

# Issues of Implementing Islamic Hire Purchase in Dual Banking Systems: Malaysia's Experience

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## Executive Summary

*Malaysia, being one of the first countries to promote Islamic finance, has experienced a dual banking system whereby a full-fledged Islamic banking system operates on a parallel basis with a sophisticated conventional banking system. Operating within a dual banking system provides a relative advantage to Islamic banks as compared to operating in a single Islamic banking system. One of the latest innovations is the development of the Islamic hire-purchase instrument, which is commonly known as al-ijarah wa-iqtina'; in the Malaysian experience, it is called al-ijarah thumma al-bai' (AITAB). This article aims to examine some critical issues arising from the implementation of AITAB from jurist, legal, and practical perspectives. It presents a comparative study with conventional practices to highlight similarities and differences, thus invoking a number of jurist, legal, and practical issues about the concept and implementation of AITAB. It is hoped through the assessment of the Malaysian experience to offer practicable solutions to help provide better and more legitimate structured implementation of Islamic hire purchase in financial institutions. © 2007 Wiley Periodicals, Inc.*

## INTRODUCTION

For more than two decades, Islamic banking in most locales has survived the challenge of operating side by side with its conventional counterpart, which is particularly the case with the “dual banking” systems in Malaysia, Egypt, and

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Saudi Arabia. The dual banking system of Malaysia is uniquely characterized among other countries as a tightly governed legal system, where separate regulatory systems for Islamic banks<sup>1</sup> and other banks are operating side by side. In Malaysia, Islamic banking was formally set up in 1983 by virtue of the Islamic Banking Act 1983. Subsequently, the Interest-Free Banking Scheme was introduced in 1993 to accommodate a full-fledged Islamic banking system on a parallel basis with a conventional banking system. Dual banking systems are juristically criticized for not totally eliminating interest-rate financing, which is prohibited in Islamic jurisprudence, but duality has its own viable merits over the full-fledged single Islamic banking systems. Stiff competition between Islamic products and long-standing conventional instruments in the dual financial market has effectively resulted in Islamic banking products that are more sophisticated and have a more diversified range than those offered in single Islamic systems. The challenge of surviving in such competitive markets requires innovative efforts in designing Islamic financial products to satisfy conventional needs of sophisticated customers, which, however, have to be clearly guided by *Shariah* principles to ensure Islamic legitimacy.

One such innovation is the Islamic hire-purchase mode of financing, commonly known as *ijarah wa-igtina*<sup>2</sup>. Islamic hire purchase is a unique contract involving a combination of leasing (*ijarah*) and sale at different stages of the transaction, thus invoking a number of jurist, legal, and practical issues. The main reason why the *ijarah* contract has become one of the most popular financing modes is the fact that few people can afford to buy a house or land on a cash basis. Different countries use different terminologies in referring to the concept of *ijarah wa-igtina*<sup>2</sup>. Nevertheless, the mechanisms used, in general, do not differ significantly. *Ijarah*, the Arabic word for leasing, is growing in importance in the world of Islamic banking and finance, though its full potential for financing long-term business assets is yet to be explored (Vogel and Hayes 1998). Wilson (2000) highlights the practice of *ijarah* by the Kuwait Finance House in car financing and the practice of the Jordan Islamic Bank (JIB) in financing the purchase of equipment by professionals such as dentists. However, JIB does not involve itself in consumer credit for household purchases. In small business finance, leasing/*ijarah* proves to be the second most popular method of financing for many Islamic banks, but this has also become more significant for conventional banks. Conventional banks provide leasing through specialized subsidiaries but for Islamic banks, leasing is a mainstream activity and part of their core business. It is also stated that there is a little risk involved, as the

goods or equipment being leased serve as collateral for the financing. To exemplify, Al Barakah Investment Company uses *ijarah wa-iqtina'* to finance the purchase of large capital items such as property, industrial plants, and heavy machinery. It involves direct leasing, where investors in the scheme receive regular monthly payments, which represents an agreed-upon rental. At expiry of leasing, the lessee purchases the equipment (Ahmed, 1993). In the Islamic Development Bank (IDB), lease finance has become one of two major sources of medium-term financing. It provides financing for development projects, which are sufficiently remunerative to meet market criteria. At present, it is available for middle- and high-income member countries (Khan & Wilson, 1995). The Dar Al-Mal Al-Islami (DMI) Group also offers Islamic hire purchase to its clients. In the event of transferring ownership, the client may elect to purchase the goods on any due date at the optional purchase price attributable to that due date by giving notice to the institution at least three days prior to such date. In this event, the client naturally pays all taxes or similar government charges incident to the transfer of title to him (Ali, 2000).

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Malaysia is one of the countries that takes special care to distinguish the Islamic concept of *ijarah wa-iqtina'* from its conventional counterpart. This article seeks to discuss basic issues in the concept and implementation of Islamic hire purchase in the Malaysian context from jurist, legal, and practical perspectives. It is hoped that this paper will highlight pertinent issues in Islamic hire-purchase practices to contribute toward better implementation of Islamic hire purchase in dual banking systems.

## THE OPERATION OF ISLAMIC HIRE PURCHASE IN MALAYSIA

Hiring and leasing are used interchangeably in the literature (Bakar, 2000). Hiring or leasing in Arabic terminology denotes *ijarah*, which involves transferring the use of the object (its usufruct) to the lessee, not the ownership of the object itself, which must remain with the lessor. Hence, *ijarah* is a sale of usufruct not of a physical entity. In the present day, *ijarah* has been developed into a more innovative financing facility, widely known as *ijarah wa-iqtina'*. In Malaysia, *ijarah wa-iqtina'* is commonly known as *al-ijarah thumma al-bai'*, which is abbreviated in the commercial practice as AITAB. It combines a lease contract and sale contract in one trading document, but the contract of leasing and sale work separately: first, the contract of

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leasing will operate, whereby the lessee will pay monthly rental to the lessor within a fixed period. Upon expiry of the leasing or rental period, the hirer has the option to enter into a second contract to purchase the goods from the owner at an agreed-upon price. In this event, the purchase price will be determined according to the value of the goods, market condition, and necessary profit to the bank. The purchase price cannot be predetermined at the beginning of the hire purchase agreement, because a predetermined contract is clearly prohibited by *Shariah*. Hence, AITAB involves three main parties: customer, financing company, and vendor. Using, for the sake of illustration, the common example of motor vehicle financing, AITAB operates as follows:

- (a) Finance company buys the vehicle from vendor or car dealer, to the order of customer.
- (b) Finance company rents the vehicle to the customer at a rate agreed upon for a specified period of time.
- (c) The customer (hirer) agrees to pay for road tax and insurance coverage. He also will be responsible for its maintenance.
- (d) At the end of the period, the finance company and the customer will sign the sale and purchase agreement.

A rebate, or *ibra'*, can be given for early settlement, according to a standard formula provided by the Hire-Purchase Act 1967. However, the rebate is not given in cash. It merely reduces the balance outstanding. Currently, AITAB is limited to the financing of certain items such as motor vehicles, due to their popularity in the present customers' demand.

In the general practice of AITAB, the financial institution will rent a movable or immovable property to its client, who will pay an agreed-upon sum by installments over an agreed-upon period into a savings account held with the same financial institution (Salleh, 1986). These installments are invested in *mudarabah* ventures for the client's account. Capital and profit will allow the client to offset the rental cost and to purchase the rented property. If he decides not to acquire the property, the remaining profit (after rental cost and expenses are deducted) is given to the client, and the property is taken back by the financial institution. The option to acquire the property signifies that there is no condition or obligation imposed on the lessee to purchase the property, avoiding a preconditioned contract, which is forbidden by *Shariah*. The lessee has a complete option either to purchase the property at the end of the lease period or return it to the bank.

It is worth noting that AITAB differs from a similar but an alternative form referred to as “lease ending with ownership”. In the latter case, the customer will pay part of the price of the product in addition to rent, and to that extent the ownership of the customer will gradually increase in the product and his rent will gradually decrease. At the end of the contract, upon satisfying the purchase price and rental payment, the title of the goods will be transferred to the hirer as *hibah*. The hirer will then become an absolute owner. This form of contract is commonly applied as a mode of financing.

Islamic hire purchase has been used to finance many activities in Malaysia, including trade, commerce, industry, agriculture and fisheries, housing, and personal advances. In fact, *ijarah* emerges as a popular technique of financing among some Islamic banks, such as the Islamic Development Bank, Bank Islam Malaysia Berhad, Tabung Haji, and commercial banks in Pakistan (Ahmad, 1995).

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## **A COMPARISON WITH CONVENTIONAL HIRE PURCHASE IN THE MALAYSIAN CONTEXT**

Hire purchase aims to protect the interest of the hirer, in particular, and other parties involved such as owner and guarantor, in general. Interestingly, we will find that most principles in hire purchase are in fact in line with *Shariah*, except in certain aspects, which are then highlighted. Due to this close similarity, many financiers appear to refer to both transactions as one and use the terminology interchangeably. This equating of the two poses a problem in a dual banking system in which Islamic hire purchase operates side by side with its conventional counterpart, sometimes under the same roof. In fact, Islamic hire purchase should be clearly distinguished from the conventional one because both rest on different principles, though in practice they may seem to be quite similar. There are some important differences between the two from a *Shariah* point of view. This section will present comparative features between Islamic hire purchase and conventional hire purchase from a *Shariah*, as well as from a practical, perspective.

### **Comparative Features from *Shariah* Perspective**

First, there are certain technical terms relating to the transactions that must be put in the right context. To illustrate, a hire-purchase transaction is commonly perceived as an ordinary type of loan. Islamic hire purchase, on the other hand, is regarded as a financing instrument. The

**Table 1. Differences Between Conventional Hire Purchase and Islamic Hire Purchase from Shariah Perspectives**

Item	Conventional Hire Purchase	Islamic Hire Purchase
Terms	<ul style="list-style-type: none"> <li>• Loan</li> <li>• Interest rate</li> <li>• Hiring charges</li> <li>• Late payment interest</li> </ul>	<ul style="list-style-type: none"> <li>• Financing</li> <li>• Profit rate</li> <li>• Markup</li> <li>• Late payment charges</li> </ul>
Eligible Customer	Good credit rating	Not involved in immoral activities against Shariah
Goods	Limited to consumer goods, motor vehicles & non-Act goods (corporate)	Applicable to all types of goods
Contract	one standard contract	2 Aqad in sequential contracts
Purchase Price /Installments	$\frac{\text{cost price} \times \text{interest rate}}{\text{months}}$	$\frac{\text{cost price} + \text{profit}}{\text{no. of payments}}$
Profit Margin /Interest Rate	Floating based on the annual rate, decided up front	Determined based on market value
Responsibility	Hirer/customer bears all costs of maintenance	Owner bears basic and structural maintenance

former results in a relationship of debtor and creditor between the bank and customer, whereas in the latter transaction there is a sale and purchase executed between the bank as seller and the customer as the buyer. One of the most important elements in any Islamic transaction is that its origin and purpose must be legal. Hence, a customer whose income derives from any forbidden source or who intends to use hire purchase for illegal activities—for instance, alcohol, gambling, or prostitution—cannot take out an Islamic hire-purchase facility. In Malaysia, the customer will be offered conventional hire purchase instead of an Islamic facility. Other differences are illustrated in Table 1.

An Islamic hire-purchase facility is applicable to all types of goods, movable or immovable, including real property. By contrast, the application of conventional hire purchase is limited to consumer goods, motor vehicles, and machineries (non-Act goods).<sup>2</sup> Hence, buying a house or other immovable property cannot be done using a conventional hire-purchase facility.

There is a basic difference in documentation. Under conventional hire purchase, a customer needs to sign a standard agreement as specified by the Hire-Purchase Act 1967, but under Islamic hire purchase he will need to sign two agreements: a hiring agreement (*'aqad ijarah*) and a sale and purchase agreement (*'aqad bai'*).

The purchase price of goods in conventional hire purchase is determined by adjusting for timing its cost price with the prevailing interest rate. The interest rate is floating based on the annual rate. In contrast, the purchase price in Islamic hire purchase is calculated by adding to the cost price an agreed-upon amount of profit based on the *murabahah* principle. The profit is determined based on market value at the time of agreement. Installments or periodic payments are computed by dividing the purchase price by period of agreement, which is usually in months (12 months, or more).

*The purchase price of goods in conventional hire purchase is determined by adjusting for timing its cost price with the prevailing interest rate.*

Regarding responsibility, during the course of the Islamic hire-purchase transaction, the owner will bear basic and structural maintenance of the goods, while the hirer is made responsible for operational and routine maintenance since he constantly uses the goods. However, in conventional hire purchase, all costs and responsibility of maintenance shall be borne by the hirer alone.

### **Comparative Features from a Practical Perspective**

In practice, the difference between the two facilities can be seen in certain aspects, while in most parts they are unavoidably similar. For instance, both are governed by the same law, the Hire-Purchase Act 1967. The subject matter of both transactions includes all goods as specified in the First Schedule of the Act, comprising consumer goods and motor vehicles. Both apply to the same customer groups consisting of individual, sole proprietor, partnership, and corporate companies.

Other similarities include term charges, period of financing, and early settlement. Term charges are calculated based on a formula set in the Hire-Purchase Act and according to the prevailing market rate. The minimum period of financing is 12 months, while the maximum is up to 84 months. In determining early settlement, the Hire-Purchase Act 1967 has specified the manner of exercising this right. However, the granting of rebate is the bank's right. Thus, it is up to the bank to exercise its discretionary power in this matter.

Despite their close similarity, in some aspects they are different. Conventional hire purchase is a hiring of goods with an option to purchase at the end of the agreement. Islamic hire purchase involves two transactions undertaken in sequence: *ijarah* (leasing) in the first phase and *bai'* (sale and purchase) in the second phase. The principles of each transaction must be observed in its respective stage. However, in practice, these principles, particularly *ijarah* principles, have received little consideration by the bankers,

mostly because they are unwilling to hold responsibility as the owner of the goods.

The source of funds in an Islamic hire-purchase facility is derived from permissible (*halal*) funds only. This stipulation means that the funds should not come from *Shariah*-prohibited activities such as gambling, prostitution, operating bars or clubs that sell liquor, and so on, which has been observed by all financial institutions and monitored by the Central Bank. In contrast, there is no limitation of its sources of funds in conventional hire-purchase facility.

One of the significant differences between the Islamic and conventional facilities is regarding the imposition of a late penalty fee.

In respect of the agreement, conventional hire purchase has a standard hire-purchase agreement based on the Hire-Purchase Act 1967, which incorporates details of the transaction, conditions and warranties, parties' rights and obligations, offenses, and penalty. On the other hand, an Islamic hire-purchase agreement must consist of two separate contracts: a contract of hiring or leasing and a contract of sale at a different phase of the transaction. Terms and conditions in both contracts will be based on principles of *ijarah* and sale. Local practices and some mutual arrangements made by the parties should be clearly specified in the agreement. In the current practice, the Islamic hire-purchase agreement is still based on the Hire-Purchase Act 1967, with an additional agreement to affect the sale at the end of the transaction. All agreements are signed by the customer up front. After the customer has settled the payment, the bank will sign the agreements and tender a release letter to the customer.

One of the significant differences between the Islamic and conventional facilities is regarding the imposition of a late penalty fee. Defaulters under conventional hire purchase will be charged 8.0% per annum; while in an Islamic hire-purchase scheme, the penalty for late charges is only 1%. Some banks do not even impose this penalty, not only because the amount is very low, but as an attraction to their potential customers. Finally, an Islamic facility requires its user to use Islamic *takaful* as an insurance coverage, while the conventional user will necessarily subscribe to a comprehensive conventional insurance policy.

In addition to the above discussion, some other supplementary points are summarized in Table 2. It is worth noting that the differences between Islamic hire purchase and conventional hire purchase are not limited to the above discussion. Some conflicting aspects between the two will be covered when discussing certain issues arising from the current practice of Islamic hire purchase in the next section.

**Table 2. Comparison Between Islamic Hire Purchase (AITAB) with Conventional Hire Purchase**

	AITAB (ISLAMIC HIRE PURCHASE)	CONVENTIONAL HIRE PURCHASE
Definition/ Concept	<ul style="list-style-type: none"> <li>▪ 2 <i>aqad</i> in sequence; <i>jarah</i> and sale</li> <li>▪ same except 2 <i>aqad</i></li> <li>▪ sale and purchase</li> <li>▪ <i>riba</i>-free</li> <li>▪ based on hire-purchase concept</li> <li>▪ a type of debt financing</li> </ul>	<ul style="list-style-type: none"> <li>▪ similar to AITAB</li> <li>▪ hire then option to purchase</li> <li>▪ 1 contract; 2 <i>aqad</i> in one</li> <li>▪ <i>riba</i></li> </ul>
Eligible Customer	<ul style="list-style-type: none"> <li>▪ those who do not involve themselves in immoral activities that are against <i>Shariah</i> (e.g., gambling, drugs, and prostitution)</li> <li>▪ individual and corporate</li> </ul>	<ul style="list-style-type: none"> <li>▪ no such limitation as AITAB</li> <li>▪ individual and non-individual</li> </ul>
Type of Goods	<ul style="list-style-type: none"> <li>▪ similar to conventional hire purchase</li> <li>▪ open to all</li> <li>▪ non-Act goods; industrial goods</li> </ul>	<ul style="list-style-type: none"> <li>▪ refer to First Schedule of HPA</li> <li>▪ corporate customer</li> </ul>
Price	<ul style="list-style-type: none"> <li>▪ determined and fixed at the beginning</li> <li>▪ determined at the end of <i>jarah</i> contract based on market value (e.g., price of gold cannot be fixed for sale in 10 yrs time)</li> <li>▪ purchase price is used as a symbol of sale and purchase taking place</li> </ul>	<ul style="list-style-type: none"> <li>▪ floating based on the annual rate</li> <li>▪ decided up front</li> </ul>
Profit Margin/ Term Charges	<ul style="list-style-type: none"> <li>▪ similar to conventional</li> <li>▪ flat rate</li> <li>▪ lower margin for non-Act goods</li> </ul>	<ul style="list-style-type: none"> <li>▪ maximum 10%</li> <li>▪ <math>\text{cost} \times \text{interest rate} / \text{year}</math></li> </ul>
	<ul style="list-style-type: none"> <li>▪ 3–4%</li> <li>▪ rental = based on profit</li> <li>▪ <math>\text{cost price} + \text{profit} / \text{no. of installments}</math></li> </ul>	<ul style="list-style-type: none"> <li>▪ same</li> <li>▪ based on interest</li> <li>▪ interest = profit</li> </ul>
Period of Financing	<ul style="list-style-type: none"> <li>▪ same with conventional hire purchase</li> <li>▪ maximum: 9 years; minimum: 1 year</li> </ul>	<ul style="list-style-type: none"> <li>▪ maximum: 84 months; minimum: 12 months</li> </ul>
Calculation of Installment	<ul style="list-style-type: none"> <li>▪ R.78</li> <li>▪ similar to conventional hire purchase</li> </ul>	<ul style="list-style-type: none"> <li>▪ R.78</li> <li>▪ fixed rate</li> </ul>
Transfer of Ownership	<ul style="list-style-type: none"> <li>▪ similar to conventional hire purchase</li> <li>▪ bank gives release letter after full settlement</li> <li>▪ <i>jarah</i> ends and asset is delivered to customer (<i>qabd</i>)</li> <li>▪ upon sale and purchase</li> </ul>	<ul style="list-style-type: none"> <li>▪ after payment of the last installment or upon early settlement</li> <li>▪ gradual retirement</li> </ul>
Maintenance Responsibility	<ul style="list-style-type: none"> <li>▪ hirer</li> <li>▪ customer: legal owner</li> <li>▪ customer: utilization, bank: ownership risk</li> </ul>	<ul style="list-style-type: none"> <li>▪ maintenance responsibility not put on owner because it is not pure lease</li> <li>▪ hirer</li> </ul>
Documentation	<ul style="list-style-type: none"> <li>▪ follows standard hire purchase but add <i>Aqad</i> letter.</li> <li>▪ 2<sup>nd</sup> Schedule, AITAB Agreement, AITAB Guarantee Agreement, AITAB Purchase Agreement, <i>Aqad</i> Letter (if applicable), Release letter</li> <li>▪ <i>Jarah</i> and sale cannot be mixed but operates in sequence. <i>Aqad</i> must correspond to actual operation</li> </ul>	<ul style="list-style-type: none"> <li>▪ Hire-Purchase Act 1967</li> <li>▪ Second Schedule, HP Agreement, Guarantee Agreement, Release letter</li> <li>▪ same</li> </ul>
Governing Law	<ul style="list-style-type: none"> <li>▪ Hire-Purchase Act 1967</li> <li>▪ <i>Shariah</i> law</li> <li>▪ guidelines from Bank Negara Malaysia</li> <li>▪ Contract Act 1950</li> </ul>	<ul style="list-style-type: none"> <li>▪ Hire-Purchase Act 1967</li> </ul>
Taxation	<ul style="list-style-type: none"> <li>▪ treated as leasing expenses</li> <li>▪ nominal RM10</li> <li>▪ in certain circumstances, government exempted stamp duty for Islamic products</li> </ul>	<ul style="list-style-type: none"> <li>▪ RM10</li> </ul>
Early Settlement (Rebate/ <i>ibra'</i> )	<ul style="list-style-type: none"> <li>▪ statutory calculation</li> <li>▪ rule 78—sign <i>Aqad</i> letter after full settlement</li> <li>▪ similar to conventional hire purchase</li> <li>▪ bank's right-looking into current practice-based on 'urf</li> <li>▪ bank's discretion, cannot declare, if so obliged to give</li> </ul>	<ul style="list-style-type: none"> <li>▪ Rule 78</li> <li>▪ 3 months' notice</li> </ul>

Table 2. (Continued)

	AITAB (ISLAMIC HIRE PURCHASE)	CONVENTIONAL HIRE PURCHASE
Penalty for Late Payment	<ul style="list-style-type: none"> <li>▪ 1% of outstanding amounts</li> <li>▪ charged on principal (e.g., installment = \$300, next month, must pay \$600.30 (300 + 300 + 1%))</li> <li>▪ binding by BNM circular</li> <li>▪ other charges (depending on financial institution)</li> <li>▪ treatment of penalty after maturity</li> <li>▪ discretion of bank</li> <li>▪ cannot impose interest-based penalty</li> <li>▪ If charged, must be into a separate account, not used by bank</li> </ul>	<ul style="list-style-type: none"> <li>▪ 8% (Hire-Purchase Act 1967)</li> <li>▪ if two successive defaults, installments are calculated again and charged. Total amount will be different and exceed original amount in agreement</li> <li>▪ impose late charges</li> </ul>
Insurance Responsibility	<ul style="list-style-type: none"> <li>▪ comprehensive—not third party</li> <li>▪ first year—bank's responsibility</li> <li>▪ <i>Takaful</i></li> <li>▪ hirer</li> <li>▪ new car—bank part, secondhand—depends on the dealer</li> </ul>	<ul style="list-style-type: none"> <li>▪ first year—owner; subsequent years—hirer</li> </ul>
Repossession	<ol style="list-style-type: none"> <li>1. based on principle of <i>Rahn</i>: <ul style="list-style-type: none"> <li>▪ must give three notices, the third-stating ways of repossession.</li> <li>▪ auction through court only</li> <li>▪ first offer made to customer's friend and relative</li> <li>▪ auction price must be deducted by the</li> </ul> </li> </ol>	<ul style="list-style-type: none"> <li>▪ Section 16 Hire-Purchase Act 1967</li> </ul>
	<ol style="list-style-type: none"> <li>outstanding amount—balance is given to customer</li> <li>2. similar to conventional hire purchase</li> </ol>	
Other	<ul style="list-style-type: none"> <li>▪ the hirer need not fully settle the payment if he terminates the contract during <i>ijarah</i> period (but in practice, similar to conventional hire purchase)</li> <li>▪ can be used during economic crisis and inflation, but marked up higher because problem in net prevailing value.</li> <li>▪ contract sale and purchase</li> </ul>	<ul style="list-style-type: none"> <li>▪ payments must be settled in full regardless whether the hirer wants to purchase the asset or not</li> <li>▪ loan contract and charged interest</li> </ul>

## ISSUES IN THE OPERATION OF ISLAMIC HIRE PURCHASE

A competitive environment within the dual banking system creates a special advantage for the promotion of innovative products like the hire-purchase transaction. However, it demands close scrutiny from a *Shariah* perspective to ensure the legitimacy of hire purchase. Ownership, transfer of ownership, maintenance responsibility, insurance responsibility, deposit payment, penalty in case of default, and legal treatment are focal issues in this respect.

### Ownership

In Islamic hire-purchase, the bank is required to have ownership of the asset before renting it out to the customer. Ownership is vital, as it represents the extent of rights and liabilities of the parties involved in the hire-purchase agreement. The time or stage in which original ownership is transferred to the lessee should be carefully examined, as this would result in the owner's exemption from being held responsible for matters attaching to the asset. Thus, as a consequence of

holding ownership of the asset, leasing and leasing-based financing would require a bank to deviate from its basic nature as financial intermediary (Khan, 1995). To be an owner, the bank will have to become involved in purchasing the asset, which requires certain marketing expertise, maintaining the asset and bearing all costs associated therewith, and disposing of it when the asset is no longer needed. Any leasing contract that absolves the bank from all these activities will violate the Shariah principle of leasing and thus should be avoided. It also falls into the category of financial leasing, which is not permitted according to *Shariah* principles.

As a consequence of holding ownership, the bank will assume some rights, liabilities, and risks associated with the asset. These include the right to repossess the asset upon customer's default, maintenance responsibility, and liability to taxes (Weist, 2000). In other words, ownership results in more risks, liabilities, and responsibilities that most banks would attempt to avoid as much as possible.

In the Malaysian practice, the bank holds beneficial ownership of the asset (usually a motor vehicle), while the customer, having his name in the document of title, becomes the legal owner. The bank will usually have to register its ownership claim over the title of the asset and have it endorsed on the registration card<sup>3</sup> (Davies, 1995). This practice is slightly modified from conventional hire purchase, whereby the bank holds the document of title as security for the hire-purchase loan. Upon satisfying all due payments, the bank will remove its claim, resulting in the customer becoming the absolute owner. There are only two different aspects in both transactions. First, the parties' intention and understanding when executing Islamic hire purchase is to have the asset leased and then sold in which the bank will have a beneficial right over the asset throughout the transaction, until complete transfer of ownership takes effect. Second, the bank's beneficial ownership is released by executing a sale/transfer of ownership contract. This signifies a complete transfer of ownership to the customer.

However, unless these two points are made clear to the customer and bank officer in charge of the transaction, there will be virtually no difference between Islamic hire purchase and conventional hire purchase regarding the ownership issue. By holding a beneficial ownership and having an ownership claim over the asset, the bank has a right to repossess the asset if the customer violates the contract. The registration of the ownership claim is an industry practice, which is not provided in the Hire-Purchase Act 1967.

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### Transfer of Ownership

As stated above, Islamic hire purchase is a development of the *ijarah* principle. If the hirer decides to buy the leased asset, the manner of transferring ownership must be mutually ascertained and documented. An Islamic hire-purchase transaction involves two separate contracts: (1) a contract of *ijarah* from the beginning of the transaction and (2) a contract completing the transfer of ownership from the owner to hirer either by way of gift or sale (Al-Nashmi, 2003; Syariah Advisory Board, 2002). Affirming the two manners of executing the second contract, the *Shariah* Legal Opinions (*Fatawa Shar'iyah*) of the Kuwait Finance House explain that the ownership can be transferred to the hirer either by means of giving the asset as a gift (*hibah*) or selling it when the lease period has expired, provided that all payments are made in entirety (Delorenzo, 2000). In addition to the above, there are some scholars who argue that the second contract should grant a call option to the hirer to eventually acquire the asset after completing the *ijarah* contract (Bughuddah, 2001; Elahi, 2000; Salleh, 1986).

...there are some scholars who argue that the second contract should grant a call option to the hirer to eventually acquire the asset after completing the *ijarah* contract.

As to procedural matters, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) *Shariah* Rules for *Ijarah* and *Ijarah Muntahia Bittamleek* (2000) provides that the method of transferring the title of the leased asset must be evidenced in a document separate from the *ijarah* contract, using one of the following methods. The first is by means of a promise to sell for a token or other consideration, or by accelerating the payment of the remaining installments, or by paying the market value of the leased asset. The second is a promise to give it as a gift (for no consideration). The third is a promise to give it as a gift, contingent upon the payment of the remaining installments.

Similarly, the operation of Islamic hire purchase (AITAB) in Malaysia undertakes two separate contracts (Rosly et al., 2004). One is a leasing (*ijarah*) contract, which refers to an AITAB agreement. The content is similar to the conventional hire purchase, except with the insertion of an Islamic contractual (*Aqad*) letter.<sup>4</sup> The other is a contract to purchase, which is executed either upon early settlement or at maturity of the AITAB agreement.

For practical purposes, the contracts are signed up front by the parties,<sup>5</sup> except for the second contract, which the bank will only sign after the first one has elapsed. However, the signing of the second contract does not make the contract automatically effective. There is a stipulation in the contract stating the manner in which the transfer

of ownership must take place. For example, paying the last installment will be considered as exercising an option to purchase the asset. When the bank accepts it and gives a release letter against the ownership claim, the contract is deemed to be executed by way of conduct.<sup>6</sup>

When transfer of ownership is affected by sale, the asset is purchased at a nominal amount, which is mutually agreed upon by both parties. The price need not necessarily be based on the market condition and the real value of the property. In common practice, final payment or last installment is considered as purchase price. When a customer has paid this last installment, he is automatically exercising an option to purchase. In this situation, the valid intention of the parties at a practical level is a problem. The issue is whether they (bank and customer) are aware and understand that they are executing a sale contract when the customer completes his final payment. One of the solutions is to spell out the intention in the agreement—for instance, an intention to hire during the first period is included in the *ijarah* contract, and then an intention to buy is put in a separate contract of sale in the latter period. It is therefore important to stipulate in clear terms how transfer of ownership takes place, and such terms must be understood and agreed upon by both parties. In deciding the terms and conditions in the contract, consideration must be made in terms of *Shariah* compliancy, practicality, and convenience of the contracting parties.

*The issue of maintenance in the ijarah is important, as it signifies the extent of the owner's responsibilities toward the leased asset.*

## Maintenance

The issue of maintenance in the *ijarah* is important, as it signifies the extent of the owner's responsibilities toward the leased asset. In an *ijarah* contract, the owner leases his property to the lessee for a specified period against a determined consideration. The owner in this situation still holds the ownership of the leased asset, and is fully responsible toward it. On the other hand, the hirer is granted full possession of the asset, so that he can ultimately use it according to the purpose specified in the contract within the agreed-upon period of time. During the *ijarah* contract, both owner and hirer bear distinct responsibilities of maintaining the leased asset. The owner is responsible to ensure that the leased property is always fit to render intended benefit to the hirer, while the hirer, who is entrusted with safekeeping the asset, shall be accountable for its proper and continuous use on regular basis. Such responsibilities can be categorized into two types:

### 1. Basic or Structural Maintenance

The owner shall bear all costs of major breakdown and basic

...the owner must remain liable for basic maintenance, although this term is often difficult to differentiate with clarity from operational maintenance, which is the responsibility of the hirer.

liabilities attached to the leased asset. For example, in the case of renting a house, the owner is responsible for the repair of the gas boiler or heater because this is a basic feature of the house. He is also bound to pay the council tax levied annually by the government because he is a legal owner of the house. This is because maintenance is the owner's responsibility, and entitlement to the rental is a consideration to the maintenance responsibility (Ahmed, 1993).

## 2. *Routine or Operational Maintenance*

The hirer will bear all costs of routine maintenance of the leased property. This includes keeping the property in a good condition for a proper use—for example, in renting a car, he must keep it clean and tidy. In addition, he shall bear the cost of car petrol, engine oil, and other ordinary car maintenance in order to keep the car functioning well.

Hence, the owner must remain liable for basic maintenance, although this term is often difficult to differentiate with clarity from operational maintenance, which is the responsibility of the hirer (Belder, 2004). Thomas and Mortimore (2001) suggested that the hirer can be asked to carry out the maintenance based upon the following:

1. To carry out the operating maintenance that is required as a result of using the leased asset and is needed in order to ensure its continuous utilization, as exemplified above;
2. Periodic maintenance, which is required to enable the asset to continue providing the benefit; and
3. Maintenance that is specified qualitatively and quantitatively in the contract or according to common practice.

The *Mejelle*, or *Majallah el-Ahkam-I-Adliya* (1880), affirms the above liabilities, which are owed by the lessor (owner) and lessee (hirer), respectively. Regarding the lessor's duty, Article 529 states, "It is the duty of the lessor to put right things that detract from the intended benefit." It explains that the repair of things detrimental to habitation, and other works connected with the building, must all be done by the owner. If the owner refuses to do these things, the lessee can leave that house. Article 532 provides the lessee's duty to keep the property in a good condition: "The removal and cleaning of dust, earth, and rubbish that has collected in the time of the lease falls on the lessee." If any repair is done by the lessee, he must inform the lessor about the damage before he starts the work. There are two situations in this respect:

- (a) If the lessee repairs something forming a substantial part of the property in which without the repair such defect will harm the lessee and cause damage to the whole property, then he can claim any cost incurred from the lessor.
- (b) If the repair concerns something that is not essential to the property but is only for the lessee's personal benefit and enjoyment, he cannot recover the cost from the lessor.

The above rule is held by the *Mejelle* in Article 530: "If the lessee has done repairs, with the leave of the lessor if the repairs are connected with the improving of the house, like changing the tiles of the roof or with the preservation of it from harm coming to it, if there is no express condition that this expense is to be paid by the lessor, still the lessee takes the expense from the lessor. And if it concerns only the benefit of the lessee, like repairing the oven, for that so far there is no express condition, the lessee cannot recover from the lessor the expense of it."

*In the current practice of Islamic hire-purchase transactions in Malaysia, maintenance responsibility is undertaken solely by the customer...*

According to the *Shariah* Legal Opinions of the Kuwait Finance House, the owner is responsible for maintenance related to the object that is leased, and on which the continued performance and usufruct of the object is customarily understood to depend, so long as there is no written agreement to the contrary. It is, moreover, lawful for the owner and hirer to agree that the hirer will be responsible for normal maintenance costs other than those related to the continued performance and usufruct of the leased equipment (Delorenzo, 2000).

In the current practice of Islamic hire-purchase transactions in Malaysia, maintenance responsibility is undertaken solely by the customer, while the bank only acts as a financier, and thus will not assume any responsibility to the asset being leased and to be purchased by the customer. The bank argues that their customers' ultimate objective of engaging in hire purchase is to own an asset, particularly a motor vehicle, not merely to hire it for a certain period of time. In fact, the customer is acknowledged in the document of title as a legal owner of the asset. The bank only acts as a beneficial owner that has an ownership claim over the asset until full payment has been made.

Therefore, it is reasonable to require the hirer to maintain the asset since he is the one who uses and utilizes it. Yet, the hirer has a right to sue the bank if he finds that the asset is defective, which results in failure of rendering intended benefits to him. If the hirer repairs the defective asset, he is entitled to claim the cost of repair from the bank.

The situation would be different if the defect were caused by the hirer's negligence. In this case, he will bear the cost of repairing the asset.

Many Islamic investors think it is necessary for the insurance of the leased assets to be the responsibility of the owner instead of the hirer as is practiced nowadays.

The above illustrated practice in Malaysia does not seem to be 100% *Shariah*-compliant, because in *Shariah*, the owner is responsible for maintaining the leased asset. In practice, all responsibilities are passed to the hirer. Some *Shariah* scholars held that this condition does not nullify the contract because the practice is based on *'uruf* (local custom) and market practice in Malaysia.

To resolve the above conflict of interest, *Shariah* advisors and scholars in Malaysia have ruled that the duty to maintain the leased property must be made clear to the contracting parties and put in clear terms in the agreement. It is unwieldy to put all maintenance responsibilities onto the owner. The responsibility can be mutually determined in a way that each party owes certain duties to make sure that the property will continuously render specified benefits, which is paramount in the *ijarah* contract.

### Insurance Responsibility

The general principle enunciates that insurance coverage, or *takaful*, of an asset is the responsibility of the owner. This is contrary to the established practice in conventional hire purchase, where it is the hirer's responsibility. The issue of insurance responsibility has been discussed by many Islamic economists and legal practitioners, who often seem to be caught in a dilemma between the conflicting principles.

Many Islamic investors think it is necessary for the insurance of the leased assets to be the responsibility of the owner instead of the hirer as is practiced nowadays (Clode, 1996). Allawi (1986) observed that in a total economic loss, the owner must pay the insurance. But in the case of partial loss, the matter is unclear. If the owner is required to bear the insurance coverage, the amount shall be added to the cost price (Shirazi, 1993). Usmani (2002), on the other hand, stresses that if an asset is insured under the Islamic concept of *takaful*, it should be at the expense of the hirer. Nowadays, insurance responsibility is usually assumed by the hirer or bank customer. Some experts in Malaysia say that risks and liabilities that are not detrimental and harmless, which include insurance and maintenance, can be transferred to the hirer. *Shariah* Legal Opinions (*Fatawa Shar'iyah*) of the Kuwait Finance House affirm that it is lawful to make the hirer

responsible for insurance, if the amount is known, because it may then become a part of the lease payment (Delorenzo, 2000).

Perhaps a measure concerning insurance approved by the Board of Executive Directors of the IDB to promote *ijarah* can shed a light on this important issue (Parker & Dawood, 1995). In this regard, the insurance burden may be shared with the lessee/hirer. The IDB should bear the cost of insuring risks incidental to ownership, such as total damage, loss, and third-party liability exposure, while the lessee will bear the cost of insuring the risks incidental to use, such as operational hazards, accidents, and negligence. This mechanism exemplifies a balanced sharing of responsibility between the bank and customer in insuring internal and external risks associated with the use of a particular asset.

*It has been a common commercial practice to pay a deposit before starting to use any newly acquired asset.*

The practice in Malaysia shows that insurance coverage or *takaful* is borne by the owner during the first year of transaction, where the cost is included in the rental payments. In the subsequent years, the hirer will undertake to pay the cost of insurance. This rule has been agreed upon by most Islamic jurists in Malaysia. Their main argument is that the purpose of taking insurance coverage is to protect oneself from any risk related to being a user of the asset. Any damages to the asset or injury to the third party caused by one's own negligence shall necessarily be his responsibility. Therefore, it is reasonable enough for the hirer to take insurance (*takaful*) coverage for the above purposes.

### **Deposit Payment**

It has been a common commercial practice to pay a deposit before starting to use any newly acquired asset. The deposit serves as security against future loss or misconduct caused by the hirer. Accordingly, the AAOFII *Shariah* Rules for *Ijarah* and *Ijarah Muntahia Bittamleek* (2000) regards a deposit made by the hirer to secure the rental payments or security against loss of a leased asset caused by the misuse or negligence of the hirer.

The amount of deposit varies in different places. In Iran, the amount of deposit is a minimum of 20% of the cost price of the properties. Before entering into a hire purchase, the receipt of deposit is compulsory and considered as part of the rent for the duration of the lease. This advance payment shall be deducted from the cost price for the computation of the bank's profit (Shirazi, 1993). Similarly, in Pakistan, a deposit payment is considered as a security deposit. The customer is required to keep the security deposit at the bank. The

minimum requirement is 20% of the asset value, and the maximum is 50% (Sattar et al., 2002).

In the Malaysian dual banking system, a deposit payment of 10% is required for an Islamic hire-purchase transaction, which is the same requirement as in conventional practice. However, in substance, the deposit paid by the customer to the vendor is perceived as a payment made on behalf of the bank, which creates the following contractual liabilities:

...in an Islamic transaction, the intention and purpose of the payment must be made clearer, especially to the customer.

1. Between the bank (owner) and vendor (seller), the deposit is considered as a part of the purchase price of the asset paid by the bank to the vendor.
2. Between the customer (hirer) and the bank, the deposit is regarded as the first rental payment and will be accounted in determining the monthly rental payment.

The payment of deposit is not a big issue because this has been an accepted practice, and most parties involved in the transaction agree to perform this obligation. However, in an Islamic transaction, the intention and purpose of the payment must be made clearer, especially to the customer. This is to ensure that he fully understands the purpose of deposit payment and the function it serves.

### Penalty in Case of Default

Generally speaking, an act of default in due payment signifies a breach of contract. When two parties or more enter into a valid contract, they will be bound by terms and conditions in the contract. Breaching any of these terms will cause the innocent party to suffer a loss that needs to be compensated (Baharum, 2004). The question is whether the default has caused actual loss or damages to the bank and, if yes, whether the bank can be compensated? In the case of default in payment of installments, there are mixed reactions from the scholars. Some of them give a very strict rule that penalty for late payment of rentals is not permissible (Hairetdinov, 1998; Meezan Bank, 2004; Usmani, 2002). Their arguments are based on the following points:

1. Rentals, once due, become a debt obligation payable by the hirer and are subject to all the rules prescribed for a debt.
2. This penalty, if meant to add to the income or generate profit for the owner, is not warranted by the *Shariah*.
3. A monetary charge from a debtor for his late payment is exactly the *riba* prohibited by the Holy *Qur'an*. Therefore, the

owner cannot charge an additional amount if the hirer delays payment of the rent.

Unfortunately, this situation has been exploited by unscrupulous customers. In order to avoid the adverse consequences resulting from the misuse of this prohibition, another alternative may be resorted to. In such circumstances, contemporary scholars have provided a solution whereby a penalty can be charged to the customer for delayed payment, though the amount recovered is only to be used for charitable purposes by the bank (Hairetdinov, 1998). In other words, late penalty charges cannot be taken as income by the bank.

In support of the above propositions, Usmani (2002) views that the hirer may be asked to undertake that if he fails to pay rent on its due date, he will pay a certain amount to a charity. For this purpose, the bank or owner may maintain a charity fund where such amounts may be credited and disbursed for charitable purposes, including advancing interest-free loans to the needy persons. The amount payable for charitable purposes by the hirer may vary according to the period of default and may be calculated at a percent, per annum basis. This arrangement, though, does not compensate the owner for his opportunity cost of the period of default, yet it may serve as a strong deterrent for the lessee to pay the rent promptly (Meezan Bank, 2004; Usmani, 2002). Allowing the above propositions, the AAOFII *Shariah* Rules for *Ijarah* and *Ijarah Muntahia Bittamleek* (2000) state that a lessee (hirer) who delays payment for no good reason shall undertake to donate a certain amount or percentage of the rental due in the case of late payment. Such donation should be paid to charitable causes under the coordination of the Institution's *Shariah* supervisory board.

On the other hand, Wohabe has a different view. According to him, it is possible to compensate the owner for any default by the lessee through increased lease payments, which represent a reassessment of the risk involved in the transaction itself (Wohabe, 1997). This is due to the fact that the bank does suffer loss if its customer defaulted, since regular payments constitute one of a bank's receivables and income. Hence, the default would necessarily expose the bank to a risk of potential loss in the secondary markets and inability to pay the shareholders and investors. In the Malaysian context, the National *Shariah* Advisory Council created a rule that the customer shall pay to the bank the sum equivalent to the costs incurred by the bank in the maintenance on such default amounts or such rate as prescribed by the Bank Negara Malaysia<sup>7</sup> (Central Bank of Malaysia). The sum

*The amount payable for charitable purposes by the hirer may vary according to the period of default and may be calculated at a percent, per annum basis.*

is calculated in the manner prescribed by the National *Shariah* Advisory Council and duly endorsed by the Bank Negara. The mechanisms of imposing the penalty are outlined as follows (Bank Negara Malaysia, 1998):

Despite being one of the most demanding facilities of an Islamic bank, Islamic hire purchase is unfortunately lacking in an explicit Shariah regulatory framework.

- (a) If the default happens before the maturity period, a penalty of 1% per annum will be imposed on the overdue installments.
- (b) If the default is caused after the maturity period, the rate of penalty must be based on the Islamic money market rate.
- (c) The maximum penalty amount for late payment cannot exceed 100% of the outstanding balance of the purchase price. For example, if the balance purchase price is RM 50,000, the amount of the penalty cannot exceed RM 50,000.
- (d) Penalty for late payment must be put into a bank account as profit and divided between the bank and investors according to the agreed-upon profit ratio.

The penalty will commence from the date of the first default until the date of actual receipt of payment by the bank. However, the bank must consider some special cases and problems suffered by the defaulters, for example unavoidable financial difficulty, or having not misused any of the financing amount for other purposes not provided by the Letter of Offer, or any case on merit disqualified from paying the costs to the bank, at the absolute discretion of the bank.

### Legal Treatment

The current practice of Islamic hire purchase in Malaysia is based on conventional hire-purchase regulations. Despite being one of the most demanding facilities of an Islamic bank, Islamic hire purchase is unfortunately lacking in an explicit *Shariah* regulatory framework. Any dispute arising from the transaction of Islamic hire purchase will be referred to the conventional regulations (Ismail, 1999), as there is no written *Shariah* law that specifically regulates the operation of Islamic hire purchase. The only existing regulatory Shariah rules on the facility can be found in *Shariah* Rules for Investment and Financing Instruments, Accounting and Auditing Organization for Islamic Financial Institutions of Bahrain (AAOFII). According to the *Shariah* Rules (2000), the permissible *ijarah muntahia bittamlik* (Islamic hire purchase), is different from hire purchase as commonly practiced by conventional financial institutions certain respects. This *Shariah* Rules governing the operation of the Bank of Bahrain, is said to be the first written and codified rule, which becomes a main reference to other Islamic banks.

In the Malaysian context, a hire-purchase transaction is jointly governed by the Finance Ministry, Ministry of Domestic Trade, Ministry of Road Transport Department, and Ministry of Internal Affairs. Currently, there is no specific regulation governing this Islamic hire purchase; thus, any institution undertaking to offer this facility tends to impose its own rules, which are said to follow the *Shariah* principle and in the spirit of the Hire Purchase Act 1967 and Contract Act 1950. Although there is no specific regulatory law on Islamic hire-purchase transactions, this facility has been offered successfully by some banks. At the moment, the main reference to this practice is still the Hire Purchase Act 1967. This Act covers all consumer goods as well as motor vehicles.

It is important to note that the hire-purchase scheme regulated by the Hire-Purchase Act 1967 is “not entirely contradicted” by *Shariah* principles (Haneef, 1997). For instance, the following provisions<sup>8</sup> of the 1967 Act are in fact in harmony with the spirit of *Shariah*:

- (a) the preparation and service of the Part I (Preliminary) and Part II (Formation and Contents of Hire-Purchase Agreements) statements;
- (b) the preparation and execution of a written hire-purchase agreement;
- (c) conditions and warranties;
- (d) protection of hirers and guarantors in Part III, IV, and V;
- (e) rules for repossession;
- (f) insurance liability on the owner in Part VI;
- (g) the formula and limitation on term charges;
- (h) the avoidance of the agreement if any of the above-mentioned requirements are not met; and
- (i) the imposition of penalties for violation of the above requirements.

Apart from the above, the Hire Purchase Act 1967 is lacking in some basic *Shariah* requirements of Islamic transactions. Intention and understanding of parties, signing of two separate documents in sequence, interest-based calculation of profit, and legal resolutions are among the crucial issues. It is observed that these matters can only be resolved by having a *Shariah* regulation that can provide a complete legal sanction to the hire-purchase practices. The latest development in Malaysia has witnessed an effort undertaken by the Bank Negara and other government entities<sup>9</sup> to come up with a special regulation<sup>10</sup> on Islamic hire-purchase transactions. This proposed law suggests some important matters, such as expanding the scope of

*It is important to note that the hire-purchase scheme regulated by the Hire-Purchase Act 1967 is “not entirely contradicted” by Shariah principles*

assets to be acquired by Islamic hire purchase, defining the agreements and manner of entering into them, ascertaining rights and liabilities of the contracting parties, jurisdiction of the courts, and many more.

*Islamic financial instruments will always have to compete with the pace of product development in a more entrenched conventional system.*

Recently, these government entities have decided to insert provisions of Islamic hire purchase into the existing Hire-Purchase Act 1967, instead of making it a self-governing law. The main reasons are to promote a harmonization between conventional and Islamic regulations and to avoid redundancy of laws in the Malaysian legal system. In this regard, there are mixed responses obtained from banking industries and experts in Islamic banking in Malaysia. Some of them strongly support a self-governing Islamic hire-purchase law, so that this practice can be properly implemented in the light of *Shariah*. Others, while supportive of the government's decision, are hoping that the harmonization will bring a positive impact to the development of Islamic law from within conventional practices. Having mentioned the above, the matter is still pending. The debate is ongoing, either to include provisions of Islamic hire purchase into the Hire-Purchase Act 1967 or allow it to exist as a separate law independently. Whatever decision is taken, the implementation of Islamic hire purchase should be properly done based on *Shariah* principles, without any legal impediments.<sup>11</sup>


## CONCLUDING REMARKS

Over the years, the Islamic banking industry has adapted many important conventional products capable of being provided subject to *Shariah* compliance. In many instances, as evidenced in the case of Islamic hire purchase, the Islamic financial products are repackaged along the lines of conventional financial products, while eliminating those elements that are not in compliance with the *Shariah*. While the adaptation will still continue, Islamic financial instruments will always have to compete with the pace of product development in a more entrenched conventional system.

In a dual banking system, it appears that Islamic hire-purchase encounters the same problems in adapting with the long-established conventional system. Some conventional practices are in conflict with *Shariah* principles, thus rendering those features invalid. Islamic bankers and Muslim scholars have attempted to resolve some basic and operational issues in order to make Islamic hire-purchase operation more viable and acceptable by *Shariah*. One of the important

conditions to sustain the continued growth and product competitiveness in a dual banking system as in the case of Malaysia, is to have a comprehensive legal infrastructure for legal redress arising from Islamic financial institutions. Efforts should therefore be intensified to develop a comprehensive legal structure to resolve potential disputes arising from Islamic financial transactions. The legal structure needs to comprise both effective regulatory and substantive laws to resolve disputes relating to Islamic financial transactions.

*Shariah* should be viewed as a potential tool for innovation and creativity, rather than a limiting constraint. More efforts therefore, are needed to fully appreciate and maximize the true potential and wisdom of *Shariah*. There is a need for greater collaboration among the *Shariah* scholars, academicians, practitioners, and researchers to undertake in-depth studies and research in relation to the Islamic hire-purchase product. This will certainly enhance product competitiveness and viability in the Islamic financial markets. In carrying out this inspiration, the Bank Negara of Malaysia (Central Bank) and banking industries should move forward in formulating a better developed Islamic hire-purchase facility. Inviting public participation in this process would indirectly increase their understanding and awareness of the product. Conducting an extensive training program for the bankers could also help to make them better understand the difference between Islamic and conventional hire purchase. A significant role is required on the part of legal experts in resolving legal issues in Islamic hire purchase through discussion and research.

Therefore, efforts must be undertaken not only scholars, but by all individuals, and should involve the government, banking industries, legal experts, and the public at large. Government administrative ministries and judiciary bodies should endeavor to provide a well-built avenue for Islamic hire purchase to be implemented efficiently by strengthening the existing legal and regulatory framework. Most important, uncertainty in the means of implementing Islamic hire-purchase regulations must be quickly resolved by the government. Bureaucratic and procedural problems that may cause delay should be put aside for the sake of having a better structured regulatory framework for Islamic hire purchase.. 

## NOTES

1. This is based on a report submitted by Dr. Tariq Hassan, Khalid Siraj, Dr. Riaz-ul-Hassan Gilani, and Mahmood Shafqat to the Supreme Court of Pakistan in 2001. In the case of Egypt and Saudi Arabia, they have no separate laws but have allowed Islamic banking to operate under

their existing laws for conventional banks. In fact, neither of these two countries has “any constitutional or judicial need or administrative policy or plan for a complete transformation of their economic and financial system” (Business Recorder, 2002).

2. Goods that are not specified in Hire-Purchase Act 1967.

3. This is required by the Road Traffic Act 1987.

4. An *aqad* letter is a supplementary document to the main Hire-Purchase Agreement. It contains the description of assets and undertakings by the finance company and customer in the following matters:

- (a) that the AITAB transaction will be bound by the Hire-Purchase Agreement and Schedule 2 of the Hire-Purchase Act;
- (b) that the asset on hire purchase shall be used for purposes that do not contravene the *Shariah*;
- (c) agree that the Hire-Purchase Act 1967 shall be governed and is applicable to the transaction; and
- (d) that other provisions in HPA 1967 that do not contradict the *Shariah* will remain in effect for both parties.

5. This is based on the rule of conditional forward sale agreement in which the parties have negotiated on terms and conditions of the contract at the beginning of the *ijarah* contract. The conditions include the manner in which the ownership is transferred, satisfactory performance in the *ijarah* contract, and so on (Malaysian Accounting Standards Board, 2004).

6. The firsthand information was obtained by conducting interviews with managers and senior officers from 13 banks and finance companies that actually provide an AITAB facility in Malaysia.

7. Resolution of the *Shariah* Advisory Council of the Bank Negara Malaysia (Central Bank of Malaysia). The imposition of penalty was made effective on January 1, 1999.

8. Points (a), (b), (g), (h), and (i) were laid down by Haneef (1997).

9. Attorney General Chambers, Ministry of Domestic Trade and Consumer Affairs, Finance Ministry and Department of Islamic Development (JAKIM).

10. The *Mu'amalah* Hire-Purchase Bill was initiated by some officials of Bank Islam Malaysia Berhad (BIMB) and then examined by *Shariah* experts in the Islamic Division of the Prime Minister Department. The discussion and examination are still carried on by the Bank Negara and Attorney General Chambers, Ministry of Domestic Trade and Consumer Affairs.

11. Legal impediments include limited application of Islamic law to commercial and banking activities, the prevailing conventional law when it is in conflict with Islamic regulation, and the unresolved position of *Shariah* courts (Rachagan. 2003).

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