

ISLAMIC HOUSE FINANCING: THE VIABILITY OF ISTIṢNĀ' COMPARED TO BAI' BITHAMAN AJIL (BBA)

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Abstract

Rata-rata di Malaysia sekarang, cara pembiayaan pinjaman perumahan yang berlandaskan perbankan Islam adalah dengan menggunakan konsep Bai' Bithaman Ajil (BBA). Konsep syariah ini tersohor untuk pembiayaan perumahan yang masih dalam pembinaan. Namun demikian, disebabkan terlalu banyak isu projek perumahan terbengkalai, baru-baru ini kerajaan mencadangkan konsep "bina dan jual¹", iaitu rumah yang hendak dijual oleh pemaju kepada orang ramai hendaklah rumah yang telah siap dan mempunyai sijil layak diduduki. Cadangan ini bertujuan untuk menjaga kepentingan awam agar tidak lagi menjadi mangsa kepada pemaju-pemaju yang tidak bertanggungjawab, di mana pembeli rumah terpaksa membayar pinjaman harga rumah kepada pihak bank walaupun rumah yang dibeli tidak siap dan tidak dapat didiami. Oleh yang demikian, artikel ini bertujuan untuk mengkaji sama ada cara pembiayaan perumahan berkonsepkan BBA sesuai dengan keadaan sekarang (iaitu pembiayaan rumah dalam pembinaan) atau mungkin lebih sesuai untuk rumah yang berkonsepkan "bina dan jual", yang sekaligus mampu menjaga kepentingan pembeli rumah dan menepati hukum-hukum syarak yang berkaitan dengannya.

INTRODUCTION

Islamic law of banking and finance which is section of Islamic Commercial Law has developed significantly in the recent decades. It covers almost every aspect of

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¹ "SPNB Sokong Pemaju Hanya Dibenar Jual Rumah Siap", *Harian Metro*, 1 September 2004.

commercial transactions from banking, finance, capital market and insurance. Interestingly enough that there are many products and modes of Islamic financing available in the market for examples *Bay' Bithaman Ājil* (better known as *BBA*) House Financing, *Istiṣnā'* House Financing, *Ijārah* financing and Islamic Hire Purchase. All these modes of financing are hoped to help the public to purchase the consumer goods particularly house.

Nowadays, the most famous mode of house financing that has been provided by the banks exercising Islamic Banking is *BBA* House Financing. This concept of financing has been introduced since 1993 with the introduction of the Interest-Free Banking Scheme (known in its Bahasa Melayu acronym as SPTF, namely *Skim Perbankan Tanpa Faedah*).

A study of the Islamic financing in Malaysia shows the tendency of the banks involved to prefer sale-based mode of financing over other modes of financing. As a general rule, sale-based mode of financing can contractually guarantee a fixed flow of income to the banks or financiers. Other modes of financing, particularly the equity-based financing are perceived as having a higher risk portfolio due to its inability to contractually guarantee neither profit nor capital. This may superficially serve as part of the reason of the market's preference to sale-based mode of financing over equity-based mode of financing.²

Sale of house under construction is a famous trend in Malaysia. Unfortunately, the house projects were increasingly being abandoned. The issue on the abandoned house project is no longer a new thing. In everyday news we can see the moaning and groaning of the victims of the abandoned project asking for the help from the government to intervene in that case.³ The government in fact, has tried up to the best level in giving hands to those victims including through legal action and also potential introduction of a new concept "Build and Sell" for the future house project. In other words, through this new concept the houses can only be sold after their completion and getting the certificates of fitness. The housebuyer can later own the house without the risk of being a victim for abandoned house project. As such, there will be a potential regulation in the future, that the house which is the subject matter of the financing should be a ready or available house.

² Engku Rabiah Adawiah Engku Ali. (2003), "Islamic Law Compliance Issues in Sale-Based Financing Structures as Practised in Malaysia", *Malayan Law Journal*. 2003: 3: p 8-9

³ "Jangan Tangguh Laksana Konsep Bina Dan Jual", *Utusan Malaysia*, 30 Ogos 2004

The government is willing to prove its concern to protect the rights and interests of the public particularly from the developers who are not responsible for an abandoned project, because the end result will be the house buyers will continue to pay the house price (amount of facility) to the bank despite the fact that the houses are incomplete and they cannot own the house purchased from the developers.

Therefore, this research aims at analyzing the issue of the most appropriate mode of Islamic house financing for both the house under construction as well as the "build and sell" house which are inline with Shariah compliances and capable to protect the interest of the house-buyers as a whole.

SALE: SHARIAH PERSPECTIVES

In general, sale can be defined the exchange of a thing of value by another thing of value with mutual consent. Sales and trade are expressly allowed and in fact encouraged in Islam. Chapter 2: verse 275 of the Quran clearly indicates that sales and trade are permitted as a general rule. Only if the sale or other trading transactions are to involve *ribā* that they become prohibited, as an exception to the general rule. The translation of the verse reads:

Those who devour usury (ribā) will not stand one whom the evil one by his touch hath driven to madness. That is because they say: "trade is like usury", but Allah hath permitted trade and forbidden usury.

Further, in a narration on the authority of Rafī':

The Prophet was asked: Which are the best forms of income generation? He replied: A man's labor and every legitimate sale.⁵

Thus, it is clear that sales and trade are approved and encouraged activities in Islam. Yet, in order to be valid and enforceable, the sale has to conform to a number of rules and conditions, principally to ensure that the trade conducted satisfies the requirement of mutual consent as evidenced in verse 29 of Chapter 4 in the Quran which reads to the effect:

⁵ Mentioned by al-Suyūti (1980), *al-Jami' al-Saghir fi Ahadith al-Bashir wa-al-Nadhir*. Bayrut: Dar al-Fikr, v. 1, p. 114.

But let there be among you traffic and trade by mutual good will.
(al-Nisa': 29)

This requirement of mutual consent is arguably that main reason for the various rules put forward by Muslim jurists for trading contracts.

In Islam, to be a valid sale, the sale contract must fulfill all these three elements namely contractual expression, contractual parties and subject matter of the contract. These elements are subjected to its own conditions, which are as follows:⁶

- i) Condition for contractual expression (offer and acceptance)
 - a) Both offer and acceptance must be made in clear terms.
 - b) Conformity between offer and acceptance
 - c) Continuity between the offer and acceptance, actually or constructively.

- ii) Conditions for contracting parties:
 - a) Having legal capacity to enter into a contract
 - b) Having legal authority to enter into a contract either as the actual owner or by delegation.

- iii) Conditions for the subject matter of contract:
 - a) The commodity should exist at the time of contract.
 - b) The seller should have acquired the ownership of that commodity. Therefore, if the commodity exists, but the seller does not own it, he cannot sell it to anybody. Mere ownership is not enough. It should have come in to the possession of the seller, either physically or constructively. If the seller owns a commodity, but he has not taken its delivery himself or through an agent, he cannot sell it. There are only two exceptions to this general principle in Shariah. One is Salam and the other is *Istiṣnā'*.
 - c) The commodity should be capable of delivery at the time of contract.
 - d) The commodity should be ascertained and known by both contracting parties.

It is observed that all the rules and conditions above are meant to accord adequate information and legal certainty to both contracting parties, as to the results and

⁶ Wahbah al-Zuhayli (1989), *al-Fiqh al-Islāmī Wa Adillatuh*. Vol 4. Syria: Dar al-Fikr, p.104

consequences of the contract that they are entering into. The avoidance of uncertainty is of paramount importance. Since the contract is a financial exchanges contract, both parties must be sufficiently informed of all the terms and counter values involved, so as to ensure their satisfaction and consent to the contract. The rules and conditions are also meant to safeguard the contracting parties' interests against any potential frustration or disputes regarding the obligations arising from the contract.⁷

Therefore, the issue of appropriateness of the modes of house financing for both the house under construction as well as the ready or available house can reflect the rights and interests of the house buyers. This is because the house under construction where it is deemed to be inexistence at the time of the contract could trigger the condition of subject matter. This issue will be attended to, later in the article.

BAY' BITHAMAN AJIL (BBA)

BBA can be defined as the sale of an object against an obligation to provide payment on a future date. It is a contract of exchange, whereby the commodity exchanged is delivered immediately and the price is paid by instalments.⁸ It is the most favourite and common type of Islamic financing as few people can afford to buy a house, land consumer goods etc. on cash terms. However, *BBA* financing is widely used for housing purchases⁹, particularly for the house under construction.

Concepts

This financing is based on the *BBA* contract which is referred to a sale with a deferred payment. Normally, *BBA* has been utilized for financing the house under construction. This situation happens where the customer pay ten percent (10%) payment of the house to the developer upon signing sale and purchase agreement, and the remaining ninety percent (90%) shall be financed by the bank using *BBA* House financing.

As laid down by the banks practicing Islamic banking, the modes of financing under the principle of *BBA* are as follows:¹⁰

⁷ Engku Rabiah Adawiah Engku Ali (2003), "Islamic Law Compliance Issues in Sale-Based Financing Structures as Practised in Malaysia", *Malayan Law Journal*, Vol. 3, p. 11

⁸ Norhashimah Mohd Yasin (1997) "Financing Aspects of Al Bay' Bithaman Ajil (BBA) Contract", *Current Law Journal*, Supp i: p.1.

⁹ Norhashimah Mohd Yasin, *op. cit*

¹⁰ BIMB (1994), *Islamic Banking Practice: From the Practitioners' Perspective*. Kuala Lumpur, p.72

- a) The bank first determines the requirements of the customer in relation to the period and manner of payment;
- b) The bank purchases the asset concerned;¹¹
- c) The bank subsequently sells the relevant asset to the customer at an agreed price comprising the actual cost of the asset of the bank plus the bank's margin of profit and allows the customer to settle payments by instalments within a period and in the manner as agreed.

Rules

BBA, sometimes referred as *Bay' Al Mu'ajjal* have its rules pertaining to it as given by the Ḥanafis conpedium of *fiqh*, i.e. *Majallah al-Aḥkām al-Adliyyah* in articles 245-251. The *Majallah* refers to *bay' al mu'ajjal* as *bay' al nasi'ah* or *bay' bi ta'jil wa al taqsīt*. Article 245 provides for the validity of *bay' al-mu'ajjal*, whereby, it says:

"A sale for a deferred payment or payment by installment is good."

In deferred sales, it is necessary that the time for payment of the price be fixed and known by both parties.¹² The deferred sale is considered *bāṭil* (bad) of the bargain is made for a time not fixed, such as, when it has rained.¹³ Alternatively, the *Majallah* provides in Article 249 that if no time is fixed when a sale is made on credit the time for payment expires in one month. With regards to the calculation of the time for payment, Article 250 provides that in case of deferred payment or payment by installments; the time agreed upon is calculated from the delivery of the thing sold. The *Majallah* also gives recognition to use and custom in determining whether a sale is to be paid by deferred payment or not. It provides in Article 251 that a sale without stipulation as to time is an agreement for ready money. But in a place where there is a use and custom to pay by known installments or at a time known, the unconditional sale is turned into a sale for payment at that time. For example, if anyone sells a thing from the market without saying anything about deferred payment; it becomes necessary to pay the money at once. But, if there is a use in the town to receive a fixed quantity or the whole amount of the price, at the expiration of a week, or a month, respect is paid to the custom.

¹¹ In usual practice, the bank will appoint the customer as its purchasing agent to purchase the required asset on its behalf.

¹² *Majallah al-Aḥkām al-Adliyyah*, Articles 246-247

¹³ *Ibid*, Article 248

Legal Issues

Ownership

There is a Shariah requirement that the seller must own the property before he can sell that particular thing/asset. This opinion is based on the prophet's hadith:

"Do not sell what is not with you" means not to sell what one does not own (*lā tabi' mā laysa 'indaka*) at the time of sale.¹⁴

Therefore, under BBA, which is deferred payment sale, the seller is supposed to have an ownership over the property of which he wanted to sell. Under the Property Purchase Agreement, the customer is supposed to have that ownership. There is an argument that sale and purchase agreement (through the payment of ten percent deposit), has created a beneficial ownership in favour of the customer. Although this principle is just an equity principle, but it is still considered as good for the customer to sell his beneficial ownership to the bank under the Property Purchase Agreement. However, whether or not the Sale and Purchase Agreement can create beneficial ownership is still a contentious matter.

Contract

Based on BBA House financing, the relevant financing documents are Property Sale Agreement (PSA) and Property Purchase Agreement (PPA). These two agreements are very important where they regulate the contract between the bank and the customer. Under this situation, the bank purchases the asset concerned and subsequently sells the relevant asset to the customer at an agreed price comprising the actual cost of the asset of the bank plus the bank's margin of profit.

The issues arise because the practice for the sell and buy back does not reflect the real BBA. This is because the ultimate intention for BBA is to acquire an asset or property, whereas for this practice (sell and buy back), the ultimate intention under PSA and PPA is simply to obtain cash money to be paid to the house developers.

The intention to obtain the money reflects the concept of *Bay' al-'Inah*. *Bay' al-'Inah* is generally known as sale based on the transaction of *Nasī'ah* (delay). The (prospective) debtor sells to the (prospective) creditor some object for cash which is payable immediately; the debtor immediately buys simultaneously the same object for

¹⁴ Muhammad Ibn Ismail al-San'anī (t.t), *Subūl al Salām Sharḥ Bulūgh al-Marām*. Vol 3, Cairo: Al-Maktabah al-Tijāriyyah, p.17.

a greater amount for a future date.¹⁵ Thus the transaction amounts to a loan. The difference between these two prices represents the interest. Such contract was evolved in the early period of Islam and it exists for the fundamental reason that a loan for interest is forbidden because it is equivalent to usury (*ribā*). In this contract, there is an economic interest for both the borrower and the lender, which at the same time circumvents the prohibition of usury. The issue which concerns us here, is how does Islamic law view such contract: whether the sales be allowed *prima facie*, or disallowed because the motive behind the sales is to legalize that which is illegal or usurious.¹⁶

In Islamic law, *Bay' al-'Inah* is only permissible under the Shāfi'is and Zāhiris, where they argued that since the contracts fulfilled all the requirements of a valid sale, they cannot be nullified by mere assumption of the existence of an illegal ulterior intention to circumvent the prohibition of *riba*. According to them, legal judgment can only be given based on the expressed or manifest intention, not the hidden intention which is left to be judged by God.

Therefore, according to Shāfi'ī school such sales are allowable because, in the words of Imam Shāfi'ī, contracts are valid (*ṣāḥiḥ*) by the external evidence that they were properly concluded: the unlawful intention (*niyya* or *qaṣd*) of the parties is immaterial, it does not invalidate their act, unless expressed in that act.¹⁷ Al-Shafi'ī considered that the intention of the parties is taken into account only when the invalid intention is explicitly mentioned in the contract. However, both the Shāfi'is and Zāhiris considered *Bay' al-'Inah* as discourages (*makrūh*) despite acknowledging its validity.¹⁸

On the other hand, for the other schools of law (majority's view) namely Mālikis and Ḥanbalis disallow it and consider *Bay' al-'Inah* is void, because it is a legal trick to circumvent the prohibition of *riba* (usury). This argument is based on the concept of "plugging the door to harm (*sadd al dhāriah*), or perhaps comparable to modern-day concept of closing flood-gate.¹⁹

Besides that, the main arguments of those who are against *BBA* is that it opens the back-door towards interest-based transactions. They argue that if we accept the

¹⁵ Schacht (1993), *An Introduction to Islamic Law*. New York : Oxford University Press, p. 79.

¹⁶ Saiful Azhar Rosly, Mahmood M. Sanusi (1999), "The Application of Bay' Al-'Inah and Bay' Al-Dayn in Malaysian Islamic Bonds: An Islamic Analysis", *International Journal of Islamic Financial Services*, Vol 1 No.2

¹⁷ Qadri. *Islamic Jurisprudence in the Modern World*, pp. 334-335.

¹⁸ al-Zuhailī, *op. cit.*, pp. 466-467.

¹⁹ *Ibid.*

difference between spot and future prices of commodities, we cannot logically reject interest, which is also an identical difference between the spot and future prices of a commodity called money. Hence they argue that *BBA* is a mere stratagem to avoid the name of interest and yet retain its substance. The report of The Council of Islamic Ideology (Pakistan) on the Elimination of Interest, for example, sounded a note of caution in this regard in these words:

“However, although this mode of financing is understood to be permissible under the Shariah, it would not be advisable to use it widely or indiscriminately in view of the danger attached to it of opening a back door for dealing on the basis of interest.”

Ṣiddīqī has also expressed his sentiments in the matter in the following words: “I would prefer that *bay' al mu'ajjal* be removed from the list of permissible methods altogether. Even if we concede its permissibility in legal form, we have the overriding legal maxim that anything leading to something prohibited stands prohibited. It will be advisable to apply this maxim to *bay' al-mu'ajjal* in order to save interest-free banking from being sabotaged from within.”²⁰

Another argument forwarded by the opponents of *Bay' al Mu'ajjal* is that it is what was intended by the prophet in His Hadith:

*“The Prophet s.a.w. prohibited two sales in one single sale”*²¹

The Hadith is subjected to many interpretations by the jurists that are with regards to the meaning of “*two sale in one single sale*”. Among the interpretation of the phrase is, the sale of a commodity with two different prices, i.e. one for the spot price and the other with two different prices (spot and future prices) in one transaction is prohibited.

Sale of Thing Which is Non-Existent

Under the current practice of *BBA*, the customer is selling non-existence or incomplete existence of a house to the bank and vice versa. This situation is actually contrary to the Shariah requirements for the conditions of subject matter. In sale contracts, subject matter is among the most essential elements of the contract. Failure to meet such elements for the subject matter may render the sale contract void. Even when the

²⁰ Siddīqī, Muḥamad Nejatullah (1983), *Issues in Islamic Banking*. Leicester: The Islamic Foundation, p. 139.

²¹ Narrated on the authority of Abū Hurairah. Ibn 'Umar, Ibn Mas 'ūd; as quoted by Wahbah al Zuhailī. Op. cit. Vol.4, p.471.

subject matters exist, they are subject to quite stringent conditions as to ascertain ability, control and value. What more if the subject matter is non-existent, where the Islamic law rules of contract applicable are admittedly much more rigorous, compared to straight-forward sale contracts with ready or available subject matter. As such, the transaction using *BBA* house financing could trigger the basic condition for the subject matter of a valid contract namely the commodity should exist at the time of contract.

Financing Documents²²

Property Purchase Agreement

This is an agreement made between the bank and the customer. The bank purchases the property from the customer at an agreed price. It reflects the purchase transaction by the bank of the property from the customer. This agreement is exempted from stamp duty under the Stamp Duty (Exemption) Order 1987 (P.U. 69/87) 20.1.87.

Property Sale Agreement

This is an agreement made between the bank and the customer. The bank sells the property to the customer at the price, repayment period and monthly instalment agreed upon. It reflects the sale transaction by the bank of the property to the customer. This agreement is subject to *ad valorem* stamp duty.

Charge Document (Form 16A and Annexure) (Asset Acquisition When The Issue Document Of Title (IDT) Has Been Issued)

The customer agrees to charge the property to the bank to secure the payment of the bank's selling price within the payment period agreed upon.

Deed Of Assignment (By Way of Security) (Asset Acquisition When The IDT Has Not Been Issued)

This is an agreement made between the bank and the customer whereby the latter agrees to assign all his rights and interests over the property to the former as security for the financing facility granted. The agreement will be endorsed by the developer to signify acknowledgement and consent to such an assignment.

²² Norhashimah Mohd Yasin, *op. cit.*

It is argued that the practice of a financier executing sale agreement *cum* assignment when selling a property, for which IDT is not issued as yet, is also not necessary. An assignment, in this circumstance, is argued to be no different from the case where a developer sells property without individual title.

ISTIṢNĀ'

Concept and Definition

The word *Istiṣnā'* is derived from an Arabic word of *sana'a* which means making,²³ manufacturing or constructing something.²⁴ *Istiṣnā'* is a contract of exchange with deferred delivery, applied to specified made-to-order items. This is a contract whereby a party undertakes to produce a specific thing which is possible to be made according to certain agreed-upon specifications at a determined price and for a fixed date of delivery. This undertaking of production includes any process of manufacturing, construction, assembling or packaging. It is also an instrument of pre-shipment financing and it is a contract where the deal can be referred to something not in existence at the time of concluding the contract. However, in *Istiṣnā'*, the work is not conditioned to be accomplished by the undertaking party and this work or part of it can be done by others under his control and responsibility.

Istiṣnā' differs from *ijara* in that the manufacturer must procure his own raw materials. Otherwise the contract would amount to a hiring of the seller's wage labour as occurs under *ijārah*. *Istiṣnā'* also differs from *Salam* in that;

- a) The subject-matter in *Istiṣnā'* is always something that needs manufacturing while *Salam* is possible in anything whose descriptive conditions can be fulfilled;
- b) It is necessary in a *Salam* contract that the price is paid in advance while in *Istiṣnā'* it can be prompt, deferred or paid in installments;²⁵
- c) The classical jurists have also maintained that *Salam* is binding while *Istiṣnā'* is not. However, this is not the modern approach

²³ Ibn Manzūr, Muhammad Ibn Mukarrām (1990), *Lisān al-'Arab*. Beirut: Dār Ṣadīr, Vol. 8, pp. 208-212

²⁴ Ibn Ya'acub al-Fayrozabadī (1983), *al-Qamūs al-Muḥīṭ*. Beirut: Mua'ssat al-Risālah, p.54

²⁵ Dunya, Shawkī Aḥmad (1991) *al-Ju'āla wa al-Istisna' Taḥlīl Fiqhī wa Iqtisādī*. Jeddah, Saudi Arabia: al-Bank al-Islāmī Li al-Tanmiyyah, p.30.

- d) The Classical jurists have also pointed out that the time of delivery is an essential part in the contract of *Salam* while it is not necessary in *Istiṣnā'*.²⁶ However, modern jurists again reject this point of difference.

Istiṣnā' and Parallel Istiṣnā'

Generally, in Islamic banking practiced in Middle East countries, *Istiṣnā'* is frequently employed to finance manufacture or construction projects. For example, if a client seeks financing for the construction of a house, the financier may undertake to construct the house on the basis of *Istiṣnā'*. Since it is not necessary that price to be paid in advance, nor it is necessary to be paid at the time of delivery, the parties may agree in the manner and time for payment. As such, the payment may be in installment, according to the convenient of the customer. Another arrangement is called back to back *Istiṣnā'* or parallel *Istiṣnā'*. In this arrangement, the bank will enter into the contract of *Istiṣnā'* with the customer, and later contracted the second *Istiṣnā'* contract with the manufacturing party. This structure is normally used by the Islamic bank to finance purchases of major manufactured goods such as ships or planes. Under the first *Istiṣnā'* the bank as a seller accepts a long term schedule of payments from its customer, while under the second *Istiṣnā'* he bank as buyer pays the manufacturer over a shorter period with progress payments.²⁷

Therefore, applying the same process and principles in Malaysia this process of parallel *Istiṣnā'* can be used by the bank to finance the construction of a house. Under this scenario, the bank will enter into an *Istiṣnā'* contract with the customer to construct a house based on the agreed terms and conditions while adding a reasonable profit over the cost. The bank will then enter into another *Istiṣnā'* contract with the contractor to construct the house as per the agreed terms and conditions and will make periodical payments to the contractor according to the stage of work completed (the Bank may appoint the customer as its agent to monitor the progress of the construction).

Upon completion the bank will deliver the property to the customer and the customer will pay (normally on deferred terms) the cost plus the bank's required profit. It is not a condition for *Istiṣnā'* that the price should be paid in advance.

²⁶ Ibn 'Abidin (1986) *Rād al-Mukhtār 'ala Sarḥ al-Dūr al-Mukhtār*. Makkah al-Mukarramah: al-Maktabah al-Tijāriyyah, v. 7, p.225.

²⁷ Muhammad Taqi 'Usmani (1999) *An Introduction to Islamic Finance*. Pakistan: Idārat al-Maārif, pp.185 – 198

Time of Delivery

As pointed out earlier, it is not necessary in *Istiṣnā'* that the time of delivery is fixed. However, the purchaser may fix a maximum time for delivery which means that if the manufacturer delays the delivery after the appointed time, he will not be bound to accept the goods and to pay the price. In order to ensure that the goods will be delivered within the specified period, some modern agreements of this nature contain a penal clause to the effect that in case the manufacturer delays the delivery after the appointed time, he shall be liable to a penalty which shall be calculated on daily basis. Can such a penal clause be inserted in a contract of *Istiṣnā'* according to Shariah? Although the classical jurists seem to be silent about this question while they discuss the contract of *Istiṣnā'*, yet they have allowed a similar condition in the case of *ijārah*. They say that if a person hires the services of a person to tailor his clothes, the fee may be variable according to the time of delivery. The hirer may say that he will pay Rs. 100/- in case the tailor prepares the clothes within one day and Rs. 80/- in case he prepares them after two days. On the same analogy, the price in *Istiṣnā'* may be tied up with the time of delivery, and it will be permissible if it is agreed between the parties that in the case of delay in delivery, the price shall be reduced by a specified amount per day.²⁸

Legal Issues

Sale of Thing Which is Non-Existent

The importance of studying the existence of the subject-matter of a contract during the conclusion of *Istiṣnā'* lies, in the fact that the contract of *Istiṣnā'* is basically a future trading contract where the subject-matter is non-existent at the time of the contract.²⁹ However, Ḥanafis considered *Istiṣnā'* as an independent legal contract on the basis of *Istiḥsān* (public interest).

Muslim jurists have tried to establish the legality of this contract from different legal sources: the Quran, the *Sunnah*, *Ijmā'*, *Qiyās*, *Istiḥsān* and *Māslāhah*. However *Istiḥsān* seems to represent the first legal basis for this contract especially in the literature of the classical schools of law. Al-Kasani in this regard said:

²⁸ Muhammad Taqi Usmani, *op. cit*

²⁹ al-Kasāni (t.t.), *Baddī' al-Sanaī'*. Vol 6, p.2678

...Concerning the legality of *Istiṣnā'*, in principle it would not be allowed on the basis of *Qiyās* because it is a sale of what we do not have nor on the basis of *Salam* and the Prophet had prohibited the sale of what we do not have...and it is allowed because people are unanimous about its need. They have used it through the ages and the prophet has said” My Community shall never agree on an error” and “What is good for Muslim is good in the sight of Allah”.³⁰

The Option of Defect and the Option of Desired Description in Istiṣnā'

The two major types of options related to the contract of *Istiṣnā'* are the option of defect and the violation of the desired description because a commodity manufactured under *Istiṣnā'* may turn out to be defective.

These two kinds of options have great similarities and have the same legal bases.³¹ The option of defect is the right of the buyer to cancel the contract or to confirm it if he discovers a defect in the object, which diminishes its value. The option of the violation of the desired description is the right to rescind the contract due to the absence or violation of the desired description stipulated by the contracting parties in the subject-matter of the contract.

As a mode of financing

Istiṣnā' can be used for providing the facility of financing in certain transactions, especially in the house finance sector. If the client has his own land and he seeks financing for the construction of a house, the financier may undertake to construct the house at that open land, on the basis of *Istiṣnā'*, and if the client has no land and he wants to purchase the land also, the financier may undertake to provide him a constructed house on a specified piece of land.

Since it is not necessary in *Istiṣnā'* that the price is paid in advance, nor is it necessary that it is paid at the time of delivery, (it may be deferred to any time according to the agreement of the parties,¹), therefore, the time of payment may be fixed in whatever manner they wish. The payment may also be in installments. On the other hand, it is

³⁰ This is not a genuine Hadith. It is just that saying of Ibn Mas'ud, reported by Aḥmad, al-Bazzār and al-Ṭabarī, see Ahmad Shakīr's comment on *Musnad al-Imām Aḥmad*, vol. 5, p.211 Hadith No. 3600.

³¹ Ibn Ḥazhm, 'Ali Ibn Aḥmad, *al-Muḥalla*, Beirut: Dār al-Fikr, Vol 9, p.41; Vol. 8, p. 314

not necessary that the financier himself constructs the house. He can enter into a parallel contract of *Istiṣnā'* with a third party, or may hire the services of a contractor (other than the client). In both cases, he can calculate his cost and fix the price of *Istiṣnā'* with his client in a manner which may give him a reasonable profit over his cost. The payment of installments by the client may start, in this case, right from the day when the contract of *Istiṣnā'* is signed by the parties, and may continue during the construction of the house and after it is handed over to the client. In order to secure the payment of the installments, the title deeds of the house or land, or any other property of the client may be kept by the financier as a security until the last installment is paid by the client.

The financier, in this case, will be responsible for the construction of the house in full conformity with the specifications detailed in the agreement. In the case of any discrepancy, the financier will undertake such alteration at his own cost as may be necessary for bringing it in harmony with the terms of the contract.

In other case, the instrument of *Istiṣnā'* may also be used for project financing on similar lines. If a client wants to install an air-conditioning plant in his factory, and the plant needs to be manufactured, the financier may undertake to prepare the plant through the contract of *Istiṣnā'* according to the aforesaid procedure. Similarly, the contract of *Istiṣnā'* can be used for building a bridge or a highway.

The modern BOT (Buy, Operate and Transfer) agreements may also be formalized on the basis of *Istiṣnā'*. If a government wants to construct a highway, it may enter into a contract of *Istiṣnā'* with a builder. The price of *Istiṣnā'*, in this case, may be the right of the builder to operate the highway and collect tolls for a specified period.³²

Financing Documents- applicable for a house construction where the customer is not the contractor³³

Istiṣnā' Facility Agreement (Bank–Customer)

³² Muhammad Taqi 'Usmānī, *op. cit.*

³³ Ahmad Lutfi Abdul Mutalip (2004), *Legal Documentation for Istisna' Financing*, paper presented in Course on Legal Documentation for Islamic Financing, Pan Pacific Hotel Kuala Lumpur, 15-16 June 2004, pp. 9-14

On approval of application, the bank will enter into this agreement with the customer to set out the terms of the financing and the terms therein will have to be acknowledged by the contractor nominated by the customer.

Istiṣnā' Sale Agreement (Bank-Customer)

The bank will enter into this agreement with the customer for the bank to construct and sell the house to the customer based on the agreed terms at the *Istiṣnā'* selling price (being financing amount plus the bank's profit).

Istiṣnā' Purchase Agreement (Bank – Contractor/Developer)

The bank will then enter into this agreement with the contractor to construct and purchase the house from the contractor as per the agreed term at the purchase price (being financing amount requested by the customer) and will make progressive payments to the contractor according to the stages of works completed.

Supervision and Construction Agreement (Contractor/Developer –Customer)

Pursuant to the *Istiṣnā'* Purchase Agreement, the bank will authorize the customer to enter into the Supervision of Construction Agreement with the contractor wherein the customer will supervise and oversee the construction of the house on behalf of the bank.

General agreement upon principles of practice is difficult to identify, however it is often stated that:

- a) the nature and quality of the item to be delivered must be specified.
- b) the manufacturer must make a commitment to produce the item as described.
- c) the delivery date is not fixed. The item is deliverable upon completion by the manufacturer.
- d) the contract is irrevocable after the commencement of manufacture except where delivered goods do not meet the contracted terms.
- e) payment can be made in one lump sum or in installments, and at any time up to or after the time of delivery.
- f) the manufacturer is responsible for the sourcing of inputs to the production process.

Where the Challenges lie?

Based on the discussion on the legal issues of *BBA* and *Istiṣnā'*, the application of *BBA* house financing as practice nowadays by the banks is subjected to many contentious issues to be discussed. The question of appropriateness of this mode of financing to the non-completion house (under construction) is never challenged by the banks. As we discussed earlier, the reason could be that this mode of financing is the easiest way for the banks to get the profit. However, the rights and interests of the house buyers are never concerned particularly when the house projects are abandoned by the house developers.

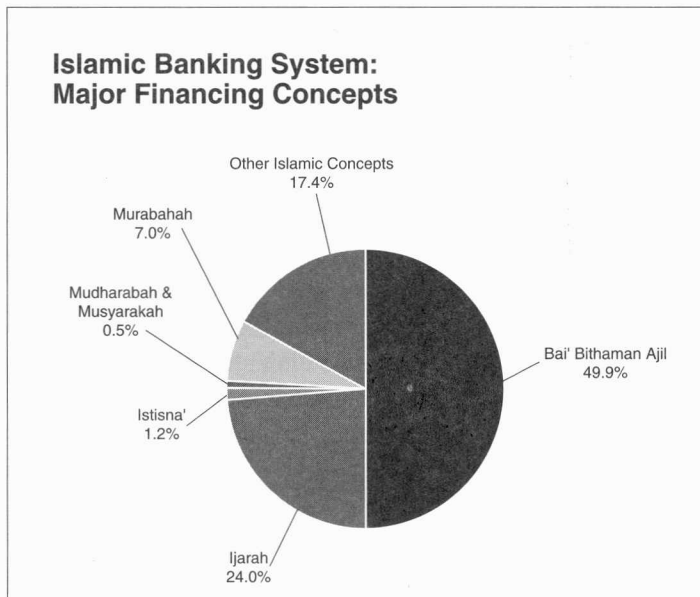
On the other hand, *Istiṣnā'* financing seems to be the most appropriate tool of financing for the house under construction. However, it is undeniable that the reality in practice may make it difficult if not impossible for the tripartite parallel *Istiṣnā'* described above to be undertaken by the parties. In reality, financiers always show reluctance to undertake any arrangement that is perceived as high-risk. In the tripartite arrangement, the financiers are directly exposed to the risks associated with *Istiṣnā'* contracts, where the financiers contractually bear the responsibility of ensuring the successful completion of the construction, back-to-back with the actual contractor. The financiers are also directly answerable to their end-buyer (house-buyers/customer); who, for all the obligation arising from the *Istiṣnā'* contract, including that of non-completion or defective construction of the building. In practice, financiers are generally not keen of undertaking all these risks.

Furthermore, *Istiṣnā'* remains as less popular financing concept and can still be regarded as relatively new whether in one layer –layer financing structure, as well as multi-layered financing structure. In 2004, it was also reported by the Bank Negara that financing based on *BBA* (deferred payment sale) concept remained dominant, constituting 49.9% of total financing while financing based on *Istiṣnā'* only constituted 1.2% (Refer to graph below).³⁴

However, if the banks or financiers provide *Istiṣnā'* financing, in which the banks and the financiers as well as the developer would bear the risk for the completion of the house, the problem of abandoned house project might be decreased. This is happen when these two bodies are given the greater responsibility for the completion of the house project before getting the profit from the house sold. The concept of *BBA* financing

³⁴ Bank Negara Malaysia (2004) *Annual Report*. Kuala Lumpur: BNM.

might be more appropriate for the new concept of “Build and Sell”, but not for the house under construction.



Source: Bank Negara Malaysia

CONCLUSION

From the foregoing discussion on *Bay' Bithaman Ajil (BBA)* and *Istisnā'*, it is clear that *BBA* house financing might be appropriate for the ready or available house through the new concept of “Build and Sell” and the house projects which are under construction might be appropriate with *Istisnā'* house financing.

It is observed that, through all the rules and conditions of sales in Shariah, the appropriate mode of house financing is able to safe guard the interests of the house-buyers. Therefore, it is hoped that there will be a room for the improvements to the structure and practice of Islamic banking and finance in Malaysia for the house financing. Islamic financing fraternity must take up challenges to continuously develop new products and improve the existing ones. These improvements of course, would require the collective responsibility between the banks or financiers and the house developers as well as the government, so as to ensure that the house buyers will be no longer become the victims of the abandoned house projects.