Siddiqi, M. Nejatullah, Social Dynamics of the Debate on Default in Payment and Sale of Debt,
In: *Islamic Finance: Current Legal and Regulatory Issues*, edited by Ali, S. Nazim. Cambridge, Massachusetts: Harvard Law School, ILSP, Islamic Finance Project, 2005, pp.107-116

Social Dynamics of the Debate on Default in Payment and Sale of Debt

M. Nejatullah Siddiqi[1]

The current debate on regulatory issues in Islamic finance reflects a variety of approaches. Most experts in Islamic law, *the fuqaha'*, employ analogical reasoning and use past rulings as a guide to a rule for today. Most economists, on the other hand, argue in terms of socio-economic consequences and seek rules that shape a desired state of the world. Jurists are trained to arrive at new rules governing a wholly or partly novel situation mostly by analogical and deductive reasoning. Social philosophers are concerned with certain values such as justice and fairness, even promotion of the common welfare. They evaluate new rules based on these criteria, often concluding that the new rules are insufficient. As long as there is a strong case for improvement, the jurists are obliged to have a second look by invoking methods that are more accommodative of the very values that concern the social scientists.

In the Islamic tradition we often come across rules arrived at by analogical reasoning *(qiyas)* that are abandoned in favor of rules designed to protect/promote the benefit *(maslaha)* desired. In economic literature there has been a debate between those who would maximize production (thereby creating as much new wealth as could be created) and those concerned primarily with social justice and ensuring dignity and security for every human being. Law is concerned primarily with fairness, whereas social good (including economic good) is conceived in terms of provisions that depend, ultimately, on production. Fairness is necessary to ensure dignity, whereas wealth is needed to guarantee security.

This brief paper proposes to demonstrate that a similar tension is discernable in the current debate on legal and regulatory issues in Islamic finance. It focuses on two issues that are attracting considerable attention: (1) how to deal with delays in payment of debts resulting from sales on

---

[1] Independent researcher. The author is thankful to M. Anas Zarqa and M. Umer Chapra for their comments on an earlier draft of this paper.

credit, mostly in *murabaha* deals, and (2) the permissibility of securitization and sale of debts resulting from *murabaha* and other credit transactions.

Widely different positions have been taken on these issues. The paper will propose that these differences may be rooted in the priorities of the position taker. Those placing greater importance on production and the creation of wealth value efficiency. They seek to ensure the flow of credit, economize on the use of cash, etc. By contrast, those more concerned with fair dealings and social justice seek to avoid any involvement with *riba*/interest, whose prohibition is the first threshold in deterring injustice and unfair practices. For them, characterizing any procedure as involving *riba*/interest amounts to declaring it to be unfair and unjust.

Islamic economics as a discipline is concerned about justice and fairness as well as efficiency. It acknowledges that in a balanced realization, the two complement each other. This does not, however, preclude the possibility that scholars of different backgrounds may differ in their priorities. Economists tend to care more about efficiency, or at least seem to give it higher priority. The more that is produced, the fairer one can be in distribution. The less that one has, the greater the temptation to be self-serving. Therefore, economists always seek to maximize efficiency. Law, by contrast, focuses on fairness in a given situation. As the debate on current legal and regulatory issues in Islamic finance involves scholars drawn from various disciplines, tensions develop that have the fortunate potential of leading to resolutions that a narrower approach would fail to achieve.

THE DEBATE ON DELAY IN PAYMENT

The debate on *mumathala*, or delay in payment of a debt incurred in a credit purchase, predates the debate on the sale of debt *(bay‘ al-dayn)*. It began in earnest late in the last century. The practice of *murabaha*, the chief source of debts under discussion, had been spreading, bringing this issue to the forefront. The possibility of delay in payment raised the questions of how and when to penalize the defaulter, whether to compensate the creditor, and if so, how? The principle of penalizing a defaulter who is capable of payment is universally accepted, but neither the need to compensate the creditor nor the method of doing it so as to prevent *riba* is agreed upon.[2]

The debate was conducted in various forums, including *shari‘a* advisory boards, seminars and conferences, and academic journals. This paper will focus on the last, particularly the journal published by the Center for Research in Islamic Economics at the King Abdulaziz University in

[2] Saleh 2002: 92-93.

Jedda.[3] A good summary of the debate is provided by a paper jointly authored by Mohammad Anas Zarqa and Mohammad Ali Elgari (henceforth referred to as Zarqa and Elgari).[4]

The issue, restated, is how we are to deal with one who buys on the promise to pay within a certain date but delays payment, thereby inflicting harm on the seller/creditor? Zarqa and Elgari rightly begin their paper by highlighting the importance of this issue in a system that does not charge interest. They also note the importance of credit in an economy that thrives on the division of labor and exchange. Islamic finance needs a mechanism capable of eradicating the phenomenon of delay in payment by those capable of timely payment, a phenomenon characterized as delinquency.

How can we deter the delinquent? Do we compensate the creditor? If yes, why, how, and when? The answers to these questions vary. Some propose deterrence by punishment through incarceration, or even corporal punishment for the debtor. Blacklisting delinquents and exposing them to the public has also been suggested. All these proposals, however, involve courts of law, and litigation requires time. This is rightly seen as a disadvantage that decreases the efficiency of the Islamic financial system. Efficiency calls for a mechanism that is triggered automatically. One mechanism can be a financial penalty. Such a fine can be proportional to the sum of money involved. It can also be related to the actual length of delay. This approach, however, would be similar to *riba*/interest in form if not in spirit. Some also claim that it may not be an effective deterrent, insofar as the market rate of interest at any particular time may be higher than the rate at which the fine is imposed. In such a case, the delinquent debtor can pay the fine and "roll over" the debt, much to the chagrin of the creditor.

Proposals on deterring the delinquent can be classified into two categories. A monetary penalty automatically triggered ensures efficiency. It should be noted, however, that proponents of a fine nevertheless opine that only a court of law can fix its quantity. It cannot form part of the contract and come into effect automatically. On the other hand, the obligation to avoid interest prompts some scholars to reject the fine option altogether, irrespective of who levies it. Out of the eight opinions listed by Zarqa and Elgari, one scholar (Nazeeh Hammad) insists that only punishment by a court of law can deter a delinquent.[5] Two scholars (Shaikh Mustafa Zarqa and Zakiuddin Sha'ban) opt for a fine that must be decreed by a court.[6] Two other scholars agree to a predetermined fine that, according to one (Ali al-Saloos, who combines incarceration with a fine),

[3] Because the same scholars have been involved in all these forums, hopefully no substantial issues will be overlooked.
[4] Zarqa and Elgari 1991: 25-57.
[5] Hammad 1985: 104, 106.
[6] Zarqa 1985: 96.

goes to a charity.[7] Another suggestion is to send the fine to a special fund under the aegis of the state (Siddiqi). The remaining scholars (Siddiq al-Dareer and Zaki Abdul Barr) agree on a fine that would serve as a deterrent, but insist that it should not exceed the actual harm suffered by the creditor/Islamic bank.[8] Al-Dareer regards the average rate of profit earned by the bank in the relevant period as a good measure of its loss.

With respect to compensation, one opinion (Nazeeh Hammad) rejects the idea, arguing that it is only the original sum owed that a creditor may collect. One can say that the possibility of delay must have been factored into the mark-up, the increase over and above the cash price. Sheikh Dareer would compensate only to the extent of actual profit lost, which he then equates with the average profit earned by the creditor (Islamic bank, for example).[9] In effect, this is what the creditor would get according to the formula approved by Shaikh Zarqa. But Zaki Abdul Barr is not comfortable with this formula; he would rather have it analyzed by a court and have compensation given in exceptional cases only.[10] Siddiqi would make the affected creditor seek compensation from the special fund under the auspices of the state to which all fines go.[11]

Mention ought also to be made of the proposal of the authors themselves, Zarqa and Elgari. In their view, the delinquent debtor is to be obliged, by a court of law, to make a counter-loan (interest free) to the creditor in the amount owed and for a period equal to the period of delay. The idea is to compensate for a lost opportunity by providing a similar opportunity, and no more. This proposal, however, has received no endorsements. One commentator described it as neither efficient nor fair.[12] The marginal efficiency of money to the creditor was not necessarily the same at the two points of time involved. The different timings of the two opportunities, the one lost due to delay and the one being provided as compensation, could not be treated as equal. Also, the counter loan provided as part of the contract made it similar to *riba*/interest, insofar as the extra time was matched by a "benefit."

Zarqa and Elgari, together with Siddiqi, visited the issue again in "Banking Law—A Suggested Model for Organizing the Islamic Banking Sector."[13] Appendix 9 to that text details what is provided briefly in clause 4 of the model law. All fines for delay are to go to a public fund supervised by the central bank. The fund serves society in various ways, but the lender does not benefit from it by any means.

---

[7] Zarqa and Elgari 1991: 37-38.
[8] al-Dareer 1985: 112, and Abdul Barr 1991: 61.
[9] al-Dareer 1985: 112.
[10] Abdul Barr 1991: 62.
[11] Zarqa and Elgari 1991: 37. Also in Elgari et al. 1993: 93 (Arabic section), clauses 4 and 5 of Appendix 9.
[12] al-Roobi 1992.
[13] Elgari et al. 1993.

In the year 2000, the Islamic *Fiqh* Academy, a subsidiary of the Organization of the Islamic Conference headquartered in Jedda, passed a resolution on this issue. That resolution went further than an earlier resolution in 1990 which stated: "If the buyer/debtor delays the payment of installments after the specified date it is not permissible to charge any amount in addition to its principal liability, whether it is made a precondition in the contract or it is claimed without a previous agreement, because it is *riba*, hence prohibited in *shari'a*."[14] The new resolution reaffirmed the above, but added: "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 contract is usury in the strict sense." It also laid down that: "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 loss."[15] These resolutions provide some relief only to those affected by delays in fulfillment of *salam/istisna'* obligations. The amounts owed in installment sales and *murabaha* sales that have become debts remain outside their purview. In other words, little attention is paid to the efficiency-based pleas of the scholars reported above and the verdict focuses solely on the ethical aspect as surrogated by *riba*/interest.

The issue of delay in payment is taken up in Chapra and Khan (2000). Concerned with the efficiency of the Islamic financial system, they observe: "If the late payment does not lead to any penalty, there is a danger that the default may tend to become a widespread phenomenon through the long run operation of self-enforcing mechanisms. This may lead to a breakdown of the payment system if the amounts involved are significantly large."[16]

They proceed to suggest an index of "loss given a default" (LGD) "to determine the compensation in a way that reduces subjectivity as well as the possibility of injustice to either the defaulting or the aggrieved party."[17] This comes, however with the proviso that "the concept of compensation for loss becomes accepted by the *fuqaha'*."[18] The authors report, without comment, the "conservative view" that "prohibits the imposition of any compensation to the aggrieved party for fear that this may become equivalent to interest."[19]

The latest response to this issue seeks a balance. It makes a penalty for default/delay automatic, but the proceeds of the penalty go to charity. With

[14] Islamic *Fiqh* Academy 2000: 104.
[15] Ibid., 252.
[16] Chapra and Khan 2000: 72.
[17] Ibid., 73.
[18] Ibid., 73.
[19] Ibid., 72.

respect to compensation for harm done, the issue is left to courts of law. In its guidelines relating to *murabaha*, the State Bank of Pakistan states:

> It can be stipulated while entering into the agreement that in case of late payment or default by the client he shall be liable to pay penalty calculated at percent per day or per annum that will go to the charity fund constituted by the bank. The amount of penalty cannot be taken to be a source of further return to the bank (the seller of the goods) but shall be used for charitable purposes. . . . The bank can also approach competent courts for award of solatium which shall be determined by the courts at their discretion, on the basis of direct and indirect costs incurred, other than opportunity cost.[20]

One of the peculiarities of a market economy is the press for efficiency. This is achieved largely through competition. Unfortunately, the market has no similar mechanism to ensure justice and fairness. That is left, in the first instance, to the conscience of the players, the economic agents, and then the regulatory authorities. In other words, the market works for the private interests of the participants whereas the public interest (which includes the interests of non-participants) is the responsibility of the state, the guardian of public interest. Islam works on the conscience of the economic agents through moral orientation. Also, social authority is empowered to take the steps necessary to protect public interest, a principle enshrined in the traditional Islamic institution of *hisba.* Because the prohibition of *riba*/interest is directed at ensuring justice, the jurists rightly insist that no provision should involve *riba*/interest. But can they stop there? If they do (as they seem to have done until now) can the market stop pressing for an efficient solution to the problem under scrutiny?

SALE AND SECURITIZATION OF DEBT

The second issue we analyze is the sale of debt, *bay‘ al-dayn.* Prohibition of interest almost eliminates the direct lending of money for business. There is no bond market in an Islamic economy whose liquidity is at issue. Direct lending of money is replaced by *murabaha* and similar credit transactions, effectively tying the expansion of credit with the growth of the economy. In place of conventional treasury bonds, Islamic financial markets have bonds based on *ijara* (leasing), *salam* (prepaid orders), or *istisna‘* (manufacturing orders on a pay as you get basis). But there is also a huge debt created by installment sales and *murabaha*. To some, waiting until maturity implies waste. This waste occurs at two levels. Firstly, those holding IOUs will need credit to command real resources to continue producing, having presumably exhausted their own resources in producing what they already

[20] State Bank of Pakistan 2004: 3.

sold on credit. This means that society will always carry a large amount of non-liquid assets, the IOUs. This may secondly force sellers/producers to refuse to sell on credit and to instead demand cash. A society in which all IOUs must await redemption by the original debtor cannot economize on the use of cash.

It may rightly be noted that one must await the maturity of debts incurred in the process of acquiring command over real resources on credit. As Keynes pointed out in commenting on the "liquidity fetish," not everybody can be liquid all the time. It is, however, more efficient to provide opportunities for exchange between those who are willing to wait and share the risks involved (given that the Islamic framework does not reward pure waiting) and those who seek liquidity. One way to do so is to allow IOUs as collaterals for fresh credit—a practice already in vogue in the Islamic financial market. It is also permissible to exchange these IOUs for goods and services. But some believe more should be offered.

The juristic objection to the sale of debts resulting from *murabaha* is the same as in the case of selling a debt created by a money loan. If I buy for 90 an IOU worth 100 after a year, I am doing so in order to earn 10 as interest. Jurists see no reason to distinguish between IOUs created by *murabaha* and IOUs created by lending money. This is what seems to underlie the latest Islamic *Fiqh* Academy resolution on the subject, which states:

> It is not permissible to sell a deferred debt by the non-debtor for a prompt cash, from its type or otherwise, because this results in *riba* (usury). Likewise it is not permissible to sell it for a deferred cash, from its type or otherwise, because it is similar to a sale of debt for debt which is prohibited in Islam. There is no difference whether the debt is the result of a loan or whether it is deferred sale.[21]

However, the view equating money loans with debts resulting from credit has been challenged. There are reasons to treat the two differently, say Chapra and Khan:

> The debt is created by the *murabaha* mode of financing permitted by the *shari'a* and the price, according to the *fuqaha'* themselves, includes the profit on the transaction and not interest. Therefore, when the bank sells such a debt instrument at a discount, what it is relinquishing, or what the buyer is getting, is not interest but rather a share in profit.[22]

In other words, a debt resulting from *murabaha* has an element absent from a debt arising from borrowing money—the mark-up on spot price. The sale

[21] Islamic *Fiqh* Academy 2000: 234.
[22] Chapra and Khan 2000: 78.

and purchase of *murabaha*-based debt would take place on this extra profit margin.

There is a problem with this proposition. That which was a profit margin for the seller of goods and services (on a *murabaha* basis) may not necessarily remain so when the same seller "sells" the IOU arising from that transaction. Some of the factors involved in the determination of the mark-up on spot price in *murabaha* may be different from those involved in the sale of the resulting IOU at a discount. Furthermore, the extra profits earned in *murabaha* sale, over and above those that can be earned in selling for cash, are still made against the sale of goods and services. But the portion that goes to the buyer of the *murabaha*-based IOU (according to the above rationale) has no goods and services corresponding to it. It is money for money with only a difference of dates.

Chapra and Khan proceed to argue that there is hardly any *gharar* involved in the sale of debt-instruments under discussion, a point we will not address given the limited scope of this paper. What is more noteworthy is their plea that the *fuqaha'* reconsider the case of asset-based debt instruments and allow their sale, as it would lead "to the accelerated development of an Islamic money market."[23] They proceed to emphasize the need for such a market by pointing out that Islamic banks may face a liquidity crunch in its absence, thereby paralyzing the whole system. They also believe "it is difficult for banks to play effectively their role of financial intermediation, without being able to securitize their receivables."[24] After discussing alternative avenues of raising large funds required by client companies through banks, they conclude that "it would be preferable to allow banks to rely on the sale of their own assets to raise liquidity."[25]

So it is efficiency that is at stake, in an environment where the inefficient may not long survive. Again, the same story unfolds, that of jurists bent on ensuring justice by avoiding anything similar to *riba*/interest, while the economists are keen to maintain efficient markets. Do they understand each other's concerns? Is the rationale *(hikma)* of prohibiting *riba* also applicable to the sale of debts resulting from *murabaha* so that it must be blocked in order to ensure justice? What about a trade-off between the twin objectives of *shari'a*, justice and wealth creation? Is such a trade-off acceptable under certain circumstances? Is it sometimes unavoidable? Can we agree on a formula that ensures a reasonable degree of fairness with a reasonable level of efficiency? These questions have yet to be examined thoroughly. Those arguing in favor of legitimizing the sale of debt must demonstrate that no alternative methods of ensuring liquidity are available. They must also address the objection that once the sale of debt is allowed

---

[23] Ibid., 79
[24] Ibid.
[25] Ibid., 80.

insofar as asset-based IOUs are concerned, prohibiting the sale of IOUs based on money lending will be difficult, if not impossible, to sustain.

Bay'al-dayn is approved by Malaysian *shari'a* scholars.[26] It has a place in Islamic banking as practiced in Southeast Asia. *Shari'a* scholars in that region follow the Shafi'i school of Islamic law. They base their opinion on certain rulings with which scholars in the heartland of Islamic finance, who follow other schools, generally do not agree.[27] Bank Islam Malaysia is marketing Negotiable Islamic Deposit Certificates (NIDC) backed by *murabaha*-based assets.[28] According to al-Amine, "In Malaysia the Islamic benchmark bond was introduced in 1990 and is believed to be based on the *murabaha* concept. They are the most popular form of Islamic financing method used in Malaysia."[29] Al-Amine goes on to note, however, that controversy continues to surround the *shari'a* legitimacy of these bonds.[30] Many Islamic debt instruments on sale in the Malaysian market are criticized on the ground that they involve *bay' al-dayn* and *bay' al-'ina*.[31] But some scholars refer to certain Hanbali and Maliki jurists (e.g., Ibn Qayyim and Dasuqi, respectively) who "are of the opinion that selling *dayn* to a third party is not against syarak (*shar'*)."[32] It is noted that there is a difference between the debtor being asked by the creditor to pay more than the price agreed upon in a credit sale in lieu of delay in payment, and selling the IOU arising from that credit sale to a third party. In the latter case the seller on credit, who holds the IOU, is no longer dealing with the debtor. He is dealing with a third party to whom he sells the IOU. The deal between this third party, which now holds the IOU, and the debtor, is free of the constraints attending upon the deal between the seller on credit and the one who buys on credit. According to Ishak, *bay' al-dayn* to a third party, however, is distinguishable because a third party does not ask for an increase in price from the debtor. The debtor will just pay according to the initial contract. As *dayn* has been sold to a third party, the initial creditor will no longer make a claim but the third party will.[33] Ishak proceeds to argue:

> Can *haqq al-dayn* (be) sold at a lower price? The answer is yes, because it is not a currency and the attributes transferred when bought consist of *haqq mall* not currency. . . . Based on the above, if the initial seller is willing to reduce his right and give the third party the full right, it is not at all against syriah (shari'a) principles. The same with share certificates traded, it is an ownership

---

[26] Securities Commission 2002.
[27] Usmani 2000a.
[28] Archer and Karim 2002: 132.
[29] al-Amine 2001: 3.
[30] Ibid., 4.
[31] Rosley and Sanusi 1999.
[32] Ishak 1997: 6.
[33] Ibid., 7

right in a company and when sold in the secondary market the price is essentially different from the initial price.[34]

This argument is unconvincing, as a shareholder does not hold a claim to a definite sum of money to be paid in the future. But there is no need for me to evaluate these arguments in analogical terms. What matters is their focus on distancing the sale of debt from *riba*/interest and trying to present it as a fair trade, free of the injustice symbolized by *riba*/interest. Hence, the claim that asset-based securities are like share certificates and necessary for the well being of people. This is evidenced by Ishak's appeal to the *shari'a* principles of *ra'fa* and *takhfif* in his conclusion.[35] In other words, it is being asserted that allowing the sale of debt arising from credit sales is neither unjust nor unfair as it does not involve *riba*/interest. It is also emphasized that it should be permitted in order to make life easy and prosperous. Perhaps it would have been more beneficial if, instead of analogizing between a certificate of ownership in a company and an IOU, Ishak had pursued the *maslaha*-based arguments on which he bases his conclusions.

It would be far better to conduct the debate openly in the framework of ease versus hardship, efficiency versus fairness, and growth versus distribution. The trade-offs could then be openly examined, even measured. At the macroeconomic level, we need to know why liquidity cannot be guaranteed without legitimizing the sale of debt. It must be discussed how giving debt-financing a greater role is likely to change the nature of the Islamic economy, which emphasizes risk sharing and participatory finance. Unfortunately, this is not how legal issues are handled, especially in an industry in a hurry (as the Islamic financial industry currently seems to be) under pressure from its more "efficient" competitors. While the *shari'a* scholar sitting on an Islamic bank's advisory board may not have the time necessary to consult relevant texts as to whether a particular type of analogical reasoning is acceptable, the task of the social scientists and moral philosophers is more contemplative and time consuming. An appeal to *maqasid al-shari'a* (objectives of *shari'a*) is not as easy as it may initially seem to the uninitiated. It involves an understanding of Islam as a way of life, a process of social reconstruction, and a mission with humanity—an understanding far deeper than what one would normally expect from a contemporary legal expert. Islamic finance should consider all of these objectives, many of which are difficult to realize through analogical reasoning, and even financial engineering.

---

[34] Ibid.

[35] Ibid., 8.