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Hanafi's Approach to Deal with Shari'ah Non-Compliance Transactions in Islamic Finance

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Abstract: The study aims at discussing the approach toward Shari'ah non-compliance transactions in Islamic financial institutions (IFIs). The Hanafi's approach in dealing with invalid contracts is employed. The study reveals that defects in contracts requires either re-execution or rectification. Based on the Hanafi's approach, not every defect in contracts calls for re-execution and purification. Some defects need only rectification. Once the necessary amendments have been made, the contract is valid and the legal effect is then operative. Moreover, not all Shariah non-compliant transactions is to be purified by way of channeling it to charity. There are also possible instances whereby the proceeds generated need to be returned to the original owner. The study provides a new approach to IFIs in dealing with Shari'ah non-compliant transactions and gives clear insight on how the defects in contracts are to be treated. The finding of the study is valuable for regulators in formulating the appropriate methodology on how to treat Shari'ah non-compliant transactions in IFIs.

Key words: Hanafi's approach, *batil*, *fasid*, purification, rectification.

INTRODUCTION

The concern over Shari'ah-compliant transactions is firmly entrenched in the activities and operations of Islamic financial institutions (hereafter IFIs). As a business entity established within the ambit of Shari'ah, an IFI is expected to be guided by values, principles, objectives and rulings of the Shari'ah. However, ensuring effective Shari'ah compliance is not a straightforward matter. As financial markets become increasingly sophisticated, heightened product innovations and engineering in Islamic finance entail genuine concern over the need to strengthen Shari'ah compliance throughout the product life cycle. This means that, while a product may be deemed Shari'ah compliant prior to its launch (ex-ante), the IFI must also be cognizant of the need to ensure that the entire ex-post process—including contract execution, utilization of funds, investment activities, the audit and governance process—are all in place. Off course, we never expect that IFIs are dealing with Shari'ah non-compliant transactions, but many cases in the market prove that non-Shariah compliance is sometimes unavoidable.

In addition to, there is a kind of misperception in the market today that should a bank fails to act in accordance with the Shari'ah rules, the transaction is null and void from a Shari'ah viewpoint so that re-execution should be made from the beginning in place and that all income derived from it is tainted and to be purified. However, the obligation resulting from Shari'ah non-compliant transactions is not always purification. There are also instances in which the transaction can be rectified and the proceeds can still be recognized as the IFI's income, provided all the necessary amendments have been made.

Against this backdrop, the present study undertakes the approach on dealing with Shari'ah non-compliant transactions in Islamic finance. In particular, the study provides critical analysis to deal with invalid contracts based on Hanafi's approach. In view of this, the study aims to address the following questions:

1. what is the classical jurists' views on invalid contracts and the method to deal with?
2. how the Hanafi's approach in dealing with Shari'ah non-compliant transactions is applied in IFIs?

Following this brief introduction, the study is organized in accordance to the following structure: the next section discusses the established schools of thought in Islamic jurisprudence and the theory of contract from Shari'ah perspective. The third section elaborates the Hanafi's conceptualization on invalid contracts. The fourth section examines the approach to dealing with invalid contracts based on Hanafi school. The next section provides sample scenarios for how IFIs treat Shariah non-compliant transactions, while the final section concludes the study.

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Established Schools of Thought:

Islamic law is established upon two primary sources, namely divine revelation (*naqli*) and personal reasoning (*'aqli*). The former is detailed in the Qur'an and Sunnah which assume the central references of Shariah. Meanwhile, the letter is the basis of Islamic jurisprudence (*fiqh*) which is done through the process of *ijtihad* (juristic reasoning) in deriving the Shari'ah ruling from Qur'an and Sunnah particularly on the issues related to financial and commercial transactions (*muamalah*). The latter approach was further developed mainly by schools of thought (*madzhab*) (Kamali, 2002; Kamali, 2006).

Madzhab, as a body of doctrine taught by a leader and is followed by the member, plays paramount role in formulating Islamic jurisprudence. It is because being principles sources of Shariah, Quran and Sunnah only provide the general guidelines on almost every major topic of Islamic law thus requires further examination and interpretation from Islamic jurists. There are mainly four authoritative schools of thought recognized by majority sunni muslim, namely Hanafi's school, Maliki School, Shafii School and Hanbali School (Nyazee, 2002)

The Hanafi school is one of the earliest school of thought found by Abu Hanifah Nu'man Ibn Thabit (d.767). He has made a notable contribution particularly to the development of the law on commercial transaction (*mu'amalat*). The Hanafi's school was favored by the ruling of Abbasid dynasty and known for his extensive reliance on personal opinion and analogy (*ra'yu and qiyas*). It is considered as the most humanitarian school of thought particularly concerning the treatment of non-muslim and war captives (Kamali, 2006).

Theory of Contract:

In Islam, contract is the basis of financial transaction in which the income can be legally generated. Islam put emphasis that transactions between two parties have to be established on the notion of mutual consent (4:29) which is translated into modern practice through the law of contract. This provides a parameter for determining the status of income derived from any transaction conducted. According to the majority of jurists, there are only two possible rulings on the status of a contract: valid (*shahih*) and invalid (*ghayr shahih*), and this latter category has other names (*batil* and *fasid*) which can be used interchangeably for it (Zuhaily, 2004). *Shahih* is a contract that is good in its essence (*asl*) and lawful in its external attributes (*wasf*) (al-Rumi, 2004). It is a contract in which all the essential elements ―such as the contracting parties, subject matter, and offer and acceptance―and all the underlying conditions are fulfilled (al-Minyawi, 2010).

From a Shariah point of view, a valid contract establishes all the legal implications that the Shariah has assigned to a contract of that type (al-Namlah, 1999). For example, the buyer attains the exclusive right to utilize the asset while the seller becomes entitled to the consideration. All income generated from this class of contract is deemed legal, and the contract becomes effective upon its execution. The majority of jurists hold the view that the effectiveness of a valid contract may be suspended until the occurrence of a future event. In contrast, the Shafii School and some Hanbali jurists hold that a valid contract must become immediately effective upon its execution (Ayyub, 2007).

On the other hand, a contract that is invalid (*ghayr shahih*) is one that violates the pillars and conditions of the contract (al-Shawkani, n.d). The following are examples of factors that render a contract invalid: the sold asset is an impure or prohibited commodity such as blood, pork, wine, a carcass; the asset is not fully possessed by the seller or is undeliverable; there is excessive uncertainty in the delivery date or price; or the contract is performed by parties without legal eligibility to execute contracts; i.e., one of the parties is insane, immature or not of sensible conduct. From the Shariah point of view, an invalid contract does not produce the legal effects of that contract. There is no exchange of financial rights and responsibilities due to it; the buyer does not have any right to dispose of the asset, while the seller cannot possess the income realized. Such a contract must be properly re-executed, starting from scratch.

The majority of jurists do not distinguish between *batil* (void) and *fasid* (irregular) in financial transactions (Ibn Qudamah, 2002). Both terms are the opposite of *shahih*, having a single legal implication (al-Ramli, n.d), and are often used interchangeably. On the other hand, the Hanafi School took a different position from the majority of classical jurists. They further classified contracts into three different categories: *shahih* (valid), *fasid* (irregular) and *batil* (void).

Hanafi's Approach to Invalid Contracts:

According to Hanafi school, *batil* and *fasid* assume different ruling and legal implication. While Hanafi agree with majority with regard to the legal implication of *batil*, *fasid*, on the other hand, is an in-between class of contract between *shahih* and *batil* (al-Bukhari, 1997). The Hanafi's stand is premised upon the fact that a defect in a contract is due either to a fundamental element (*asl*) or an accessory attribute (*wasf*). A defect in a contract's fundamental element renders the contract void and that it cannot be rectified. However, a defect in an external factor will only make the contract irregular (*fasid*) (al-Bukhari, 1997). It does not necessarily render it void.

As a illustration, a sale contract enumerates four fundamental pillars: the two contracting parties and the two counter-values. If the four pillars are satisfied and free from any Shariah prohibition, then the contract is valid. In contrast, if the contract is defective in any of its fundamental pillars, it is void. However, if the defect is due to external factors attached to the pillars, the contract is irregular (*fasid*). The following are scenarios that elucidate the Hanafi view regarding the differences between *shahih*, *batil*, and *fasid* (al-Qarafi, n.d):

1. An insane person sells pork for a payment of wine to another insane person. In this case, all the fundamental pillars are defective and, hence, the contract is batil.
2. A legally competent person sells clothes for a payment of pork to another legally competent person. In this case, one of the fundamental elements (pork) is defective, which renders the contract batil.
3. A legally competent person sells one gram of silver in exchange for another gram of silver to another legally competent person. In this case all the pillars of the contract are sound and, hence, the contract is shahih.
4. Based on Scenario No. 3 above, assuming that one gram of silver is exchanged for two grams of silver, the contract is defective due to the existence of an external factor, i.e., an increment. Since the defect is not in its pillars or fundamental elements, the contract is irregular (*fasid*) but rectifiable. Once the increment is removed, the contract becomes valid

Batil Contracts:

According to the Hanafi School, *batil* is a contract that is invalid due to a defect in any of the essential elements (pillars) of the contract (al-Kasani, 1986). The following are examples of such defects: if the contract involves impure or prohibited items as the subject matter; the subject matter has no value from the Shariah perspective; the asset is not fully owned by the seller; the acceptance is not in conformity with the offer; the contracting parties have not reached the age of maturity; the contract contains fraud, deceit, etc.

The Hanafi conception of a *batil* contract shares the same implications as the majority's category, *ghayr shahih* (invalid). A *batil* contract does not give rise to any legal consequences. The contract is treated as if it does not exist. Therefore, the buyer in a sale contract is not entitled to the asset while the seller has no right to the consideration. All income generated from a void contract is ruled as non legitimate; hence, it cannot be possessed or utilized (al-Baz, 2004).

Fasid Contracts:

A *fasid* contract is a unique class of contract recognized in the HanafÊ School's categorization scheme. Unlike a *batil* contract, the essential elements of a *fasid* are present, but the contract is tainted by a defect in an accessory attribute (Mahmud, 2000, 8:139).

Hanafi jurists identified various factors leading to a *fasid* contract, as highlighted below:

1. Ignorance; i.e., insufficient information that may exist with regard to four matters:

a. the asset; e.g., the seller says, "I hereby sell you some of my cloth," and the parties disperse without the seller specifying which cloth is being sold.

b. the price; e.g., the seller says to the buyer, "I hereby sell this asset to you for RM 100 spot payment or RM 200 deferred payment" and the parties disperse without the buyer accepting one of the prices in particular (al-Imrani, 2006).

c. the time of delivery.

d. the guarantee, surety or the pledge; e.g., a seller stipulates a guarantee or pledge without specifying what it is (Zuhaily, 2004).

Insufficient information about any of these four matters, according to Hanafi, renders the contract *fasid* because it will create a dispute between the contracting parties (Zuhaily, 2004). However, if the lack of information entails excessive uncertainty about the delivery date—e.g., selling an asset for delivery if rain falls or if a certain person comes—the contract is ruled *batil* according to all four schools of thought, including the Hanafis (al-Kasani, 1986).

2. The existence of an invalid condition. The Hanafi School defined an invalid condition as a condition that is neither consistent with the nature and implication of the contract, nor endorsed by textual authority, nor admitted by customary practice. The condition even offers a benefit to only one of the contracting parties (or a third party) at the expense of the other contracting party (Zuhaily, 2004). One example is tying a loan agreement to a sale contract; e.g., Ali agrees to give a loan to Bakar on the condition that Bakar sells his asset to Ali. In this case, Bakar may consider discounting the price in favour of Ali due to the loan facility, resulting in a loan that extracts profit (Arbouna, 2007).
3. The existence of an element of *riba* (usury). The majority of jurists consider the existence of *riba* to invalidate the contract. However, the Hanafi School holds that *riba* does not make a contract void; rather, it makes it irregular (*fasid*) and, hence, rectifiable (Wizarat al-Awqaf wa al-Shu'un al-Islamiyyah, 1404-1427AH).

Unlike a *batil* contract, the income from a *fasid* contract is not irretrievably illegal; it is irregular but rectifiable. Once the intolerable elements are eliminated, the contract becomes *shahih*; thus, the income becomes legal.

Indeed, the Hanafi approach to invalid contracts in financial transactions is also supported by some Maliki and Shafii jurists. Al-Qarafi of the Maliki School acknowledged that the Hanafi approach is sound (al-Qarafi, n.d). Some Shafii scholars also differentiate between *fasid* and *batil* in certain contracts such as agency contract (*wakalah*) and leasing contract (*ijarah*). Some even completely follow the Hanafi view in all types of contracts (al-Ramli, n.d). Contemporary *fiqh* scholars have generally adopted the Hanafi's view. Therefore, this paper has employed the Hanafi's model approach to invalid contracts as the methodology to deal and treat Shari'ah non-compliant transactions in IFIs. The authors view the Hanafi differentiation between *batil* and *fasid* to be more practical and relevant to the current context and the needs of market players, due to a number of reasons:

First, practically speaking, not every contractual defect is serious enough to warrant re-execution. Some defects are minor and can easily be rectified by removing the objectionable elements. Second, in the current context, re-execution of contracts creates practical complexity as institutions tend to use boilerplate contracts to undertake the same basic type of transaction with thousand of clients, and some contracts involve cross-border transactions. Adopting the majority view will undoubtedly impose hardship and difficulty on the market. Thirdly, the Hanafi categorization provides more options to the market players to apply the Islamic law of contract in modern financial operations.

Dealing with Invalid Contracts:

In Islam, a Muslim is not supposed to enter into any transaction that is in violation of Shariah rulings and principles. However, in the event that he does transgress the boundary of Shariah principles, the Shariah requires the Muslim to repent and rectify the wrongdoings immediately. In a financial or business transaction, repentance is not sufficient if one still possesses the impermissible assets or income. It is imperative that any invalid contracts shall undergo an immediate process of rectification or purification.

However, the rectification and purification process may vary, depending upon causes. Some invalid contracts to be re-executed and the income recognized is to be purified by channeling all of the tainted money to charity while in some cases it may be required to return the wealth to the original owner. In certain scenarios, rectification can be made without resorting to channeling all the income to charity or the original owner. The following discussion examines the Hanafi's model approach to deal with and treat treatment of Shari'ah non-compliance transactions resulting from invalid contracts.

Treatment of a Batil Contract:

As highlighted earlier, the Shariah does not consider a batil contract to be in existent. Therefore, the transaction does not have any legal effects or implications. Hence, any income derived from this type of contract is unlawful and must be purified. A void sale contract, for example, does not cause any transfer of ownership. The seller should therefore refund the price while the buyer has to return the "purchased asset". Re-execution of contract should be made from the beginning in place if the parties want to proceed with transaction.

Notwithstanding the above ruling, in case the transacted asset is an item clearly prohibited by the Shariah, such as pork, wine or other impure items, the counter-value of such asset must be channeled to public benefit (Ibn Taymiyyah, 2005) and is not to be returned to the original owner. This is in consideration of the Shariah principle that it is unlawful to assist others to commit sins. In this case, re-execution cannot be made as the subject matter is substantially illegitimate.

Treatment of Fasid Contract:

Unlike batil contract, an fasid contract, as promulgated in the Hanafi's approach, does not necessarily require re-execution of the contract. In most cases, the rectification process can be done in one of two ways. The first way is to eliminate objectionable elements that render the contract *fasid*. If such elements are eliminated, the contract becomes valid. This is based on the Hanafi legal maxim: "When the impediment disappears while the reason for the ruling is present, the [original] ruling returns" (Wizarat al-Awqaf wa al-Shu'un al-Islamiyyah, 1404-1427AH, 12:60). Following are examples of objectionable elements that may be rectified by eliminating such elements (Wizaratu al-Awqaf wa Al-Syu'un al-Islamiyah, 1404-1427AH):

1. The existence of ignorance or lacking information in regard with the asset or the price or time of delivery. In this case, according to Hanafi jurists, the contract is deemed *fasid* and may be rectified by eliminating such ignorance elements. The parties should specify the asset to be transacted and determines type of payment to be applied, either on the spot or deferred. The party may also rectify the fasid contract due to ignorance in time delivery by determining the precise and specific time.
2. The existence of invalid condition. The process of rectification may be done by removing the objectionable invalid conditions, thus the contract is valid.
3. The existence of riba element. In this case, the contract may be rectified by removing the condition of *riba* or returning the *riba* element to the original owner.

The second way of rectification process can be done by changing the *fasid* contract into another suitable nominate contract that make the contract valid by looking into substance and essence. There are many examples

of that form discussed by Hanafi jurists, among other are (Wizaratu al-Awqaf wa Al-Syu'un al-Islamiyah, 1404-1427AH):

1. Kafalah contract with the condition that debtor is free from any liability. The contract is basically *fasid* as the condition does not fit the nature and legal effect of kafalah. However, it can be rectified by shifting the contract into hawalah with all its ruling and legal consequence. Once the contract is shifted to hawalah, the contract will eventually valid.
2. Mudharabah contract. The original ruling of mudharabah contract is that a *mudharib* (manager) is a trustee and not held liable for any financial loss. Any profit is shared between *mudharib* and capital provider based on profit sharing ratio agreed upfront. However, if it is stipulated in the contract that all profit belongs to *mudharib* and not to be shared with *rabb maal*, the condition cause the contract *fasid* and may be rectified by turning the contract into *qard* will all ruling and condition of loan. The reason is that a person, from jurisprudence perspective, has an exclusive right to get the entire profit if he is the owner of the capital. Therefore, when a mudharib stipulates a condition that all profit belongs to him, he assumes that he possess the capital. When he possess the capital, it means that he treats the capital of *rabb maal* as a loan to be repaid in kind (*qard*).
3. Wadi'ah is basically a trust based contract. A custodian is not entitled to utilize the deposit in anyway and not held liable to any loss or damage unless in case of negligence or misconduct. However, in case the custodian stipulates the condition to utilize and invest the deposit, the wadi'ah contract becomes fasid. Yet, it can be rectified by turning the wadi'ah contract into the concept of *qard* (loan to be repaid in kind). As a consequence, a custodian is required to guarantee the sum of the deposit and indemnifying it in case of losses or damages.

However, if the objectionable elements persist and the contract is not shifted to another contract that make it valid, the contract becomes void so that all income generated or asset received should be returned to the original owner.

Application of Hanafi's Approach to Islamic Financial Institutions:

The study on the treatment of IFIs has been a subject of wide discussion in the field of Islamic jurisprudence. As discussed in the previous discussion, different defects in contracts necessitate different treatments and approaches. For the purpose of this study, we simplify the discussion by providing examples of their application to various Islamic finance operations.

Table 1: The Treatment of Shariah non-Compliant Transaction Based on Hanafi's Appoach.

1	Description	Treatment
Batil transaction due to a defect in the subject of the contract.	1. The IFI was found to have advanced working capital financing to a wine manufacturing company or to finance the purchase of bottles for the wine.	1. The IFI must channel all profits derived from the financing to charity. The principal amount can be retained. 2. Re-execution of the contract is not allowed because the subject matter is *haram*.
	2. In managing a portfolio, it is found that one of the securities which was previously classified by the Securities Commission as Shariah-compliant stock has been reclassified as non-Shariah-compliant.	1. The IFI must immediately dispose of the non-Shariah-compliant stock. 2. Any capital gain derived from the divestment process can be retained if the disposal took place on the announcement date made by the Securities Commission. 3. If the disposal took place long after the announcement made, then only the principal amount can be retained while any capital gain from the announcement date until the date of actual divestment needs to be channelled to charity.
B. Batil transaction due to absence in one of the pillars in the contract	1. In extending a credit line or cash financing to a company which previously enter into a Letter of Credit (LC) *murabahah* agreement with the IFI, it is found that the second leg sales contract signed with the company does not involve any asset, but mere signing of a document.	1. The contract can be re-executed provided that the asset is still available. 2. If the asset is no longer available (e.g., it has been consumed) or the transaction was completed long ago, the IFI must return to the client all profits earlier recognized from the financing. If the client cannot be traced, it should be channelled to the Bayt al-MÉl. The principal amount can be retained.
	2. In *bay bi thaman ajil* (BBA) for a cash line facility to a corporation, as practised by many Islamic banks in Malaysia, the Asset Sales Agreement (ASA) must be executed first, prior to executing the Asset Purchase Agreement (APA). However, it is found that the APA was executed prior to the ASA, which effectively means the APA was executed without an underlying asset since the client had not become owner of the asset before selling it to the bank. Therefore, whatever amount of financing disbursed by the bank is now deemed a loan rather than originating from a sale contract. Hence, any amount	1. The APA contract is void. 2. The profit derived from the transaction is deemed to be *riba* and, hence, must be returned to the client. 3. If the client cannot be traced, the profit should be channelled to the charity. 4. The principal portion of the financing can be retained by the bank.

	repaid by client in excess of the principal is deemed *riba*.	
C. Fasid transaction due to the presence of an alien condition that is rectifiable.	1. In reviewing a sale contract, it was found that a condition was imposed that the buyer would not have the right to take delivery of the asset purchased.	1. The clause in which the condition is stated must be removed, and the customer must be notified of the rectification.
	2. In reviewing a bank guarantee (BG) facility document based on the *kafalah* contract, it is found that one of the clauses contains a condition that the client (the applicant for BG) shall be released from his debt to the creditor (BG beneficiary). This condition contradicts the nature of *kafalah*, which does not release the client from liability until debt settlement, either by the bank or the client himself.	1. The condition alien to *kafalah* makes the contract irregular (*fasid*). 2. This can be rectified by changing the *kafalah* contract into a *hawalah* contract with all its rules and conditions.
D. Fasid transaction due to the presence of an alien condition that is not rectifiable.	1. In reviewing an inter-bank deposit-placement scheme based on the *wakalah bil istithmar* contract, it was found that a clause required the deficit bank (as agent or *wakil*) to guarantee a certain percentage of return to the Islamic bank as the principal (surplus bank). The contract has matured, and payment of both principal and profit has already been made and received by the IFI.	1. The *wakalah* contract is irregular due to the presence of the unwarranted condition. 2. The contract is deemed a loan. 3. The principal amount can be retained. 4. The profit amount which was previously recognized needs to be clawed back and returned to the counterparty.
	2. In reviewing London Metal Exchange (LME) procedures and policies, it is found that physical delivery of commodities is not allowed. This affects the status of the *murabahah* sales contract signed with the broker, which has a specific clause that disallows taking delivery.	1. The sale contract is irregular due to the presence of unwarranted condition. 2. The contract is deemed a loan. 3. The principal amount can be retained. 4. The profit amount which was previously recognized needs to be clawed back and returned to the counterparty.

Conclusion:

This paper has presented an approach and methodology to deal with Shariah non-compliant transaction for IFIs based on Hanafi's model. It started with the discussion on the theory of contract in Islam. This includes classical jurists views on the validity of contracts. The discussion proceeds with the discussion on the Hanafi's approach and the reason why the Hanafi's model is employed in this study. Various sample scenarios are also presented to give a clear understanding to the readers.

Overall the approach presented here may benefit the practitioners of Islamic financial institutions, and even Muslim entrepreneurs in general, who need specific guidance to improve their exercise of Shariah-compliant practices. The discussion on the diverse approaches to deal with invalid contracts not only provides adequate guidance to IFIs, who must decide which courses to take and how much to commit to them, but more importantly, assists them in constructing a robust Shariah-risk-management framework to prevent noncompliant transactions from actually happening.

Such approach can, therefore, be instrumental in enhancing stakeholders' trust and confidence in the operations of IFIs. It is now commonly acknowledged that the consequences of a weak Shariah compliance process are not only financial but also legal and reputational and can impact the economy as a whole. Hence, sound Shariah compliance practices have become essential for the efficient, viable and sustainable growth of Islamic financial institutions. The fact that Islamic finance has become an integral part of the financial system in many countries means that the soundness of its operations is essential to maintaining the overall robustness of those economies.

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