

**PART V:
SHARIAH ISSUES IN ISLAMIC FINANCE**

116. Priority of Depositors in Recovering Deposit in the Event of Winding Up of an Islamic Banking Institution

Islamic banking deposits use various types of Shariah concepts with different implications from one another (for example *wadi'ah* and *mudarabah*). Generally, Islamic banking deposits can be classified into three main categories, namely *wadi'ah*-based deposit, *mudarabah*-based deposit and deposits based on other concepts such as BBA and *bai' inah*.

In this regard, the SAC was referred to ascertain the priority of certain category of depositors over other depositors in recovering their respective deposits in the event of winding up of an Islamic banking institution.

Resolution

The SAC, in its 26th meeting dated 26 June 2002 and 30th meeting dated 28 October 2002, has resolved that in the event of winding up of an Islamic banking institution, depositors' priority in recovering their respective deposits in the Islamic banking institution is subject to the underlying contract or concept concluded with the Islamic banking institution.

In this regard, *wadi'ah* and debt-based deposits are given priority over *mudarabah*-based deposit. Nevertheless, in order to meet the current legal requirements under section 81 of the Bank and Financial Institutions Act 1989, *mudarabah*-based deposit should be given priority over other creditors' claim and other liabilities. This is because *mudarabah*-based deposit is regarded as deposit and has priority in terms of claims.

With regard to deposits other than *wadi'ah* and *mudarabah*-based deposits (for instance, deposits based on *murabahah* and *bai' inah* concepts), these deposits are considered as having a similar status as *wadi'ah* and *mudarabah*-based deposits in terms of definition. Thus, the priority of recovery is based on their underlying concept. In addition, these deposits shall be valued based on their face value at the date of winding up of the Islamic banking institution.

Basis of the Ruling

Please refer to basis of the ruling for issue 113.¹⁸⁵

117. Surplus Sharing Post Liquidation and Payment of Claims between Islamic and Conventional Banking Funds

With regard to the winding up of conventional banking institutions offering Islamic Banking Scheme (IBS), the SAC was referred to on the issue as to whether the surplus from the liquidation and payment of claims in Islamic banking fund may be utilised to cover deficit in the conventional banking fund or vice versa.¹⁸⁶

Resolution

The SAC, in its 26th meeting dated 26 June 2002 and 29th meeting dated 25 September 2002, has resolved that any banking institution offering IBS shall execute separate winding up process for its conventional and Islamic banking funds. Nevertheless, any surplus (after settlement of all liabilities) in one fund (conventional or Islamic) may be utilised to cover the deficit in the other fund.

Basis of the Ruling

The surplus from the liquidation process and claims payment in Islamic banking fund can be used to cover the deficit in conventional fund and vice versa. This is because the owner of the company (which is the shareholder) is the same entity and is responsible to return the principal or capital to the depositors regardless of whether the deposits are Islamic or conventional.

¹⁸⁵ Status of PIDM's Claim Against Depositors' Claim in the Event of Winding up of an Islamic Banking Institution.

¹⁸⁶ This issue is specifically applicable in the context of IBS only.

118. Status of Conventional Fund Placed in *Mudarabah* Special Investment Account in the Event of Winding Up of Banking Institutions

In 1995, Bank Negara Malaysia allowed IBS banking institutions to acquire funds from conventional banking operations and to place the fund under *Mudarabah* Special Investment Account for a minimum period of one year. This was to enable IBS banking institutions to provide Islamic financing facility in the event the institution is unable to obtain funds from the market.

In this regard, the SAC was referred to ascertain the status of such conventional fund in the event of winding up of an IBS banking institution which is whether it is classified as *mudarabah*-based deposit or part of the shareholders' fund.

Resolution

The SAC, in its 37th meeting dated 7 August 2003, has resolved that conventional fund placed in *Mudarabah* Special Investment Account is classified as *mudarabah* deposit and does not form part of the shareholders' fund. Thus, the status of this *Mudarabah* Special Investment Account is similar to the status of other *mudarabah* deposits in the event of winding up of an IBS banking institution.

Basis of the Ruling

The aforesaid SAC's resolution is based on the consideration that the agreement concluded between both parties is based on *mudarabah* and that the fund is intended for the purpose of *mudarabah*. In this regard, it carries the status of *mudarabah* in the event of winding up of the IBS banking institution.

119. Method for Profit Distribution

In the current financial practices, the distribution of profit between the Islamic financial institution and customer is made at the gross profit level, which is the profit for the whole operation after deducting all direct expenses for all investment funds and the deposits received. The amount of net profit of the Islamic financial institution will be determined after deducting its operating expenses from the gross profit portion received by the Islamic financial institution.

In this regard, the SAC was referred to on the issue as to whether the profit distribution method which is calculated based on gross profit is permissible.

Resolution

The SAC, in its 16th meeting dated 11 November 2000, has resolved that the profit distribution method based on gross profit is permissible.

Basis of the Ruling

The profit distribution method based on gross profit is aimed to safeguard the customers' interest as investors or depositors since the financial institutions have to bear their own operating expenses. In *musyarakah* contract, the contracting parties may agree to choose either gross profit or net profit as the method for profit distribution.¹⁸⁷ As for the *mudarabah* contract, the majority of scholars are of the opinion that the *mudarib* shall bear all indirect expenses. Therefore, profit distribution method at the gross profit level is in line with the aforesaid requirement.

¹⁸⁷ Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Idara Isha'at at-e-Diniyat, 1999, p. 66.

120. Method for Revenue Recognition

The SAC was referred to on the issue as to whether Islamic financial institutions may adopt accrual method to recognise revenue.

Resolution

The SAC, in its 16th meeting dated 11 November 2000, has resolved that the accrual method for revenue recognition is permissible.

Basis of the Ruling

According to Shariah, both cash and accrual methods are acceptable in recognising the revenue. In the context of current practices, the accrual method is preferable due to the changes in commercial practices that have become more diversified and varied.

Accrual method is permissible on the basis that a party is entitled to the realised revenue even though it has not been received in cash yet.¹⁸⁸ In view of its effectiveness in recording credit transactions, the accrual method is regarded as consistent with Islam that ordains credit transactions (such as sale with deferred payment) to be properly recorded. This is line with the following verse of the al-Quran:

يَا أَيُّهَا الَّذِينَ آمَنُوا إِذَا تَدَايَنْتُمْ بِدَيْنٍ إِلَىٰ أَجَلٍ مُّسَمًّىٰ فَاكْتُبُوهُ وَلْيَكْتُب بَيْنَكُمْ كَاتِبٌ
بِالْعَدْلِ

*"O believers! When you contract a debt from one another for a fixed period, put it (its amount and period of repayment) in writing. And let a scribe write it down between you justly (truthfully)..."*¹⁸⁹

¹⁸⁸ Majmu'ah Dallah Barakah, *Fatawa Nadawat al-Barakah*, 1981 – 1997, p. 134, *fatwa* no. 8/2.

¹⁸⁹ *Surah al-Baqarah*, verse 282.

Notwithstanding the above, there is no Shariah objection on the adoption of the accrual method and this is consistent with the necessity (*hajah*) that arises from current practices. In addition, it is also in line with the following *fiqh* maxim:

المعاملة تجري على عادة أهل البلد و عرفه

“(Decrees of) transaction goes around based on custom of a particular state and ambience of a place.”¹⁹⁰

121. Application of “Substance over Form” Principle in Islamic Finance

“Substance over form” is an accounting principle that emphasises on the financial reality of a particular transaction rather than its legal form. It also refers to financial reporting that records the whole economic effects of a transaction, or a series of related transactions, instead of reporting it merely from disjunctive contracts or legal perspective.

For instance, in a sale and buy back contract, the financial reporting will record the overall effect of all contracts involved in the transaction, whereby the profit generated from the contracts will be recorded as the financing cost payable by the financee.

In this regard, the SAC was referred to on the issue as to whether the application of “substance over form” principle in Islamic financial reporting is permissible.

Resolution

The SAC, in its 57th meeting dated 30 March 2006 and 71st meeting dated 26 - 27 October 2007, has resolved that in principle, “substance” and “form” are equally important and highly taken into consideration by the Shariah. In this regard, the Shariah emphasises that “substance” and “form” must be consistent and shall not contradict one another. In the event of inconsistency between “substance” and “form” due to certain factors, the Shariah places greater importance on “substance” rather than “form”.

¹⁹⁰ Ali Ahmad al-Nadwi, *Jamharah al-Qawa'id al-Fiqhiyyah fi al-Mu'amalat al-Maliyyah*, Syarikah al-Rajhi al-Masrafiyyah li al-Istithmar, 2000, v. 2, p. 951.

Basis of the Ruling

In current Islamic finance contexts, most of the underlying contracts in financial products, especially financing products, are contemporary contracts (*`uqud mustajiddah*). These new contracts contain collective elements derived from different traditional contracts (*`uqud musamma*) and the elements are binding on one another in a certain manner. The absence of any of the elements would curtail the objective of the contract. Independent reporting of a series of transactions involved in this new contemporary contract would raise ambiguity in the overall transactions. Therefore, there is a need to record the series of transactions involved in the new contract as one transaction only. This is based on the application of “substance over form” principle.

The aforesaid consideration is also in line with the following *fiqh* maxim and the objective of the Shariah:

الأمر بمقاصدها

“Matters are determined according to intentions.”¹⁹¹

العبرة في العقود للمقاصد والمعاني لا للألفاظ والمباني

“In contracts, effect is given to intention and meaning and neither words nor forms.”¹⁹²

122. Application of Probability Principle

The principle of probability refers to the practice of recording transaction although the contract has not yet been completely concluded. In this regard, assets will be recorded once there is a probability of economic resources inflow whilst liability will be recorded once there is a probability of economic resources outflow due to current obligation and its amount can be estimated with certainty. Instances of item recorded based on the principle of probability is *wa'd* (whether it is a binding promise or non-binding promise) and provision for impairment. Nevertheless, such practice is not meant to equalise promise and contract (*aqad*). Instead, it is aimed at notifying on the economic effect upon the execution of the arrangement.

¹⁹¹ Ahmad al-Zarqa', *Syarah al-Qawa'id al-Fiqhiyyah*, Dar al-Qalam, 1989, p. 47.

¹⁹² Ali Ahmad al-Nadwi, *Jamharah al-Qawa'id al-Fiqhiyyah fi al-Mu'amalat al-Maliyyah*, Syarikah al-Rajhi al-Masrafiyyah li al-Istithmar, 2000, v. 1, p. 550.

In this regard, the SAC was referred to on the issue as to whether the principle of probability in Islamic financial reporting is permissible.

Resolution

The SAC, in its 71st meeting dated 26 - 27 October 2007, has resolved that the application of probability principle in Islamic financial reporting is permissible as it does not contradict the general *fiqh* principles.

Basis of the Ruling

Some scholars are of the view that strong presumption (*zan al-ghalib*) may be taken into consideration in ascertaining a ruling. This has been discussed by a number of scholars such as Al-Amidi¹⁹³, Al-Ghazali¹⁹⁴ and Mustafa Al-Zarqa¹⁹⁵.

In addition, the permissibility to apply the principle of probability in Islamic financial reporting is based on the following *fiqh* maxims:

الأصل الصحة

*"The original state of thing is permissible."*¹⁹⁶

العبرة للغالب الشائع لا للنادر

*"Consideration is based on the prevailing practice and not on the isolated cases."*¹⁹⁷

ما قارب الشيء أعطي حكمه

*"Whatever is close to something it would take the same ruling."*¹⁹⁸

الظن واجب الاتباع

*"Presumption shall be followed."*¹⁹⁹

¹⁹³ Al-Amidi, *Al-Ihkam fi Usul al-Ahkam*, Dar al-Kitab al-'Arabi, 1983, v. 3, p. 317.

¹⁹⁴ Al-Ghazali, *Al-Mustasfa fi 'Ilm al-Usul*, Dar al-Kutub al-'Ilmiyyah, 1992, p. 286.

¹⁹⁵ Ahmad al-Zarqa', *Syarh al-Qawa'id al-Fiqhiyyah*, Dar al-Qalam, 1989, p. 151.

¹⁹⁶ Al-Ansari, *Asna al-Matalib fi Syarh Rawd al-Talib*, Dar al-Kutub al-'Ilmiyyah, 2000, v. 2, p. 2154.

¹⁹⁷ Ahmad al-Zarqa', *Syarh al-Qawa'id al-Fiqhiyyah*, Dar al-Qalam, 1989, p. 235.

¹⁹⁸ Ali Ahmad al-Nadwi, *Jamharah al-Qawa'id al-Fiqhiyyah fi al-Mu'amalat al-Maliyyah*, 2000, v. 1, p. 468.

¹⁹⁹ Al-Amidi, *Al-Ihkam fi Usul al-Ahkam*, Dar al-Kitab al-'Arabi, 1983, v. 3, p. 317.

123. Application of Time Value of Money Principle

The concept of time value of money refers to the difference in value of money received in cash vis-à-vis the value of money received on deferred basis in future. The difference between cash and deferred price is usually termed as revenue or expenditure of the financing.

In this regard, the SAC was referred to on the issue as to whether the application of time value of money principle in Islamic financial reporting is permissible.

Resolution

The SAC, in its 71st meeting dated 26 - 27 October 2007, has resolved that the application of time value of money principle in Islamic financial reporting is permissible only for exchange contracts that involve deferred payment. However, it is strictly prohibited in debt-based transactions (*qard*).

Basis of the Ruling

The aforesaid SAC's resolution is based on the following considerations:

- i. There are discussions by jurists that allow higher deferred selling price as compared to cash selling price²⁰⁰, indicating that time factor may be taken into consideration in determining the selling price.

In addition, Al-Kasani highlighted that any item that is purchased on deferred payment (*al-ajl*) is not allowed to be sold on *murabahah* basis unless the potential buyer is informed that the item has been purchased on deferred basis.²⁰¹

²⁰⁰ Al-Syawkani, *Nail al-Awtar*, Dar al-Ma'rifah, 2002, v. 2, p. 1072; Al-Kasani, *Bada'i al-Sana'i fi Tartib al-Syara'i*, Dar Ihya' al-Turath al-'Arabi, 2000, v. 4, p. 466.

²⁰¹ Al-Kasani, *Bada'i al-Sana'i fi Tartib al-Syara'i*, Dar Ihya' al-Turath al-'Arabi, 2000, v. 4, p. 466:

ولو اشترى شيئاً نسبته لم يبعه مراجعة حتى يبين؛ لأن للأجل شبهة المبيع وإن لم يكن مبيعاً حقيقة؛ لأنه مرغوب فيه ألا ترى أن الثمن قد يزداد لمكان الأجل فكان له شبهة أن يقابله شيء من الثمن.

ii. Al-Sarakhsi also highlighted similar view as follows:

“Certainly something which is deferred is lower in terms of value as compared to something which is on spot.”²⁰²

The above Sarakhsi’s view shows that the present time is higher in value as compared to the future. Thus, pricing in deferred sale should be marked up so as to ensure justice to the contracting parties particularly the seller who has to sacrifice the present consumption of money as the payment is not made in cash.

Al-Kasani explains that if a sale involves deferred payment, such deferment warrants consideration (*iwad*) in a form of money by way of price mark-up. However, the permissibility is limited to sale transactions only, while in debt-based transactions (*qard*), consideration in terms of money is not allowed for the deferment as it would tantamount to *riba nasi’ah* which refers to money begets money (*al-naqd yalid al-naqd*).

However, it does not mean that Islam does not recognise time value of money in debt-based contract. This is because deferment in this contract is given consideration in terms of multiple rewards in the Hereafter, in line with its underlying principle of *ihsan*. On the other hand, sale and purchase contracts which are based on justice principle may accept increase in price due to the deferment.

Apparently, should the principles of *ihsan* and justice be compared, *ihsan* would be of higher status than justice given that the former receives great reward in the Hereafter which is better than monetary reward.²⁰³

²⁰² Al-Sarakhsi, *Al-Mabsut*, Dar al-Fikr li al-Tiba’ah wa al-Nashr, v. 13, p. 64: فإن المؤجل أنقص من الحال في المالية:

²⁰³ Al-Ghazali explained as follows:

ونعني بالإحسان: فعل ما ينتفع به المعامل وهو غير واجب عليه، ولكنه تفضل منه والعدل سبب النجاة فقط وهو يجري من التجارة بجرى رأس المال والإحسان سبب الفوز ونيل السعادة وهو يجري من التجارة بجرى الربح ولا يعد من الغفلاء من قنع في معاملات الدنيا برأس ماله فكذا في معاملات الآخرة فلا ينبغي للمتدين أن يقتصر على العدل واجتناب الظلم ويدع أبواب الإحسان

124. Deposit or Customer's Investment Fund from Doubtful Sources

The SAC was referred to on the issue as to whether Islamic financial institutions may accept application to open deposit account or investment account from a customer (individual or corporate company) without conducting investigation to ascertain whether the sources of the customer's fund is permissible (*halal*), forbidden (*haram*) or a mixture of the two.

Resolution

The SAC, in its 58th meeting dated 27 April 2006, has resolved that Islamic financial institutions are allowed to accept application to open deposit account or investment account from a customer without conducting investigation to ascertain whether the sources of the customer's fund are permissible (*halal*), forbidden (*haram*) or a mixture of the two. Notwithstanding this, the SAC has no objection for Islamic financial institutions to establish an internal screening process to ascertain whether the sources of the fund received are Shariah compliant.

Basis of the Ruling

The aforesaid SAC's resolution has considered the following evidences and *fiqh* maxims:

- i. *Hadith* of Rasulullah SAW:

روى الخلال بإسناده عن عطاء قال: نهى النبي - صلى الله عليه وسلم - عن مشاركة اليهودي والنصراني إلا أن يكون الشراء والبيع بيد المسلم

*"Al-Khalal reported based on narration from Ata', he said, Prophet Muhammad SAW prohibited (Muslims) from running a partnership with Jew and Christian except if the transaction is under the supervision of the Muslim."*²⁰⁴

²⁰⁴ Al-Bahuti, *Kasshaf al-Qina`an Matn al-Iqna'*, Dar al-Fikr, 1982, v. 3, p. 496.

This *hadith* indicates that Rasulullah SAW allows Muslims to enter into partnership (*musyarakah*) transactions with non-Muslims even though their sources of fund are doubtful, provided that all the transactions or sales are under the supervision of Muslims.

Apart from that, there are scholars who said that Rasulullah SAW would not be indebted to Jews who charge him interest. Instead, Rasulullah SAW was reported to have transacted in deferred payment transactions in which he had securitised his shield. It is reported in the following *hadith*:

عن عائشة رضي الله عنها قالت : توفي رسول الله صلى الله عليه وسلم ودرعه مرهونة عند يهودي بثلاثين صاعا من شعير

*"From Aisyah (Allah Blessed her) said to the effect: On the day Prophet Muhammad SAW died, his shield was still mortgaged to a Jew for (his debt amounting to) 30 so` (a type of measuring tool) wheat owed to him."*²⁰⁵

- ii. Since sources of funds in the present financial markets are complicated and diversified, Islamic financial institutions are exposed to the involvement of people who possess property gained through illegal or doubtful sources. Therefore, even though the intention to disallow the inflow of illegal funds to the Islamic financial systems is praiseworthy, it is not incumbent on the Islamic financial institution to investigate the legality of the sources of funds received because of its impracticality to appraise. This approach is in line with the following *fiqh* maxims which conclude that for matters which their true status are hard to determine, it is adequate for the appraisal to be based on its external appearance:

الأحكام على الظاهر والله ولي المغيب

*"Ruling of something is based on the external appearance, whereas internal matter is left to Allah the All Knowing."*²⁰⁶

²⁰⁵ Al-Bukhari, *Sahih al-Bukhari*, Dar Ibn Kathir, 1987, v. 3, p. 1068, *hadith* no. 2756.

²⁰⁶ Al-Syafii, *Al-Umm*, Bait al-Afkar al-Dawliyyah, (n.d.), p. 720.

الأحكام تجرى على الظاهر فيما يعسر أو يتعذر الوقوف على الحقيقة

*"Ruling of something is based on the external factor, should it be impossible to comprehend the actual meaning."*²⁰⁷

فمن محاسن الشرع ضبط الأحكام بالأسباب الظاهرة وإقامتها عللا يدور الحكم معها وجودا وعدما

*"Hence, among the beauty of Shariah is the determination of legal ruling based on the external factors, and deemed (these external factors) as an effective cause (illah), a ruling exists if the illah exists and vice versa."*²⁰⁸

المعاملات على الظواهر والمعلوم الباطن خفي لا يعلق عليه الحكم

*"Mu'amalah is based on the external factors, undoubtedly internal matters are hidden and ruling cannot be based on the latter."*²⁰⁹

125. Financing to a Party Who Explicitly Performs Non-Shariah Compliant Activities

The SAC was referred to on the issue as to whether Islamic financial institutions may grant financing facilities to a party who performs non-Shariah compliant activities such as liquor industry, gambling activities, brothel and others.

Resolution

The SAC, in its 58th meeting dated 27 April 2006, has resolved that Islamic financial institutions are prohibited from granting financing to companies, bodies or individuals whose activities explicitly involve non-Shariah compliant elements such as gambling, liquor industry and brothel.

²⁰⁷ Ali Ahmad al-Nadwi, *Jamharah al-Qawa'id al-Fiqhiyyah fi al-Mu'amalat al-Maliyyah*, Syarikah al-Rajhi al-Masrafiyyah li al-Istithmar, 2000, v. 1, p. 4334.

²⁰⁸ Al-Subki, *Al-Ashbah wa al-Nazha'ir*, Dar al-Kutub al-'Ilmiyyah, 1991, v. 2, p. 190.

²⁰⁹ Ibnu Hajar al-'Asqalani, *Fath al-Bari Syarh Sahih al-Bukhari*, Dar al-Ma'rifah, 1959, v. 4, p. 302.

Basis of the Ruling

The aforesaid SAC's resolution is based on the account that such financing would result in the revenue of Islamic financial institutions being generated by non-Shariah compliant activities. The prohibition is consistent with the saying of Allah SWT as follows:

وَتَعَاوَنُوا عَلَى الْبِرِّ وَالتَّقْوَىٰ وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

"...help one another in furthering virtue and God consciousness, and not in what is wicked and sinful..."²¹⁰

126. Application of Conventional Overdrafts to Cover Insufficiency in *Wadi'ah* Current Account

The SAC was referred to on the issue as to whether a customer may use conventional overdrafts to cover any insufficiency in *Wadi'ah* Current Account.

Resolution

The SAC, in its 8th meeting dated 12 December 1998, has resolved that in principle, the use of conventional overdrafts to cover any insufficiency in *Wadi'ah* Current Account is contrary to Shariah. However, since conventional and *wadi'ah* accounts are customer's rights and liabilities, Islamic financial institutions have no right to prohibit their customers from doing so. However, it is the duty of Islamic financial institutions to inform their customers that such practice is contrary to the Shariah.

Basis of the Ruling

The aforesaid SAC's resolution is based on the account that the practice of using conventional overdrafts to cover insufficiency in *Wadi'ah* Current Account by a customer is beyond the control of the Islamic financial institutions.

²¹⁰ *Surah al-Ma'idah*, verse 2.

127. Commitment Fee on Unutilised Balance of Islamic Overdraft Facility or Revolving Credit

A customer who has received Islamic overdraft and revolving credit facility from an Islamic financial institution will probably only use a portion of the facility at a particular time and will reserve the unutilised balance for future needs. This situation requires the Islamic financial institution to allocate a portion of money for the facility to the customer, thereby restricting the Islamic financial institution from utilising that allocation to finance other customers or other activities that would generate higher profit.

In conventional banking practice, financial institutions will impose a commitment fee at a certain rate on the unutilised balance of the overdraft and revolving credit facility. The financial institutions will also observe the utilisation of the credit facility by their respective customers. If a customer does not utilise the credit facility after three months from the date of completion of the facility's documentation, the financial institution will acquire a written verification/confirmation from the customer that the granted facility is still needed. If the customer fails to verify, the financial institution has the right to withdraw the facility. This practice aims to ensure that the customer does not apply for financing in excess of his actual needs and thereby denies the opportunity of other customers to obtain the credit facility.

In this regard, the SAC was referred to on the issue as to whether Islamic financial institution may impose commitment fee on the remaining unutilised balance of the Islamic overdraft or revolving credit facility.

Resolution

The SAC, in its 12th meeting dated 24 February 2000, has resolved that the proposal to impose commitment fee on the remaining unutilised balance in Islamic overdraft or revolving credit is not allowed.

Basis of the Ruling

Since Islamic overdraft and revolving credit facility are based on *bai` inah* or *tawarruq* contract, imposing commitment fee on the remaining unutilised balance of Islamic overdraft or revolving credit is contrary to the executed sale contract. Under *bai` inah* or *tawarruq* contract, once the sale contract is executed, the facility amount allocated to a customer belongs fully to him.

128. Islamic Financial Instrument as Underlying Asset in Conventional Transaction

Several Islamic money market instruments have been introduced to facilitate market participants to manage their liquidity, where normally, these instruments are issued through direct tender to Islamic financial institutions only. Nevertheless, since these instruments are also traded in the secondary market, a number of conventional financial institutions which own these Islamic financial instruments (for example *sukuk*) were found to have been using these instruments as underlying asset in their conventional transactions (for instance repo) to fulfill their liquidity needs.

In this regard, the SAC was referred to on the issue as to whether conventional financial institutions are allowed to use Islamic financial instruments as underlying asset in their conventional transactions.

Resolution

The SAC, in its 19th meeting dated 20 August 2001, has resolved that since the Islamic financial instruments are owned by the conventional financial institutions, it is the institutions' right and choice to use the Islamic financial instruments as the underlying asset in any conventional transaction. However, those parties who transact conventionally will be held responsible for any transaction which is contrary to Shariah. Shariah compliance of the Islamic financial instruments used in conventional transactions is preserved as long as the executed transaction is not detrimental to the contract and fundamental features of the instruments.

Basis of the Ruling

The conventional financial transactions using Islamic financial instruments as the underlying asset do not affect the validity of the instruments since the contract and basic structure of the Islamic financial instruments remain unchanged and unaffected. Nevertheless, any Shariah ruling implication arising from the involvement in conventional transactions will have to be borne by the transacting parties.

129. Financial Market Instruments as Underlying Asset in Deferred Transaction

Various assets have been produced as instruments in the financial market, among others, *mudarabah*-based assets (such as *Mudarabah* Investment Certificate) and debt-based assets (such as Islamic accepted bills and negotiable Islamic debt certificates). These assets are also used for various purposes including for charge/mortgage.

In this regard, the SAC was referred to on the issue as to whether the aforesaid financial market instruments may be used as underlying asset in deferred transactions.

Resolution

The SAC, in its 19th meeting dated 20 August 2001, has resolved the following:

- i. *Mudarabah* Investment Certificate may be used as the underlying asset in deferred transaction, such as *bai` `inah*, because it is an asset which is possessed by its owner and it is not considered as a *ribawi* item;
- ii. Any debt-based asset shall not be transacted on deferred basis because every debt sale (*bai` dayn*) must be made on cash basis; and
- iii. A charged asset may be used as an asset in *bai` `inah* transaction with the consent of the chargee.

Basis of the Ruling

The aforesaid SAC's resolution is based on the following considerations:

- i. The sale of *Mudarabah* Investment Certificates by the certificate holder is identical to the trading of share certificates in which its permissibility has been verified;
- ii. A charged asset belongs to the chargor. As the ownership of the underlying asset in a *bai` inah* transaction will be returned to the original owner, it does not affect any interest under the executed charge; and
- iii. The scholars unanimously agree that debt shall not be sold on deferred basis.

130. Mechanism in Determining the Amount of Settlement Price in Financial Market

In the sale of Islamic debt securities, the sale price and early redemption price are determined at the time the sale contracts are concluded. Nevertheless, there are occasions in the financial market, particularly for the Islamic private debt securities, where the settlement amount and the initial agreed sale price differ. The price differences are due to the regulation imposed by the Real Time Electronic Transfer of Funds and Securities (RENTAS) system whereby the system imposes additional payment or compensation in calculation of dividend payment for the leap year.²¹¹ Such payment or compensation is also imposed if the dates in which the dividends are paid and the securities are redeemed fall on an unexpected public holiday. This practice is prevalent in the context of private debt securities without secondary notes. In this regard, the SAC was referred to on the issue as to whether such mechanism is allowed by Shariah.

²¹¹ A year that consists of 366 days (once in every four years).

Resolution

The SAC, in its 21st meeting dated 30 January 2002, has resolved that the aforesaid mechanism in determining settlement price as practised in the financial system is contrary to the Shariah principles. This is because the total settlement price (dividends and principal sum) in Islamic private debt securities has to be equal to the total sale price as agreed at the time a contract is concluded. The SAC has also resolved that the late payment due to the unexpected public holiday shall not be a factor for imposition of any damages or compensation on the parties involved.

Basis of the Ruling

For Islamic private debt securities that are issued based on a sale contract, the price of the Islamic securities has already been determined at the time of the conclusion of the contract. Therefore, any differences in the payment amount are not allowed. In the event of excess payment, the recipient of the payment shall refund the excess amount to the payor.

In addition, damages or compensation may only be imposed in cases of intentional late payment or due to negligence and carelessness. If the maturity date of the securities falls on an unexpected public holiday, no damages or compensation may be imposed as such situation does not tantamount to intentional late payment.

131. Restructuring and Rescheduling in Islamic Financing Agreement

One of the features that differentiate Islamic financing documentation from conventional financing documentation is the requirement for a new legal document to capture every variation of terms and conditions since Islamic finance emphasises on agreement and mutual consent of contracting parties. This requirement becomes more apparent when it involves rescheduling and restructuring of a financing, especially for sale-based financing. In restructuring a sale-based financing which involves sale agreement, the original sale must firstly be terminated (*fasakh*) before concluding the new agreement. The effect of such requirement causes additional costs to be borne by the Islamic financing customers in terms of new legal fee and stamp duty for the new legal documents, unlike in the practice of conventional loan, where the contracting parties simply need to conclude a supplementary agreement to reschedule or restructure the loan.

In this regard, the SAC was referred to on the proposal to insert a new paragraph in the Islamic financing facility agreement which verifies it as a rescheduling or restructuring agreement and that it has to be cross referred to the original agreement. However, in the event of restructuring, an issue arises regarding the termination of the cross reference to the original agreement.

Resolution

The SAC, in its 26th meeting dated 26 June 2002, has resolved that the proposal to cross refer a rescheduling and restructuring Islamic financing agreement to the original agreement for the purpose of stamp duty exemption is permissible provided that it is done after termination of the original agreement. In relation to the case of restructuring, the SAC has recognised the cross reference method to the original agreement which has been terminated on the ground of *maslahah*, which is, to avoid double payment of stamp duty.

In the 32nd meeting dated 27 February 2003, the SAC has also resolved that based on mutual agreement, the financing period for the customer may be extended without the need for a new contract, provided that both parties satisfy all concluded promises and the price imposed on the customer does not exceed the original sale price.

Basis of the Ruling

Islamic financing can be arranged based on sale contract, *ijarah*, *musyarakah*, *mudarabah*, and others. In this regard, any changes to the duties of the financing receiver and financier must be referred to the concluded original agreement. In the context of a sale contract, normally the price has been fixed during inception of the contract. Therefore, any changes to the price require a new agreement in order to avoid *riba* and *gharar* (as the case may be).

132. Bidding Concept by Principal Dealer in Islamic Money Market

A principal dealer in Islamic money market is responsible to bid at certain minimum amount for each *sukuk* issuance. However, it is observed that the said principal dealer's responsibility is unlikely based on voluntary bidding concept. In this regard, the SAC was referred to on the issue as to whether bidding at certain amount for each *sukuk* issuance as practised by the principal dealer is in accordance with Shariah principles.

Resolution

The SAC, in its 26th meeting dated 26 June 2002, has resolved that the bidding concept as practised by the principal dealer in Islamic money market is Shariah compliant.

Basis of the Ruling

This concept is a business practice which has been determined by the authority or the regulator and is viewed as consistent with Shariah principles since there is no elements of *riba*, *gharar* and *maysir*.

133. Financing Settlement Through New Financing

In Islamic financing scheme, there is a possibility where the customer would be facing cash flow problem and hence unable to pay to the Islamic financial institution during the financing period. To overcome this problem, there was a proposal to allow the customer to restructure his financing and issue debt securities or *sukuk* to the Islamic financial institution as a method of settling an existing financing facility.

In this regard, the SAC was referred to on the issue as to whether financing settlement through the issuance of debt securities or *sukuk* to the original financier (which will indirectly create new financial obligation) is allowed by Shariah.

Resolution

The SAC, in its 38th meeting dated 28 August 2003, has resolved that the financing settlement through the issuance of Islamic debt securities to the original financier is permissible. Nevertheless, the rescheduling and restructuring method shall be implemented by taking into consideration the Shariah requirements such as, the existence of clear contract, Shariah compliant sale asset, and terms and conditions which are not contrary to Shariah.

Basis of the Ruling

Islamic restructuring of debt through a separate issuance of debt securities or *sukuk* to the original financier involves a scenario in which the existing contracting parties enter into another separate and independent contract.

Generally, there is no Shariah impediment (*manî syar'ie*) for the contracting parties to execute another separate and exclusive contract amongst them. The issuance of debt securities or *sukuk* to the original financier is viewed as a transaction which does not affect the validity of the existing financing contract. This permissibility is seen as in line with the following *fiqh* maxims:

تصحيح العقود بحسب الأمكان واجب

*"It is compulsory to validate a contract as possible as it could be."*²¹²

الأصل حمل العقود على الصحة

*"The original method of ruling is all contracts are (deemed to be) valid."*²¹³

134. Undetermined Sale Price in Sale and Purchase Agreement

The SAC was referred on the issue as to whether undetermined and uncertain sale price in sale and purchase agreement is acceptable. For instance, a clause regarding the definition of sale price is stated as follows:

"Islamic financial institution will purchase the asset from the customer at a purchase price which will be determined later based on the terms and conditions of the agreement."

Resolution

The SAC, in its 40th meeting dated 23 December 2003, has resolved that the undetermined and uncertain sale price in a sale and purchase agreement is not allowed.

²¹² Ali Ahmad al-Nadwi, *Jamharah al-Qawa'id al-Fiqhiyyah fi al-Mu'amalat al-Maliyyah*, Syarikah al-Rajhi al-Masrafiyyah li al-Istithmar, 2000, v. 1, p. 297.

²¹³ Ali Ahmad al-Nadwi, *Jamharah al-Qawa'id al-Fiqhiyyah fi al-Mu'amalat al-Maliyyah*, Syarikah al-Rajhi al-Masrafiyyah li al-Istithmar, 2000, v. 1, p. 297.

Basis of the Ruling

The undetermined and uncertain sale price would lead to the element of *gharar* in a sale contract which is forbidden in Shariah because it would cause injustice and dispute. The sale price must be determined either by way of amount or by certain specific and definite methods agreed at the time of an agreement is concluded.

Rasulullah SAW prohibits conclusion of contract or imposition of condition which contains element of *gharar* as mentioned in the following *hadith*:

عن أبي هريرة قال نهى رسول الله صلى الله عليه وسلم عن بيع الحصاة وعن بيع الغرر

*"From Abu Hurairah who said that Rasulullah SAW prohibited sale that is based on throwing of pebbles (hasat) and an uncertain sale (gharar)."*²¹⁴

Among the elements of *gharar* which annuls a financial transaction is *gharar* in the determination of price, whereby the sale is executed without determining the price, or the price is determined unilaterally or by a third party.²¹⁵

135. Underlying Concept for Islamic Block Discounting Transaction

As an alternative to credit companies for acquiring additional fund to be used as business revolving capital, an Islamic financial institution would like to implement Islamic block discounting concept based on *bai` wadhi`ah* which is a sale contract with a lower price than the acquisition cost. Briefly, Islamic block discounting involves the sale of ownership of a contracted right in an Islamic hire purchase (*ijarah*) agreement by a credit company on discount to the Islamic financial institution (financier). The credit company will be appointed as an agent to collect rent on behalf of the Islamic financial institution. If the credit company failed to surrender the rental collection to the Islamic financial institution within an agreed period, the Islamic financial institution will terminate the facility and take over the duty of direct rental collection.

²¹⁴ Muslim, *Sahih Muslim*, Dar al-Mughni, 1998, p. 814, *hadith* no. 1513.

²¹⁵ AAOIFI, *Al-Ma`ayir al-Syar`iyyah*, Standard no. 31 (*Dabit al-Gharar al-Mufsid li al-Mu`amalat al-Maliyyah*), 2003, paragraph 4.

In this regard, the SAC was referred to on the issue as to whether the application of *bai` wadhi`ah* concept as the underlying contract in Islamic block discounting transaction as proposed is allowed by Shariah.

Resolution

The SAC, in its 66th meeting dated 22 February 2007, has resolved that the application of *bai` wadhi`ah* concept for Islamic block discounting transaction is inappropriate. The SAC further resolved that *bai` al-usul bi al-khasm* (sale contract at discount) is more suitable underlying concept to be used as a *takyif fiqhi* in Islamic block discounting transaction.

Basis of the Ruling

It appears that the application of *bai` wadhi`ah* does not correspond to the features of Islamic block discounting transaction. This is because *bai` wadhi`ah* is a sale with a discount of the cost price, whereas Islamic block discounting is a sale with a discount of the cost price plus profit (principal + profit).

In this regard, *bai` al-usul bi al-khasm* is viewed as the more appropriate underlying concept to be used as *takyif fiqhi* in Islamic block discounting transaction. Although there is no juristic discussion and classical *fiqh* literature on *bai` al-usul bi al-khasm*, it is an acceptable concept in the context of current practice. The term *usul* refers to the underlying asset in the hire purchase agreement that also covers the economic value generated from the asset.

