The 182nd Meeting of the Shariah Advisory Council (SAC) of Bank Negara Malaysia

The SAC of Bank Negara Malaysia at its 182nd meeting dated 28 November 2017 ruled on the following:

Collateralisation of Deposit or Investment Account in Islamic Financial Institutions

SAC Ruling

The SAC ruled that the practice of collaterising deposits and investment accounts to secure a financing obligation is permissible. The account can be utilised by Islamic financial institutions (IFIs) (as pledgee) with the consent of customers (as pledgor), subject to the following conditions:

(i) Customers are allowed to choose any type of account, including deposit or investment account as collateral against the payment of financing obligation; and
(ii) The financial obligation or liability owed by the customer to the IFI does not arise from a loan *(qard)* contract.

Background

- The collateralisation of deposits and investment accounts to secure a financing obligation is a common practice in the Islamic banking industry. In the event of default, the value in the collateralised account would be used by the IFI to settle the outstanding amount of the financing payment.

- When the IFI requires the account to be held as collateral against the financing, the customer will grant the IFI a lien on the account until the financing is fully paid. At the same time, the account shall remain to function as a deposit or investment account.

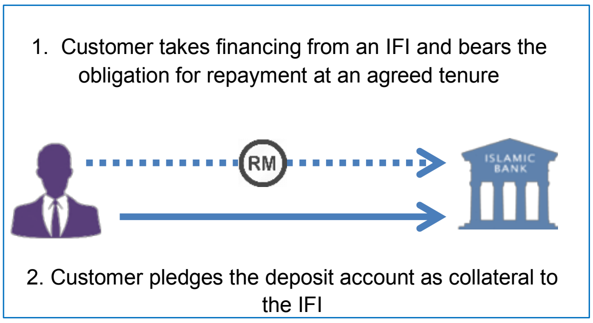
- In this regard, the SAC is referred to on the practice of collateralisation of deposit or investment account and its treatment from the Shariah perspective.

Shariah Issues

- Can the customer's asset in the form of deposit or investment account be pledged as collateral (*marhun*)?

- What is the *fiqhi* adaptation of collateral in the form of deposit or investment account and its utilisation by the pledgee from the Shariah point of view?

Illustration:
Example of collaterisation of deposit account



Key Highlights of the SAC Discussion

What are the features for an asset to be a collateral?

- Classical scholars, namely Hanafi jurists, adopt the most stringent interpretation which prohibits debt-based and *musya*` assets (non-divisible assets) to be pledged as collateral. Some Maliki jurists, however, adopt a more lenient view. This is because *rahn* is recognised as a supporting contract where the element of uncertainty (*gharar*) in supporting contracts is deemed acceptable.

- Other assets which are recognised by jurists to be pledged as collateral include physical assets, debt-based assets and *musya*` assets.

- Jurists also allow the collateralisation of cash in general, of which Maliki jurists include a condition that the cash shall not be utilised by the pledgee.

What are the views of contemporary scholars and Shariah resolutions regarding the deposit account that is charged as the collateral?

- The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shariah Standard on *rahn*[1] states that when a current account or cash is pledged as collateral, the IFI should not use the account unless an agreement is reached between the two parties to transfer the account to an investment account, thus making it subject to the rulings of *mudarabah* instead of *qard*. Upon transference of the account to an investment account, both parties are entitled to share the profit based on an agreed ratio. The AAOIFI justifies the permissibility of pledging assets in the form of cash on account that a pledgor is also allowed to pledge his assets that are in the possession of pledgee.

- The International Islamic Fiqh Academy[2] underlines that the collateralisation of deposit accounts is permissible, whether it is a saving, current, or investment account, provided that there are no withdrawals made from the account during the tenure of pledge. When the bank is the pledgee, the amount in the deposit account should be transferred to an investment account, thus the applicable contract is converted from *qard* to *mudarabah*. Upon conversion, account holders are entitled to the profit generated from the investment account. Therefore, the issue of pledgee benefits from the charged asset (collateral) could be avoided.

- Syeikh Taqi Usmani quoted the opinion of Ibn Qudamah[3], which stated that majority of jurists view that a chargeable asset (collateral) should be physical and sellable. As for a cash deposit, it is viewed as an asset in the form of debt because it is a liability of the bank. Therefore, according to this view, cash deposit accounts are not allowed to be charged as collateral. The Maliki school, on the other hand, allows the collateralisation of debt, provided that the tenure of the debt matches or exceeds that of the financing obligation of the pledgor.

What is the fiqhi adaptation of collateral in the form of deposit account?

- Muslim jurists often deliberate on the status of physical collateral that is borrowed by the pledgee. A majority of jurists are of the view that when an asset is made into collateral, the status of the asset changes from *dhamanah*[4] to *amanah*[5]. This is to preserve the original principle of collateral, of which it should be kept by pledgee on the basis of *amanah*. However, Shafi`i jurists are of the view that the status of borrowed asset remains *dhamanah.*

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[1] AAOIFI, *Al-Ma`ayir al-Shar`iyyah, 2015,* A*l-Rahn wa Tatbiqatuhu al-Mu`asirah*, no. 39, item 1/6 - 2/6.
[2] OIC Fiqh Academy, *Majallah Majma` al-Fiqh al-Islami, 1995,* 9th conference, no. 9, v.1, resolution no. 90/3, p. 931.
[3] Ibnu Qudamah, *Al-Mughni*, Maktabah al-Kaherah, 1968, v. 4, p. 260
[4] Dhamanah: where a person takes possession of an asset as an owner not as a proxy whereby he is bounds to guarantee it in all circumstances.
[5] Amanah: where a person takes possession of an asset as proxy not an owner whereby he is not liable for the asset in his custody unless it was due to his negligence, misconduct and breach of specified terms.

- There are differences between the collateral in the form of deposit accounts as compared to the collateral in the form of physical assets. In this context, the SAC considers collateral in the form of deposit accounts to be construed as a debt (receivable). The debt arises from the *qard* transaction under the deposit in which the depositor has the right to receive the amount owed by the IFI.

Is there any issue arising from the utilisation of the deposit account (collateral) by the IFI?

- Based on current banking practices, IFIs utilise the deposit that is charged as collateral and at the same time benefit and profit from it. In principle, the pledgor as the owner of the collateral shall be entitled to any benefits or profits from the deposit account. This common practice by IFIs can be allowed under the following conditions:

  (i) The customer (pledgor) consents to the utilisation of the deposit by the IFI; and
  (ii) The placement of deposits on the basis of *qard* is not conditional upon the debt and financial obligation of the customer.

- From another perspective, when the collateral in the form of deposit account is construed as debt (receivables) arising from a loan contract *(qard)*, the IFI is not deemed as utilising the debt. In fact, it is utilising the cash borrowed from the customer through a *qard* contract. Therefore, the issue of the IFI as the pledgee gaining benefit from the utilisation of the collateral does not arise.

Basis of Ruling

- The collateralisation of deposit accounts to secure financial obligations is allowed as the SAC views the collateralised asset *(marhun)* as the customer's debt (receivables).

- The purpose of allowing the customers to choose any deposit or investment account to be pledged as collateral is to ensure that the placement of *qard* deposit will not be made conditional to obtain financing.

- Even though the pledged asset is in the form of debt from the deposit account, the IFI would indirectly benefit from the pledged account. Therefore, the financial obligation borne by the customer should not arise from a loan contract. This is to ensure that the IFI will not gain any benefits from the *qard* contract, as mentioned in the hadith:

عن علي رضي الله عنه قال: قال رسول الله صلى الله عليه وسلم: كل قرض جر منفعة فهو ربا.

"From Ali r.a. who said, that Rasulullah SAW said: Any loan which brings benefits (to the creditor) amounts to riba" [6]

[6] Ibnu Hajar a-`Asqalani, *Bulugh al-Maram min Adillah al-Ahkam*, Matba`ah al-Salafiyyah, 1928, p. 176.

Implication of the SAC Ruling

- This ruling is essential to clarify:-

  (i) The practice of collateralisation of deposit or investment account to secure a financing obligation in IFIs;
  (ii) The conditions that should be complied with if IFIs need to utilise the collateral; and
  (iii) The issue of the utilisation of deposit or investment account by IFIs.

The effective date of this ruling is subject to the effective date of the Policy Document on Rahn which is expected to be issued mid-2018.