The Shariah Advisory Council of Bank Negara Malaysia (SAC) Ruling on Collateralised Commodity *Murabahah* as an Islamic Financial Market Instrument

190th SAC Meeting dated 26 February 2019

Part I: SAC Ruling, Its Effective Date and Applicability

Pursuant to section 52 of the Central Bank of Malaysia Act 2009, SAC has made a ruling that the proposed collateralised commodity *murabahah* product using scripless financial asset as collateral which incorporates the concept of *tawarruq* (commodity *murabahah*) and *rahn* (pledge) is allowed[1] subject to the following requirements:

i. Change in the collateral (*marhun*) registration from the pledgor (*rahin*) to the pledgee (*murtahin*) does not constitute an actual transfer of ownership as it only involves the transfer of legal title while the beneficial rights remain with the pledgor;
ii. The pledgor still assumes all liabilities[2] of the collateral and is entitled to the benefits arising from the collateral;
iii. The pledgee has no right to sell the collateral to a third party except for the purpose of liquidating the asset in the event of default[3];
iv. The pledgee has no right to pledge the collateral to a third party except with the consent of the pledgor[4]; and
v. The pledgee is obliged to return the collateral to the pledgor upon settlement of the debt arising from the commodity *murabahah* transaction[5].

This ruling comes into effect upon the ruling made by the SAC dated 26 February 2019 and is applicable to the following Islamic financial institutions (IFIs):

(a) licensed persons under the Islamic Financial Services Act 2013 (IFSA);
(b) licensed banks and licensed investment banks approved under section 15(1) of the Financial Services Act 2013 (FSA) to carry on Islamic banking business; and
(c) prescribed institutions approved under section 33B(1) of the Development Financial Services Act 2002 (DFIA) to carry on Islamic financial business.

In line with sections 28(1) and (2) IFSA or sections 33D(1) and (2) DFIA, as the case may be, IFIs are required to comply with this ruling as compliance with any ruling of the SAC in respect of any particular aim and operation, business, affair or activity of IFIs shall be deemed to be in compliance with Shariah.

Part II: Background

- An IFI has proposed a liquidity instrument namely collateralised commodity *murabahah* (CCM). CCM is an Islamic financial instrument introduced to enhance liquidity in the Islamic financial market and to provide an additional instrument for IFIs to raise funds through funds placement by other banking and/or non-banking institutions/clients.

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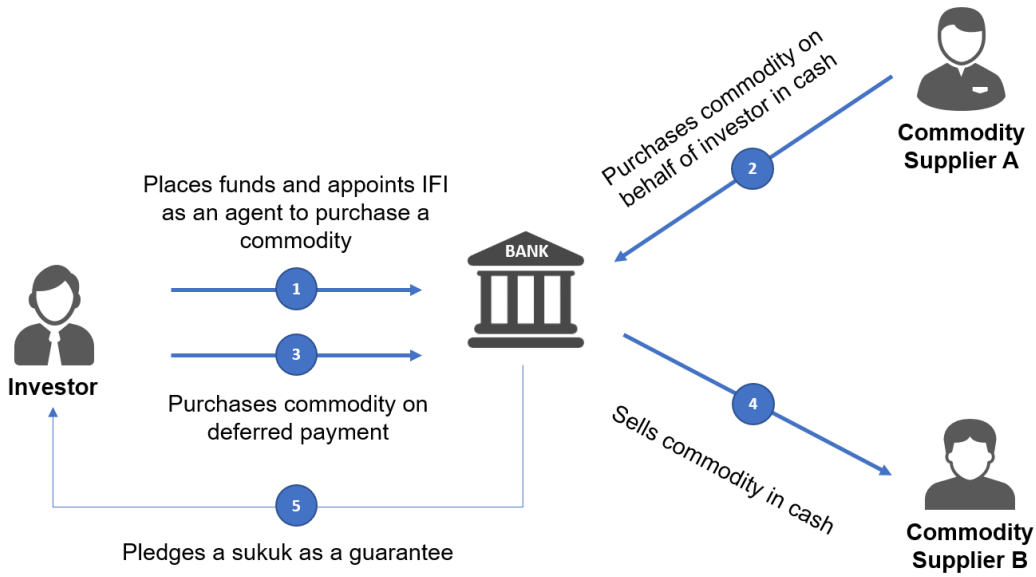
1 Paragraph 19.1 of *Rahn* Policy Document (*Rahn* PD).
2 Paragraph 16.2 and 16.3 of *Rahn* PD
3 Paragraph 14.10 and 17.1 of *Rahn* PD
4 Paragraph 15.3 (a) of *Rahn* PD
5 Paragraph 14.13 and 27.2 of *Rahn* PD

- CCM is an arrangement which incorporates the concept of *tawarruq* (commodity *murabahah*) and *rahn*. An investor places the funds by entering into a commodity *murabahah* agreement with an IFI. Consequently, the IFI is obliged to pay the deferred selling price (the principal plus profit) to the investor on a maturity date. The IFI (as debtor) pledges a collateral to the investor to guarantee its indebtedness. In view that most of the collaterals involved are scripless securities or financial instruments[6], the legal title of the collateral will be transferred to the investor and recorded in the custodian account through RENTAS[7] or other settlement systems. This is to preserve the rights of the pledgee to liquidate the collateral in the event of default. Upon maturity, the IFI settles the deferred payment obligation while the investor returns the collateral to the IFI.

Brief description of the proposed product



1. Investor enters into a commodity *murabahah* agreement and places funds with an IFI. Investor appoints the IFI as an agent to purchase a commodity.
2. IFI purchases the commodity from commodity supplier A on behalf of the investor in cash.
3. IFI then purchases the commodity from the investor on a deferred payment basis.
4. IFI sells the commodity to commodity supplier B in cash.
5. The IFI has to place a collateral throughout the tenure to guarantee its debt. In this case:
   a. The collateral shall meet the regulatory capital requirement.
   b. The IFI (as the pledgor) transfers the legal title of the collateral to the investor (as a pledgee).
   c. The collateral will be held and recorded in the custodian account through RENTAS or other settlement systems.
   d. The investor (as the pledgee) holds the collateral throughout the tenure, and shall not sell the collateral except in the event of breach of terms of the contract by the IFI such as default of payment.

[6] Paragraph 14.1 (b) of *Rahn* PD

[7] The Real-time Electronic Transfer of Funds and Settlement System (RENTAS) is a real-time gross settlement system designed primarily for the transfer and settlement of high-value payments between banks and securities transactions.

e. However, the investor (as the pledgee) may pledge the collateral to a third party provided that the:
   i. Investor has obtained permission from the IFI (as pledgor) to pledge the asset to a third party; and
   ii. Investors may return the collateral based on the mutually agreed terms of the agreement.

Note: At the end of the contract (on maturity date), the IFI (as a purchaser/pledgor) settles the debt and the investor (as the pledgee) returns the collateral to the IFI (as a purchaser/pledgor).

Shariah issue

1. Does the transfer of the collateral legal title from the IFI (pledgor) to the investor (pledgee) contradict the requirement of Rahn policy document *(Rahn PD)?*

2. Whether the use of the collateral (i.e. pledging to a third party) by the investor with the IFI's permission voids the *rahn* contract?

Part III: Key Discussion

Change in the collateral legal ownership from pledgor to pledgee

- The *Rahn PD* stipulates that the pledgor must own the collateral before transferring its possession to the pledgee[8]. During the term of the *rahn* contract, the pledgee holds the collateral as a guarantee against the debt obligation[9].

- In the proposed CCM product, the IFI places security in the form of scripless financial assets such as *sukuk,* Government Investment Issues (GII) or other assets as collateral against the debt arising from the deferred payment obligations in the *murabahah* transaction.

- In the context of a *rahn* transaction involving a security asset in the form of scripless financial asset, IFI as the pledgor transfers the collateral's legal title to the pledgee which will be recorded in the Central Securities Depository. This is to facilitate pledgee for liquidation of the collateral in the event of default by pledger in accordance with the agreed terms and conditions as stipulated in the agreement. Whereas, the pledgor as the beneficial owner of the collateral still assumes all liabilities[10] and is entitled to receive any profits or dividends arising from the collateral based on the terms and conditions specified in the agreement between the pledgor and the pledgee.

[8] Paragraph 14.5 of *Rahn* PD. Please take note that the *Rahn* PD allows the collateral to be owned by another party. Please refer para 29.4 and Appendix 3 E

[9] Paragraph 14.7 of *Rahn* PD.

[10] Paragraph 16.2 and 16.3 of *Rahn* PD.

Pledging of collateral to a third party

- In order to deepen the market activities, the pledgee may pledge the collateral to a third party[11], subject to the consent of the first pledgor. This flexibility does not affect the original contract between the pledgor and the pledgee due to the following:
  - The pledgor has an obligation to return the collateral by acquiring the same asset from the market since the collateral is in the form of a convertible or fungible asset;
  - The economic benefits arising from the collateral remain with the original owner;
  - The *rahn* contract between the pledgor and the pledgee remains in force despite the collateral being pledged to a third party as agreed by both parties; and
  - Pledging to a third party is subject to the similar terms and conditions as the first *rahn* contract, but there is no interdependency between the first and second *rahn* contract.

Part IV: Basis of Ruling

- The change in registration of the collateral from bearing the pledgor's name to the pledgee's name involving a security asset in the form of a scripless financial asset does not constitute a transfer of ownership. This is due to the fact that the transfer of legal title of the collateral is only executed administratively to the pledgee, while beneficial ownership remains with the pledgor based on underlying legal documentation of the transaction.

- Shariah recognises both legal and beneficial ownership[12] and proof of ownership is based on the terms and conditions stipulated in the agreement between the contracting parties. This is also a common market practice especially for hire purchase financing and sukuk structuring whereby the ownership is evidenced based on the legal documentation signed by the contracting parties.

- As the scripless financial assets are fungible in nature, in the event that the pledgee pledges it to a third party, there are huge possibilities for the pledgee to re-acquire the asset from the market, and be able to return it to the pledgor upon settlement of its financial obligations.

- The ruling takes into account that the pledgor will still bear all liabilities associated with the collateral based on the terms and conditions specified in the agreement despite the transfer of the legal title to the pledgee. As such, the pledgor remains entitled to any proceeds and profits derived from the collateral. This is based on the *hadith* of Rasulullah SAW as follows:

عن سعيد بن المسيب أن رسول الله صلى الله عليه وسلم قال: لا يغلق الرهن ، الرهن من صاحبه الذي رهنه له غنمه وعليه غرمه[13]

"From Said bin al-Musayyib that Rasulullah SAW has said: A collateral asset will not diminish from its owner (when he has not yet settled his debt). Any profit of the collateral belongs to its owner and any liabilities must be borne by him"

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11 Paragraph 15.3 of *Rahn* PD

12 OIC Fiqh Academy, Majallah Majma` al-Fiqh al-Islami, 1990, no. 6, v. 1, p. 771.

13 Abu Bakr Ahmad al-Bayhaqi, *al-Sunnan al-Saghir*, 1989, al-Mansurah, Dar al-Wafa' li-l-Tab'ah wa-l-Nashr wa-l-Tawzi' v. 2, p. 290.

- For pledging of collateral to a third party, the pledgee must obtain the consent of the pledgor before entering into the *rahn* contract with the third party[14]. Whereas for the sale of collateral, the pledgee can liquidate the asset only in the event of default by the pledgor. This is in line with the objective of the *rahn* contract to protect the interest of the contracting party.

جعل عين مال متمولة وثيقة بدين ليستوفى منها عند تعذر وفائه[15]

"Making the financed asset as a security for the debt, as a means of payment in case of difficulty in paying off the debt"

Part V: Implication of the SAC Ruling

- The SAC ruling provides an opportunity for IFIs to manage and enhance their liquidity through fund placements by banking and/or non-banking institutions/clients.

- However, this ruling is confined to the product being structured based on the concept collateralised commodity *murabahah,* which incorporates the concept of *tawarruq*/commodity *murabahah* and *rahn* contract using scripless financial asset as the collateral.

[14] 170th SAC Meeting dated 30 August 2016, Kompilasi Keputusan Syariah dalam Kewangan Islam, Third Edition, 2017

[15] Syams al-Din Muhammad Ibn Abi Abbas al-Ramli, *Nihayah al-Muhtaj ila Syarh al-Minhaj*, Beirut, Dar al-Kutub al-'Ilmiyyah, v.4, p. 234.