; however, when *murabaha* contracts are structured according to domestic common laws, which are set up solely for conventional banking and finance systems, there may be conflicts with shariah principles that risk the contract being noncompliant with shariah. Conversely, when *murabaha* contracts are structured according to shariah law they may violate the domestic common law. The requirement for *murabaha* transactions to simultaneously comply with these different legal systems creates legal and regulatory impediments for them.

Chapter 1 also outlined the qualitative methodological approach used in this study, in which Islamic and non-Islamic legal texts, court cases and academic journals were analysed to understand the theory and practice of *murabaha* finance. Since there have been no matters relating to the courts and dispute resolutions in Islamic finance in Australia, the study used court cases from the UK and Malaysia with the intention of benefiting from their histories in this area. Thus, the data used in this study came from analysis of documents relating to Islamic law, literature of finance and legal cases concerning *murabaha* transactions, and was used to examine whether it was possible to enable IFIs to provide shariah-compliant financial products in common law jurisdictions.

## 8.3 Chapters 2–3: Sources of Islamic Law and Theory of Islamic Finance

Chapter 2 discussed Islamic contract law and its sources—a combination of a civil code (the Quran and the Sunnah) and a common law system created by jurisprudence, regulation and supervision—as they relate to Islamic finance. The opinions of the Islamic schools of jurisprudence that form shariah law are diverse and often provide different views on same issues; as such, this study approached Islamic jurisprudence as a unified legal system rather than risking personal selection bias by examining a specific school of law. To maintain objectivity, the AAOIFI was chosen as a representative reference for Islamic finance and the KLRCA i-Arbitration as a supplementary reference, particularly regarding arbitration.

Chapter 3 discussed the theory, principles and approaches of Islamic finance. It discussed the main characteristics and foundations that distinguish Islamic finance from the interest-bearing financial system (i.e., the prohibitions of *riba*, *gharar* and transactions involving activities or products that are unlawful within shariah law, the emphasis on asset-backed transactions and the PLS principle). As part of this, it discussed the theory that conceptually and contextually underpins Islamic finance and summarised the major theoretical approaches towards Islamic financing and *murabaha* contracts.



## 8.4 Chapter 4: *Murabaha* as a Sale Contract

Chapter 4 discussed the use of *murabaha* as sale contracts, comparing them with sale contracts in Australian common law and international commercial law with special reference to the *Goods Act 1958* (Vic) and the *CISG*, the latter of which has been implemented in every Australian jurisdiction.

This chapter examined the areas in which shariah law conflicts with common law (i.e., the requirement that the financier possess the object of finance before selling it, the prohibition of *riba* and the requirement to avoid *gharar*). It also investigated whether the dual legal system operating on *murabaha* contracts attracts extra legal or financial risks for these transactions. The study found that both shariah and common law legal systems are based on precedent and they generally agree on the essential elements that are necessary for the validity and enforceability of *murabaha* sale contracts within Australian law. While shariah law and Australian contract law agree on most essential elements of sale contracts, they differ on several issues: charging interest to the breaching party of the contract, assuming the risk of the subject of finance and avoiding excessive uncertainty in financial transactions. On the other hand, although *murabaha* transactions can be compliant with Australian common law, they are vulnerable to noncompliance with shariah law unless amendments are made to the relevant elements of Australian commercial law. Because shariah is not a national system of law and it lacks a standard, codified Islamic law to be used as guidance or reference, domestic common law typically governs contracts and provides certainty on the rights and obligations of the parties. This law may still conflict with the principles of shariah law pertaining to *murabaha* transactions, which makes them vulnerable to noncompliance with shariah law.

## 8.5 Chapter 5: *Murabaha* as a Credit Contract

Chapter 5 discussed the use of *murabaha* as credit contracts. It examined the ways that this practice conflicts with the conventional banking and finance system (i.e., the requirement that the financier must possess the object of finance, the prohibition of *riba* and the avoidance of *gharar*). This chapter discussed *murabaha* dispute cases in Britain and Malaysia, and examined whether the existence of a dual legal system creates extra financial risk for *murabaha* transactions in Australia.

In analysing the practice of IFIs in Britain and Malaysia, the study revealed that *murabaha*, as a credit contract, is not that different from conventional financial products for several reasons:

### 8.5.1 Ownership of the Object of Finance

To avoid exposure to the risks associated with the ownership of financed assets, IFIs often assume neither the ownership of financed assets nor the risks associated with their ownership—at least physically. In addition, when IFIs do assume the ownership of financed assets, they only expose themselves to this risk for a brief time. Like conventional banks, they usually transfer the risk of finance directly to customers by giving them

ownership of the financed assets. For instance, to avoid exposure to the risks associated with ownership, IFIs usually require customers to make payment unconditionally and irrevocably without linking it to the delivery of the financed assets or the transfer of the title to customers. Therefore, IFIs normally pay against the documents and limit their responsibility to only paying the supplier the price of the financed assets; by consequence, they exclude their liabilities from defects, loss or damage to the goods during transit.

### 8.5.2 *Murabaha* Profit Margins and Interest

- By deploying legal mechanisms to circumvent the prohibition of *riba*, IFIs benchmark *murabaha* mark-ups with the official interest rate or other market interest rates (e.g., LIBOR or BLR).
- By closely benchmarking the *murabaha* profit margin with commercial interest rates, they guarantee themselves the same profit margins as conventional loans, making the *murabaha* mark-up indistinguishable from conventional interest rates.
- The resemblance between *murabaha* financing and conventional banking practices prevents IFIs from incurring any extra financial risk in common law jurisdictions.
- This resemblance has made customers, financial markets and other stakeholders comfortable with *murabaha*.

### 8.5.3 Default and Rebate in *Murabaha* Finance

- IFIs penalise defaulting customers in the same way as do conventional financial institutions.
- IFIs are not required to give discounts or rebates for early settlement of loans because the portion of the unearned profit margin tied up with the tenure of the loan is considered part of the selling price.

### 8.5.4 Guaranteeing *Murabaha* Finance

Islamic law permits guaranteeing *murabaha* payments. As *murabaha* payments are payable in the future and customers may default or their capacity to pay may deteriorate in the future, IFIs are entitled to ask customers to provide guarantors for the payment of the loan. By using *guarantee*, IFIs may have several entitlements:

- When a client defaults, IFIs—like conventional banks—are entitled to claim the amount of debt either from the borrower or the guarantor; however, they cannot ask for any guarantee unless a credit contract is created between the bank and the client.
- IFIs may charge administrative expenses for issuing a letter of guarantee on the condition that the fees are the same as the administrative expenses charged on similar services.
- IFIs may charge fees for guaranteeing commercial and trade transactions.

This study found that these risk-management techniques allow IFIs to avoid extra financial risk that might disadvantage them in comparison to their conventional counterparts. Such techniques are pivotal for *murabaha*

financing because of the constraints and challenges that the Islamic finance industry faces within the well-established conventional financial system.

This thesis found that the resemblance of these techniques to the risk-management techniques employed by the conventional finance system does not make *murabaha* contracts non-Islamic for the following reasons:

- *Murabaha* financing, to be shariah-compliant, does not need to be wholly different and outside the framework of the conventional financial system.
- *Murabaha* transactions may resemble conventional financial products and have the same economic effects as interest-bearing financial transactions and still be shariah-compliant as long as they meet the core shariah principles.
- There is nothing in shariah law that forbids the returns of *murabaha* financing from resembling those of conventional finance as long as all transactions meet the core shariah requirements.
- As Islamic finance is its infancy and has not yet revolutionised its own financing system, it is necessary to use conventional risk-management techniques.
- The Islamic finance and banking system is not supported by a central banking system and unified legal system to support it; because of these constraints, Islamic banking can resemble conventional finance on the grounds of the shariah principle of necessity.
- As domestic legal systems do not recognise Islamic law as a system of law capable of governing contracts, IFIs have no choice other than to offer products that closely resemble conventional ones.
- Benchmarking the returns from *murabaha* financing against conventional interest enables Islamic banks to attract Islamic investors as well as non-Muslim investors who are only familiar with the conventional finance system.
- Benchmarking against conventional banking practices enables IFIs to enjoy similar economic advantages to conventional financial institutions and provide the same rate of return to their customers as do conventional financing instruments.

Using these risk-management techniques, IFIs avoid extra financial risk and receive the same legal treatment as conventional institutions in common law jurisdictions. This has made financial markets and other stakeholders feel comfortable with *murabaha* as a financing instrument. At the same time, the divergence of these practices from the theory of Islamic finance may make them vulnerable to noncompliance with shariah law.

As the Islamic financial market becomes increasingly global, financial participants from multiple jurisdictions are taking the opportunity to gather their resources and form alliances for joint participation in international business. Given that the cornerstone of Islamic finance is the application of shariah principles, these principles are being adapted into international commercial agreements and assimilated into non-Islamic legal

environments. Attempts are being made to implement Islamic finance transactions in jurisdictions that are not bound to Islamic principles, at least in terms of commercial agreements. As shariah is not a national system of law and there is no standard, codified Islamic law to be used as guidance and reference, parties cannot merely adopt Islamic law as the governing law without reference to the law of a particular jurisdiction. Because of this, national law systems are often used as the governing law to provide more certainty on the rights and obligations of the transacting parties.

## **8.6 Chapter 6: *Murabaha* Dispute Resolution by Litigation**

The main legal challenges for the Islamic finance industry in Australia are the lack of a comprehensive legal framework and the lack of recognition of shariah as a system of law capable of governing a contract in Australia.

This chapter examined *murabaha* dispute cases litigated in the courts to discern whether the requirement that the *murabaha* transactions comply with dual legal systems makes it attract extra legal or financial risks. Within this, it also examined how the courts in common law jurisdictions deal with *murabaha* disputes and shariah principles. This chapter drew on the Malaysian and UK experiences by examining *murabaha* financing disputes in both countries to understand how *murabaha* disputes have been resolved in common law jurisdictions. In both countries, *murabaha* transactions have been challenged as noncompliant with shariah principles by both customers and financiers. This creates an ethical dilemma for IFIs: when they endeavour to comply with shariah principles, they may violate domestic laws; when they attempt to satisfy domestic law requirements they may violate shariah principles. This can result in *murabaha* transactions risking noncompliance with either domestic common law or shariah law and, thus, losing legitimacy in the eyes of target groups.

The key findings regarding *murabaha* litigation in both countries are summarised below.

### **8.6.1 Murabaha Dispute Litigation in British Courts**

In the UK the requirement for *murabaha* contracts to comply with both shariah principles and British common law raises several legal issues for this type of transaction. Notable legal quandaries arise from the conflict between shariah and common law regarding interest, possession of the subject of finance, assumption of the financial risk associated with the ownership of the subject of finance and avoidance of *gharar*.

The key findings regarding *murabaha* litigation in the UK are summarised as follows:

- Shariah law is not applied in the UK, and English law does not recognise shariah as a system of law capable of governing a contract. This is because English law does not provide for the choice or application of a system of law other than a system of national law (according to the *Rome Convention 1980*, which requires that the governing law of an agreement be the law of a country).

- The courts dismissed the applicability of shariah principles in financial agreements in the UK, arguing on the basis of the principle of the conflict of laws that financial contracts cannot be governed by two competing legal systems within the English jurisdiction. The English courts distinguished between shariah and the contractual governing law of an Islamic finance agreement by ruling that shariah issues are not justiciable in the English courts.
- The courts interpreted *murabaha* transactions according to common law principles and ruled that *murabaha* contracts were credit contracts in the same way as conventional credit contracts.
- The courts extended the same legal protections to *murabaha* transactions as apply to conventional credit contracts, preventing *murabaha* transactions from attracting any extra legal or financial risks.
- If the courts had accepted the incorporation of shariah law into secular common legal systems, it would have been difficult to interpret shariah law according to modern legal provisions because of the lack of a unified standard for the Islamic finance system.
- Even if the courts recognised shariah law as the governing law for *murabaha* contracts, they might have decided that contemporary *murabaha* transactions as practiced by the IFIs are noncompliant with shariah law due to their divergence from the theory of Islamic finance and the traditional structure of *murabaha* contracts.

### 8.6.2 *Murabaha* Dispute Litigation in Malaysia Courts

This chapter discussed *murabaha* financing in the Malaysian common law jurisdiction in three distinct stages.

The key findings are summarised below:

- In the first stage, Islamic financial transactions in Malaysia faced problems with procedural and technical issues related to the actual claim amount in unstated rebates. In some cases, financiers had not repaid or given discounts to customers who settled loans before their due date.
- In the second stage, *murabaha* disputes mainly involved the validity and enforceability of contracts, which made it difficult to determine whether *murabaha* contracts were genuine sale contracts or loans on interest. To solve this problem, the courts went beyond the interpretational approach of classical common law by seeking advice from the SAC to determine whether *murabaha* financing contracts were shariah-compliant or not. However, as the advice of the SAC was not mandatory at this stage, the courts sometimes considered its opinions and sometimes ignored them. This caused conflicting rulings on identical matters, which created uncertainty regarding financial transactions and undermined the confidence of the Islamic finance industry in the litigation system.
- In the third stage, the Malaysian government introduced the *CBA* in 2009 to address uncertainty regarding the governing law of *murabaha* contracts. The *CBA* made it mandatory for courts to both refer issues that relate to Islamic finance to the SAC for advice and to consult the published

ruling of the SAC in Islamic finance cases. Without this approach, IFIs might have faced the risk of noncompliance with shariah law that would defeat the very purpose of Islamic finance.

The Malaysian court cases, as with the UK cases, showed that *murabaha* contracts were interpreted in a similar fashion to conventional credit contracts; as a result, they are entitled to receive the same legal protection as conventional financial transactions. The analysis of UK cases in particular showed that, although IFIs drafted *murabaha* contracts in such a way that the governing law would be used subject to shariah principles, IFIs tended to choose English law as the governing law for Islamic cross-border finance transactions.

For these reasons, *murabaha* transactions can be still vulnerable to noncompliance with shariah law, in cases where one party argues for the noncompliance of the transaction despite its compliance with the common law and the legal protections it receives. Therefore, parties to *murabaha* contracts could elect to have *murabaha* disputes determined and resolved in accordance with shariah principles by submitting to arbitration according to the rules that oblige arbitral tribunals to decide disputes with reference to either a national law chosen by the parties or any other agreed considerations, such as shariah principles.

## **8.7 Chapter 7: *Murabaha* Dispute Resolution by Arbitration**

Although the attempt to draft *murabaha* contracts in such a way that the governing law will be used subject to shariah principles within the law of a chosen jurisdiction has been unsuccessful, *murabaha* disputes have faced challenges in the process of litigation. Thus, as the implementation of Islamic finance transactions in jurisdictions that are not bound by Islamic principles encounters legal impediments in terms of litigation, arbitration appears to be the most appropriate *murabaha* dispute resolution. For this reason, Chapter 7 discussed arbitration as an ADRS for *murabaha* disputes. It examined whether, in arbitration, *murabaha* transaction are legally compliant while also remaining shariah-compliant.

Chapter 7 examined *murabaha* dispute resolution within the context of the IAA and using the framework of an Islamic arbitration system. The AAOIFI's *Shariah Standard No 32 on Arbitration* was taken as a reference and the *KLRC i-Arbitration Rules* as complementary. By analysing *murabaha* disputes within the arbitration systems, the study compared these frameworks with the *UNICITRAL Model Law* and the *New York Convention*, to which the IAA gives the effect of law.

The following advantages were found to arbitration over litigation for *murabaha* disputes:

- The Australian arbitration dispute system enables shariah law principles pertaining to *murabaha* contracts and the international commercial arbitration system to be harmonised in resolving *murabaha* disputes.

- Arbitration can provide an effective and coherent dispute resolution system for *murabaha* finance disputes by allowing parties to settle disputes in accordance with both the norms of common law and Islamic law principles pertinent to *murabaha* transactions.
- There is no significant difference between shariah law and commercial arbitration law in terms of *murabaha* transactions except on the issues of interest and assuming the risk of financed goods. These issues can be resolved within the ADRS as far as the tribunal rules the dispute according to what the parties have agreed upon; however, if the parties disagree on the shariah compliance of these issues, the tribunal should seek advice from an IFAC, which should be established for this purpose.
- Arbitration is flexible, fast, cost-effective and confidential and its awards are easier to enforce than court judgements.

For these reasons, arbitration is the most appropriate method for resolving disputes regarding *murabaha* transactions because of its ability to accommodate shariah law principles pertaining to these contracts. It enables the reconciliation of shariah principles with domestic and international commercial laws. It also closes the gap between shariah principles and the law of arbitration on *murabaha* commercial agreements and creates stability and certainty in international commercial relationships.

## 8.8 Recommendations

This thesis explored the feasibility of using *murabaha* sale contracts for financing in the Australian legal context, while also remaining shariah-compliant. It found that although Islamic law and Australian common law agree on most elements of *murabaha* contracts, they conflict on some issues (i.e., interest, possession of financed assets and assuming the financial risk of financed assets), which have made it difficult to reconcile Islamic law with common law. This has become challenging as the Australian government does not recognise shariah as a system of law capable of governing a contract and seems unwilling to incorporate shariah principles pertaining to Islamic finance into the Australian legal and regulatory system—this was most visible in the Australian government’s inaction regarding the 2010 report on Islamic finance. Since there is no legal and regulatory framework for Islamic finance in Australia and, as a result, the risk of noncompliance with shariah principles still exists, this study provides recommendations regarding both the litigation and arbitration systems.

### 8.8.1 Litigation

As the success of Islamic finance depends on its incorporation into the conventional legal and regulatory systems and because the parties to *murabaha* agreements may prefer litigation over arbitration, this thesis puts forward two proposals: one related to IFIs and one related to the Australian regulatory authorities.

#### a) Islamic Financial Institutions in the Australian Context

As the Australian law does not recognise shariah as a system of law capable of governing a contract and because shariah is not a national law or a standard, codified body of Islamic law, IFIs must propose a unified standard for Islamic financial products. IFIs in Australia should establish a shariah supervisory council drawing on lessons from the Malaysian experience. This council should form a group including shariah scholars, financial experts and legal experts to prepare draft standards to guide and act as a reference for Islamic financial transactions. These standards should reconcile and work in parallel with conventional laws until such a point as they violate shariah principles. Such a set of standards should include the following:

- The Islamic finance industry should adopt the standard guidelines set by the AAOIFI, with shariah-compliant changes if necessary. With shariah standards that harmonise with Australian law, Australian IFIs would be able to offer shariah-compliant financial products and services to the Muslim community. This would enable the Australian Muslim community to achieve financial inclusion and also attract non-Muslims who are looking for ethical finance and investment.
- IFIs should structure *murabaha* contracts in such a way that they comply with both shariah law and Australian law without necessarily making changes to the existing Australian laws.
- IFIs should benchmark the *murabaha* profit margin against conventional interest or any other commercial interest rates (e.g., LIBOR); however, as the price of the *murabaha* price cannot be increased once it is fixed, this rate should be fixed for the duration of the loan.
- IFIs should obtain signed promises from customers before providing them finance with *murabaha* contracts.
- Financial institutions should be able to charge penalties for defaulters who delay payment without acceptable reasons; however, to ensure the rate of the penalty is not the same as the interest that conventional banks charge to their customers, IFIs should benchmark the penalty rate to the rate that IAHs have earned or could have earned during the defaulting period. Before charging penalties to defaulters, financiers should give defaulting clients a reasonable grace period—starting from the maturity of the debt—to pay the defaulted amount. At the lapse of the grace period, the financier would commence charging the penalty.
- IFIs should pay discounts or rebate for earlier settlement of loans to encourage customers to make payments earlier. Additionally, financiers should waive the unearned portion of the profit margin from the financing as do conventional banks when customers make early settlement of their loans.



## **b) Incorporation of *Murabaha* into the Australian Legal System**

Islamic law and Australian common law agree on most elements of *murabaha* contracts. Consequently, *murabaha* transactions receive the same legal protections as conventional financial products. Despite this, *murabaha* financing can be vulnerable to noncompliance with shariah principles because Australian law does not recognise shariah as a system of law capable of governing contracts. This jeopardises the legitimacy of *murabaha* as an alternative, shariah-compliant financing system to interest-based financial products. On this basis, the Australian government should make suitable amendments to law regarding *murabaha* contracts, incorporating them into the Australian legal system and providing *murabaha* transactions a level playing field alongside conventional financial products. Specifically, the government should amend the following law elements:

- The Australian government, like the Malaysian government, should seek advice from a shariah supervisory council established either by itself or by Australian IFIs. This supervisory body should include shariah, finance and legal experts and should provide advice to the Australian regulatory bodies and courts on matters related to Islamic finance.
- On the basis of s17 of the *Goods Act* (and the *Credit Act*), the exemption for *murabaha* transactions on double stamp duty should analogically extend to the issues of interest by treating the *murabaha* mark-up as a return to satisfy shariah requirements. The government should allow the Australian Tax Office to treat the *murabaha* mark-up as interest, while also allowing IFIs to treat their *murabaha* mark-up as a return in their books.
- s60 of the *Credit Act*, which allows charging interest to the defaulting party, should be amended to state that IFIs can apply penalties to defaulters on payment of the loan. This amendment should allow IFIs to impose penalties, instead of interest, based on the expected rate of return that banks had given or should have given to IAHs during the defaulting period. IFIs should record the penalty in their books, although the Australian Tax Office could treat it as interest. The reason for benchmarking the penalty with the expected return for IAHs is to avoid any resemblance to the commercial interest rates that conventional banks impose on their clients.

### **8.8.2 Arbitration**

The lack of recognition in Australian law for shariah as a system of law capable of governing a contract makes *murabaha* transactions vulnerable to noncompliance with shariah law under the court litigation dispute resolution system. This makes arbitration, as an ADRS, the most appropriate dispute resolution forum for *murabaha* disputes. It makes *murabaha* transactions legally compliant and commercially desirable while also ensuring shariah compliance within the Australian common law jurisdiction. The following recommendations are proposed to improve the practice of *murabaha* contracts in Islamic finance:

- The Islamic finance industry should take advantage of the option given by the *Model Law* to the parties of commercial contracts to choose the law applicable to their agreement, regardless of whether the chosen law is incorporated into the domestic national legal system or not. This will allow the arbitral tribunal to determine *murabaha* agreements according to the law or other considerations (such the shariah principles) chosen by the parties to a contract.
- IFIs in Australia should establish an IFAC comprised of Islamic finance experts, legal experts and finance experts to set up standard guidelines within the framework of the Islamic arbitration system. This would solve the problems caused by different scholars giving different interpretations of shariah law—a process that affects the contractual structures of Islamic finance products in general, and particularly *murabaha* contracts.
- The standards proposed by the IFAC should take the AAOIFI's *Shariah Standard No. 32 on Arbitration* as a reference and the *KLRC i-Arbitration Rules* as complementary, with some changes if necessary to suit the Australia legal system.
- The standards set by IFAC should explain the shariah-compliant terminology used in Islamic finance in general and, in particular, the *murabaha* contract in such a way that enables arbitral tribunals to understand the requirements for shariah compliance in *murabaha* transactions.

Arbitration not only closes the gap between shariah principles and common law in *murabaha* contracts but also creates stability and certainty for commercial relationships between financial institutions and their customers. This will enable Australian financial institutions to offer shariah-compliant financial products and services to the Muslim community, thus achieving financial inclusion. It will also enable *murabaha* contracts to effectively operate under Australian law and be commercially viable while remaining shariah-compliant. Further, arbitration is cost-effective, confidential and its awards are generally easier to enforce than court judgements. On this basis, this thesis recommends that Australian conventional banks—alongside the fully-fledged IFIs—adopt this approach to cater to religiously conscious Muslim community in Australia, to maximise lending and investment opportunities in Australia, to promote interaction between the Islamic and conventional financial sectors and to increase investment and development within the Australian financial market.

Finally, although Murabaha as a sale contract seems to be more Shariah compliant, Murabaha as credit contract is more applicable in the Australian context. Therefore, financial institutions should use Murabaha credit contract, to the extent that it does not violate the Shariah principles, if they wish it to be a competitive business proposition.

## **8.9 Suggestions for Further Research**

The amount of research on Islamic banking and financial systems has increased considerably over the past two decades. This study's purpose was to examine IFIs expanding operating in Australia that extend finance under Murabaha contract. However, due to the lack of certain fundamental elements in the Australian Islamic banking system, such as a comprehensive legal and shariah framework, this study focuses on examining how lessons from the British and Malaysian experiences of Islamic banking and finance that can be transferred to Australia. Further, in terms of Islamic financial regulatory bodies, it focuses solely on the AAOIFI. As there is more Murabaha activity in Australia, perhaps sufficient cases will arise to enable further research on its legal and economic dimensions.

Beyond the practice of Islamic finance in Australia, which is the topic of this thesis, there are still significant issues that need to be critically examined. As this study was limited to theoretical and legal analysis, other studies might examine whether or not murabaha transactions within common law jurisdictions create extra legal and financial risk by empirically testing murabaha transactions and disputes in the Australian context.

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