Penalty and Compensation in Financial Commitments

A Critical Shariah Review

Abdulazeem Abozaid

Associate Professor of Islamic Jurisprudence
College of Islamic Studies
Hamad Bin Khalifa University, Qatar
abozaid.abdulazeem@gmail.com

Received: 30/8/2020 Revised: 30/9/2020 Accepted: 16/11/2020

Abstract

Purpose: The aim of this paper is to critically review the position of Shariah and contemporary *ijtihād* on penalty provisions in financial commitments. It is also to show that some relevant *fiqh* resolutions have dealt differently with similar issues despite the absence of any grounds for such differentiation and to show how penalty provision in contracts has been expanded to include what cannot be accommodated by Shariah principles. All this necessitates a review of those stances, as they may have both unnecessarily burdened the Islamic finance industry and challenged some Shariah principles.
Methodology: This paper employs a qualitative research methodology that adopts textual and *fiqh* comparative analysis approaches. The methodology also incorporates a macro perspective for treating the subject by analyzing the issues being examined from the perspective of *Maqāṣid* al-Shariah (Shariah objectives) in consideration of existing market practices and needs.
Findings: This study primarily indicates that penalties or compensation provisions in contracts are accepted if they are intended to prevent actual harm rather than for gain, because profiting merely through stipulation is forbidden in Islamic law.
Originality: Although this paper addresses an issue that has been addressed before, it acquires significance and value by setting the basis for what constitutes a valid penalty provision in Islamic finance and by showing areas of conflict and inconsistency in some of the contemporary stands on the matter, thus necessitating a review of these stances.

Keywords: Financial penalty; Compensation; Islamic finance; Islamic banking; *'urbūn*

Cite this article as: Abdulazeem Abozaid, "Penalty and Compensation in Financial Commitments - A Critical Shariah Review", *Journal of College of Sharia and Islamic Studies*, Volume 38, Issue 2, (2021).

https://doi.org/10.29117/jcsis.2021.0276

© 2021 Abdulazeem Abozaid, Published in *Journal of College of Sharia and Islamic Studies.* Published by QU Press. This article is published under the terms of the Creative Commons Attribution-NonCommercial 4.0 International (CC BY-NC 4.0), which permits non-commercial use of the material, appropriate credit, and indication if changes in the material were made. You can copy and redistribute the material in any medium or format as well as remix, transform, and build upon the material, provided the original work is properly cited. The full terms of this licence may be seen at https://creativecommons.org/licenses/by-nc/4.0/.

مراجعة نقدية للاجتهادات المعاصرة المتعلقة بالشرط الجزائي والتعويض في الالتزامات المالية

عبد العظيم جلال أبوزيد

أستاذ مشارك في الفقه الإسلامي، جامعة حمد بن خليفة، مؤسسة قطر، قطر
abozaid.abdulazeem@gmail.com

تاريخ استلام البحث: ٣٠/ ٨/ ٢٠٢٠ تاريخ تحكيمه: ٣٠/ ٩/ ٢٠٢٠ تاريخ قبوله للنشر ١٦/ ١١/ ٢٠٢٠

ملخص البحث

أهداف البحث: يهدف هذا البحث إلى مراجعة الاجتهادات المعاصرة في قضية التعويض والشرط الجزائي، وكيف أن بعض هذه الاجتهادات فرق بين متماثلات ووسع دائرة التعويضات؛ لتشمل ما قضت أصول الشريعة بمنع التعويض فيه، مما يحتم مراجعة تلك الاجتهادات التي ربما أثقلت العمل المصرفي الإسلامي دون ضرورة أو حمّلت الشريعة ما لا تحتمل.

منهج الدراسة: اتبع البحث المنهجي الاستقرائي المقارن للنصوص المتعلقة بالتعويض والشرط الجزائي. ويتناول البحث المسألة أيضًا بمنظار مقاصدي لا يغفل حاجات السوق وطبيعة المعاملات المالية المعاصرة.

النتائج: توصل البحث إلى أن الإطار المقبول للشرط الجزائي هو في حصره في دائرة التعويض عن الضرر الفعلي، لا التكسب، وإلى الأصول الشرعية تنافي التكسب بالشرط، كما هو حال الربا.

أصالة البحث: على الرغم من وجود بعض الدراسات السابقة في المسألة، إلا أن أهمية البحث تكمن في وضع الضوابط المعيارية لجواز الشرط الجزائي، وربط ذلك بأصول الشريعة ومقاصدها، وهو الأمر غير المسبوق، فضلًا عن إظهار مواطن الاضطراب في الاجتهادات المعاصرة المتعلقة بهذه المسألة المالية المهمة وذات التطبيق الواسع في الصيرفة الإسلامية.

الكلمات المفتاحية: الشرط الجزائي، التعويض عن الضرر، التمويل الإسلامي، المصارف الإسلامية، العربون

للاقتباس: عبد العظيم جلال أبو زيد، «مراجعة نقدية للاجتهادات المعاصرة المتعلقة بالشرط الجزائي والتعويض في الالتزامات المالية»، مجلة كلية الشريعة والدراسات الإسلامية، المجلد ٣٨، العدد ٢، ٢٠٢١

https://doi.org/10.29117/jcsis.2021.0276

© ٢٠٢١، عبد العظيم جلال أبو زيد، مجلة كلية الشريعة والدراسات الإسلامية، دار نشر جامعة قطر. تم نشر هذه المقالة البحثية وفقًا لشروط Creative Commons Attribution-NonCommercial 4.0 International (CC BY-NC 4.0) وتسمح هذه الرخصة بالاستخدام غير التجاري، وينبغي نسبة العمل إلى صاحبه، مع بيان أي تعديلات عليه. كما تتيح حرية نسخ، وتوزيع، ونقل العمل بأي شكل من الأشكال، أو بأية وسيلة، ومزجه وتحويله والبناء عليه، طالما يُنسب العمل الأصلي إلى المؤلف.
https://creativecommons.org/licenses/by-nc/4.0

Introduction:

The penalty provision that is placed on financial transactions can refer to either:

1- A condition of compensation that one of the contracting parties places on the other if he delays the delivery of an agreed-upon work or delivers it in a way that differs from what was agreed upon.

2- A condition of compensation that the lender places on the debtor in case the latter is delayed in repaying the debt.

Thus, a penalty provision relates to a breach of commitment whether in relation to work/labor or debt. The first type of penalty includes supplying commodities of a specific description by a specific date or an agreed-upon property of a certain description by a certain date. The second type of penalty includes repaying the debt of a loan or a deferred price in a sale contract. An example of the first type is the obligation of the seller to pay a certain amount for every day of delay in delivering the project specified in a contract. An example of the second type is the contract stating that the debtor buyer is committed to paying a specific amount or percentage of the debt installment for every day of delay in repaying the debt.

Penalty provisions have become commonplace in contracts today, especially in construction, supply and lease contracts, as well as in contracts that initiate debts, such as sales on a deferred payment basis.

The reasons for the prevalence of penalty provisions currently include a lack of transparency, the great financial harms that could result from breaching obligations, and the interdependence of contracts and obligations whereby a condition placed by one contracting party leads the other parties to reciprocally place similar conditions on the same or other contracting parties. For example, the purchaser in an *istiṣnā'* contract (*mustaṣni'*) of a building places a penalty provision on the *istiṣnā'* seller (*ṣāni'*), making the *ṣāni'* place a penalty provision on the contractor, and the latter then placing a penalty provision on the supplier of the building materials and so on.

Another reason for the prevalence of the penalty provision is the desire to avoid or ease litigation proceedings in courts. Penalty provisions specify when compensation is required so that it is not left to the courts, as it could take months, if not years, to determine the basis and the amount of compensation in court. A judge could specify a lesser amount or even dismiss the case. The penalty provision can solve this problem because the court considers the agreed-upon terms in a contract binding for the contracting parties, and it is not for the judge or anyone else with authority to alter them.

In fact, the idea of the penalty provision was originally related to harm; the party that could be harmed includes it in the contract in case the other contracting party fails to fulfil his obligations. However, it has since been expanded such that the contracting party makes it conditional upon others—even if he/she is not actually harmed by the other failing in his obligations, and the amount of compensation is conditioned beforehand and is not based on the degree of actual harm.

However, the default position in the Shariah is to give compensation for harm that has already occurred, and the penalty is not determined beforehand, because the compensation is related to the magnitude of the harm, which is only known after the harm occurs.(1)

(1) Among the Shariah texts relating to this matter are the following. From the Holy Quran: "If you were to retaliate, retaliate to the same degree as the injury done to you. But if you resort to patience—it is better for the patient". [16:126]. From the Sunnah: "One of the Prophet's wives sent some food on a plate to where he was with another wife [Āisha]. Āisha [out of jealousy] broke the plate. The Prophet [peace be upon him] said: food for food and a plate for a plate [Āisha must pay as compensation similar food and plate]. Muḥammad b. Ismā'īl al-Bukhārī. *Ṣaḥīḥ Al-Bukhārī*, (Damascus: Dar al-'Ulūm, n.d.) Ḥadīth no. 2349; Muḥammad b. 'Īsā al-Tirmidhī, *Sunan al-Tirmidhī*. (Beirut: Dār 'Iḥyā' al-Turāth al-'Arabī, 1931) Ḥadīth no. 1359.

Thus, the penalty provision in its contemporary form includes novel matters that require attention to clarify the extent to which the provision is acceptable.

Chapter One: The Shariah Stand on the Penalty Provision

In classical *fiqh*, people's wealth is protected and is prohibited from being used in nonlegitimate ways or without the consent of both parties. The compensation for harm is one of the legitimate ways intended to overcome the harm that one of the contracting parties may cause the other, whether intentionally or unintentionally. Whoever destroys the wealth of another person, intentionally or not, is obliged to compensate him for it. However, a question that can be raised in this context is whether it is permissible for the contracting parties to agree that in case of a breach of the contract, the one who is liable for the breach must pay the other a sum of money unrelated to the amount of harm caused by the breach.

It is well known that conditions in a contract, from an Islamic perspective, are either Shariah conditions, which the contracting parties cannot breach, such as the contract being free of *ribā* and excessive *gharar*, or consensual conditions (*shurūṭ ja'liyya*) that the contracting parties can place in the contract with their mutual consent and agreement. With regard to the Shariah conditions, the jurists differ between being strict and lenient; however, they agree that a consensual condition that violates a Shariah ruling or contradicts the purpose of the contract, such as a condition that restricts the ownership of a buyer regarding his property, is a void condition. It may be deemed void on its own while the contract remains sound, or it may invalidate the contract.(1)

Thus, the previous question can be rephrased as follows: does a penalty provision in which the compensation is not relative to actual damage violate the Shariah (rule) such that it is not possible to be included in a contract, or does it not violate Shariah and can therefore be included?

If to find a similar case in *fiqh*, then it is in the *'urbūn* sale(2). This sale contains a condition in which, if the buyer rescinds the sale, the amount paid becomes the property of the seller regardless of whether the seller has been harmed by the cancellation of the contract. Additionally, it does not matter whether the amount of '*urbūn* is higher than the amount required to alleviate the actual harm that befell the seller.

Speaking of *'urbūn*, it is well known that the majority of jurists have prohibited *'urbūn* sales. (Abozaid, 2014). The reasoning behind their prohibition is that such sales represent earnings for the seller without providing a countervalue, i.e., earning simply from a condition without giving a countervalue. It is incorrect for a condition to be the basis for earning. Some jurists added to their reasoning that the time period in the contract of an *'urbūn* sale could be unknown. However, this issue does not relate to *'urbūn* as earning from a condition; besides, and it can be overcome by specifying the time period.(3)

(1) The Ḥanbalīs are the most lenient in this regard. To them, permissibility is the original norm in regard to placing conditions in contracts. See the different juristic positions on the matter in 'Abdullāh b. Aḥmad Ibn Qudāma, *al-Mughnī*, (Beirut: Dār al-Fikr, 1404 H), 6/165; 'Alā' al-Dīn Al-Kāsānī, *Badā'i' al-Ṣanā'i'*, (Beirut: Dār al-Kutub al-'Arabī, 1982), 5/17; Muḥammad b. Aḥmad Ibn Rushd, *Bidāya al-Mujtahid wa Nihāya al-Muqṭaṣid*, (Beirut: Dār al-Fikr, 1960), 2/121; Abū Isḥāq Al-Shīrāzī, *al-Muhadhdhab*, (Beirut: Dār al-Fikr, n.d), 1/268.

(2) *'urbūn* refers to a sale contract where the buyer pays a down payment that is regarded as part of the price if he chooses to conclude the sale or is forfeited if he chooses to revoke the sale. See Muḥammad Al-Sharbīnī, *Mughnī Al-Muḥtāj 'ilā Ma'rifa Ma'ānī Alfāẓ al-Minhāj*, (Beirut: Dar al-Fikr. 1995), 2/395; Muḥammad 'Arafa Al-Dasūqī, *Ḥāshīya al-Dasūqī 'Alā al-Sharḥ al-Kabīr li Aḥmad al-Dardīr*, (Beirut: Dār Iḥyā' al-Kutub al-'Arabiyya, n.d), 3/63, Manṣūr b. Yūnus Al-Buhūti, *Sharḥ Muntahā Al-'Irādāt*, (Beirut: 'Ālam al-Kutub, 1996), 2/165.

(3) It is also said that Ibn 'Abbās and Al-Ḥasan al-Baṣrī viewed the sale as unlawful. In Sunnah, there are two additional Hadiths relating to *'urbūn*; one allows it, while the other prohibits it. However, both hadith are weak and cannot be used as evidence. See 'Abdullāh b. Aḥmad Ibn Qudāma, *al-Mughnī*, (Beirut: Dār al-Fikr, 1404 H), 6/331; Muḥammad Al-Sharbīnī, *Mughnī Al-Muḥtāj 'ilā Ma'rifa Ma'ānī Alfāẓ al-Minhāj*, (Beirut: Dar al-Fikr. 1995), 2/395; Muḥammad 'Arafa Al-Dasūqī, *Ḥāshīya al-Dasūqī 'Alā al-Sharḥ al-Kabīr li Aḥmad al-Dardīr*, (Beirut: Dār Iḥyā' al-Kutub al-'Arabiyya, n.d), 3/63.

By contrast, Imām ʻAḥmad b. Ḥanbal permits *ʻurbūn*. Similar stands are taken by Ibn Sīrīn and Saʻd b. al-Musayyib. They base their position on the actual occurrence of such sales, as it is reported that "Nāfiʻ b. ʻAbdul Hārith bought a house to be used as a prison from Ṣafwān b. Umayya for 4,000 dirhams; if ʻUmar is content with the deal, the sale is final; if ʻUmar is not content, then Ṣafwān gets 4,000 dirhams."(1)

The OIC Fiqh Academy acknowledged *ʻurbūn* on the condition of its time period being determined.(2) OIC Fiqh Academy also allowed penalty provisions in contracts "whereby the original obligation is not a debt", such as *salam*. However, it does not allow a penalty provision to include just any amount that the contracting parties agree upon; only the actual financial harm that caused the emphatic loss of earnings to the other contracting party may be included. This resolution places the burden of proving the absence of harm on the obliged side, i.e., the default position is of payment until the party obliged by the condition proves the absence of financial harm or the loss of earnings. The resolution also restricts the implementation of the penalty provision to the inability of the party obliged by the condition to prove that the breach of the contract was due to a reason beyond his control.(3)

It seems clear that the position permitting *ʻurbūn* sales implicitly contains the position that supports the permissibility of earnings from a condition, i.e., the permissibility of earnings from a penalty clause because the *ʻurbūn* can realize earnings for the seller, and these earnings come from a condition. The seller is the one who conditions it, and he is the one who determines the amount that the buyer pays in *ʻurbūn*, which may achieve earnings for the seller. Hence, the position taken by the OIC Fiqh Academy in the two issues (*ʻurbūn* and the penalty clause) contains a degree of contradiction because it permits *ʻurbūn* unconditionally and irrespective of the harm caused, but it restricts the penalty provision to the amount of actual harm despite the fact that *ʻurbūn* is, in reality, nothing but a penalty clause.

The more suitable position on the issue, which conforms with Shariah principles, is to deem the pen-

(1) Abū Bakr Abī Shayba, *Muṣannaf Ibn Abī Shayba*, ed. Mukhtār Aḥmad al-Nadwī, (India: al-Dār al Salafiyya, 1980), 7/306, no. 3252.

(2) See International Islamic Fiqh Academy Resolution No. 85 regarding *ʻurbūn* sale. It states that "down payment (*ʻurbūn*) sales are permissible if the time frame of the contract is set, and the down payment is considered as part of the selling price if the purchase is carried through, and as the property of the seller if the buyer desists from buying".

(3) See International Islamic Fiqh Academy Resolution No. 109 regarding a penalty clause. It reads: "Firstly: A Penalty Provision in legal terminology is a condition agreed to by the two parties of a contract as to how compensation stipulated for one of them in case of default or delay from the part of the other can be assessed. Secondly: The Council confirms its previous resolutions regarding Penalty Provision including the following: Its Resolution No. 85 (2/9) on Salam which stipulates that 'it is impermissible to include a Penalty Provision for delay of providing the commodity since a commodity sold through Salam is a debt and it is impermissible to impose an additional charge for delayed repayment of debt.' Its Resolution No. 65 (3/7) on istiṣnāʻ which stipulates that 'It is permissible to include a penalty provision in the istiṣnāʻ contract except for inevitable circumstances.' Resolution No. 51 (2/6) on Installment Sale which stipulates that 'When the purchaser delays payment of due installments no additional charge should be imposed on him whether by virtue of a predetermined condition or otherwise. Such a practice amounts to commitment of prohibited usury.' Thirdly: It is permissible to include the Penalty Provision in the original contract or make it as a separate agreement that succeeds the contract and precedes the occurrence of the anticipated loss. Fourthly: It is permissible to include a Penalty Provision in all financial contracts except when the original commitment is a debt. Imposing a Penalty Provision in debt contracts is usury in the strict sense. Consequently, it is permissible, for instance, to make a Penalty Provision on the contractor in contractual agreements, the deliverer in delivery contracts and the manufacturer in istiṣnāʻ contracts who fails to or delay in meeting his commitments. Whereas it is impermissible, for instance, to make a Penalty Provision in Installment Sale on a debtor who delays repayment of outstanding installments, whether due to insolvency or payment evasion. It is also impermissible to impose such a provision in the istiṣnāʻ contract on a purchaser who delays or fails to meet his obligations. Fifthly: The loss that may be compensated includes actual financial loss incurred by the partner, any other material loss and the certainly obtainable gain that he misses as a result of his partner's default or delay. It does not include moral losses. Sixthly: The Penalty Provision should become null and void when the concerned partner proves that his failure to meet obligations was due to reasons that fall out of his control, or when he proves that no loss has been incurred by his partner as a result of his breach of the contract".

alty clause a compensation for emphatic harm and not as a means for earning. Earnings must be gained in return for a counter value, as the jurists state, whether that value is work or monetary investment in legitimate ways. In fact, *ribā* involves nothing but earnings from a condition without a countervalue—hence its prohibition. Therefore, the penalty provision must be restricted to compensation for the actual harm caused and must not be a reason for earnings. If the amount of harm cannot be precisely calculated, it can be approximated. It is no secret that permitting a penalty provision unconditionally without linking it to the actual loss opens the door to exploitation in contracts. The stronger party can exploit the weaker party and dictate his own conditions, especially in modern so-called contracts of subjection (ʻuqūd idhʻān), where one of the parties has no choice but to accept the contract as is, without having the power to adjust any clause.

Chapter Two: Applications

This chapter discusses different applications pertaining to penalty provisions and compensation in Islamic financial contracts as follows.

Case One: The difference between *istiṣnāʻ* and *salam* contracts in permitting penalty provisions

A resolution passed by the OIC Fiqh Academy differentiates between *istiṣnāʻ* and *salam* in regard to the soundness of a penalty provision that stipulates material compensation for a delay in the delivery of the item being sold. Such a provision is permitted in *istiṣnāʻ* but not in *salam* contracts. This position has been adopted by the AAOIFI Shariah Standards and is observed by some Islamic banks. The penalty provision is not applied in *salam*, the reasoning being that the item being sold is a debt; hence, the penalty provision is forbidden. Such provisions are permitted in *istiṣnāʻ* on the basis that the item being sold in *istiṣnāʻ* is something that is worked on, i.e., it is manufactured and is therefore not considered a debt.(1)

The text of the OIC Fiqh Academy resolution pertaining to *istiṣnāʻ* reads as follows: "it is permissible for an *istiṣnāʻ* contract to contain a penalty provision that is agreed upon by the contracting parties as long as there are no compelling circumstances".(2) The text of the resolution pertaining to *salam* reads as follows: "it is not permissible for a penalty provision for the delayed delivery of the *salam* item (*muslam fīhi*), because it represents a debt, and it is impermissible to condition an increment in a debt due to delay".(3)

This distinction between *istiṣnāʻ* and *salam* invokes discussion from two perspectives:

First, the buyer in *salam* has to pay the whole price stipulated in the contract, while this is not necessarily the case for the buyer in *istiṣnāʻ*. Thus, he is more deserving of the inclusion of the penalty provision to guarantee his rights when compared with someone who pays only some or even none of the price. Second, in both *istiṣnāʻ* and *salam*, the items for sale are sold based on a description and

(1) AAOFI standard on Salam, paragraphs 5/7 reads: "It is not permitted to stipulate a penalty clause in respect of delay in the delivery of *al-muslam fīhi* (the object matter of sale). Reason is "The basis for not allowing penalty clauses in *salam* is because *al-muslam fīhi* is considered to be a debt; and it is not permitted to stipulate payment in excess of the principal amount of debts". However, according to AAOIFI standard on *istiṣnāʻ*, "it is permissible for the contract of *istiṣnāʻ* to include a fair penalty clause stipulating an agreed amount of money for compensating the ultimate purchaser adequately if the manufacturer is late in delivering the subject-matter. Such compensation is permissible only if the delay is not caused by intervening contingencies (force majeure). However, it is not permitted to stipulate a penalty clause against the ultimate purchaser for default on payment" (7/6). The reason for this is that "the basis for the permissibility of a penalty clause in an *istiṣnāʻ* contract is such that a clause is in the interest of the contract and because it is laid down in respect to an obligation regarding items that must be produced and delivered in the future and not in respect to monetary debt". Appendix B.

(2) OIC Fiqh Academy Resolution No. 65 regarding the *istiṣnāʻ* contract.

(3) OIC Fiqh Academy Resolution No. 85 regarding *salam* and its contemporary applications.

are a liability (*mawṣūf bi al-dhimma*), making them a real debt. Surprisingly, the Shariah Standards recognize this in another place, thus creating a contradiction.(1)

As a matter of fact, the item for sale in an *istiṣnā'* sale is nonspecific (*mu'ayyan*) and cannot be specific because it is nonexistent. In the case of *istiṣnā'* in property development, the specification of the land on which the property will be built does not constitute specification of the actual item for sale itself. Hence, *istiṣnā'* and *salam* must be treated equally in this regard, as both are nonspecific (*mu'ayyan*). As for the issue of the item for sale in *istiṣnā'* being something that admits working upon, this fact makes no difference in reality because it is known that the subject of the *istiṣnā'* contract is the commodity and not the labor (the efforts of the manufacturer). There is no mention of the labor in the contract, such that the manufacturer can bring the manufactured item ready from the market. In addition, labor may also exist in *salam* contracts. If the buyer in *istiṣnā'* is harmed by the delay, and the labor required to produce the commodity is part of a reason for this delay, the same conditions as in *salam* apply; the buyer in *salam* is harmed by a delayed delivery, which may be attributable to the labor required to produce the *salam* item being sold. It is illogical to negate the permissibility of a penalty provision in a contract to buy computers with particular specifications if the contract is formulated as "*salam*"(2) while at the same time permitting a penalty provision in a contract for the same computers if the contract is formulated as "*istiṣnā'*", despite the fact that the item for sale is the same (a debt) in both cases. This is a strange and illogical distinction and is a reversal of the maxim that says, "Consideration in contracts goes to the objectives and meaning, not the terms and structures". Indeed, both contracts should be treated the same.

Case Two: Compensation for the harm caused by reneging on a promise in exchange contracts

One issue related to the penalty provision is that of placing a promise in certain banking and financial transactions in order to oblige the client to give compensation when it is not possible to place a condition of compensation in the contract. In *murābaḥa* financing, for example, the Islamic bank is supposed to sign the sale contract with the client only after the bank owns the commodity. To prevent the risk of the client reneging on the purchase after the bank buys the commodity for cash from its owner, the bank takes promise from the client to go ahead with the purchase after buying the commodity. If the client reneges on her promise, she is obliged to pay compensation for failing to honor her promise, which has resulted in harm to the promisee. Contemporary *ijtihād* has permitted obliging the promisor to compensate the promisee for the actual harm resulting from reneging on the promises made in financial transactions. OIC Fiqh Academy also adopts this position.(3)

(1) The AAOIFI standards contradicted themselves when they recognized that the item for sale in *istiṣnā'* is a debt, so *istiṣnā'* is not valid on a specified commodity. An *istiṣnā'* contract involves a sale for future delivery based on a specification. Therefore, if the items to be sold are specific, identified items, the transaction involves selling identified items that the seller does not own, which is prohibited by the saying of the Prophet (pbuh): 'Do not sell what you own not'. The items to be manufactured or constructed do not yet exist and thus cannot be specific and identified. The nonexistent item is to be produced and delivered later and thus it is a debt. However, when justifying the permissibility of penalty clause in *istiṣnā'* contract, the standards mention that an *istiṣnā'* item is not a debt: "The basis for the permissibility of a penalty clause in an *istiṣnā'* contract is that such a clause is in the interest of the contract and because it is laid down in respect to an obligation regarding items that must be produced and delivered in the future and not in respect to debt", *istiṣnā'* Standard, Appendix B.

(2) In fiqh, any item that can be sold under *istiṣnā'* can also be sold under *Salam*.

(3) According to the International Islamic Fiqh Academy Resolution No. 40-41 (2/5 and 3/5) regarding fulfilling a promise and *murābaḥa*, "A promise (made unilaterally by the purchase orderer or the seller), is morally binding on the promisor, unless there is a valid excuse. It is however legally binding if made conditional upon the fulfillment of an obligation, and the promisee has already incurred expenses on the basis of such a promise. The binding nature of the promise means that it should be either fulfilled or a compensation be paid for damages caused due to the unjustifiable non fulfilling of the promise. 41: Mutual promise (involving two parties) is permissible in the case of *murābaḥa* sale provided that the option is given to one or both parties. Without such an option, it is not permissible, since in Murābaḥa sale, mutual and binding promise is like an ordinary sale contract".

Case Three: The difference between *murābaḥa* and diminishing *mushāraka* regarding compensation for reneging on a purchase

Islamic banks receive compensation from a client who reneges on a *murābaḥa* sale. The fatwa permitting this is based on the position of Mālikis and those who agreed with them about a binding promise if breaking it would cause material damage. The resulting compensation should equal the difference between the cost that the bank incurred for acquiring the property and the amount that it receives from selling the commodity or returning it to its previous owner; thus, the compensation equals to the amount of actual losses.(1)

By contrast, if the client and bank are partners in the commodity or assets in a diminishing partnership,(2) some Islamic banks do not extract compensation if the client reneges on his promise to gradually buy the bank's share of the item subject to their partnership. This is because such a commitment to compensation amounts to one partner (the client) guaranteeing the capital of the other partner (the bank). A partner guaranteeing the capital of another invalidates the partnership contract.

However, we see the distinction between the two transactions—*murābaḥa* and diminishing *mushāraka*—regarding the permissibility of compensation for reneging unjustifiable. What is the difference between the bank paying the whole price of the commodity and paying 90% of its price or less that would legitimate it receiving compensation for reneging in the first case but would not legitimate it in the second case? The client's contribution to some of the price of the asset in a partnership should not prevent the bank from having the right to receive compensation for reneging if doing so is allowed in essence. The partnership between the two parties is not a real partnership because the bank does not actually participate with the client in profit sharing but provides the amount of financing with an increment known in advance, which represents the bank's profit from the financing operation.

Thus, it is necessary when passing the ruling to differentiate between two cases. In the first case, the partnership is a real investment partnership in which both parties—the bank and the client—buy investment assets with the aim of carrying out a joint investment with the understanding to gradually sell the bank's share to the client, and share in the realized profits at the end of the partnership. In this partnership, both parties must agree on the profit ratio between them, and it is impermissible for either partner to provide the other any form of guarantee of the capital or the expected profit. It is also impermissible to specify in advance the price that the client will buy the bank's portion for each time. This partnership is known in Shariah legal terms as *sharika al-'aqd* (a contractual partnership).

In the second case, the purchase of the joint asset is not made with the aim of making a joint investment and distribution of profits between both parties. Rather, the aim is for the bank to finance the client to buy an asset or a commodity that she wants. This formula differs from that of the known Shariah partnership, i.e., a contractual partnership (*sharika al-'aqd*) due to the absence of the of investment intent of both contracting parties. The client seeks to use the liquidity available to him to pay for a portion of the house/asset that he wants to acquire. The bank agrees to finance the purchase of the house with him through a diminishing *mushāraka*, whereby the client pays say 10% of the price of the house, while the bank pays the rest; there is an agreement between them that the client will gradually acquire the bank's portion. This formula bears no relation to a normal investment partnership, as it does not involve investment, nor is there any profit accrued from the financed asset. It is unreasonable to consider this an investment partnership and to formulate the agreement's rules accordingly.

It is also unreasonable to include the ratio of profit distributed between the bank and the client in the

(1) This position is also taken by the AAOIFI. See the standard on *murābaḥa*, paragraph 2/5/4.

(2) A diminishing partnership refers to an agreement between the bank and client in which they jointly buy a house, for example, and then the bank's share is divided into parts and sold periodically to the client until the client becomes the sole owner of the house.

financing contracts on the basis of diminishing *mushāraka*, since the contract is not an investment contract that would generate a profit, and the bank agrees in advance to sell the client its share for a specified amount. When considering the value of its share, the bank does not take into account the change in the price of the asset in the market, which negates any intention of investing and the possibility of there being an investment partnership (*sharika al-ʻaqd*).

In fact, contracts must be classified according to the aim of the contracting parties and the essence of the contract, not according to terminology and formalities. The essence of diminishing *mushāraka* home financing is closer to *murābaḥa*[1] than to a partnership contract and does not differ from *murābaḥa* apart from the fact that the client contributes to some of the original price and that the bank's portion is gradually sold to the client instead of all at once. These two considerations do not make the operation a partnership contract.[2] Rather, the partnership between both parties is an ownership partnership (*sharika al-milk*) only, i.e., a partnership in the ownership of an asset or commodity; therefore, it is necessary to permit in this joint ownership what is permitted in *murābaḥa* regarding compensation for reneging on the promise to purchase the bank's share.

From another perspective, it is incumbent on the Islamic bank, in its capacity as a partner in ownership, to take responsibility for its ownership liabilities, as every owner should, from the moment the asset or commodity is bought to the moment the bank fully sells its share to the client and to not to pass that responsibility on to the client. In fact, this, rather than the fulfillment of certain formalities connected to financing, such as stipulating a ratio of profit distribution when there is no profit or no aim to distribute profits at all, is what confers legitimacy to this financing formula and justifies the bank's profits.

Case Four: Compensation for a delay in installment payments

The issue of the buyer-debtor being delayed in making installment payments towards the overall price is also related to the penalty provision and financial compensation for harm. The client may be delayed in paying some installments according to the financing contract, which harms the creditor.

In this instance, the debtor is either considered insolvent (*muʻsir*) and unable to repay the debt or a procrastinator (*mumāṭil*). The jurisprudential ruling mentioned in the books of *fiqh* on the repayment of debt is as follows:

If the debtor is insolvent, there is no difference in opinion regarding giving him respite, as per the verse: "And if someone is in hardship, then [let there be] postponement until [a time of] ease"[3]. Therefore, the insolvent person must be given additional time until he is able to pay.

If the debtor is procrastinating, he is required to pay and should also be punished, though there are different opinions regarding the punishment, prison or public exposure (*tashhīr*), based on the hadith: "who has money but does not pay, his honor and punishment are permissible".[4]

(1) It is less complicated when the bank sells its entire share in one *murābaḥa* deal to the customer, but the bank may prefer to sell its share gradually so that it can adjust the selling price according to the interest rate changes in the market.

(2) Diminishing *mushāraka* also involves leasing, as the bank leases its unsold share to the customer. This lease has two benefits: it enables the client to benefit from the entire asset, and it provides flexibility for the financing bank to adjust the variable rentals to match the market interest rate.

(3) The Holy Qur'ān 2:280.

(4) The narrator of this Hadith is Al-Sharīd b. Suwayd al-Thaqafī, and the Hadith is repored by Muḥammad b. Ismā'īl al-Bukhārī. *Ṣaḥīḥ Al-Bukhārī*, (Damascus: Dar al-ʻUlūm, n.d.), 2/845; Sulaymān b. al-Ashʻath Abū Dā'ūd, *Sunan Abī Dā'ūd*, (Beirut: Al-Maktaba al-ʻAṣriyya, 1984), 4/45, no. Ḥadīth no 3628; Aḥmad b. Shu›ayb Al-Nasa'ī, *Sunan Al-Nasa'ī al-Kubrā*, (Beirut: Dar Al-Kutub Al-Ilmiyya, 1991), 7/316, Ḥadīth no. 4689; Muḥammad b. Yazīd Al-Qazwīnī, Sunan Ibn Mājah. (Beirut: Dar Al-Kutub Al-Ilmiyya, n.d.), 2/811, Ḥadīth no. 2427; Aḥmad Ibn Ḥanbal, *Musnad Imām Aḥmad*, (Cairo: Mu'assasa al-Qurṭuba, n.d), 7/117, Ḥadīth no. 19473; Muḥammad b. ʻAbdullah Al-Ḥākim, *Al-Mustadrak ʻalā al-Ṣaḥīḥayn* (Beirut: Dār al-Ma'rifa, 1986), 4/102.

The jurists did not permit the creditor to demand that the procrastinator pay more money because it would then turn into *ribā*, as it would lead to an incremental increase in the debt in return for an extension that occurred in the time period.(1)

However, some Islamic banks have justified for themselves, through the fatwas of their Shariah supervisors, receiving compensation from the client in case he delays in repaying the debt if his financial health has been confirmed, i.e., he is proven to be a procrastinator. This compensation is determined based on the forgone earnings whereby the client pays an average of what the bank would normally earn in the delay period. The Shariah supervisors base this compensation on the principle of usurpation (*ghaṣb*), with the reasoning that the client has usurped the bank's right to the money and its profit. Hence, it is incumbent upon the client to return this money with the profit.(2)

This reasoning (*ijtihād*) is debatable because it supports the bank reaping earnings from debt, which is the essence of *ribā*. If the justification of the loss of earnings was sound, Islam would not have prohibited *ribā* or would have restricted its prohibition to certain cases. The bank must hedge its debts by taking adequate credit risk guarantees and should not enforce higher payments on debtor clients if they delay repayment.

Case Five: Enforcing penalties for a delay in payments that the financing bank does not benefit from

Islamic banks tend to extract fines from their clients in case of defaulting on debt payments. The bank deducts and keeps for itself an amount corresponding to the actual damages incurred due to a delay in repayment, such as the cost of following up with clients to pay their debts, and then donates the remaining amount to charitable causes. The aim of these fines is to make the debtor pay on time and avoid procrastination, not to gain and keep compensation. This matter seems acceptable and reasonable since, on the one hand, it does not involve *ribā*, as the creditor (the bank) does not materially gain from it, and on the other hand, it is necessary for the banking business. If Islamic banks do not do this, many of their clients would make late payments, causing the bank to lose its money and the money of the depositors. However, it is necessary to restrict the permissibility of this action by enforcing those fines only on procrastinators, not on those who are insolvent, because an insolvent person deserves charity and *zakāt*. It is improper to make him give to charity when he himself is in need of it. However, it is procedurally possible to enforce a fine on every defaulter, but the money should be returned to those who prove to be insolvent, and the proof of insolvency in order to have the fine retracted rests on the client.

Case Six: Annulment of a nonperforming debt with another new debt

Some Islamic financial institutions have invented ways of dealing with nonperforming debts that involve annulling a debt through another debt (*faskh al-dayn bi al-dayn*), i.e., restructuring the debt with an additional amount. The bank buys an asset from the defaulting client for an immediate payment that represents the value of his debt or financial obligation towards the bank, with an agreement to lease that asset as an *ijārah* ending-in-ownership; the total amount of the installments is increased above the amount of the purchase. Hence, the bank achieves an annulment of the old debt through a new increased debt, as the old debt is set off against the asset's selling price, and the client will have to pay the new debt as *ijārah* installments. This *ijārah* contract is a spurious contract, as the

(1) Shams al-Dīn Al-Ramlī, *Nihāya Al-Muḥtāj 'ilā Sharḥ al-Minhāj*, (Beirut: Dār al-Fikr, n.d), 4/323; 'Alā' al-Dīn Al-Kāsānī, *Badā'i' al-Ṣanā'i'*, (Beirut: Dār al-Kutub al-'Arabī, 1982), 7/173; Muḥammad b. Aḥmad Ibn Juzayy, *al-Qawānīn al-Fiqhīyya*, (Beirut: Dār al-Kutub al-'Ilmiyya, n.d), 313; Abdullāh b. Aḥmad Ibn Qudāma, *al-Mughnī*, (Beirut: Dār al-Fikr, 1404 H), 6/585

(2) 'Umar 'Abdulḥalīm, *Abhāth Nadwa Khuṭṭa al-Istithmār Fī al-Maṣārif al-Islāmiyya*, (Amman: Publisher, 1987), p.220.

leased asset may not provide any benefit, and the bank does not bear responsibility for any of the ownership liabilities as the new owner of that asset. Some banks instead use either *tawarruq* or *ʾīna* contracts with the same aim of annulling previous debts with new ones. In the case of *tawarruq*, the bank sells an asset for 110k to the client (whose debt liability is, for example, 100k) and then sells it on his behalf for 100k in the market, using the latter amount to settle the old liability and creating a new debt with a 10k increase to compensate for the forgone profit. In the case of *ʾīna,* the bank sells the client an asset for 110k and then buys it back for 100k, using the latter amount to settle the old liability and creating a new debt with a 10k increase to compensate for the forgone profit.

In truth, using a sale or *ijārah* contract with the aim of restructuring debts or achieving for-profit cash financing represents a misuse of these contracts and contradicts agreed-upon Shariah principles—the prohibition of providing money to someone for a guaranteed profit, as occurs with a *ribawī* loan, and the prohibition of annulling a debt with another debt.

Indeed, the real problem may be the willingness of some Islamic financial institutions to deal with debts and profit-making instruments in the same ways as conventional banks. These institutions fail to recognize that not every conventional product can be Islamized and that Islamizing the un-Islamizable will produce nothing but a product that is alien to the Shariah, negating its objectives and inheriting the harms that the rules of the Shariah are intended to prevent (Motlaq, 2019).

Conclusion

This study shows that penalty or compensation provision in contracts is accepted as long as it is within the framework of removing the actual harm done and not intended for gain, because gaining merely by virtue of stipulation is forbidden in Islamic law. *Ribā* is in fact nothing but gaining through stipulation. The study also points out that compensation should not include cases of default in debt repayment and that an increase in debt in this case is unlawful regardless of the method used to achieve it. The study also presents similar issues in contemporary *ijtihād* that have been treated differently and different issues that have been treated in the same way, all in terms of the validity of penalty or compensation provisions, as in the case of *Salam* and *Istiṣnāʿ* or the case of *Murābaḥa* and diminishing *Mushāraka*.

The paper also highlights the following important results:

• The principles of Shariah do not prohibit compensation for damage, but that compensation must be in proportion to the damage actually suffered and not exceed it in such a way as to gain from it.

• Gaining merely by virtue of stipulation is prohibited in Islamic law, and allowing such gain contradicts the prohibition of *ribā*, since *ribā* is, in essence, earning through stipulation, as nothing justifies the increase in debt.

• If the compensation cannot be accurately estimated to be equal to the damage, there is nothing wrong with imposing an estimated amount so that gains are not thought to have been made by the compensated party.

• Salam contracts should be treated the same as *Istiṣnāʿ* contracts in the contemporary consideration of the issue of compensation for damage, because nothing justifies differentiating between them in this regard.

Murābaḥa and diminishing *Mushāraka* home financing should also be treated equally in terms of the renunciation of purchases, as nothing suggests any substantial difference between them in that regard.

• The restructuring of debts by any means that leads to an increase in debt is prohibited by Shariah, as it prohibits compensation for the damage caused by late payment of debts.

References

AAOIFI, *Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Standards*, Bahrain. (n.d.).

'Abdulḥalīm, 'Umar, *Abhāth Nadwa Khuṭṭa al-Istithmār Fī al-Maṣārif al-Islāmiyya*, (in Arabic), (Amman: Publisher Unspecified, 1987).

Abī Shayba, Abū Bakr, *Muṣannaf Ibn Abī Shayba*, ed. Mukhtār Aḥmad al-Nadwī, (in Arabic), (India: al-Dār alSalafiyya, 1980).

Abū Dā'ūd, Sulaymān b. al-Ash'ath. *Sunan Abī Dā'ūd*, (in Arabic), (Beirut: Al-Maktaba al-'Aṣriyya, 1984).

Abozaid, 'Abdulazeem, "Shariah and Maqasid Analysis of Financial Derivatives", (in Arabic), *Journal of King Abdulaziz University: Islamic Economics,* 2014, vol. 27, issue 3, pp. 3-44. https://iei.kau.edu.sa/Files/121/Files/143321_27-03-01.pdf (Scopus Indexed).

Al-Buhūti, Manṣūr b. Yūnus, *Sharḥ Muntahā Al-'Irādāt*, (in Arabic), (Beirut: 'Ālam al-Kutub, 1996).

Al-Bukhārī, Muḥammad b. Ismā'īl. *Ṣaḥīḥ Al-Bukhārī*, (in Arabic), (Damascus: Dar al-'Ulūm, n.d.).

Al-Dasūqī, Shams al-Dīn Muḥammad 'Arafa, *Ḥāshīya al-Dasūqī 'Alā al-Sharḥ al-Kabīr li Aḥmad al-Dardīr*, (in Arabic), (Beirut: Dār Iḥyā' al-Kutub al-'Arabiyya, n.d).

Al-Ḥākim, Muḥammad b. 'Abdullah, *Al-Mustadrak 'alā al-Ṣaḥīḥayn*, (in Arabic), (Beirut: Dār al-Ma'rifa, 1986).

Al-Kāsānī, 'Alā' al-Dīn, *Badā'i' al-Ṣanā'i'*, (in Arabic), (Beirut: Dār al-Kutub al-'Arabī, 1982)

Al-Nasa'ī, Aḥmad b. Shu'ayb, *Sunan Al-Nasa'ī al-Kubrā*, (in Arabic), (Beirut: Dar Al-Kutub Al-Ilmiyya, 1991).

Al-Qazwīnī, Muḥammad b. Yazīd, *Sunan Ibn Mājah*, (in Arabic), (Beirut: Dar Al-Kutub Al-Ilmiyya, n.d).

Al-Ramlī, Shams al-Dīn, *Nihāya Al-Muḥtāj 'ilā Sharḥ al-Minhāj*, (in Arabic), (Beirut: Dār al-Fikr, n.d).

Al-Sharbīnī, Shams al-Dīn Muḥammad, *Mughnī Al-Muḥtāj 'ilā Ma'rifa Ma'ānī Alfāẓ al-Minhāj*, (in Arabic), (Beirut: Dar al-Fikr. 1995).

Al-Shīrāzī, Abū Isḥāq, *al-Muhadhdhab*, (in Arabic), (Beirut: Dār al-Fikr, n.d).

Al-Tirmidhī, Abū 'Īsā Muḥammad b. 'Īsā, *Sunan al-Tirmidhī*, ed. Aḥmad Muḥammad Shākir. (in Arabic), (Beirut: Dār 'Iḥyā' al-Turāth al-'Arabī, 1931.

Ibn Ḥanbal, Aḥmad, *Musnad Imām Aḥmad b. Ḥanbal*, (in Arabic), (Cairo: Mu'assasa al-Qurṭuba, n.d).

Ibn Juzayy, Muḥammad b. Aḥmad, *al-Qawānīn al-Fiqhīyya*, (in Arabic), (Beirut: Dār al-Kutub al-'Ilmiyya, n.d).

Ibn Qudāma, 'Abdurraḥmān b. Muḥammad, *al-Sharḥ al-Kabīr 'Alā Matn al-Muqni'*, (in Arabic), (Beirut: Dār al-Fikr, n.d).

Ibn Qudāma, Abū Muḥammad 'Abdullāh b. Aḥmad, *al-Mughnī*, (in Arabic), (Beirut: Dār al-Fikr, 1404 H).

Ibn Rushd, Abū al-Walīd Muḥammad b. Aḥmad, *Bidāya al-Mujtahid wa Nihāya al-Muqtaṣid*, (in Arabic), (Beirut: Dār al-Fikr, 1960).

IIFA. *International Islamic Fiqh Academy Resolutions*, (n.d.).

Moṭlaq, Muḥammad ʻAssāf, "Cryptocurrency According to the Objectives of Islamic Law" (in Arabic), *Journal of College of Sharia and Islamic Studies*, 2019, vol. 36, issue 2, pp. 21-48. https://journals.qu.edu.qa/index.php/sharia/article/view/1313/838