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The (mis)use of al-Hilah (legal trick) and al-Makhraj (legal exit) in Islamic finance

Islamic finance

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Abstract

Purpose – The purpose of this paper is to discuss the concepts of *hilah* (legal stratagem or legal trick) and *makhraj* (legal exit) and to examine their relevance and application in the contemporary Islamic financial services and products.

Design/methodology/approach – This paper uses the qualitative research approach to provide a theoretical overview of *hilah* and *makhraj* literally and technically and to examine their practical applications in Islamic financial products and services. In particular, this paper evaluates several Islamic financial contracts and examines its practices in light of the implications of *hilah* or *makhraj*.

Findings – The paper finds that there is a glaring difference in perception and application of *hilah* and *makhraj*, as argued by some scholars. It has been found that the principle of *hilah* has been extensively used in the Islamic finance industry as a way to circumvent the *riba* prohibition. For example, Islamic financial instruments such as *bay' bithaman al-ajil*, *bay' al-'inah*, *tawarruq*, commodity *murabahah*, *musharakah mutanaqisah* and, in some cases, the sale and lease back *sukuk* are found to be tainted by *hilah*.

Research limitations/implications – Because this is a theoretical paper, it should be explored in more detail, and critical analysis of Islamic financial services and products should be reviewed in line with these two principles to ascertain if the products and services are in line with Shariah requirements and devoid of *hilah* practices or not and to align the industry with the *maqasid al-Shariah*.

Practical implications – This paper identifies a serious challenge that Islamic finance practitioners face in product development in their effort to provide more competitive services to their customers. As a result, it demonstrates the need to proactively use *makhraj* in innovating Islamic financial products and proffering more sustainable and competitive solutions.

Originality/value – This paper discusses a topic that attempts to dispel the suspicious perceptions of some analysts as to the genuineness of Islamic financial practices.

Keywords Islamic finance, *Tawarruq*, *hilah* (legal stratagem), *Makhraj* (legal exit), *Bay' bithaman ajil* (BBA), *Bay' al-'inah*

Paper type Research paper



1. Introduction

The concept of *hilah* (legal stratagem) and *makhraj* (legal exit) remain two contemporary controversial issues in Islamic law in general and in Islamic finance, in particular, because of the overriding meaning of both concepts when applied in the process of the product development initiative. During the glorious era of the companions of the Prophet (s.a.w.s), the application of *hilah* and *makhraj* recorded no controversies as the Prophet (s.a.w.s) readily and naturally

resolved issues arising thereof and the companions swiftly got answers to whatever bothered them (Al-Faqih, 2009) [1].

Today, *ulama* (Muslim scholars) unanimously accept the application of makhraj (legal exit), as it helps an applicant to meet some or all of Shariah requirements, especially when faced with a difficult situation that requires wisdom and caution. On the other hand, the *ulama* significantly differ in the application of *hilah* (legal stratagem) for serious and obvious reasons. Hence, this paper explores the concepts of *hilah* and makhraj from *fiqhi* point of view and their contemporary applications within the Islamic finance industry (IFI), drawing some existing examples and analysing them through the filter of Shariah principles, as these two concepts are contemporary controversial issues in Islamic law in general, and in Islamic finance in particular. Consequently, a line has to be drawn between a genuine need to apply makhraj and the artificial trick to defeat Shariah through *hilah*.

Although numerous articles have been written on topics related to Islamic finance and banking, its principles, contracts, products and services, limited studies are available that investigate *hilah* and makhraj principles and their applications to the IFI. The majority of studies discuss overall performance and technical issues related to the IFI and only a few are focussed on some aspects related to the topic of this study.

For instance, according to Billah (1997), *hilah* has been used extensively in IFI as “a legal (i.e. a technically valid) means used to avoid a prohibited or inconvenient action” and hence he sees Islamic financial instruments as being in line with Shariah requirements. Similarly, Yaakob *et al.* (2016) address the issue of *hilah* and its application to *ijarah* contract as applied in Malaysia. According to them, the majority of Islamic financial instruments nowadays are structured using *hilah*. In the case of Pakistan, Mansoori (2011a, 2011b) argues that *hilah* has been used as makhraj in most of the Islamic banking products. Nevertheless, it has been misused through contracts such as *bay' al-'inah*, *tawarruq*, commodity *murabahah* and in some cases of sale and lease back *sukuk* (Islamic certificates or bods) contracts. Similar findings are reported by Aziz and Nordin (2019) in the case of Malaysia.

Given this short literature review on the topic, it is believed that there is a genuine need to investigate this topic further. Thus, this study aims to investigate the principles of *hilah* and makhraj and how they are related to the IFI. The following research objectives are at the core of this study:

- to define *hilah* and makhraj theoretically and practically and to relate it to the products and services of the IFI; and
- to elaborate (mis)use of *hilah* and makhraj in certain products used by Islamic financial institutions

This study provides the following major contributions to the existing literature. Firstly, over the years, several issues related to practical applications of Islamic finance surfaced. Some of these issues are in one way or the other related to *hilah* and makhraj which are not properly addressed in the modern literature. Consequently, this study provides a detailed analysis of the theoretical and practical aspects of *hilah* and makhraj. Secondly, although several studies have been focussing on legal and practical issues related to Islamic financial products, they have not been placing much attention and relating those issues to principles of *hilah* and makhraj. Consequently, the study addresses this issue by filling in the gap and providing new perspectives and new insights through a qualitative analysis of the existing financial products in the IFI. Finally, by providing a detailed analysis of *hilah* and makhraj and their applications in the IFI, it is hoped that the current study will contribute to a better understanding of Islamic financial products and services and provide additional insights on their improvements

The remaining of the paper is organized as follows. Section 2 examines the definition of the concepts, their literal and technical meaning. Section 3 argues for the necessity of incorporating Shariah requirements through the application of *makhraj* in the process of future development of the IFI. Section 4 illustrates *hilah* and *makhraj* using examples. Finally, Section 5 is reserved for the conclusion.

2. Definition, concept and legal authorities of *hilah* and *makhraj*

In essence, *hilah* may be defined literally as a legal trick (Abu Jib, 1988-1408AH; Cowan, 1980) or stratagem, whereas *makhraj* may be defined as an exit or a relief (Abu Jib, 1988-1408AH). In the context of Shariah, the application of the former facilitates in eluding a Shariah ruling (Abu Jib, 1988-1408AH), but the later assists in executing a Shariah requirement.

References to *hilah* and *makhraj* are found in the Holy Qur'an. In particular, the following two verses are related to the concept of *hilah*:

And well ye knew those amongst you who transgressed in the matter of the Sabbath: We said to them: 'Be ye apes, despised and rejected'. (Al-Qur'an, 2:65)

Ask them concerning the town standing close by the sea. Behold! they transgressed in the matter of the Sabbath. For on the day of their Sabbath their fish did come to them, openly holding up their heads, but on the day they had no Sabbath, they came not: thus did We make a trial of them, for they were given to transgression. (Al-Qur'an, 7:163)

On the other hand, a reference to *makhraj* can be found in the following verse:

Thus when they fulfill their term appointed, either take them back on equitable terms or part with them on equitable terms; and take for witness two persons from among you, endowed with justice, and establish the evidence (as) before Allah. Such is the admonition given to him who believes in Allah and the Last Day. And for those who fear Allah, He (ever) prepares a way out. (Al-Qur'an, 65:2)

In short, the Qur'an, *Sunnah*, *Ijma'* (consensus) and logic are in agreement when it comes to the prohibition of *hilah* (Ibn Taymiyyah, 1987-1408AH). The scholars who subscribe to its permissibility cling to the story of the prophet Ayyub (a.s) [2].

Interestingly, prominent scholars across ages have had divergent views on the technical meaning of *hilah*, and they all seemed to agree that *makhraj* is usually an exit from an already committed or to be committed mistake, whereas *hilah* is a gateway into *haram*. Further, they maintained that *hilah* usually could be recognized when a religious restriction is being smartly bypassed and relegated (Al-Shatibi, 1997-1417AH).

There are two views on *hilah*. One view – represented by the Hanbalis and Malikis – strongly opposes the application of *hilah*, whereas the other – represented by Hanafis [3] – allows it albeit very reluctantly and cautiously (Mansoori, 2011b). This group of *ulama* shows little tacit approval to the practice for fear of Shariah abuses. The Hanafi School of thought did use it although not on a scale as seen today (Al-Faqih, 2009). The overall underlying concerns and worries of the scholars in this camp are in the unwarranted application of *hilah* to defeat the *maqasid al-Shariah* (objectives of Shariah) or any of the fundamentals of Shariah. Scholars who oppose the application of *hilah* believe that it demeans Shariah, gravely undermines religious rules and injunctions and naturally makes a mockery of the divine objective of the laws. These are the underlying concerns raised by the Hanbalis and the Malikis.

Contrary to this, the Hanafis have given tacit approval although with strong reservations and cautiousness. They looked at *hilah* from the angle of the applicant's motives and

objective. Thus, five fundamental rules would apply to the objective as sought after by the application of the *hilah*. As the major controversy is on *hilah*, it, therefore, attracts the five fundamental Shariah rulings or (*al-ahkam al-khamsah*) in Islam, namely, *wajib/fard* (obligatory), *mustahabb/mandub* (recommended), *mubah* (neutral), *makruh* (disapproved) and *haram* (forbidden). Therefore, *hilah* application can be *halal* or *haram* depending on the objective of the applicant as mentioned earlier. For instance, if A wants to apply *hilah* to commit *haram* acts such as *riba* (interest) transaction but through *halal* activity such as *bay'*, applying *hilah* in that regard becomes *haram*. On the other hand, if A wants to apply *hilah* to carry out *halal*, then his application of *hilah* becomes *halal* or permissible.

2.1 *hilah* and makhraj: historical perspective

It is vital to have an idea where this issue originated from. Knowing the source of the issue can help shape the understanding and possibly provide a remedy. Therefore, the topic of *hilah* and makhraj is as old as history. The *People of the Book* (Jews and Christians) took this issue to yet another level. Not surprisingly, even after the advent of Islam, the application of *hilah* continues to surface especially when a tactic is devised to outsmart Shariah instructions or to circumvent its prohibitions or forbidden acts trickery. Ibn Bata (1996-1417AH) narrated that Abu Hurairah reported the Prophet (s.a.w.s) said "Do not commit what the Jews committed so that you would make halal what Allah has prohibited with the slightest hiyal [4] (tricks or ruse)" (Ibn Taymiyyah, 1987-1408AH). As *hilah* is *haram*, its application is equally *haram*, especially when *maqasid al-Shariah* is violated.

The Qur'an reports vividly an instance where *hilah* was resorted to. This *hilah* was a trick to circumvent the prohibition. Ibn Kathir (1999-1420AH) narrated the story of a group of Jews who broke their covenant and manoeuvred their way to fish on the prohibited day. This story implies that *hilah* was an act of repugnance even in the teachings of the previous religions before the advent of Islam. One of the fundamentals of Islamic legal system is the affirmation of previous legal systems as long as they do not violate the Shariah. The full details of this story are narrated in the Qur'an (see 7:163).

Nevertheless, the application of makhraj has been common in the Islamic history but *hilah* was never practiced during the era of the Prophet (s.a.w.s) or after his death by his companions because it is the attribute and character of past followers before Islam as cited in the above story. Whenever the companions were in a difficult situation, the Prophet (s.a.w.s) was available to direct them for an exit or makhraj [5]. The companions of the Prophet (s.a.w.s) were entirely against the practice of *hilah* when it is to be used to manipulate the Shariah for personal objectives. Issuing a *fatwa* on the use of *hilah* has not been observed during the era of these companions. It only surfaced during the late period of the *Tabi'in*. Some scholars strongly argue that the real appearance of the practices of *hilah* in the Shariah started in Bagdad and was extensible allowed by some Hanafi jurists. As a result, the Hanafis has been popular in the application of permissible *hilah* or makhraj, in some situations. It was reported that they were the first to issue a *fatwa* on using it. Be it as it may, to apply *hilah* to circumvent the Shariah rulings is *haram*. To this end, both Imam Malik and Ahmad were very strict about it (Ibn Taymiyyah, 1987-1408AH).

On the whole, Islamic jurists have dedicated significant importance to the topic of *hilah*. Combing through their literary collections, one would impeccably see tens of thousands of written literature and works on *hilah* (Al-Faqih, 2009). Some have dedicated books on the issue of *hilah*, whereas others have kept back separate chapters on it; all in their effort to portray the seriousness of *hilah* in which *Shariah* could be breached. As *hilah* and makhraj are critical to Islamic finance, in what follows, the origin of *hilah* practice will be identified.

3. Incorporating Shariah requirements in the application of makhraj for the advancement of Islamic finance industry

To incorporate Shariah requirements in the current, ever-increasing, challenging and changing complexities of the financial industry, Muslim practitioners will have to understand thoroughly the application of makhraj, its parameters and suitable methods of arriving at Shariah-compliant solutions. To this end, it is not only incumbent on the *muftis* [6] and practitioners to fully possess a higher level of understanding of the Islamic law of jurisprudence and legal dictum to be able to use makhraj efficiently and effectively but also to comprehend the fabrics of conventional finance. This urge increases alongside with the spiral speed of the development in the industry seen recently. Furthermore, a fresh interpretation of the scripts in the light of contemporary conditions will aid Islamic finance to meet the Shariah requirements.

Any passive attitude towards today's complex financial landscape does not help the course of the IFF. They need help in product development to catch up with the rock-speed technological advancement. It is not enough to identify a non-Shariah-compliant product as practitioners simply do and remain mute but to come up with alternatives through makhraj. This task is considered to be the major pressing issue and the most imperative one. In this regard, an active attitude to this seemingly plethora of changes flaring relentlessly is extremely relevant. The idea of clinging to flimsy excuses for Shariah interpretation differences is irrelevant in the face of these challenges.

It follows that Islamic financial institutions must be proactive and adaptive to current issues and situations by properly applying makhraj when a need arises. Analysts observe that the lack of expertise in the industry is a major hurdle confronting the niche market. As Islamic finance practitioners have taken the stride to create Shariah-compliant products and services, their stride and the reality demand a more pro-active approach, and therefore, failure is not an option. As a Shariah guided industry, the Shariah-compliant product innovation is excruciatingly difficult for practitioners owing to different requirements, such as local regulatory requirements, Shariah requirements and international standard settings. In fact, with the rocket-speed changes in the day-to-day conventional practices, Islamic scholars would do better by being actively responsive in *fatwa* issuance on a real-time basis. To achieve the demand at the fastest possible span, makhraj is the way out for sure. Here, the burden is on the same scholars to ensure quick response but within the purview of Shariah requirements. As long as makhraj is properly applied, any concerns should not arise and changes in market pace would be tackled timely.

This is based on a well-known legal maxim that says: "All transactions are permissible except those found non-Shariah-compliant". With this guiding dictum, Islamic finance will go forward in product innovations. As product innovation is one of the most difficult issues startling the IFI. The difficulty demands the need to understand the parameters fully under which *hilah* and makhraj come into play to proffer cogent solutions. As a result, the application of makhraj is the most appropriate.

Against this background, the application of *hilah* or makhraj to create alternative products for Muslim consumers is the core issue this paper seeks to address. However, one thing is obvious that opinions differ across schools of thoughts and webs of interpretations of our preserved and revered Shariah legacies. Some opinions approve a particular transaction simply because it fulfils its Shariah conditions and pillars in legal terms regardless of the driving intentions or motives underlying it and its real impact on public interests and substantial conflict with Shariah. Others, on the contrary, clearly see intentions as one of the criteria and bedrocks for any recognizable and Shariah acceptable contractual agreements. For the most part, the differences in opinions are daily phenomenal realities in socially complex life conducts. In Islamic history, unlimited instances of such occasions

occurred and remained pristine in the record of the legacies, but the ultimate aim of these occurrences from the parties involved was the search for truth (*haqq*) and the desire to apply it correctly and satisfactorily. As a result, interpreting the scriptures, at the individual level varies considerably, owing to human depth of comprehension. Hence, opinions are subject to approval or disapproval. In this situation, the Shariah goes with the opinion closest to the *dalil* (proof).

4. Innovation and product development through *hilah* and *makhraj*

Over the years, criticisms over the nature of Islamic financial products and services grew significantly to the point that some *ulama* consider the current Islamic banking products un-Islamic (Mansoori, 2011a, 2011b). Critics highlighted a tendency of Islamic financial products and services to be focussed more on the form while ignoring substance. For instance, products such as *bay' bithaman ajil* (BBA – differed payment sale) that is based on *bay' al-'inah* (buy-back) and *tawarruq munazzam* (organized *tawarruq* or monetization) are but a few examples of financial products that are based on *hilah* (Aziz and Nordin, 2019; Billah, 1997; El-Gamal, 2006; Iqbal, 2013; Mansoori, 2011b). Here, the principles of *hilah* have been used to avoid direct involvement in *ribawi* (usurious) transactions that are principally prohibited. In other words, it seems that these products have used *hilah* approach as an alternative or a camouflage to *riba* (usury) instead of representing legal exist (*makhraj*) to it.

While addressing this controversy and its relationship to the theory of *maqasid al-Shariah*, Ahmed (2011) identified three broad categories of Islamic banking products. Firstly, a *pseudo-Islamic product* that uses *hilah* to satisfy legal requirements (form) while ignoring the substance and social needs. Secondly, Shariah-compliant products that meet both criteria, the form and the substance of Shariah. However, this category also fails to take into consideration social or public interests (*maslahah*). Finally, there are Shariah-based products that meet all the requirements, including not only the form and the substance but also public interests.

Now, we will take a closer look at some of these products and see how they are used as *hilah* instruments. Let us start with BBA. It refers to a credit sale or sale with delayed payment and is also known as *bay' mu'ajjal* and *murabahah* in Pakistan and the Middle Eastern (Smolo, 2007, 2010a). It is a type of sale that was widely used by Islamic banks and financial institutions, at least in the case of Malaysia. It originates from a contract known as *murabahah*. It is a sale and not a loan, but this is the sale with deferred payment (Abu-Ghuddah, 2003, p. 15; Chapra, 1985, p. 169; Rosly, 2005, p. 88). Usmani defines it as, “[a] sale in which the parties agree that the payment of price shall be deferred[. . .]” (Usmani, 2002, p. 40).

As *riba* is prohibited by the Holy Qur’an, Islamic banks in Malaysia have introduced BBA to cater to the needs of Muslim clients. Islamic banks are not supposed to provide ordinary offering loans. Instead Islamic bank “[. . .]theoretically purchases the house from the developer at market price (i.e. cost price) and sells it to the customer at a mark-up price” (Rosly, 2005, p. 122) [7]. However, as the citation says, this is done only “theoretically” while it is done using buy-back (*bay' al-'inah*) transaction.

Let us assume that a customer wants to buy a house that costs US\$200,000. Under conventional banking, he would approach the developer and sign a sale and purchase agreement (S&P) and pay, let us say, 20% of the whole amount, i.e. US\$40,000 as a down payment. Then he would approach a bank for financing of the rest. If the bank approves the loan, the customer would get a US\$160,000 loan and pay monthly instalments of US \$1,544.03 [8] for the next 20 years (i.e. 240 instalments assuming that annual interest rate is 10%) to the bank. The very same house will be used as collateral. This will be done through the contract called deeds of assignment/charge. The final amount payable to the bank would

be US\$275,109.60 [9]. Therefore, the profit to the bank would be US\$210,567.20 [10]. In short, Islamic finance under the conventional banking system the financing consists of two contracts:

- (1) contract of loan between the bank and the customer; and
- (2) deeds of assignment/charge (Rosly, 2005, p. 89).

However, the case with Islamic banks is a bit complicated. The customer is required to buy the property from a developer, i.e. to pay down payment. By doing so, he becomes a beneficiary owner of that property. Now the question arises:

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Q1. How can Islamic banks sell that product to a customer when it does not possess it in the first place?

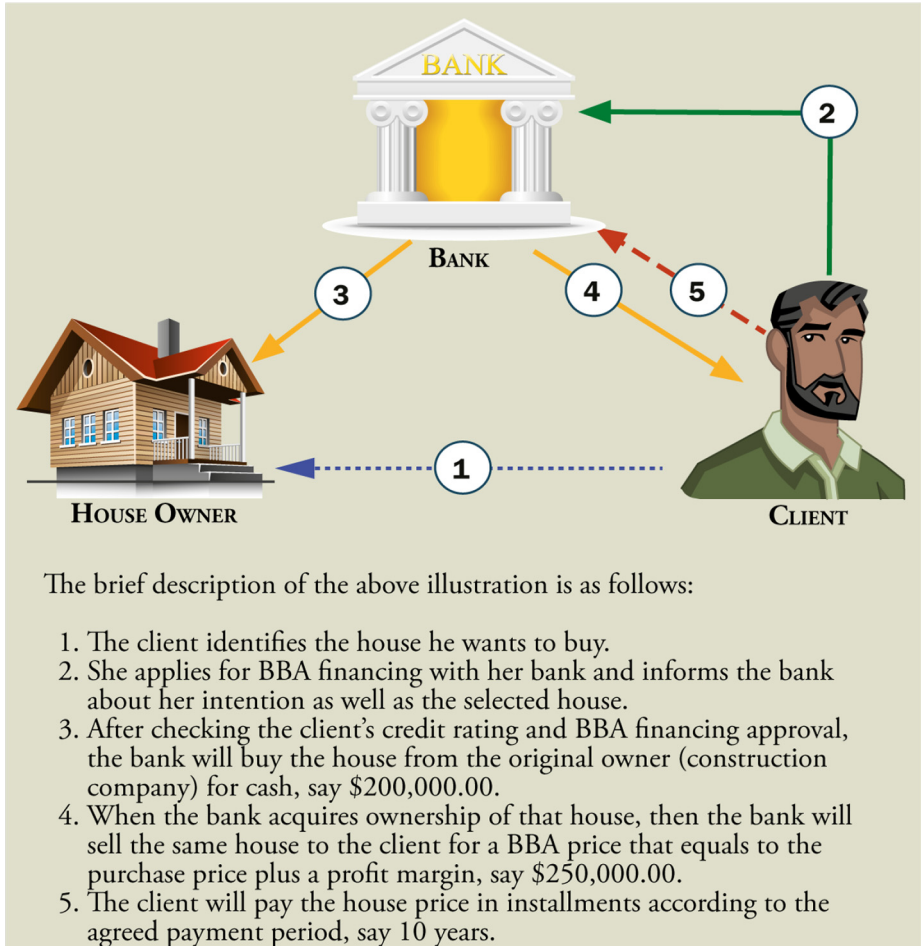
The original or true BBA is presented in Figure 1 below. Figure 1 shows how BBA *should be* implemented. Firstly, the customer identifies the property he wishes to buy. Then he approaches the bank and applies for financing. Secondly, the bank purchases the property from the developer. Thirdly, the bank sells the property to the customer who gets the delivery of the property on the spot. Finally, the customer repays the deferred price to the bank on an instalment basis throughout the agreed period (Smolo, 2010a).

However, this is not the way it was done in Malaysian Islamic banks. Instead, BBA financing is implemented in the following way. The customer, as is the case in conventional banking, will pay down payment (i.e. US\$40,000 or 20%) and sign the sales and purchase (S&P) agreement. Now, to secure the ownership (*milkiyyah*), the bank will purchase that asset from the customer through the property purchase agreement (PPA). This purchase takes place only on the papers, as there is no real transfer of ownership as there is no evidence of registration and stamp duty. Now, note that the bank will purchase that asset from the customer for the remaining amount of money needed to buy the whole house (i.e. US\$160,000). Through the introduction of PPA, the bank gets the rights over the asset and becomes the legal owner of it. Once the PPA is executed, the bank will sell the asset back to the customer at the deferred price. This deferred price or the selling price would be the cost price plus profit margin. For calculating profit margin, Islamic banks, without mentioning it, use some interest rate benchmark such as LIBOR. Therefore, the annual profit rate (APR) of Islamic banks would be very much close (if not the same) to the annual interest rate of conventional banks. If the APR and contracting period are the same as the annual interest rate and period in the above example of a conventional loan (i.e. 10%), then the monthly instalment will be the same as well, i.e. US\$1,544.03. This is illustrated in Figure 2.

In brief, the BBA sale contract consists of the followings:

- PPA: bank purchases the asset from the customer.
- Property sale agreement (PSA): bank sells the asset to the customer at BBA price, i.e. cost plus a profit margin.
- Deeds of assignment/charge: the asset is withheld as collateral by the bank (Rosly, 2005, p. 91).

As mentioned earlier, the bank uses the PPA and the PSA simultaneously. The aforementioned agreement, are “only legal devices”, as the real transfer of ownership is not taking place (Smolo, 2010a; Wei and Thaker, 2017). In addition to this artificial mechanism, the bank, as a seller, does not hold any liability to the goods sold. As result, the customer or the buyer cannot claim anything if any defects, shrinkage or faults occur. Applying this *modus operandi*, Islamic banks deviate from the objectives of Shariah (Sanusi, 2006, p. 13; Smolo, 2010a). Now, the question can be raised:



The brief description of the above illustration is as follows:

1. The client identifies the house he wants to buy.
2. She applies for BBA financing with her bank and informs the bank about her intention as well as the selected house.
3. After checking the client's credit rating and BBA financing approval, the bank will buy the house from the original owner (construction company) for cash, say \$200,000.00.
4. When the bank acquires ownership of that house, then the bank will sell the same house to the client for a BBA price that equals to the purchase price plus a profit margin, say \$250,000.00.
5. The client will pay the house price in installments according to the agreed payment period, say 10 years.

Figure 1.
Real BBA transaction

Source: Authors' own

Q2. Why do Islamic banks prefer BBA financing to other modes of finance?

The answer to this question is quite simple. Islamic banks prefer this mode of finance, as this technique is relatively simple to implement and it allows banks to earn positive profits without really bearing any risks, except in case of default and/or bankruptcy (Bendjilali, 1996, p. 43).

Thus, it can be concluded that BBA as a mode of finance, even though being allowed by Shariah scholars, is of questionable validity because of the *modus operandi* implemented in

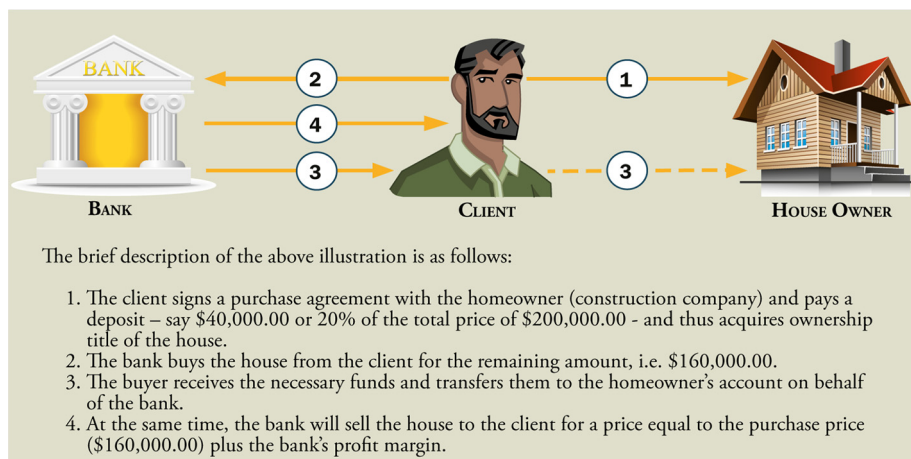


Figure 2.
Actual BBA
transaction

Source: Authors' own

Malaysian Islamic banks. The extensive use of BBA contracts and overdependence of Islamic banks on this mode of finance will result in the convergence of Islamic banks into conventional, interest-based, banks (Smolo, 2007). Criticizing this type of contract even further, Chapra says that, “[t]he danger will, however, always remain that the *mu’ajjal* and *murabahah* forms of sales may deteriorate into purely financing arrangements with the agreed profit margin being no more than a camouflage for interest” (Chapra, 1985, p. 171).

Now, we turn to *tawarruq*. The word *tawarruq* is derived from the Arabic verb *tawarraqa* which means “to eat leaves” (it is said *tawarraqa al-hayawan* or animal ate leaves), and the word *wariq* refers to dirhams coined from silver. From this, there is this derivative *tawriq* which would mean “acquiring silver”. Thus, *tawarruq* is a mechanism through which earlier generations were able to acquire silver money and is now used to get the client the paper money he needs (Bouheraoua, 2009; Usmani, 2009) [11]. Technically, the term *tawarruq* refers to a series of sales contracts, whereby the buyer (client) buys certain goods or assets from the seller (bank) with deferred payment and sells it to a third party (broker) for cash. This cash price, however, is lower than the deferred price and the main goal of this series of sales transactions is to acquire cash (monetization). *Tawarruq* is also known as the commodity *murabahah* and is widely used for a variety of financial needs using the London Metal Exchange as a platform.

Tawarruq is relatively similar to the *bay’ al-’inah* contract in the sense that through it a person wants to obtain financial means through a series of sales contracts. However, in a *bay’ al-’inah* contract, the client buys a certain item with deferred payment (in instalments) from the bank and at the same time sells the same item to the bank for a lower price (in cash). On the other hand, with *tawarruq*, the bank buys a certain item from a broker on the market for cash price. Then, the bank sells the same item to the client with deferred payment and at a price that implies a certain profit of the bank. After that, the client will sell this item to his broker for, more or less, the original cash price. This final sale of the item may be made either by the client himself or by the bank on his behalf as his agent (*wakil*). Ultimately, the

client gets the money he needs, and the bank makes a fairly simple and easy profit with minimal risk (if any).

Because of its nature which dictates the existence of three parties, the *ulama* are in some ways more flexible *vis-à-vis* the permissibility of the *tawarruq* contract. In particular, some banks that do not prefer the *bay' al-'inah* contract and consider it invalid, opt for *tawarruq* because they consider it valid. In short, *tawarruq* is used to meet the liquidity needs of a particular party, whether it is a bank or its client. Islamic banks in Saudi Arabia began using *tawarruq* around the year 2000 and then other banks in the region – Bahrain, Kuwait, Qatar and the United Arab Emirates – continued the practice (Ahmad, 2009).

Although this practice may be in line with the Shariah, the type of *tawarruq* that raised many concerns among Shariah scholars and practitioners is *tawarruq munazzam* (organized *tawarruq*). Organized *tawarruq* means a series of sales contracts performed by the seller on behalf of the buyer (*mutawarriq*) to provide him with the necessary money (Figure 3). In this case, the seller sells the goods to the buyer with deferred payment and then sells those goods – on behalf of the buyer – to a third party for cash. The money thus obtained will be forwarded by the seller to the buyer (*mutawarriq*).

Over the past decade or more, *tawarruq* and the way it is implemented in Islamic banks have attracted a lot of criticism from both Islamic scholars and ordinary people. A special turmoil in the market occurred in April 2009 when the Islamic Fiqh Academy of the OIC issued a *fatwa* banning organized *tawarruq* [12]. AAOIFI has also banned the use of organized *tawarruq* in its *Shariah Standard no. 30*. This standard specifies exactly how and in what way *tawarruq* can be used for Islamic banking and finance (AAOIFI, 2010/1432H, pp. 523–531). Also, the late Shaykh Husain Hamid Hassan believes that modern *ulama* agree with the ban on *tawarruq*. The main reason for the ban, according to him, is the manner of implementation of this agreement, where the contracting parties are not exposed to loss or risk, which are considered to be the foundation of the Islamic economy.

These reasons mentioned previously have also been mentioned by other contemporary Shariah scholars who have studied *tawarruq* in detail and its application in modern Islamic

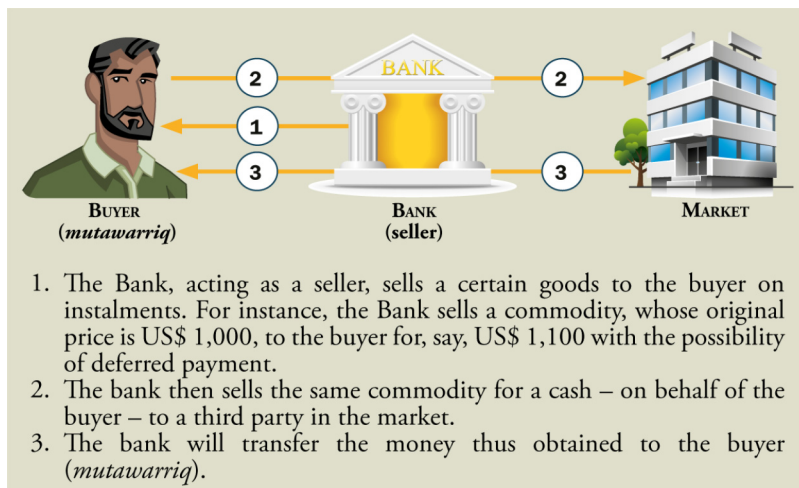


Figure 3.
Organized or banking
tawarruq

Source: Adapted from ISRA (2011, p. 217)

banks and financial institutions. The conclusion is the same, *tawarruq*, in the way it is applied today, and above all organized *tawarruq*, is not allowed. Ahmad, Al-Suwailem, Al-Zuhayli, Bouheraoua and Uthmani are of this opinion.

Apart from BBA and organized *tawarruq* discussed in detail previously in this paper, some authors are also relating other Islamic financial contracts with the practice of *hilah*. For example, [Billah \(1997\)](#) argues that *ijarah* (lease) and *salam* (forward sale) – apart from *murabahah* (mark-up sale) – are valid contracts once conditions are met. However, as they undergo significant modifications to be used as modes of finance, they all turn out to be similar to *bay' al-'inah* and its reliance on *hilah* is unavoidable as discussed previously. In other words, the result is always the same, “a loan repayable with an additional amount” ([Billah, 1997](#), p. 77).

Similarly, while trying to overcome shortcomings of the BBA and the organized *tawarruq*, scholars came up with a hybrid product called *musharakah mutanaqisah* (“MM”) or a diminishing partnership. In short, MM is a partnership or co-ownership culminating in legal ownership of the underlying asset by one of the partners, usually the customer ([Smolo and Hassan, 2011](#)). According to Usmani, MM refers to a partnership between a financier and a client who jointly own a property, equipment or commercial enterprise. The share of the financier is further divided into many units and the client is expected to purchase those units periodically. By doing so, the share of the client will increase and the share of the financier will decrease until all the units are owned by the client ([Usmani, 2002](#)). Nevertheless, MM is not found in classical *fiqh* literature, as it is an innovative product or a hybrid product consisting of several classical contracts. The pure MM consists of three contracts, namely, *musharakah* (partnership), *ijarah* (lease) and *wa'd* (promise) followed by *bay'* (sale) [13].

Regardless of MM's innovative nature and genuine intention behind its structure, it seems that MM offers similar or even worse results (in some cases such as defaults) than those produced by BBA in Malaysia ([Haneef et al., 2011](#); [Smolo, 2010b](#)). As pointed out by industry experts, MM is not significantly different from BBA, as most of its *modus operandi* is similar to BBA – especially when it comes to default cases. To put it differently, the main difference between BBA and MM lies in the way underlying contracts are intertwined, i.e. BBA is based on a sale and purchase of property, whereas MM would require both a customer and a financier/bank to jointly purchase the property, with the customer's undertaking to gradually acquire the bank's share of ownership in the property, ending in the former owning the property ([Smolo, 2010b](#)). However, when it comes to default, banks will still go through the same channel to dispose of the property, which is via auction, using *wa'd* (promise). To sum up, all that innovation that was carried out to come up with a new product that will meet Shariah requirements could be seen as a form of *hilah* or a legal trick to circumvent the prohibition of *riba*.

5. Conclusion

This paper discusses the concept of *hilah* (legal stratagem) and *makhraj* (legal exit), the difference between the two and their potential application in Islamic financial transactions. It is argued that Shariah-compliant products could be developed using the *makhraj* doctrine. However, some difficult areas have witnessed the application of *hilah* whose application has its repercussions on the reputation of the IFI. The paper, thus, highlights the importance of putting a demarcation between the genuine need of *makhraj* and the fake need to resort to *hilah*. Certainly, *hilah* is not in line with the values and morals, which Islamic finance is expected to disseminate based on its fundamental core business of full trust and ethical standards.

Furthermore, the topic of *hilah* and *makhraj* is truly interesting, though controversial, and its relevance to Islamic finance today cannot be overlooked. To come up with important solutions to the current Islamic finance travails, the forward thinking is simply to apply the *makhraj* doctrine and cautiously avoid *hilah* during the process to prevent reputational risk for the industry. Although it is evident from Shariah books that most controversies are centered on *hilah* because of its repugnant nature right from the historical perspective, some scholars do consent to the use of *hilah* but the outcome or end objective is subject to the fundamental five *ahkam* (rules) of Shariah. All seem to agree, however, that the application of *makhraj* on daily difficulties and challenges that a Muslim may face is accepted unanimously.

Some contemporary applications of *hilah* have been identified in a few financial products and the authors think that the industry should come out clean of these alien practices. Although some may argue it to be an incorrect assessment, the responsibility on the IFI to educate and remain transparent cannot be overemphasized. It is for these reasons that a further investigation on the topic is needed to address these concerns and to offer alternative solutions to these practices that will meet Shariah requirements in both form and substance.

Notes

1. For example, in an instance, the Prophet (s.a.w.s.) commanded a companion to sell inferior quality dates and then buy superior quality ones with the proceeds, rather than exchanging the inferior dates for superior dates thus entering into a *riba* transaction. This can be considered as the Prophet's application of *hilah* and *makhraj*.
2. The Prophet Ayyub swore an oath to beat his wife 100 strokes of the cane but *hilah* was devised for him to get a bunch of dates branch with 100 leaves. With it, he shall beat his wife once and such action should suffice. This is, according to the Hanafis, *hilah* or they call it a legal trick as a way out from difficulties. This is also referred to in the Holy Qur'an, see Al-Qur'an, 38:44.
3. According to the Hanafis, *hilah* is considered as a legal exit from difficulties.
4. *Hiyal* is the plural of *hilah*, which simply means ruses.
5. Refer to the *hadith* on inferior and superior dates cited later in this paper.
6. Shariah scholars who issue *fatwa* (a legal ruling) on a matter.
7. Here, the *italics* are ours for emphasis.
8. Computed using the standard formula for the present value of annuities, i.e. $PV = \frac{Pmt}{i} \left[1 - \frac{1}{(1+i)^n} \right]$ which gives $pmt = \frac{i(1+i)^n PV}{(1+i)^n - 1}$
9. Found by $US\$1544.03 \times 240 = US\$370,567.20$.
10. Found by $US\$370,567.20 - US\$160,000 = US\$210,567.20$.
11. According to Usmani (2009), the word *tawarruq* does not find its roots in the Arabic language in this form. He believes that this word was invented by earlier scholars to describe the mechanism for acquiring money.
12. However, this is not the first time that the Islamic Fiqh Academy has issued a *fatwa* on the validity of *tawarruq*. Namely, this institution previously issued two more *fatwas* on *tawarruq*. The first *fatwa* was issued by this academy in September 1998 during its 15th session. With this *fatwa*, the academy allowed a *tawarruq* transaction provided that the person who buys the goods does not sell those goods back to the same person, but it must be someone else to avoid *'inah* which is considered a legal trick to circumvent the interest ban. The second *fatwa* was issued during the 17th session in December 2003. With this *fatwa*, the Islamic Fiqh Academy has distinguished between *tawarruq fiqhi* and organized or banking *tawarruq*. Thus, the academy

allowed *tawarruq fiqhi* and banned organized or banking *tawarruq* because it considers it a fictitious transaction, as is the case with *bay' al-'inah*, which seeks to circumvent the interest ban. This *fatwa* is further confirmed by the new *fatwa* no. 179 (19/5) prohibiting organized or banking *tawarruq*. This *fatwa* was passed in April 2009 during the 19th session of the Council of the Islamic Fiqh Academy.

13. For a detailed analysis of MM and various issues surrounding its implementation please refer to the following articles (Bendjilali and Khan, 1995; Haneef *et al.*, 2011; Meera and Dzuljastri, 2005, 2009; Smolo, 2010b; Smolo and Hassan, 2011; Usmani, 2002).

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