

The Shariah Advisory Council of Bank Negara Malaysia (SAC) Ruling on Early Disbursement Feature prior to *Tawarruq* Execution for Islamic Trade Finance Products based on *Tawarruq*

217th SAC Meeting dated 30 September 2021

Part I: SAC Ruling, Its Effective Date and Applicability

Pursuant to section 52 of the Central Bank of Malaysia Act 2009, the SAC ruled that, when there is operational constraint for timely execution of *tawarruq* transaction, then, early disbursement feature prior to *tawarruq* execution which is paid directly to third-party for Islamic trade finance product is **permissible** subject to compliance with relevant Shariah and operational requirements as follows:

- a) An Islamic banking institution (IBI) is not allowed to either profiting or imposing any charges on the early disbursed fund in any way including but not limited to:
 - i. Inclusion of early disbursement period¹ in the calculation of the profit amount for subsequent *tawarruq* transaction;
 - ii. Extension of the financing tenure beyond the original tenure that has been agreed with the customer in order to compensate for the foregone profit on the early disbursement period pursuant to point (i) above;² and/or
 - iii. Any method of profit calculation that affects the prohibition mentioned in this SAC ruling.
- b) IBI shall ensure strict and robust internal controls are in place to prevent IBI from profiting or imposing any charges on the amount of early disbursement, and these controls include but not limited to strong system capabilities and sound operating procedures;
- c) The *takyif fiqhi* or Shariah contract applicable to early disbursement prior to *tawarruq* execution which is performed without the knowledge of the customer is incidental *qard*;
- d) However, IBIs may use other Shariah contracts or *takyif fiqhi* that are appropriate for early disbursement, subject to complying with all relevant Shariah requirements for the contracts.

1.1. This ruling comes into effect immediately upon publication of this ruling on Bank Negara Malaysia's website on 27 December 2021 and applies to the following IBIs:

- (a) licensed Islamic banks 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.

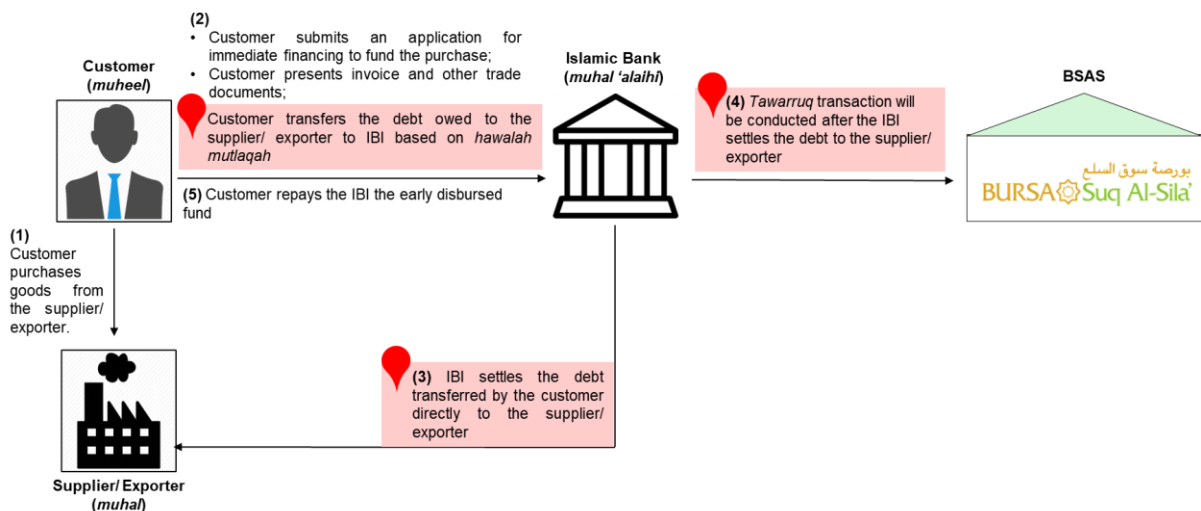
1.2. In line with sections 28(1) and (2) IFSA or sections 33D(1) and (2) DFIA, as the case may be, IBI are required to comply with this ruling as compliance with any ruling of the SAC in respect of any particular aim and operation, business, affair or activity of IBI shall be deemed to be in compliance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

¹ Early disbursement period refers to the period when the early financing disbursement been made until the *tawarruq* is executed.

² For example, if the original financing tenure agreed with customer (without early financing disbursement situation) is 30 days starting from 1 December 2021 until 30 December 2021, the early disbursement situation that occurs on 1 December 2021 shall not result in the extension of the tenure beyond 30 December 2021 in order to compensate for the foregone profit on 1 December 2021 due to the early financing disbursement that took place before *tawarruq* execution.

Part II: Background

- 2.1. Bank Negara Malaysia (the Bank) received a proposal from an IBI in relation to Islamic trade finance products namely Trust Receipt-i and Invoice Financing-i which are based on *tawarruq* with the feature of early disbursement to third-party (customer's supplier/exporter) before the *tawarruq* contract is executed.
- 2.2. The situation of early disbursement arises when the customer requests for the IBI to make a settlement to the supplier/exporter on the same day of the submission of relevant documents to the IBI. Such immediate payment is required by the customer for various reasons, among others, to obtain certain discounts or benefits from the supplier/exporter or to ensure that payment to supplier/exporter are made within the agreed timeframe.
- 2.3. Due to the IBI's operational constraints that can only perform *tawarruq* by a certain cut-off time, the IBI is unable to perform *tawarruq* transaction on behalf of the customer as requested, thus, causing the financing disbursement through normal operating procedures cannot be implemented. For example, the IBI has to perform *tawarruq* before 3.00 PM cut-off time every day, however, the customer submits the documentation at 3.00 PM and requests for the payment to be made immediately before end of business hour on the same day. Due to these operational constraints, the IBI is unable to meet the customer's needs.
- 2.4. Therefore, the IBI proposes for early disbursement feature by using *hawalah mutlaqah* contract to cater for this specific situation.
- 2.5. An illustration of the proposed *hawalah mutlaqah* structure is as follows:



Shariah Issues

Based on the proposal submitted, the potential Shariah issues identified are as follows:

- 2.6. Is the *hawalah mutlaqah* contract suitable to be applied for early disbursement feature as proposed or are there any other Shariah contracts that are more suitable?
- 2.7. Are there elements of prohibited *bai' wa salaf* (combination of exchange-based contracts and loan) that are prohibited in the proposed structure?

Part III: Key Discussion

The usage of hawalah mutlaqah contract in the early financing disbursement feature requires the consent of contracting parties

- 3.1. The *hawalah mutlaqah* contract involves the transfer of the *muhal*'s right to claim the amount of debt owed by the *muheel* to the *muhal 'alaihi*. Therefore, the consent of the *muhal* is required to conduct the *hawalah mutlaqah*. Without such consent, *hawalah mutlaqah* does not meet the conditions of its implementation.
- 3.2. In the proposed product structure, the *hawalah mutlaqah* contract is not the original and intended arrangement for the products as it occurs incidentally (*dhimni*) i.e. when the customer needs immediate financing disbursement on the day the application is made.
- 3.3. Therefore, the implementation of this *hawalah mutlaqah* contract is not stated in the facility agreement between the IBI and the customer to avoid the permanent presumption by customer that the early disbursement feature is available absolutely.
- 3.4. As IBI cannot explicitly disclose its commitment to allow early disbursement on behalf of the customer in certain situations, hence, this feature cannot be construed as *hawalah mutlaqah* as it does not meet the basic conditions of contract, that requires a clear offer and acceptance between contracting parties to represent their consent.

The early disbursed fund prior to tawarruq execution is construed as incidental qard and is subject to all incidental qard's requirements

- 3.5. Based on the above discussion, the SAC decided that the early financing disbursement to third-party (supplier/exporter) before the *tawarruq* execution is incidental *qard* as IBI's commitment to make early disbursement is not clearly stated upfront in the facility agreement and it is done based on the IBI's internal assessment on case to case basis. Therefore, the IBI must comply with all Shariah requirements relating to incidental *qard* including but not limited to neither profiting nor imposing any charges on the early disbursed fund in any way such as:
 - i. Inclusion of early disbursement period in the calculation of the profit amount for subsequent *tawarruq* transaction;
 - ii. Extension of the financing tenure beyond the original tenure that has been agreed with the customer in order to compensate for the foregone profit on the early disbursement period pursuant to point (i) above; and/or
 - iii. Any method of profit calculation that affects this prohibition.

The early disbursement has no relation to the tawarruq contract and does not provide additional profit to the IBI

- 3.6. Based on the proposed structure, the early disbursement has no relation to the subsequent *tawarruq* transaction because the *tawarruq* arrangement was determined from the outset when the customer received the facility's letter of offer from the IBI. Meanwhile, the early disbursement only occurs when the customer needs immediate financing but the *tawarruq* transaction cannot be executed on the same day due to the operational constraint.

- 3.7. In addition, the existence of the early disbursement will not contribute to the IBI's additional profit as the early disbursement period will not be included in the calculation of profit amount for the subsequent *tawarruq* transaction.

Part IV: Basis of Ruling

Hawalah mutlaqah requires a clear offer and acceptance

- 4.1. There is a consensus among Shariah scholars on the legislation of *hawalah* contract based on the hadith of the Prophet SAW as follows:

حَدَّثَنَا عَبْدُ اللَّهِ بْنُ يُوسُفَ، أَخْبَرَنَا مَالِكٌ، عَنْ أَبِي الزِّنَادِ، عَنِ الْأَعْرَجِ، عَنْ أَبِي هُرَيْرَةَ - رَضِيَ اللَّهُ عَنْهُ - أَنَّ رَسُولَ اللَّهِ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ قَالَ : مَطْلُ الْغَنِيِّ ظُلْمٌ، فَإِذَا أَتَيْتُمْ أَحَدَكُمْ عَلَى مَلِيٍّ فَلْيَتَّبِعْ

Meaning: "Procrastination (delay) in paying debts by a wealthy man is injustice. So, if your debt is transferred from your debtor to a rich debtor, you should agree." (Sahih Bukhari, Kitab *Hawalah*, Hadith no. 2287)

- 4.2. *Hawalah mutlaqah* is defined as an act of transferring a debt from *muheel* (debtor) to *muhal 'alaihi* (the party to whom the debt is transferred) and *muhal 'alaihi* commits to pay with his own funds the debt incurred by *muheel* to *muhal* (creditor to *muheel*). Further, the *muhal 'alaihi* is entitled to reclaim from the *muheel* the amount of debt that has been paid to the *muhal* at the will of the *muheel*.³
- 4.3. The contract of *hawalah mutlaqah* is recognized by the Hanafi school. However, the majority of Shariah scholars consider *hawalah mutlaqah* as equivalent to *kafalah* (guarantee) and is subject to all Shariah requirements of *kafalah*.
- 4.4. Majority of *fuqaha'* are of the view that the *hawalah* contract must be entered into via a clear offer and acceptance between *muheel*, *muhal* and *muhal 'alaihi* as it involves the formation of a new debt settlement contract between *muhal* and *muhal 'alaihi* through the transfer of *muhal's* right to claim debts from *muheel* to *muhal 'alaihi*. In addition, the *fuqaha'* also asserted that the *hawalah* contract is categorized as a contract of exchange (*mu'awadhah*), therefore, it is not permissible to tie the contract to a specific time (*ta'qiit*) or to condition its effectiveness upon a future event (*idhafah ila al-mustaqbal*).⁴

The early financing disbursement is construed as incidental qard

- 4.5. The early financing disbursement is construed as incidental *qard* because the loan contract that occurs between the contracting parties is unintended and it occurs due to certain constraints that prevent the execution of the originally intended contract for the product (in the context of this product, it is *tawarruq* contract). In addition, in terms of documentation, the SAC has ruled that the incidental *qard* can be concluded without *qard* documentation.⁵

³ *Al-Kasani, Badai' Al-Sanai'*; *Al-Sarakhsi, Al-Mabsut*; AAOIFI, *Mi'yar Shariah Hawalah*.

⁴ *Al-Mawsu'ah Al-Fiqhiyyah Al-Kuwaitiyyah*, V. 18, P. 191-192

⁵ The SAC has made a decision relating to the conclusion of incidental *qard* in its 178th meeting as follows:

The early disbursement through incidental qard does not raise the issue of prohibited bai 'wa salaf

- 4.6. Based on the parameters of prohibited *bai' wa salaf* which have been resolved by the SAC in its 176th meeting, the issue of prohibited *bai 'wa salaf* can occur in the early disbursement if it contributes to additional profit and an exclusive benefit to IBI.⁶
- 4.7. However, the proposed early disbursement does not contain the prohibited elements of *bai' wa salaf* based on the following considerations:
- i. The situation of early disbursement does not cause IBI to earn additional profit due to exclusion of the early disbursement period from the calculation of profit amount for the subsequent *tawarruq* transaction.
 - ii. The subsequent *tawarruq* transaction is executed separately and not related to the early disbursement feature, as the early disbursement is only allowed for contingency situations i.e. when there are operational constraints to perform *tawarruq* on the same day the financing disbursement is requested by the customer. Meanwhile, the implementation of the *tawarruq* transaction was agreed at the beginning of the facility agreement between IBI and the customer.
 - iii. The customer has the freedom to use fund from any source to repay the early disbursed fund by IBI and is not bound to repay the IBI from fund derived from the *tawarruq* transaction.

Part V: Implication of the SAC Ruling

- 5.1. Notwithstanding the SAC ruling, the early disbursement feature prior to *tawarruq* execution is not preferred or recommended as it may give rise to Shariah non-compliance risks in absence of robust internal control and mitigating measures. However, if there is an urgent need due to certain constraints faced by the IBI to cater for unique requirements of Islamic trade finance products, this method can be used subject to strict conditions which include ensuring strong system capabilities and sound operating procedures to ensure all Shariah requirements outlined in this SAC ruling are complied with.

“The SAC ruled that incidental qard may be concluded by conduct (mu`atah) and flexibility may be accorded by the regulator to allow Islamic financial institutions (IFIs) to conclude such qard without qard documentation.”

⁶ The SAC outlined the parameters concerning the prohibited *bai' wa salaf* in its 176th meeting as follows:

1. In situation where the transaction involves combination of exchange and loan contracts that contains explicit provision on:
 - (a) inter-conditionality and contingency between both contracts; and
 - (b) exclusive benefit to the lender.
2. Notwithstanding paragraph (1), in the case where loan is an intended (not incidental) contract, combines with an exchange contract that gives exclusive benefit to the lender, it is also regarded as prohibited *bai' wa salaf* though there is no explicit provision on inter-conditionality and contingency between the two contracts.