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Article

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Sharī'ah non-compliant assets as *rahn* (pledge) in Islamic banking products: a *fiqhī* perspective

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Abstract

Purpose – The purpose of this study is to present a framework regarding the use of Sharī'ah non-compliant assets as *rahn* (pledge) and to provide the Sharī'ah analysis on the application of numerous collateral instruments, including financial assets such as shares, unit trusts, current accounts and investment accounts which are Sharī'ah non-compliant.

Design/methodology/approach – The study adopts a library-based approach to examine the concept and requirements of *rahn*, deliberate the classification of Sharī'ah non-compliant assets and delineate the Sharī'ah views on the use of Sharī'ah non-compliant assets as pledges. It also examines the various forms of pledge available and offered in the market using document analysis as well as through discussion with industry practitioners.

Findings – In general, the study concludes that Sharī'ah non-compliant assets, either due to their essence or due to the means of acquisition where there is no ownership from Sharī'ah perspective, cannot be used as *rahn*. This study also provides the Sharī'ah analysis on the use of modern instruments such as shares, unit trusts, current accounts, investment accounts and insurance policy as pledges.

Originality/value – The paper provides a reference source for regulators in formulating an appropriate policy and framework on Sharī'ah-compliant collateral; Sharī'ah committees of Islamic financial institutions in arriving at Sharī'ah decisions on collateral; and industry practitioners in establishing internal policies and procedures on collateral.

Keywords Collateral, pledge, *rahn*, Sharī'ah non-compliant asset

Paper type Research paper

Introduction

Collateral is an important tool that banking institutions use to manage the risk of customer default. In such an event, the bank may claim from the collateral to recover payment of the customer's outstanding obligation. Practically, collateral may be either in the form of tangible assets, such as real estate and vehicles or financial assets such as bonds, *ṣukūk* and



shares. Collateral is normally charged to secure a financing facility. Over the past decade, Islamic banking products have witnessed a remarkable development, shifting from plain vanilla products to more sophisticated and exotic structures and features. This trend has been accompanied by the introduction of numerous unprecedented collateral instruments, including financial assets such as shares, unit trusts, current accounts and investment accounts. These may raise issues, particularly if they involve Sharī'ah non-compliant elements.

Against this background, there is a need for Sharī'ah investigation of the use of Sharī'ah non-compliant assets as collateral in the modern banking arena. A cursory review of the literature finds that there is lack of research on this aspect, perhaps due to the complexity of the issue and the fact that it is a relatively new area.

Research objectives

The study aims to achieve the following research objectives:

- to discuss the concept of *rahn* (pledge) from the *fiqhī* perspective;
- to deliberate the use of Sharī'ah non-compliant assets as *rahn*; and
- to assess the application of Sharī'ah non-compliant assets as pledges in Islamic banks.

Research methodology

The study is library-based, benefitting from various classical sources, Qur'ānic texts and Prophetic traditions to reach a cohesive understanding of the Sharī'ah position pertaining to the use of prohibited assets as *rahn*. It also looks into fatwas, resolutions, standards and other related literature. The study further examines the various forms of pledge available and offered in the market using document analysis as well as discussion with industry practitioners.

Sharī'ah requirements of *rahn*

The requirements of *rahn* in Islam follow the conditions of the asset in a sale contract: it must be recognized by the Sharī'ah as valuable and be existent, identifiable, deliverable and owned by the pledger. The reason for these requirements is that the function of a pledge is to settle the outstanding obligation by selling it in the event of debtor default. This is only possible if the pledge is legally recognized subject matter of the sale contract ([Ibn Qudāmah, 1388H](#), p. 4/253). Any item which is permissible as the subject matter of a sale is also permissible as collateral. On this basis, jurists developed the famous legal maxim which states, "What is permissible to be sold is also permissible to be pledged" ([al-Zarkashī, 1405H](#), p. 3/139). Inversely, a Sharī'ah non-compliant asset does not qualify to be the subject matter of *rahn*. The *Rahn Exposure Draft* issued by Bank Negara Malaysia (BNM) clearly states that the subject matter of the *rahn* contract shall be collateral (*marhūn*) that is recognized by the Sharī'ah ([BNM, 2017](#), p. 5). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in its Sharī'ah standard no. 39 also requires pledges to be Sharī'ah compliant. It states: "The mortgage asset should be a Sharī'ah-permissible property. It should also be well specified (through pointing, naming or description) and be possible to deliver" ([AAOIFI, 2015](#), p. 970).

Initial findings

The study finds that Shari'ah non-compliant assets in relation to their use as *rahn* are categorized into two major types: first is the asset prohibited in its essence (*li dhātih*) and second is the asset prohibited due to an external reason, namely, the means of its acquisition (*li kasbih*). The former refers to an asset that the Shari'ah has prohibited due to an essential attribute (*wasf*). In other words, it is an asset prohibited in its essence because it is harmful or unclean. This category includes pork, wine and other impure items. Jurists unanimously agree that these items cannot be used as a pledge. The second category of Shari'ah non-compliant assets is further subdivided into four classes, namely:

- (1) an asset acquired without the consent of the owner;
- (2) an asset acquired with the consent of the owner through a void (*bāṭil*) contract;
- (3) an asset acquired with the consent of the owner through a voidable (*fāsid*) contract; and
- (4) an asset acquired with the consent of the owner by unlawful possession without the use of any nominate contract.

For a Shari'ah non-compliant asset acquired without the consent of the owner, or with the consent of the owner but via a void (*bāṭil*) contract or by unlawful possession without any contract such as by bribery or gambling, the study concludes that it is not permissible to accept a non-monetary asset as *rahn* due to the absence of ownership. However, if the asset is monetary, there are two different scenarios:

- (1) if the money is not commingled with other money, it is not permitted for use as *rahn*; and
- (2) if the money has been mixed with other money, it is permissible to accept it as *rahn* up to the limit of the amount of the *ḥalāl* (permissible) portion.

As for the Shari'ah non-compliant asset acquired through a voidable (*fāsid*) contract, the study found that the asset can be used as *rahn*, according to the Ḥanafī school, provided that the contract has undergone rectification or the purchaser has taken possession of the asset with the seller's consent.

Based on the established Shari'ah framework presented in the paper, the study concludes that a conventional fixed deposit can be used as a pledge limited to the principal amount. In this regard, the Shari'ah Standards and Operational Requirements of Murabahah issued by BNM also states that an interest-bearing debt-based asset such as a conventional fixed deposit certificate may be used as collateral provided the collateral is valued up to the principal amount (BNM, 2016, p. 17).

The study also concludes that a conventional bond can be used as a pledge limited to the issuing price of the instrument. The Exposure Draft of Rahn clearly states: "Where a Shariah non-compliant financial asset is used as a collateral, the collateral value must be limited to the principal amount of the financial asset" (BNM, 2017, p. 5).

A Shari'ah non-compliant unit trust may also be utilized as a pledge capped at the value of the investor's initial investment and subsequent top-ups.

Furthermore, the shares of companies with mixed assets that comprise Shari'ah-compliant and Shari'ah non-compliant assets may be accepted as *rahn* provided that the core business activities of the company are Shari'ah-compliant. A share which comprises mixed activities can also be used as *rahn* valued up to the amount of the Shari'ah-compliant portion only. The shares of a company not meeting the financial ratio benchmark may also be utilized as *rahn*.

An insurance policy can be accepted as a pledge limited to the total amount of premiums the policyholder has paid. This is because the insurance company does not have a right to the premium paid by the policyholders, whereas the policyholders have no right to the coverage. Therefore, the policyholder cannot use the insurance policy as a pledge due to the absence of ownership rights associated with it. However, he can use the benefit of the insurance policy as a pledge up to the amount of the premiums he has paid.

Conclusion

This framework has been developed based on the fundamental Sharī'ah ruling on *rahn*. Other considerations, such as *maṣlahah* (benefit/interest), *ḥājah* (need), *dharī'ah* (means), that may form a basis to depart from its original ruling are put aside and left to the discretion of the respective Sharī'ah authorities on a case-by-case basis. The paper acknowledges the possible gap between the established framework and the prevailing practices. This is particularly true because the paper only deals with the issue of collateral that has the characteristics of a pledge. Further studies may examine each and every form of collateral available in the market such as debentures, charges, assignments, securities and others.

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