



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Rahn **Exposure Draft**

Applicable to:

1. Licensed Islamic banks
2. Licensed takaful operators and professional retakaful operators
3. Licensed banks and licensed investment banks carrying on Islamic banking business
4. Prescribed institutions carrying on Islamic financial business

As part of the objective to strengthen the Shariah-compliance practice among Islamic financial institutions (IFIs), Bank Negara Malaysia (the Bank) is developing a Shariah-based regulatory policy with the objective to provide a comprehensive guidance to the Islamic financial industry with respect to end-to-end compliance with Shariah.

This exposure draft consists of two components, Shariah and operational requirements with respect to the operationalisation of *rahn* contract. The Shariah requirements highlight the salient features and optional practices of a valid Shariah contract to facilitate sound understanding of a particular contract by the IFI. The operational requirements outline the regulatory expectations with respect to the governance and oversight, structuring, risk management, business and market conduct as well as financial disclosure.

The Bank invites written feedback and comments on **Part C** *i.e.* the operational requirements of a *rahn* contract, including suggestions for particular issues/areas to be clarified or elaborated further and any alternative proposals that the Bank should consider. The Shariah requirements in Part B serves as reference to facilitate the IFIs in providing feedback and comments on operational aspects of the *rahn* in line with the Shariah requirements. To facilitate the Bank's assessment, please support each comment with a clear rationale, accompanying evidence or illustration, as appropriate.

Responses shall be submitted to the Bank by **15 June 2017** to:

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Electronic submission is encouraged. Submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submission.

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PART A OVERVIEW

1. Introduction

- 1.1 Compliance with Shariah requirement is a prerequisite in ensuring the legitimacy and integrity of Islamic financial products and services. In meeting this expectation, it is essential for an Islamic financial institution (IFI) to establish the necessary operational framework and infrastructure to ensure that its conduct of Islamic financial transactions is consistent with Shariah.
- 1.2 The Shariah contract-based regulatory policy is intended to promote consistency of Shariah contract application in Islamic financial products and services. This policy is envisaged to strengthen legal certainty and Shariah compliance practices by an IFI.
- 1.3 This policy document aims to –
- (a) provide reference on the Shariah rulings applicable to a *rahn* contract;
 - (b) set out key operational requirements for the implementation of the *rahn* contract; and
 - (c) promote end-to-end compliance with Shariah requirements which further promote sound Islamic banking and takaful practices and safeguard consumer interests.
- 1.4 This policy document sets out the following:
- (a) salient features and essential conditions of the *rahn* contract in Part B; and
 - (b) regulatory and supervisory expectations for the operational requirements on governance and oversight, structuring, risk management, business and market conduct as well as financial disclosure in Part C.

2. Applicability

- 2.1 This policy document is applicable to all IFIs as defined in paragraph 5.2.

3. Legal provisions

- 3.1 The requirements in Part B of this policy document are specified pursuant to –
- (a) section 29(1) of the Islamic Financial Services Act 2013 (IFSA); and
 - (b) section 33E(1) of the Development Financial Institutions Act 2002 (DFIA).
- 3.2 The requirements in Part C of this policy document are specified pursuant to –
- (a) sections 29(2), 57, 135(1) and 155 of the IFSA; and
 - (b) section 33E(2), 41, 42C(1) and 116 of the DFIA.

- 3.3 The guidance in this policy document is issued pursuant to section 277 of the IFSA and section 126 of the DFIA.

4. Effective date

- 4.1 This policy document comes into effect eighteen months after the issuance date of the finalised policy document [the effective date will be specified upon issuance of the finalised policy document] except for paragraph 33 which takes effect immediately upon issuance of the finalised policy document.

Question 1

Highlight any significant operational consideration with appropriate justification that needs to be addressed to ensure effective implementation of the policy document upon the effective date.

5. Interpretation

- 5.1 The terms and expressions used in this policy document must have the same meanings as assigned under the Financial Services Act 2013 (FSA), IFSA and DFIA, as the case may be, unless otherwise defined in this policy document.

- 5.2 For the purpose of this policy document –

“**S**” denotes a standard, an obligation, a requirement, specification, direction, condition and any interpretive, supplemental and transitional provisions that must be complied with. Non-compliance may result in enforcement action;

“**G**” denotes guidance which may consist of statements or information intended to promote common understanding and advice or recommendations that are encouraged to be adopted;

“**Islamic financial institution**” or “**IFI**” means –

- (a) a licensed Islamic bank;
- (b) a licensed takaful operator and professional retakaful operator;
- (c) a licensed bank or licensed investment bank approved under section 15(1)(a) of the FSA to carry on Islamic banking business; and
- (d) a prescribed institution approved under section 33B(1) of the DFIA to carry on Islamic financial business;

“**obligor**” means a person who has a liability or obligation owed to a pledgee; and

“**third party pledgor**” refers to a third party who pledges either his asset or another party’s asset as a collateral to fulfil the liability or obligation of an obligor owed to a pledgee.

5.3 A glossary of terms used in this policy document is set out in Appendix 2.

6. Related legal instruments and policy documents

6.1 This policy document must be read together with other relevant legal instruments, policy documents or guidelines that have been issued by the Bank.

PART B SHARIAH REQUIREMENTS AND OPTIONAL PRACTICES**7. Compliance with this Part**

- S 7.1 An IFI which uses the *rahn* contract for its products and services must ensure that such products and services are in compliance with Part B of this policy document.

8. Definition

- S 8.1 *Rahn* refers to a contract where a party, as pledgor (*rahin*) pledges an asset as collateral (*marhun*) to another party, a pledgee (*murtahin*) to fulfil an obligor's liability or obligation (*marhun bih*) owed to the pledgee in the event of default of such obligor.

9. Nature

- S 9.1 The inherent nature of *rahn* is the assurance that the liability or obligation (*marhun bih*) owed by the obligor to the pledgee will be fulfilled in the event of a default as agreed in the terms and conditions of *rahn*.
- S 9.2 *Rahn* is binding on the pledgor upon entering into the contract. The pledgor does not have the right to revoke the *rahn* contract without the consent of the pledgee.
- S 9.3 Terms and conditions that have been mutually agreed upon and are consistent with Shariah principles shall be binding on the pledgor and pledgee.

10. Components of a *rahn* contract

- S 10.1 A *rahn* contract shall consist of the following components:
- (a) the pledgor and pledgee (collectively referred to as contracting parties);
 - (b) the offer (*ijab*) and acceptance (*qabul*) to enter into the *rahn* contract; and
 - (c) the subject matter of the *rahn* contract.

11. Contracting parties

- S 11.1 The contracting parties in a *rahn* contract shall, at a minimum, comprise a pledgor and a pledgee.
- G 11.2 The pledgor in the *rahn* contract may be the obligor or a third party.
- S 11.3 A contracting party shall be a natural person or legal entity that must have the legal capacity¹ to enter into the *rahn* contract.

¹ From Shariah perspective, legal capacity of a natural person is defined as the capacity to assume rights and responsibilities and capacity to give legal effect to his action. Among the important conditions are that the person must possess sound mind and the capacity to distinguish between what is harmful or beneficial to one's interests. The legal capacity of a

- G 11.4 Any party to the *rahn* contract may enter into the contract through an agent (*wakil*).

12. Offer (*ijab*) and acceptance (*qabul*)

- S 12.1 The *rahn* contract must be entered into through an offer and acceptance between the contracting parties.
- G 12.2 The offer and acceptance may be expressed orally, in writing or by any other methods recognised by Shariah.

13. Subject matter of *rahn*

- S 13.1 The subject matter of the *rahn* contract shall be –
- (a) a collateral (*marhun*) that is recognized by Shariah; and
 - (b) a liability or obligation (*marhun bih*) that arises from Shariah-compliant obligations and owed to the pledgee.
- S 13.2 The subject matter of the *rahn* contract must be determined upfront, made known to and accepted by the contracting parties.

14. Salient features of *rahn*

Type of collateral

- G 14.1 In relation to paragraph 13.1(a), a collateral in a *rahn* contract may be –
- (a) a physical asset that is used to carry on activities which are Shariah-compliant or otherwise; or
 - (b) a financial asset that is Shariah-compliant, partially Shariah compliant (referred to as mixed financial asset) or Shariah non-compliant.
- S 14.2 In relation to paragraph 14.1(b) –
- (a) where a mixed financial asset is used as a collateral, the core business of a person issuing such asset must be Shariah-compliant; and
 - (b) 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.

Ownership of collateral

- S 14.3 The collateral must be owned by –
- (a) the obligor;
 - (b) a third party; or
 - (c) the obligor and a third party.
- G 14.4 In relation to paragraph 14.3, the pledgor may pledge an asset that will

legal entity is defined as eligibility of an entity to acquire rights and assume responsibilities. In Malaysia, the legal capacity of both natural person and legal entity is governed by the Contracts Act 1950 and the Age of Majority Act 1971.

exist and will be owned in the future as collateral under a *rahn* contract.

- S 14.5 In the case where the pledgor pledges collateral that is wholly or partially owned by a third party, the pledgor must obtain the third party's consent to pledge such collateral.
- G 14.6 An undivided asset that is jointly owned by the pledgor with another third party may be pledged –
- (a) in proportion to the value of the pledgor's ownership; or
 - (b) as a whole in the event the undivided asset cannot be pledged in proportion to the value of the pledgor's ownership, provided that the consent of the third party is obtained.

Possession of collateral

- S 14.7 Unless a pledgee approves a delay in possession, the collateral shall be immediately possessed by the pledgee upon entering into *rahn* contract.
- S 14.8 Possession of the collateral by the pledgee shall be in the form of –
- (a) physical possession (*qabd haqiqi*); or
 - (b) constructive possession (*qabd hukmi*).
- G 14.9 The contracting parties may mutually agree for the possession of the collateral to be transferred to a third party for safe keeping.
- S 14.10 The collateral in a *rahn* contract shall be held on trust (*amanah*) by the person who is in possession of such collateral.
- S 14.11 In the event of a misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*), the person in possession of the collateral shall be liable and shall compensate for the damage or loss to such collateral.

Multiple pledgees

- S 14.12 If an asset is used as collateral with more than one pledgee under more than one *rahn* contract, the following requirements shall apply:
- (a) where the pledgees are ranked equally (*pari passu*) -
 - (i) the consent of all pledgees must be obtained; and
 - (ii) the pledgees' rights in the collateral will be shared in proportion to their respective debts; or
 - (b) where the pledgees are ranked in a way that the right of claim of a preceding pledgee is prioritized over a subsequent pledgee, the consent of the succeeding pledgee shall be obtained.

Return of Asset

- S 14.13 The pledgee or third party, as the case may be, shall return the collateral upon the obligor's fulfilment or discharge of his obligations unless the contracting parties agree to enter into a new *rahn* contract using the same collateral.

- G 14.14 Notwithstanding paragraph 14.13, the contracting parties may agree for the collateral to be kept by the pledgee for any subsequent obligation within a period agreed by the contracting parties.

Liability or obligation (*marhun bih*)

- S 14.15 In relation to paragraph 13.1(b), a liability or obligation owed to a pledgee shall be an obligation that must be fulfilled by the obligor.
- G 14.16 The liability or obligation may include those arising from any or a combination of the following:
- (a) a loan contract (*qard*);
 - (b) exchange contracts (*mu`awadat*);
 - (c) debt from the termination of sale contract;
 - (d) compensation on misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*); or
 - (e) compensation for breach of *wa`d*.
- S 14.17 The liability or obligation must –
- (a) already be established (*dayn lazim*); or
 - (b) will be established in the future (*ma ya`ul ila al-luzum*).

MANAGEMENT OF RAHN

15. Utilisation of collateral

- G 15.1 The collateral may be utilised by the owner with or without the consent of the pledgee.
- S 15.2 In relation to paragraph 15.1, the utilisation by the owner must not affect the rights of the pledgee on the collateral.
- S 15.3 The pledgee shall only utilise the collateral if the following requirements are met:
- (a) consent has been obtained from the owner;
 - (b) the liability or obligation owed by the obligor to the pledgee does not arise from a loan (*qard*) contract;
 - (c) utilisation by the pledgee is stipulated in the contract; and
 - (d) the period of utilisation by pledgee is specified.

16. Expenses in *rahn*

- S 16.1 Expenses in *rahn* are categorised into –
- (a) expenses incurred in relation to the maintenance² of collateral; and
 - (b) all other expenses incurred in relation to the *rahn* contract including safekeeping, documentation and liquidation of the collateral.
- S 16.2 Subject to paragraph 16.5, the owner of the collateral shall bear all

² This is maintenance that would have to be done even if the asset was not being used as the collateral in a *rahn* contract.

expenses under paragraph 16.1(a).

- G 16.3 In the event the owner fails to fulfil its obligations in accordance with paragraph 16.2, the pledgee may provide an advance on such expenses.
- S 16.4 In relation to paragraph 16.3, any expense borne by the pledgee under paragraph 16.1(a) shall be considered as a debt owed by the owner and the pledgee reserves the right to claim it from the owner.
- S 16.5 If the contracting parties mutually agree for the pledgee to bear the expenses under paragraph 16.1(a), the owner must reimburse the pledgee upon a claim made by the pledgee.
- S 16.6 Except otherwise agreed by the contracting parties, the pledgor shall bear all expenses under paragraph 16.1(b).

17. Liquidation of the collateral

- S 17.1 The liquidation of the collateral shall be carried out in accordance with the terms of the agreement entered into by the contracting parties.
- G 17.2 The pledgee may stipulate at the time of entering the *rahn* contract that the owner appoints him, his agent or a third party to perform liquidation process.
- S 17.3 In the absence of any stipulation as per paragraph 17.2, any person who performs the liquidation process must obtain the prior approval of owner.
- G 17.4 The liquidation of the collateral may be performed in whole or in part.
- S 17.5 In the event a mixed financial asset is liquidated, the liability or obligation owed to the pledgee must be fulfilled in any of the following manner:
(a) provided that the mixed financial asset can be segregated, only the Shariah compliant component of the mixed financial asset may be utilized; or
(b) in the event the mixed financial asset cannot be segregated, all of the proceeds may be utilized.
- S 17.6 The pledgee has the right to claim the proceeds from the liquidation of the collateral to settle the liability or obligation of the obligor.
- S 17.7 In the event the proceeds from the liquidation of the collateral are insufficient to fulfil the liability or obligation owed to the pledgee, the balance shall remain as a liability or obligation of the obligor.
- G 17.8 In relation to paragraph 17.7, the pledgee may either demand the balance from the obligor or waive his right to claim such balance.
- S 17.9 In the event that the proceeds from the liquidation of the collateral exceed the liability or obligation of the obligor, the excess amount shall be returned to the owner of the asset.

- G 17.10 If there is more than one collateral, the pledgee may stipulate any of the collateral to be liquidated to settle the liability or obligation of the obligor.
- G 17.11 In the event the collateral is in the form of money, the pledgee may directly claim the amount of the liability or obligation owed by the obligor from the collateral.

APPLICATION OF *RAHN* WITH OTHER CONTRACTS

18. Application of *rahn* in *qard*

- G 18.1 A *rahn* contract may be arranged with *qard*.
- S 18.2 The collateral shall be liquidated to recover payment of the outstanding debt amount arising from the *qard* in accordance with the terms and conditions agreed between the contracting parties.
- S 18.3 The pledgee shall not charge any fee that amounts to profit in the *rahn* contract.
- G 18.4 Notwithstanding paragraph 18.3, the pledgee may claim any direct cost.

19. Arrangement of *rahn* in *murabahah*, *tawarruq* and *bai` inah*

- G 19.1 A *rahn* contract may be arranged with *murabahah*, *tawarruq* or *bai` inah* contract.
- S 19.2 The collateral shall be liquidated to recover payment of any outstanding debt amount arising from the *murabahah*, *tawarruq* or *bai` inah* contract.
- G 19.3 In connection to paragraph 19.2, the contracting parties may agree to include a claim on actual costs incurred for the recovery of the outstanding debt payment from the collateral.

20. Arrangement of *rahn* in *istisna`*

- G 20.1 A *rahn* contract may be arranged with an *istisna`* contract.
- S 20.2 The collateral shall be liquidated to:
- (a) recover payment of any outstanding debt amount owed by the purchaser; or
 - (b) guarantee debt liability borne by the seller arising from the failure to deliver the *istisna`* asset.
- G 20.3 In connection to paragraph 20.2, the contracting parties may agree to include a claim on actual costs incurred for the recovery of the outstanding debt payment from the collateral.

21. Arrangement of *rahn* in *ijarah*

- G 21.1 A *rahn* contract may be arranged with *ijarah* contract.

- G 21.2 The contracting parties may agree to liquidate the asset for any or a combination of the following:
- (a) overdue rental;
 - (b) actual costs incurred for the recovery of the overdue rental; or
 - (c) any other amount due arising from the lessee's misconduct or negligence or breach of specified terms.

22. Arrangement of *rahn* with *kafalah*

- G 22.1 In a *kafalah* contract with recourse, the guarantor may request the guaranteed party to place an asset as collateral upon entry into the *kafalah* contract.
- G 22.2 In relation to paragraph 22.1, if the guaranteed party fails to settle the recourse amount within the agreed period, the guarantor may liquidate the collateral to settle the debt due.

23. Arrangement of *rahn* in *mudarabah*, *musyarakah* or *wakalah bi al-istithmar*

- S 23.1 A *rahn* contract shall not be arranged in a *mudarabah*, *musyarakah*, or *wakalah bi al-istithmar* contract to guarantee the capital or profit.
- S 23.2 Notwithstanding paragraph 23.1, if:
- (a) the *rabbul mal* (capital provider) take collateral from the *mudarib* (entrepreneur) in *mudarabah*;
 - (b) each partner is required to provide collateral in *musyarakah*; or
 - (c) the *muwakkil* takes collateral from the *wakil* (agent)
- the collateral can only be liquidated in the event of losses due to misconduct (*ta`addi*), negligence (*taqsir*) or breach of terms (*mukhalafah al-shurut*) of contract by the *mudarib*, partner(s) or *wakil*.

24. Arrangement of *rahn* in *wa`d*

- G 24.1 A *wa`d* contract may be arranged with a *rahn* contract.
- G 24.2 The pledgor may promise the pledgee to pledge the collateral in the future.

25. Arrangement of *rahn* with *takaful*

- G 25.1 *Takaful* coverage may be arranged in a *rahn* contract to provide *takaful* coverage on the asset in relation to:
- (a) maintenance; or
 - (b) safekeeping.
- S 25.2 In relation to paragraph 25.1, unless otherwise agreed by the contracting parties, the *takaful* coverage for:
- (a) maintenance of asset must be borne by pledgor; and
 - (b) safekeeping of asset must be borne by pledgee.

DISSOLUTION (*FASAKH*) AND COMPLETION (*INTIHA'*) OF THE *RAHN* CONTRACT

26. Dissolution of *rahn*

- S 26.1 The *rahn* contract shall dissolve under any of the following circumstances:
- (a) destruction of the collateral caused by force majeure or by actions other than misconduct (*ta`addi*) or negligence (*taqsir*) or breach of terms (*mukhalafah al-shurut*);
 - (b) termination of the *rahn* contract by the pledgee;
 - (c) termination or mutual cancellation (*iqalah*) of the contract that the *rahn* is pledged to; or
 - (d) disposal of the collateral by the owner with the consent of the pledgee, resulting in the transfer of ownership of the collateral through contracts such as sale, *hibah* and *waqf*.
- S 26.2 Notwithstanding paragraphs 26.1(a) and 26.1(d), the *rahn* contract shall not dissolve if there is a prior agreement between the contracting parties to repair, replace or substitute the destroyed or disposed collateral, as the case may be.
- S 26.3 Dissolution of *rahn* contract does not dissolve the liability or obligation of the obligor owed to the pledgee.
- S 26.4 In the event that there is demise, dissolution or loss of legal capacity of either contracting party as the case may be –
- (a) the *rahn* contract shall not dissolve; and
 - (b) the legal heirs or successors shall assume the rights and obligations of the contracting party that has demised, dissolved or lost the legal capacity.

27. Completion of *rahn*

- S 27.1 The *rahn* contract completes under the following circumstances:
- (a) settlement of the liability or obligation owed to the pledgee by the obligor, his guarantor or through the transfer of such liability or obligation to a third party (*hiwalah al-dayn*);
 - (b) set-off (*muqassah*) of full debt obligations between the obligor and the pledgee;
 - (c) liquidation of collateral to fulfil the obligation of the obligor; or
 - (d) the pledgee waiving the right (*ibra'*) to claim the whole obligation from the obligor.
- S 27.2 In the event that the *rahn* contract has completed under paragraphs 27.1(a), 27.1(c) or 27.1(d), the pledgee shall return the collateral to the owner.
- S 27.3 Upon completion of the *rahn* contract, the contracting parties shall be absolved from further contractual obligations.

PART C OPERATIONAL REQUIREMENTS**28. Governance and oversight**

- S 28.1 The requirements under this part complement the broad governance and oversight expectations specified under the relevant policy documents on governance issued by the Bank.
- S 28.2 While the broad governance and oversight principles are applicable to *rahn* contract, an IFI must observe specific requirements on governance requirements as outlined in this policy document to address the distinct risks associated with *rahn* transaction.
- S 28.3 An IFI must have sufficient understanding of its risk profile and ensure the availability of personnel with the appropriate knowledge and skills to implement *rahn* contract.

Board of Directors

- S 28.4 The Board of Directors of an IFI (the Board) must establish sound governance structure to facilitate effective oversight on the management and implementation of *rahn* contract. The adequacy of the governance structure shall commensurate with the nature, complexity and risk profile of *rahn* contract.
- S 28.5 The Board has overall responsibility for corporate governance, Shariah governance and Shariah compliance of an IFI. As such, the Board must –
- (a) approve the business and risk strategy of the IFI with regard to the application of *rahn* contract;
 - (b) approve and oversee the implementation of policies and procedures governing the application of *rahn* contract which must include the following aspects:
 - (i) eligibility criteria of collateral;
 - (ii) management of collateral;
 - (iii) utilisation of collateral;
 - (iv) monitoring of collateral;
 - (v) concentration of collateral;
 - (vi) redemption of collateral; and
 - (vii) liquidation of collateral;
 - (c) ensure that the internal policies and procedures remain relevant, current and effective in managing the overall operational conduct and risk profile of the *rahn* contract;
 - (d) ensure that appropriate internal controls, systems and infrastructure are in place to implement *rahn* contract in accordance with Shariah requirements;
 - (e) ensure that sufficient resources are in place and that the IFI has adequate and qualified personnel with sufficient knowledge and competency on the concept, application and risks associated with the *rahn* contract; and

- (f) ensure independent reviews³ are conducted regularly to assess compliance with the policy documents issued by the Bank and internal policies established by the IFI.

Shariah Committee

- S 28.6 The Shariah Committee has the responsibility to advise an IFI in ensuring its business, affairs and activities involving a *rahn* transaction comply with Shariah requirements. As such, the Shariah Committee must –
- (a) endorse the application of Shariah requirements in the relevant policies and procedures governing the *rahn* contract;
 - (b) review the terms and conditions stipulated in legal documentation and other documents⁴ and endorse that such terms and conditions are in compliance with Shariah;
 - (c) advise and provide clarification on relevant Shariah rulings, decisions or policy documents on Shariah matters issued by the Bank and, if relevant, any other authorities; and
 - (d) deliberate Shariah matters that are referred by Shariah review and Shariah audit and endorse any rectification measures that are needed to ensure that the *rahn* transaction complies with Shariah requirements.

Senior management

- S 28.7 The senior management has the responsibility to ensure that the business and operations of an IFI complies with Shariah requirements. As such, the senior management must –
- (a) establish policies, processes and procedures with regard to proper management of the *rahn* contract;
 - (b) develop and implement relevant internal systems, infrastructure and adequate mechanisms to identify, measure, control and monitor risk inherent in the *rahn* contract;
 - (c) ensure that the IFI monitors and has proper and adequate reporting of the *rahn* contract operations and performance;
 - (d) identify, assign and train key personnel with the appropriate skill set for *rahn* contract and ensuring that the roles and responsibilities are properly delegated to the relevant functions within the IFI;
 - (e) undertake regular reviews and monitoring compliance with the approved policies; and
 - (f) ensure timely disclosure of relevant information to the Board and the Shariah committee.

³ Independent review is undertaken by Shariah review function or compliance function.

⁴ Such as information published in promotional materials product manuals or other publications.

29. Structuring

Purpose

- S 29.1 An IFI must clearly specify –
- (a) the purpose of the financial product and services that apply *rahn* contract; and
 - (b) the subject matter of the *rahn* contract.
- S 29.2 An IFI must also ensure that the overall structure and outcome of the financial product and services do not contravene Shariah requirements as provided in this policy document.

Contracting parties

- S 29.3 An IFI shall ensure the contracting parties in *rahn* contract involve, at minimum, two parties namely the IFI and a customer or third party.
- S 29.4 The contracting parties shall be clearly identified as the pledgor or pledgee in line with the purpose of the *rahn* contract.
- G 29.5 In relation to paragraphs 29.3 and 29.4, the pledgor and the pledgee may be identified in the following manner:

No	Scenario	Pledgor	Pledgee	Obligor
(a)	Customer pledges his collateral to secure his obligation to the IFI	Customer	IFI	Customer
(b)	Customer pledges another party's collateral to secure his obligation to the IFI	Customer	IFI	Customer
(c)	Third party pledges his collateral to secure a customer's obligation to the IFI	Third party	IFI	Customer
(d)	Third party pledges collateral owned by another party to secure customer's obligation to the IFI	Third party	IFI	Customer

Illustration on the identification of pledgor and pledgee in *rahn* contract is provided under Appendix 3.

- S 29.6 Where applicable, an IFI shall identify the person appointed as an agent to appraise, safe-keep, or liquidate the collateral.

Offer and Acceptance

- S 29.7 In entering into a *rahn* contract, an IFI must ensure that an offer and acceptance is clearly evidenced by appropriate documentation or record.

Asset as collateral

- S 29.8 An IFI shall identify and ensure the asset used as collateral is recognised by Shariah and is in line with the internal policy on eligibility criteria of collateral as specified in paragraph 28.5(b).
- G 29.9 An IFI may consider the following aspects in developing the internal policy on eligibility criteria of collateral:
- (a) marketability of collateral;
 - (b) measurability of collateral value;
 - (c) time taken for liquidation of collateral;
 - (d) correlation between collateral value and credit quality of customer; and
 - (e) restriction or priority of claims on collateral.
- G 29.10 In relation to paragraph 14.2(a), an IFI may refer to the list of Shariah-Compliant Securities by the Shariah Advisory Council of the Securities Commissions of Malaysia or other Shariah screening criteria set out by the respective regulatory or supervisory authority that are in line with the Shariah resolutions by Shariah Advisory Council of Bank Negara Malaysia or Shariah Advisory Council of Securities Commissions of Malaysia to ascertain the core business of companies issuing financial asset e.g. shares.

Utilisation of collateral

- S 29.11 An IFI shall ensure the utilisation of collateral is in line with the internal policy on utilisation of collateral as specified in paragraph 28.5(b).
- S 29.12 At minimum, an IFI shall include the following in the internal policy on utilisation of collateral:
- (a) use or purpose of the utilisation of collateral;
 - (b) rights and responsibilities of contracting parties in the utilisation of collateral; and
 - (c) tenure of the utilisation of collateral.

Expenses of collateral

- S 29.13 An IFI must ensure the expenses incurred in relation to *rahn* contract are documented.
- S 29.14 An IFI shall develop a list of permissible expenses borne by the IFI, customer or third party pledgor, as the case may be.

- S 29.15 In relation to paragraph 29.14, where the expenses are borne by the customer or third party pledgor, an IFI shall ensure the expenses are based on the direct costs of the identified services, benefits or privileges that is directly related to the pledging of collateral, without any profit or mark-up element. Such expenses must be –
- (a) actual or estimated amount;
 - (b) identifiable; and
 - (c) measurable.

Question 2

- (a) Please highlight the implication of the proposed requirements on expenses to the existing product offerings in particular where current fees and charges borne by the customers or third party pledgor are beyond direct cost.
- (b) Please identify the type of fees and charges borne by customers or third party pledgor that are charged beyond direct cost and the practical measures to ensure compliance to the proposed requirement in this concept paper.

Redemption and liquidation of collateral

- S 29.16 An IFI shall ensure the redemption and liquidation of collateral are in line with the internal policy on redemption and liquidation of collateral as specified in paragraph 28.5(b).
- S 29.17 At minimum, an IFI shall include the following in the internal policy on redemption of collateral:
- (a) events of redemption of collateral e.g. fulfilment of customer's obligation with the IFI such as full settlement of outstanding financing; and
 - (b) where applicable, process and procedure on redemption of physical collateral that is safe-kept by the IFI as follows:
 - (i) verification that event of redemption has been fulfilled;
 - (ii) verification the person redeeming the collateral is the pledgor or any person authorised by the pledgor; and
 - (iii) treatment on unredeemed collateral.
- S 29.18 With respect to the internal policy on liquidation of collateral, the IFI must ensure that at minimum, the internal policy includes the following:
- (a) events of liquidation of collateral e.g. default, insolvency or bankruptcy of customer;
 - (b) process or method of liquidation of collateral e.g. public auction or private offer;
 - (c) methodology of valuation of collateral for the purpose of the liquidation of such collateral;
 - (d) proportionality of collateral value to be liquidated i.e. wholly or partially in line with paragraphs 17.4;
 - (e) notification to the pledgor or owner of the collateral as the case may be, prior liquidation of collateral including –
 - (i) method of notification e.g. letter, notice at branch,

- (ii) website announcement or others; and
- (ii) duration of notification e.g. 2 weeks before liquidation of collateral; and
- (f) treatment and disclosure to customer on excess or shortfall of the liquidated collateral to settle the customer's liability or obligation owed to the IFI.

S 29.19 An IFI must ensure the redemption and liquidation of collateral are documented.

Documentation

S 29.20 An IFI must develop comprehensive and legally enforceable documentations⁵ that clearly stipulate the terms and conditions in the *rahn* contract which are in compliance with Shariah and regulatory requirements.

S 29.21 At minimum, an IFI must ensure the legal documentation reflects the salient features of *rahn* contract as follows:

- (a) contractual relationship between the various contracting parties;
- (b) rights, roles and responsibilities of the contracting parties in the *rahn* contract;
- (c) description of collateral;
- (d) liability or obligation secured by collateral;
- (e) tenure of *rahn* contract;
- (f) terms on redemption and liquidation of collateral; and
- (g) where applicable –
 - (i) expense claimable from customer or third party pledgor including the corresponding payment terms;
 - (ii) description of trigger events that requires IFI's mitigation action in relation to paragraph 30.16; and
 - (iii) rights of the IFI to undertake mitigation action upon occurrence of the trigger event in relation to paragraph 29.21(g)(ii).

S 29.22 Where applicable, an IFI must ensure the relevant consent for the purpose of *rahn* contract is documented including the consent from –

- (a) a third party or another party who is the owner of the collateral that is used to secure customer's liability or obligation owed to the IFI;
- (b) the joint owners of collateral in the event the collateral cannot be pledged proportionately;
- (c) the IFI in the event –
 - (i) customer or third party pledgor utilises the collateral as the case may be;
 - (ii) delayed possession of collateral; and
 - (iii) the collateral's ownership will be transferred *via* sale,

⁵ Legally enforceable documentations covers contracts, agreements, master agreements and commercial documents such as invoices, delivery notes, trade confirmation and other generally acceptable documents in trade and financial transactions.

- hibah or waqf*;
- (d) the customer or third party pledgor in the event the –
 - (i) IFI utilises the collateral; and
 - (ii) terms on appointment of pledgee, his agent or any other party to perform the liquidation process is absent to liquidate the collateral;
 - (e) the pledgees if the collateral is used to secure multiple obligations where claims to the collateral is ranked *pari passu* and right to each other; and
 - (f) the succeeding pledgees if the collateral is used to secure multiple liability or obligations where the pledgees are ranked in a way that the right of claim of a preceding pledgee is prioritised over a subsequent pledgee.

S 29.23 An IFI shall adequately clarify or translate the use of Arabic terminology in the legal documents to facilitate understanding of the contracting parties. Any translation shall be consistent with the rulings of SAC.

Question 3

- (a) Please highlight the adequacy of the proposed requirements on the documentation. Where the proposed requirements are inadequate or less relevant, please provide specific proposal for enhancement.
- (b) Please identify any potential operational and/or legal impediment that may hinder the current documentation to meet the expectations outlined in this exposure draft.
- (c) Where challenges and impediments are identified under Question 3(b), please provide the proposed measures to ensure the compliance to the policy document.

30. Risk management

- S 30.1 An IFI must establish comprehensive risk management policies and procedures, processes, systems and internal control in line with the IFI's risk appetite, throughout the life cycle of the *rahn* contract and shall include the following:
- (a) the identification, measurement, monitoring, control and reporting of risks including, where applicable, risk arising from movement of the collateral value or change in quality of the collateral accepted;
 - (b) the formulation of appropriate valuation methodology of the collateral and as applicable, establishing controls to ensure valuations are obtained in an independent and objective manner;
 - (c) the establishment of risk exposure limits including concentration limits on the collateral, as applicable, in line with the IFI's risk appetite; and
 - (d) the risk mitigation techniques including establishing –
 - (i) appropriate eligibility criteria and review process in identifying a list of approved collateral type to be used in the *rahn* contract;
 - (ii) where applicable, clear segregation of roles and duties to

- (iii) be performed by appointed agents to safe-keep or liquidation of collateral; and where applicable, contingency plan on the safe-keeping of physical collateral.

Concentration risk

- S 30.2 An IFI shall ensure that the collateral accepted is not concentrated to a particular type of asset, single geographical location or others. In this regard, the IFI must establish internal policy governing concentration risk on collateral in line with paragraph 28.5(b).
- G 30.3 In relation to paragraph 30.2, the internal policy governing concentration risk on the collateral may include:
- (a) setting out internal limits (e.g. collateral concentration limit on specific type of asset, a single geographical location or others) that are reflective of the IFI's risk appetite and risk bearing capacity; and
 - (b) monitoring and reporting mechanism to ensure adherence to the internal limit.
- S 30.4 An IFI shall have in place adequate verification process and procedures to ensure collateral accepted is in line with the internal policy on collateral in paragraphs 28.5(b) and 30.3.
- G 30.5 An IFI may appoint another party to support the verification process of the collateral⁶.
- S 30.6 An IFI must ensure the value of the acceptable collateral is sufficient to fulfil customer's liability or obligation in accordance with the IFI's risk management strategies.
- S 30.7 In relation to paragraph 30.6, an IFI must take into consideration the value of collateral that is permissible to fulfil customer's liability or obligation as provided in paragraphs 17.5.
- S 30.8 An IFI shall identify and ensure the valuation methodology is appropriate for the type of collateral accepted.

Management of the collateral

- S 30.9 An IFI must ensure the collateral is managed in accordance to the terms of the *rahn* contract.
- S 30.10 In relation to the paragraph 28.5(b) and 30.9, an IFI must establish internal policy on the management of collateral. At minimum, the IFI shall include the following in its internal policy:
- (a) identification of collateral that requires safe-keeping by the IFI or

⁶ For example, the IFI may appoint a property valuer to appraise the value of property as collateral.

- third party e.g. safe-keeping of collateral documentation or safe-keeping of physical collateral; and
 - (b) roles and responsibility of the person involved in the management of the collateral.
- S 30.11 In relation to paragraph 30.10 and where an IFI safe-keeps a physical collateral, an IFI must ensure the internal policy on management of collateral includes the following:
 - (a) location of safe-keeping;
 - (b) maintenance of the physical collateral; and
 - (c) contingency plan –
 - (i) identification of events that require contingency plan e.g. force majeure or theft; and
 - (ii) mechanism to manage the events of contingency plans e.g. secondary safe-keeping location.
- S 30.12 In relation to paragraph 30.10 and where a third party safe-keeps physical collateral, an IFI must –
 - (a) document the safe-keeping arrangement including the appointment of third party to safe-keep the collateral; and
 - (b) monitor the movement of the collateral.

Monitoring of the collateral

- S 30.13 An IFI shall assess and monitor the value of collateral to ensure the collateral value is sufficient to cover customer's obligation to the IFI in accordance to the IFI's risk management strategies.
- S 30.14 In relation to paragraph 28.5(b) and 30.13, an IFI must establish internal policy on monitoring of collateral. At minimum, the internal policy shall include the following:
 - (a) scope of monitoring e.g. value of collateral, physical condition of collateral and legal enforceability of the collateral documentation;
 - (b) method of monitoring e.g. monitor changes in market value, physical inspection on collateral or monitor changes in laws and regulation impacting legal enforceability of the collateral documentation; and
 - (c) frequency of monitoring.
- G 30.15 An IFI may appoint an agent to monitor the collateral.
- S 30.16 An IFI must identify the following corresponding to the result of monitoring of collateral:
 - (a) trigger events that invoke IFI's mitigation actions e.g. trend in collateral value or marketability of collateral; and
 - (b) mitigation actions arising from the trigger events e.g. requiring additional or substitution of collateral from customer or third party pledgor.

31. Business and market conduct

- S 31.1 An IFI shall ensure that the *rahn* contract is conducted in a fair, transparent, responsible and professional manner.

Fair dealings

- S 31.2 An IFI must ensure the internal policies and procedures on business and market conduct for the *rahn* contract reflect transparency and fair dealing practices to all contracting parties. At minimum, the IFI shall include the following in its internal policies and procedures:
- (a) information provided is accurate, clear, not misleading and provided in timely manner to contracting parties; and
 - (b) fees and charges are in line with paragraphs 16 and 29.13 to 29.15.

Disclosure of information

- S 31.3 An IFI shall provide adequate and relevant information to the customer or third party pledgor in product disclosure sheet and any other relevant materials with regard to the *rahn* contract at the pre-contractual stage as follows:
- (a) in the event the IFI utilises the collateral, the IFI shall disclose the terms on the utilisation to customer or third party pledgor including:
 - (i) use or purpose of the utilisation of collateral;
 - (ii) rights and responsibilities of contracting parties in the utilisation of collateral; and
 - (iii) tenure of the utilisation of collateral; and
 - (b) for *Ar Rahnu*⁷ product, the IFI shall disclose the following:
 - (i) the roles and responsibilities of the contracting parties;
 - (ii) the key terms and conditions of the *rahn* contract including arrangement with other Shariah contracts or concepts;
 - (iii) expenses, if applicable;
 - (iv) duration of the *rahn* contract; and
 - (v) terms on redemption and liquidation of collateral.

Question 4

Where applicable, highlight the gap between current practice and the proposed information disclosure requirements in this exposure draft. Please indicate the proposed measures to ensure the proposed requirements are met.

⁷ Based on market practice, *Ar Rahnu* is a financing product where *qard* is secured by collateral that is safe kept by the IFI with fee.

32. Financial disclosure

- S 32.1 An IFI shall maintain adequate accounting and other records in a timely manner which will sufficiently enable the preparation and reporting of financial statements that give a true and fair view.
- S 32.2 An IFI shall not disclose the *rahn* contract as financing and receivables in the financial statement⁸.
- S 32.3 In relation to paragraph 32.2 and with respect to *Ar Rahn* product, an IFI must disclose –
- (a) a *qard* (loan) as financing and receivables in the financial statement; and
 - (b) notes to the financial statements the amount of *qard* that is secured by collateral.

Question 5

Please identify any potential implication that might arise following the financial disclosure requirements as provided in this exposure draft. What are the measures that can be proposed to mitigate such implication?

33. Submission requirement

- S 33.1 An IFI that offers financial product or service that applies *rahn* contract is required to submit implementation plan to comply with this policy document to Jabatan Perbankan Islam and Takaful no later than six (6) months after the issuance date of the final policy document.
- S 33.2 The Board and the Shariah Committee must respectively approve and endorse the IFI's implementation plan to ensure compliance with this policy document by the effective date i.e. eighteen months after the issuance date of the finalised policy document.
- G 33.3 In relation to paragraph 33.2, the Bank expects the IFI to –
- (a) review and confirm existing policies, procedures and internal limits;
 - (b) clarify roles and accountabilities;
 - (c) where applicable, undertake enhancement to the existing system to address risks associated with the *rahn* contract; and
 - (d) establish appropriate monitoring and reporting mechanisms to ensure compliance with the requirements.
- S 33.4 The IFI must immediately notify Jabatan Perbankan Islam dan Takaful if the IFI identifies any cause that will affect full compliance of the requirements in this document by the effective date.

⁸ Subject to the relevant MFRS.

APPENDICES

Appendix 1 Legitimacy of the *rahn* contract

- i. The legitimacy of the *rahn* contract is derived from the Quran and founded on the Sunnah of Prophet Muhammad (peace be upon him), and further supported by the consensus of Muslim jurists (*ijma`*).

The Quran

- ii. The following verse of the Quran implies the permissibility of the *rahn* contract:

وَإِنْ كُنْتُمْ عَلَى سَفَرٍ وَلَمْ تَجِدُوا كَاتِبًا فَرِهَانٌ مَّقْبُوضَةٌ فَإِنْ أَمِنَ بَعْضُكُمْ بَعْضًا فَلْيُؤَدِّ الَّذِي أُؤْتِمِنَ أَمَانَتَهُ وَلْيَتَّقِ اللَّهَ رَبَّهُ وَلَا تَكْتُمُوا الشَّهَادَةَ وَمَنْ يَكْتُمْهَا فَإِنَّهُ آثِمٌ قَلْبُهُ وَاللَّهُ بِمَا تَعْمَلُونَ عَلِيمٌ

“If you are on a journey and cannot find a scribe to write the document, then [transact your business on the security of] a pledge in hand, but if you decide to trust one another, then let the one who is trusted fulfil his trust; let him be mindful of God, his Lord. Do not conceal evidence: anyone who does so has a sinful heart, and God is fully aware of everything you do” (Surah al-Baqarah, 2: 283).

The Sunnah of Prophet Muhammad (peace be upon him)

- iii. The following *hadith* implies the general permissibility of the *rahn*.

عَنْ عَائِشَةَ رَضِيَ اللَّهُ عَنْهَا أَنَّ النَّبِيَّ صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ اشْتَرَى طَعَامًا مِنْ يَهُودِيٍّ إِلَى أَجَلٍ وَرَهْنَهُ دِرْعًا مِنْ حَدِيدٍ.

“Aishah (r.a.) narrated that the Prophet (peace be upon him) bought some grain from a Jew on deferred payment, and he pledged steel armour as security for it” (Bukhari and Muslim).

The Consensus of Muslim Jurists (*Ijma`*)

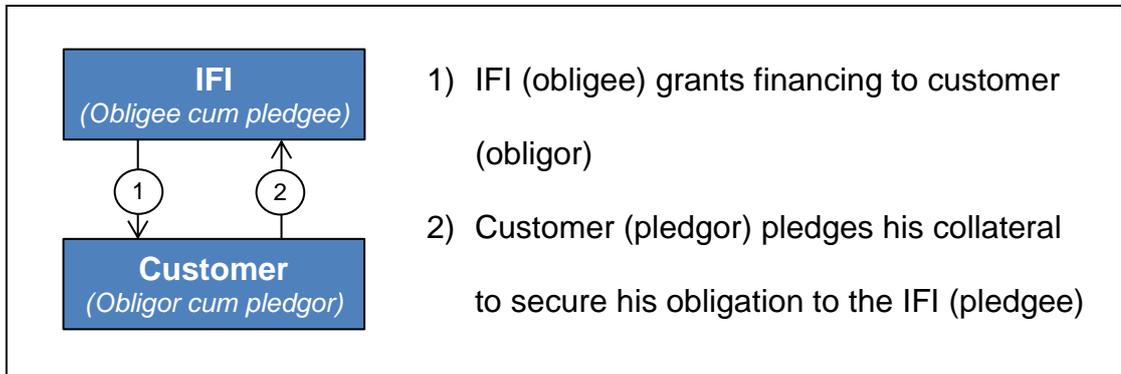
- iv. Muslim jurists have reached *ijma`* on the permissibility of the *rahn* in general, as cited by Ibn Qudamah (*Al-Mughni* 4/362).

Appendix 2 Glossary

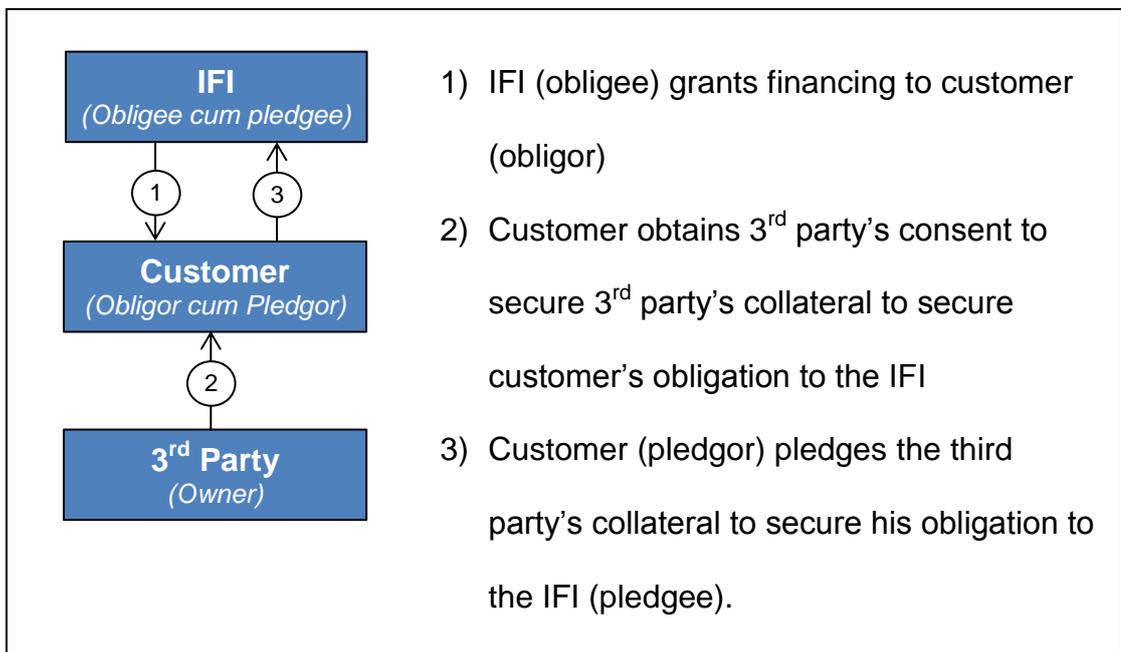
Terms	Definition
<i>Hiwalah al-dayn</i>	Assignment/transfer of debt from the liability of the original debtor to the liability of a third person so that the original debtor becomes free of liability
<i>Ibra'</i>	Rebate
<i>Kafalah</i>	A contract of conjoining guarantor's liability to the guaranteed party's liability in a way that the obligation of the guaranteed party is established as a joint liability of the guarantor and guaranteed person
<i>Murabahah</i>	A sale and purchase of an asset where the acquisition cost and the mark-up are disclosed to the purchaser
<i>Qabd haqiqi</i>	Physical possession. It refers to a state where a person has actual possession and the rights to control an asset
<i>Qabd hukmi</i>	Constructive possession. It refers to a state where a person does not have actual possession but has the legal rights to control an asset
<i>Tawarruq</i>	Two sale and purchase contracts where the first involves the sale of an asset to a purchaser on a deferred basis and the subsequent sale involves sale of the asset to a third party on a cash basis
<i>Wa`d</i>	An expression of commitment given by one party to another to perform certain action(s) in the future

Appendix 3 Illustration on the identification of parties in the *rahn* contract

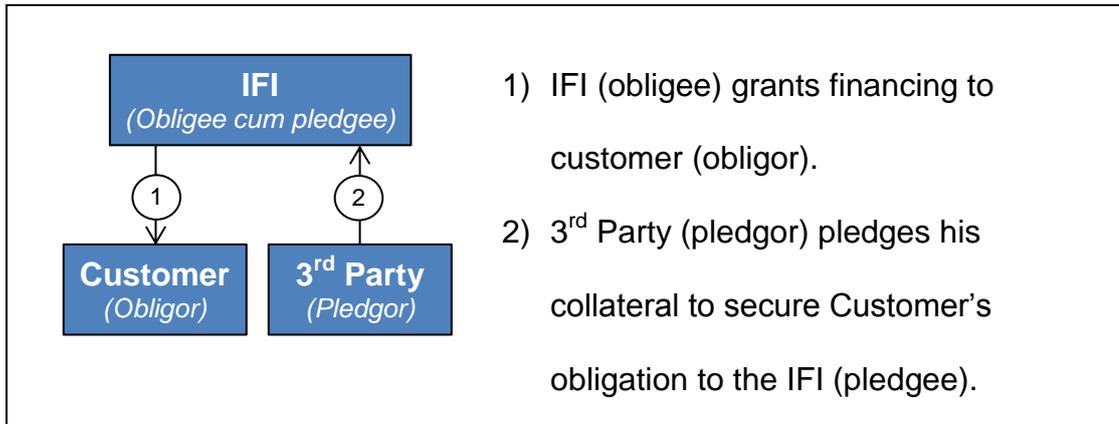
A. Customer pledges his collateral to secure his obligation to the IFI



B. Customer pledges another party's collateral to secure his obligation to the IFI



C. Third party pledges his collateral to secure a customer’s obligation to the IFI



D. Third party pledges collateral owned by another party to secure customer’s obligation to the IFI

