

SHARIAH RISK AND CLAWBACK EFFECT OF *AL-BAI-BITHAMAN AJIL* IN DEFAULT

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Abstract

The purpose of this paper is to examine the meaning, nature and measurement of Shariah risk faced by Islamic banks. BBA contract and its documentations is analyzed in the light of legal environment in Malaysia and measurement of Shariah risk based on constructed or hypothetical cases. Shariah risk will adversely affect bank's earnings when BBA contracts are deemed invalid in the court of law either in a foreclosure or ruling via court declaration. Islamic banking should be able to use our findings to estimate potential loss of Shariah risk and make the necessary provisions This paper provides new insights of risks faced by credit intensive Islamic banks who, when relinquishing critical requirement of Islamic contract such as ownership risk will suffer loss from Shariah risk.

Keywords: Al-bai-bithaman ajil, foreclosure, Shariah risk, clawback effect, profit-in-suspense

1.0 Introduction

The Islamic banking business seeks to generate profits out of revenues collected from financing activities and cost incurred in mobilizing deposits. When an Islamic bank provides a financing facility, say *al-bai-bithaman ajil* (BBA) home financing facility to its customer, it has taken a position such that exposure to risk or potential loss will turn into real losses when the customer actually defaulted on his debt obligation. In this way, an Islamic bank's shareholders face many risks. The major risk is credit risk whose unexpected losses can erode bank's capital. Market risk is critical when dealing with volatilities in the cost of funds as it may erode earnings. The 2008 subprime crises in the United States which severely paralyzed giants Lehman, Morgan Stanley and American International Group (AIG) saw increasing attention to operational risks (Caprio & Honohan 2010).

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Highly exposed Islamic banking portfolio to credit financing instruments such as BBA is not spared from losses due to default. Other unique risks faced by Islamic banks that can severely reduce its earning are risk of return risk (RoR) and displaced commercial risk (DCR). The former is potential loss arising from loss of deposits to conventional banks when rate of Islamic deposits are less competitive than interest rates on conventional deposits. The latter is the potential loss when the bank uses its own reserves to smoothen rates on Islamic deposits. Recently, a new type of risk called Shariah risk, surfaces into actual drama in both the legal and banking fraternity as it challenged the legality of BBA financing. It calls for immediate remedies to save Islamic banking from serious reputational risk as well as severe financial loss.

This paper examines two critical issues in Islamic risk management, namely the nature of Shariah risk in BBA financing and its measurement. First it examines the nature of Shariah risk within the credit environment of Islamic modes of financing in Malaysia. It gives a comparative look at the Shariah or juristic and civil requirement of BBA contract and its documentation and traces the gap that can trigger Shariah risk when an Islamic bank seeks a court order to foreclose property owned by defaulters. Secondly, this study attempts to measure Shariah risk by looking at the loss incurred by Islamic banks when a BBA contract is ruled invalid in court during the foreclosure proceeding. The size of loss depends on the timing of default, that is whether it took place in the early or later part of the financing period.

2.0 Shariah Risk

The Islamic Financial Service Board (IFSB) defines Shariah risk as one arising when an Islamic financial institution (IFI) offering Islamic financial services fails to comply with Shariah rules and principles determined by Shariah Board of the IFI or the relevant bodies in the jurisdiction in which the IFI operates. It asserts that IFIs should ensure that their contract documentation complies with Shariah rules and principles with regards to the formation, termination and elements possibly affecting contract performance such as fraud, misrepresentation, duress or any other rights and obligations (IFSB 2005).

When an Islamic financing facility is ruled invalid in the court of law due to say, fraud and misrepresentation, Shariah risk can then be defined as the potential loss to the Islamic bank arising from the nullification of contracts with adverse impact on bank's earnings. In general, Shariah risk originates from credit risk. It is triggered by default on BBA debt obligations leading to court hearing for foreclosure wherein the plaintiff and defendant will put their cases before the judge. The cost of the lawsuit may include the compensations and damages paid to customers, returning profit collected from the Islamic BBA facilities to the customers, cost of court proceedings and reputation risk.

To further understand the nature of Shariah risk, two aspects of financial transaction involving Islamic banking business are first examined, namely:

- a) The concept of the transaction: This concerns whether the contract is based on sale (*bay'*), *ijarah*, *wakalah*, *musharakah* and other common contracts in Islamic

banking, where the pillars of contract (*'aqd*) are central in determining the validity of contracts.

- b) The legal documentation of the transaction: This spells out the rights, responsibilities and obligations of the contracting parties. In conventional loans, these include the loan agreement itself, the promissory note, loan payment term, demand by lender, method of payment and default. Additional provisions regarding default include cure for default, penalty for late payment, acceleration, integration, severability etc. In essence, it defines the legal relations between the bank and the customer. Usually the documentation is based on civil law but at the options of the parties concerned.

To illustrate the difference between the two above, let's examine the following example. When a customer filed a lawsuit against the bank for non-Shariah compliance, he is making a claim for receiving damages from the bank, wherein his rights in the contract may have been breached by the bank or the bank did not fulfill its obligation as a selling party. In the case of BBA, the customer may file for damages due to failure to deliver. The judge will study the case based on the agreement made between the two parties. The agreement took shape in the form of *legal documentation* of the contract as drawn up by the bank's solicitor instead of the general character of the *'aqd*. This is because the former provides detailed rights and obligations of the two parties, which entails the core component of a contract (*'aqd*), while the latter outlines the principles of the transactions.

Shariah risk can emerge many ways such as:

- a. Foreclosure case against the customer: The bank filing lawsuit against a customer who has defaulted on his *murabaha*/BBA obligation. But the judgement may turned in favour of the defendant (ie. customer) such as in the case of Arab-Malaysia Finance v Taman Jaya when the Judge Dato' Wahab Patail ruled the contracted BBA as a *non bona fide* sale as it (ie BBA) constitutes a financing facility with a charge agreement rather than a sale. As the contract is void, the customer should only gives back the principle amount advanced to him by the bank. This also means that the bank must return the profit it has acquired from the customer, if total payments at default exceeded the original amount. This shall be discussed in more detail in Section 10.
- b. Customer seeking a court declaration that BBA is invalid:

This action may take place when the customer is facing difficulties to fulfill his BBA obligations as the housing developer has abandoned the project. The customer is paying both rental on the house his family is currently staying and the BBA monthly payments which is too hard to carry out. According to BBA contract, the bank who acts as the selling party must made delivery of the subject matter upon completion. But the seller/bank has failed to deliver the property although the customer has made payments based on the agreed contract. Another case concerns incorrect use of contract. For example, a BBA contract is only suitable for completed property but many Islamic banks have

been using BBA instead of *istisna'* for housing under construction. There is a Shariah compliance issue here at stake. In either case, the customer will file a lawsuit against the Islamic bank for not fulfilling its obligation. A lawsuit is a civil action brought before a court in which a party (plaintiff) has claimed to have received damages (ie. BBA payments without delivery, rental paid on current premise), the plaintiff, seeks a legal or equitable remedy. The defendants are required to respond to the complaint of the plaintiff. If the plaintiff is successful, judgment will be given in the plaintiff's favor, and a range of court orders may be issued to enforce a right, award damages, or impose an injunction to prevent an act or compel an act. A declaratory judgment may be issued to prevent future legal disputes.

In both cases as the above, equitable remedy in the form of compensations will erode bank earnings when hefty provisions are put aside as specified by banking supervisors.

3.0 Gharar, Ghorm and Shariah Risk

Risk is potential loss arising from an events such as death, accident and in finance, default on loan obligation. When the actual event takes place, the potential loss or risk is actualized into real loss. Real loss is not risk. Risk or *ghorm* is the one outcome of having an exposure in business. But risk can translates into actual gain too. Hence risk should not be viewed as inherently undesirable as most people think it is. The term *gharar* although referring to risk and uncertainties only applies to risk and uncertainties in business contracts rather than the outcome of the business. Hence, the business should avoid *gharar* concerning price of the subject matter or the characteristics contracting parties and embraces *ghorm* or risk-taking as a natural path of doing business.

In the banking business, the shareholders are risking their capital when loan are extended to customers, thus evidencing *ghorm* and not *gharar*. The same is applied to Islamic banking but loans are now replaced by credit financing with underlying asset. For this reason, the risks faced by Islamic banks are peculiar in nature as they have to deal with on-balance asset ownership. Efforts to avoid real asset ownership will lead to risk of Shariah non-compliance. This is the starting point of our investigation of Shariah risk in Islamic banking.

4.0 Risk-Behaviour of Islamic Banks

Islamic banks are required by the regulatory authority to allocate part of its capital to support each of the facilities extended to customers. The computation of the economic capital is based on the estimated maximum loss on the facility. Risk-weights are inserted into the computation to account of bank's risk appetite. The risk-weights are defined by the probability of default (PD), exposure of default (EAGD), loss given default (LGD) and maturity of the portfolio. Also, in giving

away funds, the bank must also estimate the risk-adjusted return on capital (RAROC) to ensure that estimation of returns must be driven by the product risk appetite (Bessis 2010)

Islamic banks that have applied BBA in most of their business operations are known to have utilized legal devices (*hilah*) to avoid potential losses arising from owning say, property before making the actual BBA sale. When customers failed to confirm the purchase, banks will sell off the property at a forced sale value where the loss, if any, will be absorbed by bank's capital. This is business risk. To make the matter worse, bank's holding of BBA as an asset for sale will call for higher risk-weights which mean more stress on capital. For these two main reasons, many Islamic banks have avoided ownership risks in conducting BBA. But by avoiding ownership risk in BBA to free itself from business risk (*ghorm*), it has instead invite uncertainties (*gharar*) in the contractual agreement in so far as ownership of asset is concerned. This in turn triggers Shariah risk.

6.0 The major elements of Shariah risk in Islamic banking and finance.

This section examines *gharar* in greater detail as it intends to investigate whether the act of avoiding ownership risk in BBA is a product of human manipulation or an act of nature. If one looks at the risk in contracts from the point of Islamic commercial law we can identify a few major components such as ambiguities (*gharar*), deception (*tagrir*), inequality and duress. These elements must be avoided and excluded from any financial transaction in order to ensure the validity of the contract.

It should be understood that *gharar* (uncertainty) and *taqhrir* (deception) in the financial transaction may render the contract and the facility provided by the bank totally null and void. Therefore the facility of BBA should be designed and structured in such a way does not provoke any potential violation of *Shariah* rules and principles, or lead to potential *gharar* or *taghrir*, the bank should clearly spell out the terms and conditions of the facility and shows to the customer clearly the flow of the BBA and its legal steps, sequence, applications and implications to avoid any potential elements of *gharar* in the contract or *taghrir* in the procedure of the facility. The Islamic bank and the legal advisor of the bank and the customer (the S&P lawyer) play a crucial role in providing a sound legal framework and smooth process for the banking facility of BBA which should be consistent with the *Shariah* rules. The *Shariah* compliance procedure should be always honored in the clauses of the contract agreement throughout the various sets of legal documentation, steps as advised by the bank.

It is within the bank responsibility to moderate the *gharar* that may exist in the contract by distinguishing between the excessive *gharar* (*gharar kathir*) and the minor *gharar* (*gharar yasir*). The first type of *gharar* is unanimously prohibited and not accepted in *Shariah* which render the financial transaction invalid, whereas the second type (*gharar yasir*), is unanimously allowed by *Shariah* such as buying a house whereby its foundation is not known even though it is part of

the asset sold, the jurists are in agreement that this minor *gharar* is tolerable and permitted.⁴ The mentioned moderation of *gharar* should be applied in the procedure of the transaction and legal documentation as well; otherwise the facility may have a *Shariah* non compliance risk element.

According the *Maliki and Hanbali* School of Fiqh and other Muslim jurists are with the opinion that the minor *gharar* in sale is permitted and accepted in *Shariah*, and it does not affect the business transactions, this legal *Shariah* approach will facilitate the business transactions, the wisdom behind allowing the minor uncertainty in business transactions is the difficulty to achieve zero *gharar* in business operations especially within today complex transactions, however the major uncertainty is not accepted, and it is strictly forbidden in all kind of trade and business activities, it is considered as one of the major components of risk.

The parties concerns that have the responsibility to design the banking facility of BBA should not take advantage of the minor *gharar* and exceed the *Shariah* requirement on that. Precaution is always appreciated in *Shariah* compliance procedure, the structuring of the BBA agreement should be based on *Maqasid al Shariah* which represent a sound guideline to ensure proper design of legal documentation and monitoring of *gharar* and *taghrir*.

In addition to that *gharar* and *taghrir* should not be associated with the terms, conditions, wording and clauses of the legal documentation in the BBA facility, the facility should demonstrate justice and fairness in financial transaction, without having a tendency to secure 100% safety in the deal by avoiding the risk 100% and put the burden of the risk and its legal sequences and financial implications on the shoulder of the customer without a valid reason. The principle of sharing the risk based on the proportion ratio of responsibility is needed to ensure realization of *Maqasid al Shariah* and the spirit of brotherhood in Islam. The pricing mechanism is another area that should be addressed to reflect the *Shariah* legitimacy of bank's earnings as the price should be reasonable. While the bank must not take advantage of the customer's financial position, the pricing formula should be based its commercial viability as well as moral value.

The element of *taghrir* may take place when knowledge is lacking among consumers. For example, a bank customer may he blindly sign the legal documentation paper without understanding the *Shariah* and legal implication of his action. The *taghrir* is also associated with security documents which are part and parcel of the legal documentation of the facility provided by the bank, the consumer may or may not be aware of the *Shariah* and legal consequences and implication of his actions, such as putting the assets that he purchase as charge to the bank. To monitor and control the degree of *taghrir*, the bank should make full

⁴ See: Ali Al Kafif, *Ahkam Al Muamalat Al Shariah*, p. 356.

disclosure of information of the transactions. This is to ensure justice and fairness in the contract agreement.

Parameter of *gharar* which invalidate the financial transaction

There are some elements that should be considered, otherwise the financial transaction may render in valid. The area of *gharar* is as follows:

- The *gharar* should be in exchange contract
- The *gharar* should be excessive
- The *gharar* should be related to the subject matter
- There is no need to engage in such financial transaction.⁵

The above elements should be observed by the IFI in the banking facilities provided, otherwise the facility may render null and void because of the un-tolerated *gharar*. In the case of the BBA facility the potential of *gharar* can be observed in the following area:

- *Gharar* rising from the sale of goods that do not belong to the selling party. The transaction is concluded before securing the ownership of the asset during the session of the contract.
- *Gharar* rising from selling what is not in one's possession. To avoid this *gharar* the bank must has possession first, and take liability and responsibility before concluding the financial transaction, the possession can be physically or constructively.
- Potential of *gharar* in BBA in the combination of contract whereby two contracts are combined together in one master agreement facility namely *murabahah* and *al-bay' al-'inah*, this combination may rise Shariah non compliance risk in the transaction.

As it is known in Shariah, ambiguities (*gharar*) and deception (*tagrir*) in the financial transaction may render the financial contract and the facility provided by the bank totally null and void. Therefore the facility of the BBA should be designed and structured in such a way does not provoke any potential violation of Shariah rules and principles, the bank should clearly spell out the terms and conditions of the facility and shows to the customer the flow of the BBA and its legal steps, sequence and applications to avoid any potential elements of *gharar* in the contract or

⁵ AAOIFI Shariah standards, no. 31. (Arabic version).

deception in the procedure. The Islamic bank and the legal advisor of the bank and the customer (the S&P lawyer) play an important role in providing a sound legal framework and smooth process for the banking facility of BBA which is consistent with the Shariah law. The Shariah compliance should be honored in the clauses of the contract agreement throughout the various sets of legal documentation provided by the bank.

The bank should be able to moderate the *gharar* by distinguishing between the excessive *gharar* (*ghara kathir*) and the minor *gharar*. The first type of *gharar* is unanimously prohibited and not accepted in *Shariah* which render the financial transaction invalid. The second type known as minor *gharar* (*gharar yasir*), is unanimously allowed by *Shariah* such as buying a house whereby its foundation is not known even though it is part of the asset sold, the jurists are in agreement that this minor *gharar* is tolerable and permitted.⁶ The mentioned moderation of *gharar* should be applied in the legal documentation.

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However the parties concerns that have the task to design the facility of BBA should not take advantage of the minor *gharar* and exceed the Shariah requirement on that. Precaution is always appreciated in Shariah compliance procedure, the parties concerns of structuring the BBA agreement should refer to *Maqasid al Shariah* which represent a very good guideline to ensure proper design of legal documentation.

The ambiguity, *gharar* and deception should not be associated with the terms, conditions, wording and clauses of the legal documentation in the BBA facility, in addition to that the facility should demonstrate justice and fairness in financial transaction, without having a tendency to secure 100% safety in the deal by avoiding the risk 100% and put the burden of the risk and its legal sequences and financial implications on the shoulder of the customer without a valid reason. The principle of sharing the risk base on the proportion ratio of responsibility is needed to ensure realization of *maqasid al Shariah* and the spirit of brotherhood in Islam. The pricing a is another area that should be addressed as well to reflect the eligibility and permissibility of the income of the bank, it should be reasonable, free from taking advantage of the financial position of the customer, the pricing formula should be based on moral value and business consideration.

⁶ See: Ali Al Kafif, *Ahkam Al Muamalat Al Shariah*, p. 356.

5.0 Rules of Bai' Bithaman Ajil (BBA)

Once the meanings of *gharar* and *tagrir* are established, it is important to examine the rulings of BBA in the light of risks faced by Islamic banks with high BBA exposures. BBA is a sale in which the parties agree that the payment of price shall be deferred on installment basis. The due time of payment can be fixed either with reference to a particular date, or by specifying a period, like three months, but it cannot be fixed with reference to a future event the exact date of which is unknown or is uncertain. If the time of payment is unknown or uncertain, the sale is void. If a particular period is fixed for payment, like one month, it will be deemed to commence from the time of delivery, unless the parties have agreed otherwise.

The deferred price can be more than the cash price, but it must be fixed at the time of sale. Once the price is fixed, it cannot be reduced in case of early settlement, nor can it be raised in case of late payment and default. In order to ensure that the buyer ie the customer pays the installments promptly, the customer may be asked to make a promise (*wa'ad*) that in case of default, he will donate some specified amount of the payments to charities. In this case when the seller ie the Islamic bank, receives such payments from the buyer, the payments will not be treated as earnings. Instead, the bank who acts on behalf of the customer gives away the money to charities. The BBA system also stipulated that when a buyer fails to pay up on its due date, the remaining installment will become due immediately.

In order to secure the payment of price, the seller may ask the buyer to furnish a security whether in the form of a mortgage or in the form of a lien or a charge on any of his existing assets. In the case of default, the seller can seek a court order to sell the property in order to recover the money used to purchase it.

6.0 Legal documentation of Al-Bai-Bithaman Ajil (BBA) Financing

Based on the above rules of BBA, an illustration is given in the following. Hamid is keen to purchase a \$200,000 apartment in Kuala Lumpur, which he has seen in person. He will meet the developer/vendor and sign a Sale and Purchase agreement (S&P) after placing a 10% down payment, i.e. \$20,000. In conventional practice, Hamid will look for a bank that can lend him the remaining sum of \$180,000. Assume that Fastbank approves the loan and disburses a sum of \$180,000 to the developer on behalf of Hamid. Thus, Hamid gets a loan from Fastbank and settled the remaining balance with the developer on cash basis. Hamid will pledge the property as collateral via the charge agreement on the \$180,000 loan. Assuming interest rate at 4% flat over 20 years, Hamid will pay the bank \$144,000 more in interest. His monthly installment = $(\$180,000 + \$144,000) / 240 = \$1350$.

To sum up, conventional financing consists of the following contracts, namely:

1. Contract of loan between the Fastbank and Hamid.

2. Deeds of Assignment/Charge.

The same procedure applies for Islamic banks. But the transaction becomes complicated when Fastbank is not involved in the sale and purchase agreement (S & P) with Hamid. Instead similar to conventional arrangement, Hamid purchases the property from the developer. He puts up RM20,000 as down payment to secure the Sales and Purchase (S&P) agreement on his favour. In this manner, Hamid becomes the beneficiary owner of the property.

But how could Fastbank observe the rules of BBA (to sell the property to Hamid) when in the first place it does not own the asset? The Holy Prophet pbuh says “do not sell what you do not own”. Here FastBank must be careful not to violate this critical Shariah injunction. To observe this Shariah rule, Fastbank is expected to purchase the property from Hamid via the Property Purchase Agreement (PPA for \$180,000). Current practice indicates that the bank makes the \$180,000 disbursement to Hamid, which it (ie. Fastbank) passes on to the developer.

Once the Fastbank holds ownership via PPA, it then sells the property to Hamid via the Property Sale Agreement (PSA). The terms are as follows:

1. Seller (Fastbank) and Buyer (Hamid)
2. Object of sale : Apartment
3. Price of object: Cost price (\$180,000) + profit margin (\$144,000) = \$324,000 = \$324,000.

Installment payments = $\$324,000/240 = \1350 per month.

Similar with conventional practice, the house will be placed as a collateral via the Deeds of Assignment or Charge. It says that the bank holds the right of beneficial ownership of the property in the manner that it holds the right to sell if when Hamid defaults on the BBA facility.

To summarize, BBA sale consists of three contracts, namely:

1. Property Purchase Agreement (PPA): Bank buys property from customer.
2. Property Sale Agreement (PSA): Bank sells property to customer at BBA price.
3. Deeds of Assignment/Charge: Bank A holds property as collateral.

It seems that the above agreements were drawn to treat BBA as a loan rather than a sale (*al-bay'*). In a BBA sale, the bank should purchase the house from the developer/vendor. Sale and Purchase agreement (S&P) should have taken place between the bank and developer. In this manner, the bank will hold risk of ownership (*ghorm*) and thus, holds the right to earn profits from the BBA sale.

When the fear of business risk may have stopped Islamic banks from entering Sale and Purchase agreement with developers, Islamic banks have opted to introduce the Property Purchase Agreement (PPA) to secure ownership (*milkiyah*) before executing the Property Sale Agreement (PSA). But the PPA is not independent of the PSA and thus invited the use of *bay al-'inah* in the BBA sale. By doing so, the PPA is not a true sale since the bank does not actually hold equitable ownership of the property. Negative risk-avoiding behavior is apparent here since the bank refuses to hold ownership for fear of holding business risk in the form of unwanted inventories if the customer declined the sale⁷. When the bank failed to prove that it actually holds equitable ownership prior the PSA, then the BBA contract resemble a financing agreement with a charge. It evidences *gharar* ie uncertainties as to who actually own the asset. Under a default situation, such a structure will invite Shariah risk. To protect himself from potential bankruptcy, the customer may seek court declaration to rule that the BBA invalid.

When Islamic banks purchase the property from the developer, then the BBA sale shall consists of the following agreements:

1. Property Sale Agreement (PSA): Bank sells property to customer at BBA price.
2. Deeds of Assignment/Charge: Bank holds property as collateral.

The above agreements will remove Shariah risk from the portfolio as the bank now takes ownership of asset prior to the BBA sale. However, when an Islamic bank adopts the *bay al-enah* contract as evidenced in the PPA and PSA agreement, ownership risk has been compromised⁸.

7.0 Measurement of Shariah risk and bank loss.

Exposure to BBA financing means that Islamic banks are equally concerned with credit risk. In managing credit risk, they are required to measure the expected loss (EL) as well as unexpected loss (UL) from their credit financing portfolios. Expected loss is covered by bank's provisioning for bad debts while unexpected loss (UL) is to be absorbed by bank's capital (Saita 2007). However, loss from Shariah risk is unique because it originates from BBA defaults, thus tying it to credit risk rather than operational risk. At the moment Islamic banks in Malaysia are more concerned with the court ruling by High Court Judge Dato' Wahab Patail in Malaysia concerning the invalidity of BBA (Abdul Wahad Patail 2008, Arab-Malaysian Finance vs Taman Ihsan Jaya). It is a civil court case that revolves around a default by Taman Ihsan Jaya who had received a BBA facility. Since the legal right of the property still remains

⁷ Risk-avoiding behavior is allowed by Shariah when the individual looks for capital protection alone which is provided for in *wadiah dhamanah* products. Negative risk-avoiding behavior refers to the twin-demand for capital protection and fixed return as evidenced in all *riba* based contracts.

⁸ BBA is also known as *bay al-enah* as the PPA and PSA agreements signify a concurrent sale and buyback transaction between two parties. The transfer of ownership from the customer to the bank (PPA) and subsequently from bank to customer (PSA) is impossible to meet as the Land Office usually takes at least 6 months to execute the title transfer.

with the client, the bank seeks to foreclose the property in court. Evidences concerning contract validity are first sought in the legal documentation of the facility rather than what the counterparties perceived the contract to be. This is to avoid *gharar*. The judge ruling ran in favour of the defendant as he found that the BBA sale is not a true sale. The defendant is required to return the original amount of the BBA facility to the bank.

Some except of the judge's opinion are given below:

“[68] This court accepts that where the bank is the owner or had become the owner under a novation agreement, the sale to the customer is a bona fide sale, and the selling price is as interpreted in Affin Bank Bhd v Zulkifli bin Abdullah. Thus, where the bank was the owner of the property, by a direct purchase from the vendor or by a novation from its customer, and then sold the property to the customer, the plaintiffs' interpretation of the bank's selling price is rejected and the court applies the equitable interpretation.

“[69] This court holds that where the bank purchased directly from its customer (ie PPA) and sold back to the customer with deferred payment (ie PSA) at a higher price in total, the sale is not a bona fide sale, but a financing transaction, and the profit portion of such Al-Bai' Bithaman Ajil facility rendered the facility contrary to the Islamic Banking Act 1983 or the Banking and Financial Institutions Act 1989 as the case may be”.

“[70] Acting upon the basis that the bank's action resulted more likely from a misapprehension rather than of intent aforethought, the court holds the plaintiffs are entitled under section 66 of the Contracts Act 1950 to return of the original facility amount they had extended”.

Although Abdul Wahab Patail's ruling was later overturned in the Court of Appeal, it is imperative to estimate the loss incurred to the bank if the customer had instead seek a court declaration for BBA invalidation or if the Court of Appeal agrees with the judge's ruling. We will consider three situations involving the BBA default and the ruling to *“return the original facility amount to the bank”*. The three situations are:

- a. Paid amount is less than original facility, which is equivalent to 75 monthly payments before defaulting.
- b. Paid amount is equal to original facility which is equivalent to 134 monthly payments before defaulting.
- c. Paid amount is more than original facility which is equivalent to 185 monthly payments before defaulting.

Based on the contract between Fastbank and Mr. Hamid, the total murabaha obligation is \$324,000 with the original facility at \$180,000.

The financing is for 20 years (240 moths) at 4% flat profit rate per annum.

Price of object: Cost price \$180,000 + profit margin \$144,000 = \$324,000.

Installment payment: $\$324,000/240 = \$1,350$ per month (\$750 principal portion + \$600 profit portion).

The three following cases are stipulated based on the assumption that once the contract is invalidated, it means the bank must return the profit it has collected from the BBA sale. Bank's profit can be classified into two forms, namely earned and unearned profits, which the bank will lose both when a BBA is invalidated. Unearned profit is given back through a rebate (*ibra*) system while earned profit is given back via the clawback of accumulated bank reserves or retained earnings from the earned profit portion of the paid installments.

It is important to note that once the BBA sale is executed, the profit margin is recorded as "profit in suspense" which is also called unearned income (or sometimes is called deferred revenue) or unearned profit. It is a liability, such as when income item is earned, the related income item is recognized, and the unearned income is reduced. Hence, when a monthly payment is made to the Islamic bank, the bank keeps the earned profits, which increases capital overtime. In the same way, in the case of BBA invalidation, the clawback effect will reduce bank's capital, which this study uses as a measurement of Shariah risk. The computation of bank loss from the clawback effect is given in the following hypothetical cases:

Case A1: Mr. Hamid has paid \$101,250 (75 months monthly installment) before defaulting. The outstanding balance is \$222,750. However, the court has ruled the nullification of BBA and the profits elements of the 75 installments paid are to be clawed back and returned back to the customer. The court requires him to pay extra \$123,750 representing the unpaid capital portion.

Basically, the total of amount of the unpaid financing will be \$222,750. The amount represents the 165 months of unpaid monthly installments ($\$1,350 \times 165 \text{ months} = \$222,750$). However, the court settlement requires Mr. Hamid to pay another \$123,750 ($\$180,000 - \$56,250 = \$123,750$) being the capital portion of original financing. In other words, any profit portions from the 75 monthly installments paid are to be returned back to the customer.

Impliedly, the court judgment states that the financing that was based on trading of asset was not a bona fide sale and therefore, there shall be no profits recognized from the transaction. Therefore, the bank has to claw back any profits that have been recognized so far. This means, there will be adjustments to be taken up to the current year's profits and the retained earnings brought forward.

From the 75 monthly installments paid by the customers, the bank has recognized \$45,000 profit paid. Therefore, \$45,000 must be reversed out or clawed back from the bank current year's profits plus retained earnings brought forward and to be returned

back to the customer. The result of the clawed back resulting the bank to loss \$45,000. Here, the customer is appearing to gain \$45,000 as a result from the court injunction notwithstanding that his liability is now \$123,750.

Case B1: Mr. Hamid has paid \$180,900 (134 months monthly installment) before defaulting. The outstanding balance is \$143,100. However, the court has ruled the nullification of BBA and the profits elements of the 134 installments paid are to be clawed back and returned back to the customer. The court requires him to pay extra \$79,500 representing the unpaid capital portion.

The total amount of financing to be paid is \$143,100. The amount represent the 106 months of unpaid monthly installments ($\$1,350 \times 106 \text{ months} = \$143,100$). However, the court settlement requires Mr. Hamid to pay another \$79,500 ($\$180,000 - \$100,500 = \$79,500$) being the capital portion of original financing. In other words, any profit portions from the 134 monthly installments paid are to be returned back to the customer.

Impliedly, the court judgment states that the financing that was based on trading of asset was not a bona fide sale and therefore, there shall be no profits recognized from the transaction. Therefore, the bank has to claw back any profits that have been recognized so far. This means, there will be adjustments to be taken up to the current year's profits and the retained earnings brought forward.

From the 134 monthly installments paid by the customers, the bank has recognized \$80,400 profit paid. Therefore, \$80,400 must be reversed out or clawed back from the bank current year's profits plus retained earnings brought forward and to be returned back to the customer. The result of the clawed back resulting the bank to loss \$80,400. Here, the customer is appearing to gain \$80,400 as a result from the court injunction notwithstanding that his liability is now \$79,500.

Case C1: Mr. Hamid has paid \$249,750 (185 months monthly installment) before defaulting. The outstanding balance is \$74,250. However, the court has ruled the nullification of BBA and the profits elements of the 185 installments paid are to be clawed back and returned back to the customer. The court requires him to pay extra \$41,250 representing the unpaid capital portion.

For this case, the total outstanding balance of the financing is \$74,250 which represents 55 months of unpaid monthly installments ($\$1,350 \times 55 = \$74,250$). However, the court settlement requires Mr. Hamid to pay another \$123,750 ($\$180,000 - \$138,750 = \$41,250$) being the capital portion of original financing. In other words, any profit portions from the 185 monthly installments paid are to be returned back to the customer.

Impliedly, the court judgment states that the financing that was based on trading of asset was not a bona fide sale and therefore, there shall be no profits recognized from the transaction. Therefore, the bank has to claw back any profits that have been recognized so far. This means, there will be adjustments to be taken up to the current year's profits and the retained earnings brought forward.

From the 185 monthly installments paid by the customers, the bank has recognized \$111,000 profit paid. Therefore, \$111,000 must be reversed out or clawed back from the bank current year's profits plus retained earnings brought forward and to be returned back to the customer. The clawback effect results in a loss of \$111,000. Here, the customer is appearing to gain \$111,000 as a result from the court injunction notwithstanding that his liability is now \$41,250.

Table 1: Summary of results

CASE	Bank gain / (loss) to the customer	Customer gain / (loss) to the bank
A1	(45,000)	45,000
B1	(80,400)	80,400
C1	(111,000)	111,000

Table 1 shows the loss incurred by the Islamic bank based on the three hypothetical cases of BBA default. It helps explain that the claw-back effect is more serious when the default occurred as the facility is approaching maturity. Islamic banks can find the measurement of Shariah useful for the making estimation of provisions due to legal actions by clients. In the worst case scenario, the loss is expected to erode banking capital as money is clawed-back from bank's reserves rather than earnings.

8.0 Conclusion

The paper examines some aspect of Shariah risk in Islamic banking. When a judge is preceding a civil lawsuit involving an Islamic banking transaction, he or she will make the necessary judicial decision based on the written agreement of the contracting parties. Thus what the Shariah says as allowable and prohibited must be put in writing in the legal documentation. Legal documentation states in clear disclosure the rights and obligations of the bank and its customer. It is through documentation that contracting parties seek protection from the court of law. Failure to document the *aqd* effectively will practically make customers helpless against the stronger party, namely the bank. These rights are originally implied in the contract ('*aqd*) must be put in writing by the solicitor under the guidance of the Shariah advisory committee. There is no problem related to the concept of BBA, however the issue at hand is the application of BBA in the banking business where the court of law saw failure to comply to the true sale character of BBA. Failure to do so by way of negligence or mischief will invite Shariah risk. This is unhealthy to Islamic banks who in the first place must focus on their core business to expand market size and fulfill stakeholders' interest. Loss from Shariah risk can erode bank's capital if the default took place in a systemic way.

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