Ruling of the Shariah Advisory Council of Bank Negara Malaysia (SAC) on Compounding Profit for Restructuring and Rescheduling (R&R) of Islamic Financing

SAC 214th Meeting dated 30 June 2021

Part I: SAC Ruling, Its Effective Date and Applicability

Pursuant to section 52 of the Central Bank of Malaysia Act 2009 pertaining to the functions of the SAC, the SAC ruled that Islamic financial institutions (IFIs) are not allowed to include and account for any accrued profit from the original financing in the new principal amount of R&R financing[1]. This is because such practice will amplify the amount of profit on debts (compounding profit). Therefore, IFIs shall ensure that in executing R&R financing:

i. the new principal amount of the R&R financing shall be equivalent to the outstanding principal amount of the original facility, if there is no additional financing involved;

ii. the amount of accrued profit and late payment charges (where applicable) from the original financing can be added to the total new debt obligation, but this amount cannot be capitalised in the calculation of the new profit; and

iii. the prohibition is applicable to R&R financing with all customers (both *musir* and *mu'sir*).[2]

1.1. This ruling is effective in accordance with the guidelines to be issued by the Bank and is applicable to the following 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 Institutions Act 2002 (DFIA) to carry on Islamic financial business.

1.2. 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

2.1. Financial performance and cash flows of individuals and businesses are expected to gradually improve in line with economic improvements. In an effort to ease the financial burden of the affected customers, various initiatives have been carried out to help them to survive in the current situation.

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[1] This revised ruling is a continuation of the previous SAC ruling in its 30th special meeting dated 14 July 2020 (revised on 16 October 2020) which prohibits the practice of compounding profit in R&R of Islamic financing during COVID-19 pandemic period.

[2] For *musir*, IFIs are allowed to charge a new profit rate on the restructuring of the financing based on the calculation method outlined in the related policy document of the Bank and the resolution of SAC. However, for *mu'sir*, it is not permitted to charge any additional profit on the existing financing. [SAC ruling at its 160th meeting dated 30 June 2015, Kompilasi Keputusan Syariah dalam Kewangan Islam, Edisi Ketiga, 2017].

2.2. Among the initiatives is the rescheduling and restructuring of existing financing to rearrange customers' cash flows. With that approach, businesses and individuals can better manage their financial obligations to suit their prevailing financial situation.

2.3. Acknowledging the challenges faced by IFIs' customers under the difficult situation, the SAC in its 30th Special Meeting dated 14 July 2020 (revised on 16 October 2020) outlined the Shariah requirements on R&R financing which intends to provide clear Shariah guidance to IFIs and customers.

2.4. Following the Shariah ruling, the SAC saw the need for a detailed discussion on extending the applicability of such prohibition on the IFIs under the business-as-usual situation (i.e. after the end of COVID-19 pandemic period) to all IFIs' customers.

Shariah issue

2.5. Does Shariah allow IFIs to impose compounding profits for R&R financing?

Part III: Key Discussion

Prohibition of compounding profits eases dharar (harm) to the customers

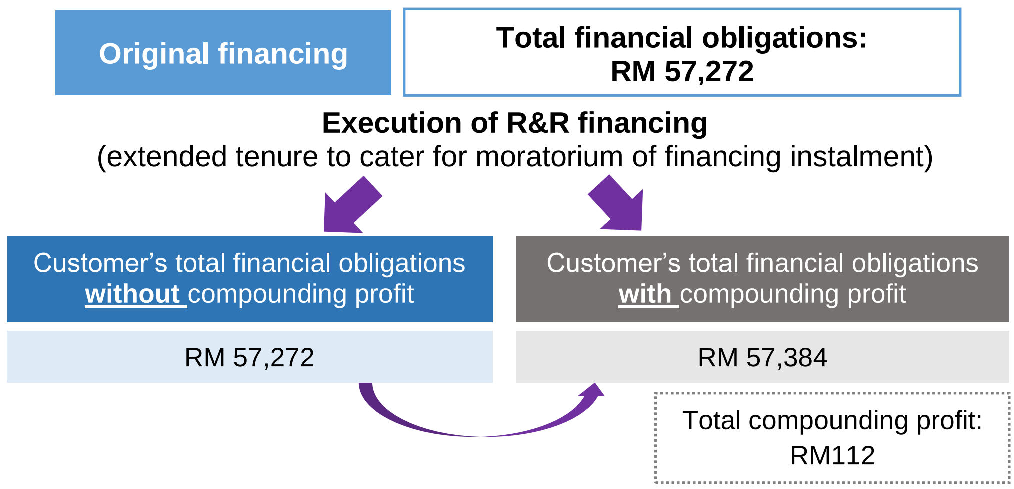
3.1. R&R financing enables customers' monthly repayment obligations to be restructured according to their payment capabilities. Through this arrangement, IFI and the customer will enter into a new agreement or agree to the revised terms and conditions based on the existing customer's financial capability. The revised terms usually result in an increase in the financing tenure and/or the imposition of a new profit rate. The impact of R&R usually causes the overall cost of financing to increase. Therefore, there is a need to consider the financial hardships faced by the affected customers and refrain from charging compounding profits in R&R financing.

3.2. The SAC in its 30th Special Meeting dated 14 July 2020, has ruled that IFIs are not allowed to include and account for any accrued profit from the original financing as the new principal amount for the R&R financing. Such practices aim to avoid amplification of profits on debt (compounded profits) that will worsen the customers' financial position.

Calculation method for compounding profits

3.3. Capitalisation of accrued profit in R&R financing occurs when accrued profit from the original financing is incorporated into the new principal amount. The new profit is calculated based on the new principal amount in determining the total amount of financing. As a result, the amount of profit will be amplified which is tantamount to compounding profit practices. The illustration of the compounding profit in R&R financing is as follows:

Illustration 1: R&R for home financing



3.4. The calculation of the new profit amount for R&R financing has taken into account the prevailing risks and cost of funds, while the accrued profits have covered the risks and costs of the previous financing. Therefore, any amount of compounding profit earned through the capitalisation of accrued profit will be tantamount to the additional profit obtained by IFI without any justifiable risks or costs.

3.5. Illustration 2: Simplified example on the calculation of the total financial obligation of R&R financing[3] with and without compounding profit:

	Existing financing amount (before R&R)	**Financing amount R&R**	
		<u>Without</u> compounding profits	**<u>With</u> compounding profits**
Outstanding principal	RM50,113	RM50,113	RM50,489**
Unaccrued/ Deferred profit	RM6,783*	RM6,783	RM6,895
Accrued profit	RM376	RM376	RM0
Overall financial obligation	**RM57,272**	**RM57,272**	**RM57,384**

* *Unaccrued profits from the previous financing are waived as a rebate (ibra') to the customer.*

*** The amount of new principal increases due to capitalisation of the accrued profits*

[The example above is strictly for illustration purposes and intended to facilitate a better understanding of how the compounding profit is calculated and its impact on R&R financing without taking into account other factors such as the extension of period and changes in profit rates. It may differ from the actual calculation at the IFI level]

[3] There are differences in the calculation of rescheduling. The new effective profit rate will be calculated based on the new risk (without compounded profit) and will not exceed the total selling price. Customers will be given a rebate on the difference between the ceiling profit rate and the effective profit rate.

Impact assessment on IFIs and customer

3.6. Based on the findings on the simulation of IFIs' profitability, the impact of prohibition on compounding profit is minimal where IFIs will be experiencing a slight reduction in profit if the prohibition continues after the pandemic period. This is because usually R&R financing will have the effect of extending the financing tenure, causing the customers to bear additional profits, while the prohibition on compounding profits will slightly reduce the additional profits from the R&R financing.

Continuation and enhancement of previous SAC rulings

3.7. Previously, there were several IFIs that did not compound profits for R&R financing. The implementation of such practice was based on the IFI's Shariah committee's decision, as there was no specific SAC ruling on the matter.

3.8. However, in light of the challenging economic situation that continues to affect customers during the COVID-19 pandemic, the SAC has ruled to prohibit IFIs from charging compounding profits for R&R financing with the objective to ease the financial hardship of customers affected by the pandemic.

3.9. Although initially, the SAC's ruling relating to the prohibition on compounding profit was made due to the COVID-19 pandemic, but taking into account the broader aspect of *maslahah* (benefits) including the *dharar* (harm) to the customers, there is a basis for the ruling to be retained and extended to all IFIs' customers under the business-as-usual situation.

Part IV: Basis of Ruling

Application of the concept of Siyasah Syar'iyyah in safeguarding the interests of the contracting parties

4.1. The Islamic financial services are based on the main principles of Shariah premised on the *maqasid 'ammah* (general objectives), i.e. prevention of harm and attainment of benefits[4]. Additionally, upholding the concept of justice and compassion serves as the pertinent basis in all aspects of finance as mentioned in the following *fiqh* maxim:

الأصل في العقود كلها إنما هو العدل[5]

"The original state in all transaction is justice"

4.2. The prohibition on compounding profits considers the concept of *siyasah syar`iyyah,* where the regulator may set certain policies appropriate to safeguard the interests of the contracting parties. This is also in line with the following *fiqh* maxim:

تصرف الإمام على الرعية منوط بالمصلحة[6]

"The affairs of the leader over the people are based on maslahah"

4 SAC has outlined key fundamental Shariah principles that should be embedded in Islamic financial services. Refer to BNM Annual Report 2019, p. 34.

5 Ibn Qayyim, *I'lam muwaqi'in 'an rabb al-a'lamin*, Dar ibn al-Jawzi lil nasyr wa al-tawzi', v.3, p. 170.

6 Al-Suyuti, *al-Asybah wa al-Naza'ir*, Dar al-Kutub al-`Ilmiyyah, 1403H, p. 121.

4.3. The consideration of *siyasah syar`iyyah* takes into account the following factors:

i) *Mafsadah* (harm) to customers and IFI due to compounding profits

- Capitalising accrued profits into the new principal amount results in increasing customers' debt and financial burden. Undeniably, IFIs also bear the financial burden arising from the R&R. However, weighing between the two harms, customers relatively experience more harm than IFIs as the customer is in financial distress and requires additional assistance to fulfil its financial obligation. Therefore, the imposition of compounding profit further worsens customers' existing severe financial conditions. This is in accordance with the following *fiqh* maxim:

درء المفاسد مقدم على جلب المصالح[7]

"Avoiding harm is prioritised over gaining benefits"

- Additionally, any matter that brings harm to a contracting party is not permissible as mentioned in the following *fiqh* maxim:

الأصل في المنافع الإباحة وفي المضار التحريم[8]

"The original state of benefits are permissibility, and harms are prohibited"

ii) Prohibition on compounding profits brings *maslahah* to the contracting parties

- *Maslahah* is the primary purpose in every Shariah ruling[9]. In the context of the prohibition on compounding profits, such ruling coincides with the Shariah approach in providing benefits by alleviating and eliminating the hardships on affected customers. It will also improve customers' perception and confidence towards IFIs because of their sensitivity and genuine care for customers in difficult times. In return, depositors and stakeholders will also benefit in the long run due to the tendency of customers to choose Islamic financing. This is in line with the following *fiqh* maxim:

المصلحة العامة مقدمة على المصلحة الخاصة[10]

"Public interest is given priority over specific interest"

iii) Justice and *ihsan* to the customer

- Syariah emphasises the need to uphold justice and *ihsan* in all matters, including *muamalah* (transaction). This is stated in the following verse of al-Qu'ran:

إِنَّ ٱللَّهَ يَأْمُرُ بِٱلْعَدْلِ وَٱلْإِحْسَٰنِ

"Indeed, Allah commands justice and good conduct"

(Surah al-Nahl, verse 90)

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7 Ahmad Al-Zarqa', *Syarh al-Qawa`id al-Fiqhiyyah*, Damsyik: Dar al-Qalam, 1989, p. 165.
8 Muhammad Sidqi al-Burnu, *Mawsu'ah al-Qawa'id al-Fiqhiyyah*, Beirut: Mawsu'ah al-Risalah, 2003, v. 12. p.11
9 Al-Shatibi, *al-Muwafaqat,* Dar Ibn `Affan, 1997, v. 2, p.9.
10 Al-Syatibi, *Al-Muwafaqat*, Dar Ibn `Affan, 1997, v. 3, p.89.

- The application of the principle of *ihsan* is appropriate in the provision of assistance for those facing difficulties by easing their financial burden. Rasulullah SAW also encourages the practice of *ihsan* in all matters, as evidenced in the following hadith:

  عن أبي يعلى شداد بن أوس رضي الله عنه عن رسول الله صلى الله عليه وسلم قال : إن الله كتب الإحسان على كل شيء[11]

  Reported by Abu Ya'la Shaddad bin Aws RA, that Rasulullah SAW said: "Verily Allah has prescribed ihsan (proficiency, perfection) in all things".

- Additionally, the determination of profit must consider the risks involved and the calculation method must be fair to both contracting parties. To achieve these objectives, the calculation method should refer to the criteria outlined in the policy document on Responsible Financing[12] and policy document on Risk-informed Pricing[13] or other relevant policies issued by the Bank. Shariah also recognises risk as one of the elements in determining profits as articulated by the hadith of the Prophet SAW:

  الخراج بالضمان[14]

  "Entitlement of profit is dependent on liability (risk)"

- In calculating the new financial obligations under R&R financing, the capitalisation of accrued profits into the new principal amount results in an increase in debt to the customer and subsequently additional financial burden. The increase has reflected the existence of an element of injustice due to the unclear consideration for the accrued profit. Even the calculation is clearly based on the risk of the previous financing.

4.4. The principle of *maqasid Shariah* is to achieve property preservation alongside the attainment of justice for the contracting parties. In the context of compounding profits, there is an injustice to the customer in the course of the IFI compensating itself from the customer's failure to settle the financial obligation according to the original terms. Therefore, the goals are not in line with the principles of *maqasid Syariah*. Based on that purpose, any *wasilah* (means) or practice that affects compounding profits is not allowed. This is in line with the following *fiqh* maxim:

الأمور بمقاصدها[15]

"Matters are determined according to goals"

11 Muslim, *Sahih Muslim*. Dar al-Ihya' al-Turath al-Arabi, Beirut. v.3, p. 1548, no. hadith 1955.

12 Date of issuance: 6 May 2019

13 Date of issuance: 16 December 2013

14 Ibn Majah, *Sunnan Ibn Majah,* Dar Ihya al-Kutb Al-Arabiyyah, no. hadith 2234, v. 2, p.754; al-Tarmizi, *Sunnan al-Tarmizi*, Beirut: Dar al-Gharb al-Islami, no. hadith 1286, v.2, p.573.

15 Ahmad al-Zarqa', *Syarh al-Qawa`id al-Fiqhiyyah*, Dar al-Qalam, 1989, p. 47.

Part V: Implication of the SAC Ruling

5.1. The SAC ruling aims to ensure clarity on the prohibition of compounding profits which is in line with Shariah and applies to all customers executing R&R financing.

5.2. Rulings on compounding profits are not retrospective in nature, considering previous R&R financing practices that may include compounding profits.