

**A Revisit to the Principles of Gharar in Islamic Banking Financing Instruments with
Special Reference to Bay Al-Inah and Bay Al-Dayn**

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Abstract

One of the significant features of Islamic banking is the elimination of riba and gharar. However many problems arise in some of Islamic banking financing instruments when they are claimed to contain significant elements of gharar thus held unacceptable in certain Muslim countries. Among these instruments are Bay al-Inah and Bay al-Dayn. This paper discusses at length the concept of gharar or uncertainty and its occurrence in the contracts of Bay al Inah and Bay al Dayn. The paper starts off with a definition of gharar and is followed by explanations of what it is in theory and in practice, including examples of the existence or occurrence of gharar in various types of contracts. Since the contracts of concern are Bay al Inah and Bay al Dayn specifically, the paper will discuss at length what each of these contracts is and how and where gharar is present in them. Subsequently, it details the legal implications of the presence of gharar on the validity of contracts in general and in Bay al Inah and Bay al Dayn contracts specifically. The opinions and views of major Muslim jurists on these matters are also highlighted. The paper concludes with recommendations and suggestions on dealing with the issue of the existence of gharar in Bay al Inah and Bay al Dayn contracts.

Introduction

Aqd, or contract, in simple terms refers to an obligation. It is defined as “an engagement and agreement between two persons in a legally accepted, impactful and binding manner”.¹ The Quran in Surah al Maidah states,

“O ye who believe! Fulfill your obligations”
[Surah al Maidah, verse 1]

There are three viruses that corrupt an Islamic contract, these are:

- Riba: interest,
- Jahl: ignorance and lack of knowledge, and
- Gharar: uncertainty and deceit.

Gharar

Gharar is an Arabic term which literally means uncertainty, ambiguity, risk, danger or peril². Technically, Gharar refers to uncertainty in a contract that may lead to unknown consequences or results, whereby one or both parties to the contract suffer injustice.³ Ambiguities in a contract are intended to commit fraud, cheat and exploit one of the parties. Gharar is synonymous with al khida or fraud.⁴ Mohammed Obaidullah states that Islamic scholars have broadly defined gharar in two ways: “First, gharar implies uncertainty. Second, it implies deceit”.⁵ Sami Al Suwailem refers to a gharar transaction as “equivalent to a zero-sum game with uncertain payoffs”.⁶ The founders of the various schools of Islamic thought have defined gharar in the following words:⁷

Hanafi—“that whose consequences are hidden”

Shafi—“that whose nature and consequences are hidden” or “that which admits two possibilities, with the less desirable one being more likely”

Hanbali—“that whose consequences are unknown” or “that which is undeliverable, whether it exists or not.”

A major factor that contributes to the existence of gharar is inadequate information which increases uncertainty. This occurs when elements and sub-elements of the contract are either absent or not well defined. For instance, gharar may occur when the subject matter of a contract is non-existent, not in possession of the owner, not deliverable, not clearly defined, etc.; if the consideration or price is not clearly stipulated, etc. Mohammed Obaidullah categorizes the various expositions of gharar into the following:⁸

¹ <http://www.islamic-world.net/economics/contract.htm>

² Muhammad Yusuf Saleem, “A Handbook on Fiqh for Economists II”, p.8

³ Muhammad Yusuf Saleem, “A Handbook on Fiqh for Economists II”, p.8

⁴ Mohammad Hashim Kamali, “Uncertainty And Risk-Taking (Gharar) In Islamic Law”, Law Journal, Vol. 7, No. 2, 1998, International Islamic University Malaysia, Kuala Lumpur, Malaysia

⁵ Muhammed Obaidullah, “Islamic Financial Services”, p. 41, <http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>

⁶ Sami Al Suwailem, “Towards an Objective Measure of Gharar in Exchange”, p. 1,

<http://www.isu.ac.ir/Farsi/Academics/Economics/edu/dlc/2rd/02/instructor/MeasureofGharar.pdf>

⁷ “Islamic Laws on Trading”, <http://ozrisk.net/2006/11/08/islamic-laws-on-trading/>

⁸ Muhammed Obaidullah, “Islamic Financial Services”, p. 42-47, <http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>

- Settlement Risk—wherein the subject matter of sale is non-existent, i.e. the seller does not have possession of the object of sale and thus delivery of the same to the buyer is uncertain, thus rendering the contract unsettled.
- Inadequacy and Inaccuracy of Information—wherein critical information pertaining to the price, subject matter, date of delivery, etc. is unknown or inadequate; also where such critical information is inaccurate due to deliberate withholding of the same by either party in an attempt to deceive or commit fraud. Ill intentions and evil motives, thus, also constitutes gharar.
- Complexity in Contracts—wherein a single contract is made up of two or more interdependent contracts leading to conditionality in the contract which renders it uncertain and ambiguous.
- Pure Games of Chance—wherein gharar occurs due to the uncertainty in events or consequences of the gamble.

Whilst riba is strictly prohibited in the Quran, there is no such explicit prohibition of gharar. Although the Quran does not explicitly mention the prohibition of gharar contracts, various ahadith of the Prophet (s.a.w.) indicate the need to avoid gharar in contracts. Some amount of gharar or uncertainty is, however, tolerable. The gharar that causes a contract to be invalid is major gharar i.e. “an uncertainty which is so great that it becomes unacceptable or it is so vague that there is no means of quantifying it”. Gharar is, thus, divided into two categories, namely⁹:

1. Gharar yasir i.e. minor or slight gharar
2. Gharar fahish i.e. major or serious gharar

The legal implications of the presence of gharar in a contract depend on which category the gharar fall into. Minor gharar is acceptable or tolerable, rendering a contract valid or in some instances voidable until the uncertainty is removed. Major gharar altogether nullifies a contract. Mohammad Hashim Kamali identifies four conditions which must be fulfilled in order for gharar to have legal consequences. First, only major gharar is shunned, while minor or slight gharar is tolerable and acceptable. Second, it should occur in commutative contracts. Third, it should directly affect the subject matter. And finally, there should be no public need for the contract.¹⁰ The Prophet (s.a.w.) prohibited various types of sales due to the elements of major gharar or uncertainty in them. Some of these forbidden sales include¹¹:

- Bay al Hasat
- Bay al Mulamash
- Bay al Munabadhah
- Bay al Muwasafah
- Bay al Muzabanah

⁹ Hassan O. Ahmed, “Shariah Contracts in Islamic Banking & Finance”, p. 6, <http://www.dayaxislamicbank.net/Shariah%20Contracts%20&%20Islamic%20Banking.ppt>

¹⁰ Mohammad Hashim Kamali, “Uncertainty And Risk-Taking (Gharar) In Islamic Law”, Law Journal, Vol. 7, No. 2, 1998, International Islamic University Malaysia, Kuala Lumpur, Malaysia

¹¹ Muhammad Yusuf Saleem, “A Handbook on Fiqh for Economists II”, p. 21-23

- Bay al Mukhadarah
- Bay al Haml
- Najash
- Talqi al Rukban
- Two sales in one sale
- Sale of things which are not owned
- Sale of defected items

The implication of the prohibition of gharar is that it ensures justice and fairness to all contracting parties, thus avoiding disputes and disagreements between them. The Quran states in Surah al Nisa,

“O you who believe! Eat not up your property among yourselves unjustly except it be a trade amongst you, by mutual consent...”

[Surah al Nisa, verse 29]

Bayal Inah

In layman’s terms it refers to a contract that involves a simultaneous sale and buyback or repurchase. In a more technical definition, Bay al Inah “refers to a sale of an asset, which is later repurchased at a different price, whereby the deferred price is higher than the cash price”.¹²

Imam Shafi defines it as “a credit purchase of an asset which is later sold to the original owner or a third party, whether at a deferred or spot, higher or lower price than the first contract, or for an exchange of goods”.¹³ Al Haskafi defines it as “a deferred sale of an asset with a motive to generate profit. The debtor, then, resells the asset to the original seller at a lower price in order to settle his debt”.¹⁴

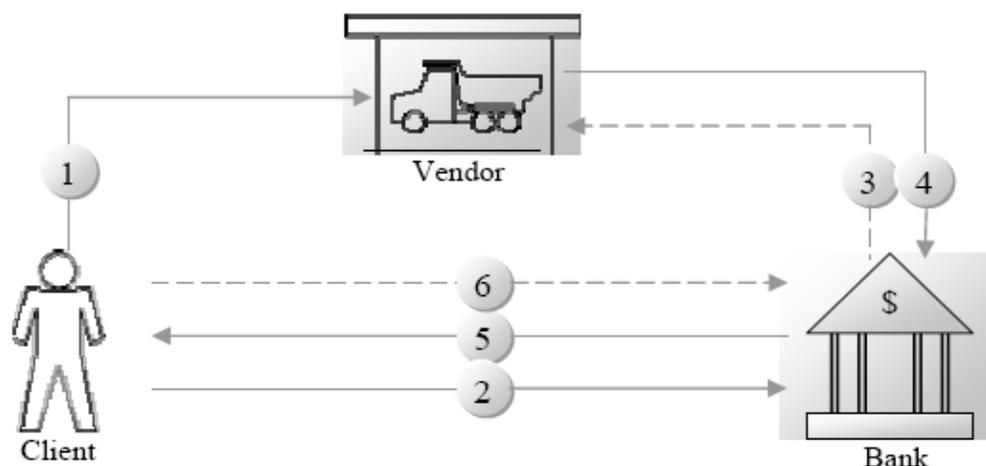
For instance, if Abdullah wishes to buy a house worth \$150,000, ordinarily under a Murabaha scheme he would approach the Bank who in turn would approach the Vendor of the house. The Bank would purchase the house from the Vendor for \$150,000 cash and sell it to Abdullah on a deferred basis for a cost-plus-markup amount, say \$200,000. The difference between the two prices is the profit amount realized by the Bank, i.e. \$50,000. The following is an illustration of the Murabaha or BBA contract¹⁵:

¹² “Shariah Resolutions in Islamic Finance”, p. 64, http://www.mifc.com/0909_shariahres.htm

¹³ Imam Shafi, “Al Um”, v.3, Dar al Fikr, Beirut, p. 79

¹⁴ Al Haskafi, “Al Durr al Mukhtar fi Sharh Tanwir al Absar”, v.5, Dar al Fikr, Beirut, p.325

¹⁵ Muhammed Obaidullah, “Islamic Financial Services”, p. 70, <http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>



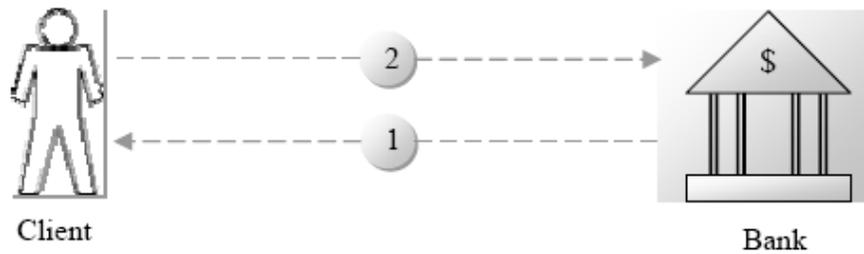
Dotted line indicates flow of funds.

- Activity 1. Client identifies and approaches Vendor or supplier of the commodity that he/ she needs, collects all relevant information;
2. Client approaches Bank for *BBA-murabaha* finance and promises to buy the commodity from the Bank upon resale at the marked-up price;
 3. Bank makes payment of base price to Vendor;
 4. Vendor transfers ownership of commodity to Bank;
 5. Bank sells the commodity, transfers ownership to Client at marked-up price;
 6. Client pays marked-up price in full or in parts over future (known) time period(s).

Exhibit 6.2 BBA-Murabaha Financing Structure II

In a Bay al Inah contract, however, the Vendor is eliminated and both contracts take place between Abdullah and the Bank resulting merely in debt creation with no real exchange or transfer of assets—Abdullah sells an asset to the Bank for \$150,000 on cash basis and the Bank sells the same asset back to him for \$200,000 on deferred basis. This asset may be anything whose real value may or may not be the same as the sale or purchase price. Abdullah may then use the cash proceeds of \$150,000 to buy the house he wanted. The structure of the contract, thus, renders it akin to a conventional loan facility where the profit earned from the spread between the cash and deferred prices is indistinguishable from interest or *riba*. The following is an illustration of a Bay al Inah contract and how it resembles a conventional loan contract:¹⁶

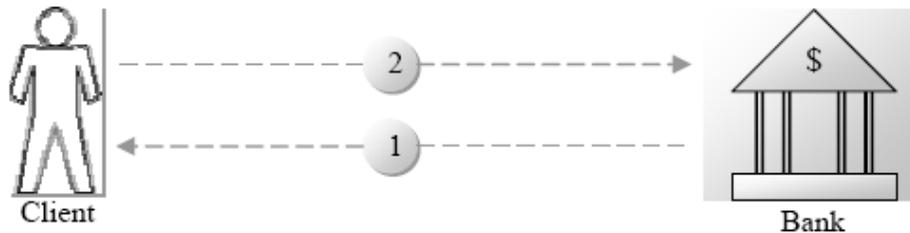
¹⁶ Muhammed Obaidullah, "Islamic Financial Services", p. 104, <http://islamiccenter.kau.edu.sa/english/publications/Obaidullah/ifs/ifs.html>



Dotted line indicates flow of funds.

- Activity: 1. Client in need of an amount C sells commodity X to Bank for a price of C on a cash basis. Client buys commodity X back at an inflated price C+I on a deferred payment basis.
-
2. Client pays C+I on maturity to Bank.

Exhibit 8.1 Structure of Repurchase



Dotted line indicates flow of funds.

- Activity 1: Client borrows an amount C now from Bank
-
2. Client pays C+I on maturity to bank.

Exhibit 8.2 Structure of Interest-Based Loan

The earlier section established that deceit also constitutes gharar. Thus, the element of uncertainty or gharar in Bay al Inah contracts is the ambiguity relating to the motives of the contracting parties which are deemed fraudulent. Generally speaking if the parties have the intention to enter into a contract and all the conditions regarding offer and acceptance, competence of the parties, subject matter, and mutual consent are met, the contract is deemed to be valid. But the cause for concern arises when all the apparent conditions are met, but the motive behind contracting is unlawful i.e. there is a conflict between the objective of contract or muqtada al aqd and the actual motive. Thus, in the contract of Bay al Inah we find that there is uncertainty with respect to the true nature or objective of the contract entered into. Bay al Inah undermines the intention and the objective to contract.

Ibn Umar said that he heard the Prophet (s.a.w.) say “when you enter into the inah transaction, hold the tails of oxen, are pleased with agriculture, and give up conducting jihad, Allah will make disgrace prevail over you, and will not withdraw it until you return to your original religion”.¹⁷

The scholars’ viewpoints on the permissibility and validity of Bay al Inah contracts are divergent. According to the Shafi school of thought, intentions and motives don’t determine the validity or otherwise of a contract. If the elements of the contract such as offer and acceptance, subject matter, capacity, consideration, etc. are met then all else is insignificant. Intention or motive would only matter if it is explicitly stated in the contract. The Maliki, Hanafi and Hanbali jurists, on the other hand, are of the view that Bay al Inah is inherently an invalid contract. They are of the opinion that one of the crucial determinants of legality is the motive or intention of the contracting parties, as to why they are entering into a particular contract. Any contract which employs a legal device, i.e. hilah, is deemed invalid and nullified. Thus, Ijma or consensus holds that Bay al Inah is an invalid contract.

Of concern are some qawaid fihiyyah, i.e. legal maxims or rules which address various issues and questions of jurisprudence, such as “Matters are determined according to intention” and “In contracts effect is given to intention and meaning and not words and forms”.¹⁸ These maxims obviously rule out the validity of Bay al Inah contracts which, on paper, have all the elements of a valid contract but in essence are devoid of sincerity and veracity.

Bay al Dayn

In Fiqh, dayn refers to “a debt which comes into existence as a result of commitment to pay later. It is incurred by way of rent, sale, purchase, marriage, etc., which leaves an obligation on an individual or an organization”.¹⁹ The debt may be a sum of money or even a commodity. Bay al Dayn, as the term reads, refers literally to the ‘sale of debt’, with Bay meaning sale and Dayn meaning debt. Saiful Azhar Rosly and Mahmood M. Sanusi state that “the trading i.e. sale and purchase of debt certificates is called bay’ al-dayn”.²⁰

An illustration of the creation of debt would facilitate comprehension—for instance, Abdullah sells goods worth \$100,000 to Ibrahim via a deferred sale contract where Ibrahim would have to pay Abdullah the \$100,000 in 3 months’ time. The \$100,000 is thus a debt on the debtor Ibrahim owed to the creditor Abdullah. Abdullah ordinarily would have to wait till the date of maturity, i.e. 3 months, to have access to the \$100,000 in cash. During these 3 months, however, either party may want to trade the debt.

The following are some of the possible reasons that may compel the debtor to engage in the trading of debt:

¹⁷ Sunan Abu Dawud, Hadith # 3455

¹⁸ “The 99 Sharia Maxims”, http://islamic-world.net/economics/99_sharia_maxims.htm

¹⁹ <http://www.badralslami.com/glossary/a-h.asp>

²⁰ Saiful Azhar Rosly & Mahmood M. Sanusi, “The Application of Bay al Inah and Bay al Dayn in Malaysian Islamic Bonds: An Islamic Analysis”, *International Journal of Islamic Financial Services*, Vol. 1, No. 2, p. 10

1. Someone may owe him a debt and he would like to use that to settle the debt he owes to the principal creditor
2. He may have sold something on deferred basis to someone and would like to settle the debt owed to him with the debt owed by him to the principal creditor

The debtor may be in a position where he would need to trade his debt with another party. For instance, Ibrahim may purchase goods worth \$100,000 from Luqman who is then indebted to the former for that amount. Ibrahim may choose to trade the debt owed to him by Luqman with the debt that he owes Abdullah. The appropriate contract here would be Hawalah al Dayn i.e. the transfer of debt by the principal debtor, with express permission from the principal creditor, to another party who then becomes responsible for repaying the principal creditor.²¹

Similarly, the following are some of the possible reasons that may compel the creditor to engage in the trading of debt:

1. He may owe someone a debt and would like to use the debt owed to him to settle the former
2. He may need to purchase something and would like to use the debt due to him as price for that thing

For any of the abovementioned reasons Abdullah may engage in debt trading with the debtor Ibrahim himself. He may also choose instead to contract with a third party, say, Sulaiman. Again the appropriate contract would be Hawalah. If he sells the debt to a third party, it would amount to Hawalah al Haqq i.e. transfer of right whereby the creditor transfers his right to the debt from the principal debtor to the new creditor/seller. The sale of debt is not unanimously accepted or validated by Muslim scholars, while some allow it in all forms and aspects, the others either disallow it entirely or allow it under certain circumstances and with certain clauses or conditions. With respect to the sale of debt to the debtor, all schools are of the opinion that such a contract is legal and acceptable. Bay al Dayn between the creditor and a third party, though, is still contentious.

Most Hanafi, Hanbali and Shafi jurists disallow sale of debt to a third party.²² The fundamental reason for objection of such a sale lies in the fact that sale to a third party would involve elements of gharar. More specifically, the debt, which represents a sum of money due to the creditor by the debtor, is an unfulfilled obligation where there is no guarantee that the debtor will not default on payment, thus creating a bad debt. This uncertainty has implications for the contract between the creditor and the third party.

Some of the primary conditions for the validity of a sale contract are that the object of sale or subject matter must be in the possession of the seller and must be deliverable to the buyer. In this case, however, the uncertainty relating to the payment of the debt by the debtor means that both possession and deliverability on the part of the creditor are uncertain. Hence, if the sale of debt proceeds and the debtor defaults, the third party suffers the loss.

²¹ Muhammad Yusuf Saleem, "A Handbook on Fiqh for Economists II", p.55

²² Saiful Azhar Rosly & Mahmood M. Sanusi, "The Application of Bay al Inah and Bay al Dayn in Malaysian Islamic Bonds: An Islamic Analysis", International Journal of Islamic Financial Services, Vol. 1, No. 2, p. 10

For instance, if Abdullah transfers the debt due to him from Ibrahim to Sulaiman, and subsequently Ibrahim defaults of the debt, Sulaiman would suffer loss and Abdullah would escape unscathed when infact he is the principal creditor who should have borne the risk of default, and furthermore as a seller he must have had possession of the object of sale and must ensure that the object would be deliverable.

On the other hand, Malikis, Hanafis and some Shafi jurists all the sale of debt to a third party provided the debt is *Mustaqir* or confirmed, the contract is conducted on the spot, the debtor has financial capability to repay, and if the debt is money then its price in the other debt should be of an identical quantity.²³ It may be concluded then that the majority opinion validates sale of the debt to the debtor himself or to a third party provided that such a trade or sale of debt occurs at the par value and not at an amount above or below that. What is still highly controversial and debatable is the sale of debt to a third party at a value other than the face value of the debt, generally at a discount.

The supporters of *Bay al Dayn* at premium or discount advocate that the debt is a commodity in itself and as such it can be traded like any other commodity, at a profit or a loss. Islamic law of contract requires that for any thing to constitute a valid object of sale it must be deemed 'al mal' i.e. property. Furthermore, it must be deemed 'mal mutaqawwim' i.e. valuable property. Thus for debt to be considered a valid object of sale it must be backed by an asset, the process of doing so is called securitization. Securitization creates *haqq mali* i.e. the right to buy or sell the commodity.²⁴ Those scholars who oppose selling debt at a discount to a third party claim that the debt doesn't meet the necessary requirements of subject matter; furthermore, the securitization process employs the contract of *Bay al Inah* which is inherently invalid in itself. Thus, sale of debt at an amount not equal to the face value of the debt amounts to *Riba al Nasiah* since the exchange of like items for each other necessitates the exchange of equal quantities of the two.

Conclusion

The paper discussed at length the concept of *gharar* and logically proved the existence of elements of *gharar* in *Bay al Inah* and *Bay al Dayn* contracts. It also shed light on the views of major Muslim jurists with respect to the overall validity or otherwise of these contracts. The million dollar question that still stands and begs an answer is whether or not the existence of *gharar* in these contracts, which the paper asserts to have proven, is significant enough to render them invalid for all times to come. There are those who argue that albeit *gharar* is a detrimental factor, there are bigger concerns that must be considered before imposing a blanket rule. They are of the opinion that in the name of the greater good of humanity or public interest, in keeping with the objectives of the Shariah, *gharar*-laden contracts such as *Bay al Inah* and *Bay al Dayn* be allowed to exist.

²³ Saiful Azhar Rosly & Mahmood M. Sanusi, "The Application of *Bay al Inah* and *Bay al Dayn* in Malaysian Islamic Bonds: An Islamic Analysis", *International Journal of Islamic Financial Services*, Vol. 1, No. 2, p. 10

²⁴ Saiful Azhar Rosly & Mahmood M. Sanusi, "The Application of *Bay al Inah* and *Bay al Dayn* in Malaysian Islamic Bonds: An Islamic Analysis", *International Journal of Islamic Financial Services*, Vol. 1, No. 2, p. 3

To back this claim they give examples of how exceptions to the law of no-gharar for the sake of public interest were created in the time of the Prophet (s.a.w.), such as Bay al Salam, Istisna, etc. They insist that the contracts under concern will facilitate the growth and development of Islamic economics and finance by ensuring efficiency. They seem to suggest that there exists a tradeoff between efficiency and justice. The opponents to the above proposition argue that non-gharar based alternatives to the contracts under consideration do exist and hence must be utilized to the fullest, and those who refuse to do so are merely making excuses and aren't respecting the objectives of Shariah. The author is of the opinion that gharar is undoubtedly a virus that corrupts not only a contract but also the fabric of society. While there does exist a case for allowing under exceptional circumstances what is otherwise prohibited or shunned, doing so would lead to a slippery slope scenario where no definite limit is set, hence triggering an avalanche. Furthermore, it closes the doors on creativity whereby the invention or discovery of new legally acceptable financial instruments is discouraged. Creativity as we know is the catalyst to achieve accelerated growth and development.

Are efficiency and justice really mutually exclusive? The author believes that in the presence of viable alternatives they aren't so. Even if we assume that alternatives do not exist, and all avenues have been explored and rendered unfeasible, it does not validate the contract, it merely renders it doubtful. An Nu'man bin Bashir narrated that the Prophet (s.a.w.) said "Both legal and illegal things are obvious, and in between them are (suspicious) doubtful matters. So who ever forsakes those doubtful things lest he may commit a sin, will definitely avoid what is clearly illegal; and who ever indulges in these (suspicious) doubtful things bravely, is likely to commit what is clearly illegal. Sins are Allah's hima (i.e. private pasture) and whoever pastures (his sheep) near it, is likely to get in it at any moment.

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