The Application of Sale Contract as a Mechanism of Ownership Transfer in Islamic Hire Purchase

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ABSTRACT

Ownership transfer is significant in Islamic hire purchase (IHP) operation as it enables customers to own the asset at the end of lease (ijarah) contract. The ownership transfer in Islamic hire purchase transaction usually takes effect by executing a sale contract. The execution of sale contract in ownership transfer to be Shariah-compliant must comply with Shariah requirement otherwise it may leads to Shariah issue. The paper aims to investigate the extent to which the banks’ practices on the application of sale contract are in compliance with Shariah requirements. It examines Shariah requirements on the application of sale contract under Shariah legal framework and compares with banks’ actual practice. The study employs qualitative method of study comprised of document analysis by analyzing Shariah legal framework as well as documents of Islamic hire purchase facility of six financial institutions in Malaysia. The study found that the banks’ practices on the application of sale contract are in compliance with Shariah requirements whereby the sale contract is executed separately from the lease contract in a correct order and the transaction is proved in written documentation. However, there are different practices among these banks in terms of the sales contract documentation adopted. Therefore the paper suggests that a comprehensive guideline together with a standard sale contract document which is specifically applicable for ownership transfer in Islamic hire purchase transaction should be prepared. It is hope that the existence of such a comprehensive guideline on the sales contract documentation can enhance good governance and ensure sustainable development of Islamic finance.

Key Words: Sale Contract; Asset Ownership Transfer; Islamic Hire-Purchase; Banks in Malaysia

keperluan Syariah di mana kontrak jualan itu dilaksanakan secara berasingan daripada kontrak sewa dalam turutan yang betul dan transaksi itu dibuktikan dalam dokumentasi bertulis. Walau bagaimanapun, terdapat amalan yang berbeza di kalangan bank-bank tersebut dari aspek dokumentasi kontrak jualan yang diterima pakai. Oleh itu kerjasama ini mencadangkan agar suatu garis panduan yang lengkap berserta dengan dokumen kontrak jualan yang standard khusus diguna pakai terhadap pemindahan pemilikan dalam urus niaga di Malaysia perlu disediakan. Diharapkan agar kewujudan suatu garis panduan yang lengkap terhadap dokumentasi kontrak jualan mampu meningkatkan tadbir urus yang baik dan seterusnya memastikan pembangunan lestari kewangan Islam.

Kata Kunci: Kontrak Jualan; Pemindahan Hak Milik Aset; Sewa Beli Islam; Institusi Kewangan di Malaysia.

INTRODUCTION

It is a common practice of banks in Malaysia that the transfer of ownership in Islamic hire purchase (IHP) transaction is effected by executing a sale contract (Azma, Rahman, & Albaity, 2013; Ramli & Onn, 2007). The execution of sale contract must comply with Shariah legal requirement to be Shariah-compliant otherwise it may leads to Shariah issue. Therefore, it is the objective of this paper to investigate the extent to which the banks' practices on the application of sale contract are in compliance with Shariah requirements.

METHODOLOGY

The study employs qualitative method of study comprises of document analysis. It analyzed Shariah legal framework comprises of Bank Negara’s resolutions in Islamic finance and Bank Negara’s Concept Paper on Ijarah. The study also analyzed documents of Islamic hire purchase facility of six banks in Malaysia. It then compared between Shariah requirements and the actual practice of these banks on the application of sale contract to transfer the ownership in hire purchase transaction.

SALE CONTRACT IN ISLAMIC HIRE PURCHASE FACILITY

Islamic hire purchase is referred to leasing concluded with purchase in which the legal title of the leased asset is transferred from owner to the hirer upon the expiry of the lease period (Khir, Gupta, & Shanmugam, 2008). In Malaysia, it is commonly known as al-Ijarah Thumma al-bai’ (AITAB) or hiring followed by sale and purchase (Sudin & Shanmugam, 1997). It is developed from ijarah (lease) principles (El-Din & Nurdiyani, 2007) and a type of Ijarah Muntahiyah bi al tamlik (Lease Ending in Transfer of Ownership). Ijarah Muntahiyah bi al tamlik is a modern application of ijarah contract that entitled the lessee to acquire the asset at the end of lease period, thus fulfilling the purpose of ownership transfer to the lessee (Ahmad Badri & Tawfique, 2015).

Islamic hire purchase transaction involves two different types of contracts that is al-ijarah (leasing/renting) contract and al-bai’ (sale) contract. In practicing Islamic hire purchase, customers will lease the asset based on ijarah from financial institutions with an option to subsequently own or purchase the asset based on al-Ijarah Thumma al-bai’ (AITAB) (Bank Negara Malaysia, 2009). Later, the ownership of the asset is transferred to the lessee at the end of the lease period by executing a sale contract (Bank Negara Malaysia, 2009) in which the asset will be sold to the same customer (lessee) at an agreed price (El-Din & Nurdiyani, 2007). The application of sale contract therefore, plays a significant role in IHP financing as it enables customer to acquire the asset at the end of ijarah contract.

SHARIAH REQUIREMENTS

Shariah compliance status of an Islamic banking product is determined by its compliance to Shariah requirements. Hence, the application of sale contract in IHP financing must satisfy Shariah requirements in order for the transaction to be in compliance with Shariah. In Malaysia, Shariah requirements of an Islamic banking product is determined by its compliance to Shariah rulings of Bank
NEGARA which is issued in various forms including the Resolutions of Shariah Advisory Council (SAC) of Bank Negara, Shariah Parameter References (SPR) of Bank Negara (Lahsasna, 2014) and Bank Negara’s Concept Paper. The Resolutions of Shariah Advisory Council (SAC) comprises all their guidelines and circulars while the Shariah References Parameters comprises of Murabaha, Ijarah, Mudarabah, Musharakah and Istisna which is going to be transformed into Shariah Standards and the process towards such effect is ongoing (Lahsasna, 2014). Concept Paper provides both the Shariah and operational requirements for the implementation of a particular Shariah contract. In terms of ijarah-based contract as in Islamic hire-purchase, Bank Negara has issued Concept Paper on Ijarah that provides Shariah and operational requirements for the implementation of ijarah contract. Any infringement with relevant provisions of Shariah framework may induce the risk of Shariah non-compliance.

SALE CONTRACT UNDER SHARIAH LEGAL FRAMEWORK

The Resolutions of Shariah Advisory Council (SAC) of Bank Negara and Concept Paper on Ijarah are referred to analyse Shariah requirements on the application of sale contract to transfer the ownership in Islamic hire purchase transaction. Based on Shariah Resolutions in Islamic Finance and Concept Paper on Ijarah, the application of sale contract to transfer the ownership of the asset must fulfill three requirements. First, the sale contract must be made separated and independent from ijarah contract. Paragraph 1 of Shariah Resolutions in Islamic Finance (Bank Negara Malaysia, 2010) states that the modus operandi of AITAB shall consist of ijarah contract and al-bai’ contract which must be made separate from each other. Upon the expiry of the lease contract, the last rental amount of ijarah could be considered as the sale price of the asset. Further, Paragraph 22(a) of the Concept Paper on Ijarah (Bank Negara Malaysia, 2014) provides that where the ownership of leased asset is transferred by way of sale, the sale contract shall be executed separately from ijarah contract upon the completion or termination of ijarah contract and both contracts must be undertaken in a correct order. Therefore, both contracts must be executed in two different transactions and should not be combined in one transaction.

Second, ijarah and sale contract must be arranged in a correct order. Paragraph 22.3 of the Concept Paper on Ijarah provides that “in pursuant to paragraph 22.2, the arrangement of the contracts shall be executed according to the correct sequence”. In addition, paragraph 30.5 imposes a duty on financial institutions to ensure that the contracts will only take effect in accordance to the correct order, regardless of the sequence of the execution of the contracts or arrangements. Hence, the sale contract will only take effect upon the expiry or completion of ijarah contract.

Third is documentation of sale contract. Paragraph 30.19 provides that financial institutions must ensure that the execution of ownership transfer is proved in a written document. Based on paragraph 30.26, the document of ownership transfer must be made independent and separated from leasing document. Further, paragraph 30.27 states that the document of ownership transfer must able to manifest the mechanism of asset ownership transfer as agreed by the contracting parties. This implies that when customer’s promise to purchase is used as a mechanism of asset ownership transfer, it must be proved by executing a sale contract which must be documented in writing. Thus, in terms of documentation, the sale contract must be proved in a written documentation which is independent and separated from leasing documentation. In brief, Shariah requirements of sale contract are illustrated in Table 1. The above discussion shows that there are relevant provisions in Shariah legal framework pertaining to the application of sale contract in IHP financing. This is very significant for a good governance of Islamic finance that can ensure sustainable development of Islamic finance.

THE PRACTICES OF FINANCIAL INSTITUTIONS IN MALAYSIA

Apart from Shariah legal framework, financial institutions also play important role for sustainable development of Islamic finance by ensuring the compatibility of a particular practice with Shariah requirements. To comprehend the practice of financial institutions on the application of sale contract in ownership transfer, the paper has analyzed documents of Islamic hire purchase facility of six banks. The result of the analysis is depicted in Table 2. The analysis shows that:

It is the practice of all the six banks that the sale contract is concluded upon customer’s exercise of option to purchase. The customer is considered as exercising his option to purchase the asset upon the last rental payment provided that he has fulfilled all the terms and stipulations in the agreement. The exercise of option to purchase by customer will terminate the lease contract and transfer the ownership of the asset to customer. However, before the conclusion of the sale contract,
the asset shall remain absolutely with the owner. Therefore, the sale contract will only take effect upon the customer’s last rental payment after the completion or expiry of *ijarah* contract. Hence the contracts are undertaken one after another. This shows that both contracts are executed separately in two different transactions in a correct order which is in compliance with Shariah requirements.

It is the practice of all the six banks that the sale contract is documented in writing independent from leasing documentation. The practice is in compliance with Shariah requirement whereby the ownership transfer must be evidenced in a written document. However, there are different forms of sale contract documentation adopted by the banks. Three banks (Bank A, Bank B, and Bank C) documented the sale transaction in the form of sale contract documentation that clearly indicates the conclusion of the sale contract between the bank and customer. The other three banks (Bank D, Bank E, and Bank F) documented the sale transaction in the form of notice whereby a sale contract is deemed to be concluded upon customer’s payment of all rentals and fulfillment of all terms and conditions of contract. The notice is signed by both customer and banks. This indicates that all the six banks fulfill Shariah requirement on documentation of ownership transfer. Nevertheless there is lacking of uniformity among the bank in terms of the form of documentation of the sale contract.

CONCLUSION AND RECOMMENDATION

The above discussion shows that the practice of all the six selected banks on application of sale contract are in compliance with Shariah requirements whereby the sale contract is made separated from the lease contract and the transaction is executed in a correct order. In terms of documentation, the sale transaction is proved in written documentation which is made independent from leasing documentation. Despite of the above, there are differences between these banks in terms of the form of sale contract documentation adopted. Therefore the paper suggests that a comprehensive guideline together with a standard sale contract document specifically applicable for ownership transfer in Islamic hire purchase transaction should be prepared. It is hope that the existence of a comprehensive guideline on documentation of sale contract can enhance the good governance and ensure sustainable development of Islamic finance.

REFERENCES


**TABLE 1: Requirements of Sale Contract under Shariah Legal Framework**

<table>
<thead>
<tr>
<th>Num.</th>
<th>Requirements</th>
<th>Relevant Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Sale contract must be made separated and independent from <em>ijarah</em> contract. Both contracts must be concluded separately</td>
<td>Shariah Resolutions in Islamic Finance (Paragraph 1)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bank Negara Concept Paper on <em>Ijarah</em> (Paragraph 6)</td>
</tr>
</tbody>
</table>
be executed in two different transactions.  

<table>
<thead>
<tr>
<th></th>
<th>2.2 (a))</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td><em>Ijarah</em> contract and sale contract must be arranged in a correct order. The sale contract will only take effect upon the expiry or completion of <em>ijarah</em> contract.</td>
</tr>
</tbody>
</table>
|   | Bank Negara Concept Paper on *Ijarah* (Paragraph 22.3)  
|   | Bank Negara Concept Paper on *Ijarah* (Paragraph 30.5) |
| 3 | The sale contract must be proved in a written documentation which must be made independent and separated from leasing documentation. |
|   | Bank Negara Concept Paper on *Ijarah* (Paragraph 30.19)  
|   | Bank Negara Concept Paper on *Ijarah* (Paragraph 30.26) |

**TABLE 2: The practice of financial institutions on the application of sale contract in ownership transfer**

<table>
<thead>
<tr>
<th>Practice</th>
<th>Bank</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>The customer is considered as exercising his option to purchase the asset upon the last rental payment provided that he has fulfilled all the terms and stipulations in the agreement. The exercise of option to purchase by customer will terminate the lease contract and transfer the ownership of the asset to customer.</td>
<td>Bank A, Bank C, Bank D, Bank F</td>
<td>The sale contract will only take effect upon the completion or expiry of <em>ijarah</em> contract. Hence, both contracts are executed separately in two different transactions in a correct order.</td>
</tr>
<tr>
<td>The hirer has right to ask the owner to sell the vehicle upon the expiry of the agreement or during leasing period upon the payment of the termination amount provided that all the terms and conditions of agreement has been fulfilled. The hirer will be considered as purchasing the vehicle at a price calculated as the amount of termination.</td>
<td>Bank B</td>
<td>The sale contract will only take effect upon the completion or expiry of <em>ijarah</em> contract. Hence, both contracts are executed separately in two different transactions in a correct order.</td>
</tr>
</tbody>
</table>
| Sales contract is documented in the “Sales Contract Form”. | Bank A, Bank B, Bank C | The ownership transfer is evidenced in a written document.  
- The sale contract document clearly indicates the conclusion of the sale contract between the bank and customer. |
| The sale transaction is documented in the “Notice of Acknowledgement”. -The bank give notice to the customer that upon payment of the final Installment or Balance Due by the customer, it shall be deemed that the customer thereby purchased from the Bank the Goods as particularly described in the agreement pursuant to the Shariah principle of *Bai’ Al-Mu’atah* (sale by conduct). | Bank D | The ownership transfer is evidenced in a written document. The document is in the form of notice that the sale contract is deemed to take effect upon the fulfillment of specific conditions. |
| The sale transaction is documented in the “Notice of Sale”. -The bank give notice to the customer that upon payment of all sums of money stipulated in the Agreement, the bank agree to sell to the | Bank E | The ownership transfer is evidenced in a written document. The document is in the form of notice that the sale contract is deemed to}
customer the Goods on the terms and subject to the conditions as set out in the Agreement. | take effect upon the fulfillment of specific conditions.
---|---

The sale transaction is documented in the “Sale Undertaking Document”. -Upon customer’s full payment and exercise of option to purchase at the sale price of Ringgit Malaysia One (RM1.00), bank undertakes to transfer all their rights, benefit and interest in the goods to the customer the that the sale contract is deemed to take effect upon the fulfillment of specific conditions. | Bank F | The ownership transfer is evidenced in a written document. The document is in the form of notice of undertaking.