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PART A: PRELIMINARY

INTRODUCTION

1. The compliance with Shariah principles is an integral feature in the Islamic banking and finance. Shariah deliberation and interpretation process is imperative in assuring such compliance. Harmonisation of Shariah interpretations will underpin a comprehensive and wholesome development of this sector. It will strengthen the regulatory and supervisory oversight of the industry and will also foster and nurture a pool of competent Shariah advisers.
2. Among initiative to achieve the above objectives, Bank Negara Malaysia has amended the Central Bank of Malaysia Act 1958 to enhance the role and functions of its Shariah Advisory Council of Bank Negara Malaysia (SAC). This amendment has accorded the SAC as the sole Shariah authority in Islamic finance. To serve this purpose, the SAC could be referred to by the court or arbitrator in disputes involving Shariah issues in Islamic banking, finance and takaful cases.
3. In light of the above, Bank Negara Malaysia has prepared the ***Resolutions of Shariah Advisory Council of Bank Negara Malaysia*** that disseminate relevant Shariah resolutions issued by the SAC.

OBJECTIVE

4. The guide aims at achieving the following:
 - (i) to disseminate Shariah resolutions issued by the SAC

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- (ii) to facilitate Islamic financial institutions in developing financial products by providing reference in Shariah matters ; and
- (iii) to promote harmonisation of Shariah interpretation in Islamic finance industry.

SCOPE OF APPLICATION

5. The Shariah resolutions shall be applicable to all Islamic financial institutions regulated and supervised by Bank Negara Malaysia. The reference to "Islamic financial institution" for the purpose of this guide means:
 - (i) an Islamic bank licensed under the Islamic Banking Act 1983 (IBA);
 - (ii) a financial institution licensed under the Banking and Financial Institutions Act 1989 (BAFIA) which participates in the Islamic Banking Scheme (BAFIA IBS bank);
 - (iii) a development financial institution prescribed under the Development Financial Institutions Act 2002 (DFIA) which carries on Islamic Banking Scheme; and
 - (iv) a takaful operator registered under the Takaful Act 1984 (TA).

PART B: RESOLUTIONS OF SHARIAH ADVISORY COUNCIL OF BANK NEGARA MALAYSIA

MUDHARABAH¹

Background

6. *Mudharabah* contract is a profit sharing contract between the entrepreneur and the capital provider. *Mudharabah* contract is applied in deposit taking arrangement such as current account, savings account and investment account. *Mudharabah* contract is also applied in inter-banks investment and Islamic bonds. In takaful industry, *mudharabah* contract is used as one of the operational model as well as being applied for investing the takaful funds.

Issue

Floating Islamic Negotiable Instrument of Deposit (INID)

7. Bank Negara Malaysia has introduced floating INID with the following mechanisms:
- (i) A customer deposits money into a bank;
 - (ii) The bank accepts customer's deposit and issues INID to the customer as an evidence of receiving deposit;
 - (iii) INID is tradable in the secondary market;
 - (iv) On maturity, the customer or holder of INID returns it to the bank and receives the principal value of INID and declared dividend; and

¹ *Mudharabah* means a contract whereby a capital owner provides his capital to be used by an entrepreneur. Any profit derived from the business is shared by both parties according to their pre-agreed conditions. Any financial loss shall be borne entirely by the capital owner while loss of effort shall be borne by the entrepreneur.

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- (v) The declared dividend is the dividend derived from the investment of the deposit.
8. The term “floating” refers to the characteristic of product that changes in value based on the dividend declared by the bank from time to time. The question is whether the investment mechanism mentioned above is in line with *mudharabah* principle.

Resolution

9. The Council in its 3rd meeting held on 28th October 1997/ 26 Jamadil Akhir 1418, resolved that Floating Islamic Negotiable Instrument of Deposit (INID) using *mudharabah* concept is permissible and can tradable in the secondary market.

***Mudharabah* Current Account**

10. There was a proposal from Islamic banking institution to introduce *mudharabah* current account product. This account is different from the *wadiah* current account in which the payment of dividend to customers is at the sole discretion of the bank. In this *mudharabah* current account, customers have right to share any profits generated in proportion to a pre-agreed ratio by both parties at the point of opening the current account. Besides, customers will be in the position to enjoy any additional facilities offered by the bank such as takaful coverage scheme. The Shariah issue here is whether *mudharabah* current account mechanism as mentioned above is in line with *mudharabah* contract.

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Resolution

11. The Council in its 4th meeting held on 14th February 1998/ 16th Syawal 1418, resolved that it is permissible to use *mudharabah* contract in current account product and the bank can offer other additional facilities to customers which are attached to the product, such as takaful scheme.

Wadiah and Mudharabah Current Account

12. Islamic banking institution has proposed to offer current account based on *wadiah yad dhamanah* and *mudharabah* concepts. Under these principles, the bank acts as a trustee and entrepreneur while the customer acts as a depositor and capital provider respectively.
13. Both parties agree on a ratio of profit sharing which must be disclosed and agreed upon by both parties at the time of opening the account. The guarantees on the deposit will only be given if the account's balance does not satisfy the conditions of profit sharing. However, if the account balances comply with the conditions of profit sharing, the customers will have to bear all the risk of financial losses (no guarantees on deposit) since the contract has now changed to *mudharabah*.
14. The issue is whether the current account mechanism of combining two types of contracts, *wadiah* and *mudharabah* is permissible in Shariah.

Resolution

15. The Council in its 5th meeting held on 30th April 1998/ 3rd Muharram 1419 resolved that current account product based on the combination of two contacts, *wadiah* and *mudharabah* is permissible in Shariah.

Indicative Rate in Islamic Banking

16. An indicative rate was introduced as an indicator to investors and depositors who want to invest or deposit their money in Islamic banking institution.
17. The indicative rate uses profit rate declared by every Islamic banking institution for assets they hold as the basis of computation. In *mudharabah* contract, the actual profits distributed will only be known after the contract has matured based on an pre-agreed profit-sharing ratio.
18. In the context of Islamic banking in Malaysia, generally, most of the investment portfolios are in the form of fixed return such as financing based of *bai` bithaman ajil* concept and investment in securities based on *bai` dayn* concept. Hence, the bank could determine from the very beginning the expected returns for a certain period.
19. Therefore, for an investor invests his money for certain period of time, the profit distribution (according to an agreed profit sharing ratio) should appropriately be made according to the bank's expected profit.
20. A proposal was made that the profit rate to be given to investors may be determined at the time when the contract is executed if the expected profit rate is known based on the asset portfolios held. The issue raised here is whether it is permissible in Shariah to indicate profit rate in *mudharabah* contract.

Resolution

21. The Council in its 9th meeting held on 25th February 1999/8th Zulkaedah 1419 resolved that the application of indicative profit in Islamic banking *mudharabah* contract is permissible based on the following conditions:
 - (i) The Islamic banking indicative profit rate is only regarded as an reference of the expected return that will be received; and

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- (ii) If the actual profit rate received by Islamic banking at the time the contract matured is different from the indicative profit rate agreed at the inception of the contract, the profit rate paid to investor must be based on the actual profit rate.

***Mudharabah* Investment Certificate**

22. The need for collateral in certain financing is common in banking activities whether the financing is conventional or Islamic based. Asset used as collateral is in various forms including real asset and financial asset. Therefore, Islamic banking institution raised an issue whether Shariah compliant financial asset like *Mudharabah* General Investment Certificate can be used as collateral in conventional financing.

Resolution

23. The Council in its 9th meeting held on 25th February 1998/ 8th Zulkaedah 1419 resolved that *Mudharabah* General Investment Certificate can be used as security (collateral) for Islamic financing. However if the certificate is used as collateral for conventional financing, it is the responsibility of the customers themselves and it is beyond the jurisdiction of Islamic banking institution.

Administrative Costs in *Mudharabah* Deposit Account

24. *Mudharabah* deposit account is an Islamic financial product offered in the market. There is a proposal from Islamic banking institution to charge administrative cost on depositors (sahibul mal) of *mudharabah* deposit account. The issue is whether the bank as *mudharib* can charge administrative cost on depositors from the Shariah perspective.

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Resolution

25. The Council in its 16th meeting held on 11th November 2000/12 Sya`aban 1421 resolved that bank cannot impose administrative cost on depositors (sahibul mal) in *mudharabah* deposit account. If the bank requires additional amount to cover the administrative cost, it should be taken into account when deciding on the profit sharing ratio as agreed by both parties.

Collateral in *Mudharabah*

26. Collateral agreement is one of the products proposals in diversifying the Islamic Accepted Bill product. The transfer of fund between a funding bank and a receiving bank is proposed to be done based on *mudharabah* as follows:

- (i) The investment from Bank A (fund provider) to Bank B (fund recipient) is done based on profit sharing arrangement;
- (ii) The difference between this contract and the normal *mudharabah* contract is the existence of security as collateral to be used if receiving bank fails to return the fund (capital) on maturity;
- (iii) The total amount of investment is equivalent or less than the market value of the pledged security;and
- (iv) The profit ratio is determined at the execution of the contract.

27. The Shariah issue is whether the collateral on investment capital is permissible in *mudharabah* contract.

Resolution

28. The Council in its 18th meeting held on 12th April 2001/ 22nd Muharram 1422 resolved that collateral in *mudharabah* contract is not permissible since it is against the *mudharabah* concept.

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Intra-Day Transaction

29. Intra-day transaction was introduced in Islamic Inter-Bank Money Market. Intra-day transaction refers to investment of fund based on *mudharabah* with its maturity and settlement is done on the same day. The objective of intra-day transaction is to facilitate the financial needs of market participants so that their position can be stabilized at certain point of time.
30. The approach used in intra-day transaction is the same as inter-bank *mudharabah* investment. The difference is only in terms of maturity period, whereby the inter-bank *mudharabah* investment's maturity period is between overnight to one year. On the other hand, intra-day transaction has a short maturity period between 9.00 a.m. until 4.00 p.m. on the same day.
31. The Shariah issue raised is whether the short investment maturity period can affect the validity of certain *mudharabah* contract.

Resolution

32. The Council in its 19th meeting held on 20th August 2001/ 1st Jamadil Akhir 1422 resolved that intra-day transaction which refers to investment of fund based on *mudharabah* in Islamic money market is permissible.

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MUSHARAKAH MUTANAQISAH²

Background

33. The Shariah recognises various contracts of muamalat such as sales, partnership, leasing and others. However the current practice of Islamic finance has largely focused on the application of sales concept without seriously looking at other feasible new alternatives. Therefore, there is a need to explore other innovative Islamic financial products based on the contracts like partnership and leasing as alternatives to the sale contracts. Product innovation which departs from the existing predominant sales concept may enhance diversification of Islamic financial products and attend to consumers' needs and interests. Hence, *musharakah mutanaqisah* is introduced to inculcate the element of sharing in terms of capital and liability between financier and customer.

Issue

Financing based on *Musharakah Mutanaqisah* Contract

34. Islamic financial institution has submitted a proposal to offer property financing product based on the concept of *musharakah mutanaqisah*. Basically, the modus operandi of the property financing product based on *musharakah mutanaqisah* is as follows:

- (i) A customers who wants to buy a property approaches the bank for financing;

² *Musharakah Mutanaqisah* means a contract of partnership between a financier and a recipient of financing to own an asset in which one of the partners give the right to the other partner to buy the his equity share of the asset either by one payment or several payments based on agreed conditions.

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- (ii) The bank and customer enter into *musharakah* agreement to jointly purchase the property based on an agreed share depending on the amount of financing requested (for example 90:10);
- (iii) The deposit already paid by will be deemed as his initial share contribution;
- (iv) The customer will rent the bank's shares of jointly acquired property through *ijarah* agreement; and
- (v) The instalment by the customer will be used to buy the share of the bank gradually until the entire bank's share is owned by the customer.

35. A Shariah issue arising from the above transaction is the combination of *musharakah* and *ijarah* in one document of agreement. This combined transaction may be perceived as having two sales in one sale contract (*bai`atain fi al-bai`ah*) which is prohibited in Shariah.

Resolution

36. The Council in its 56th meeting held on 5th February 2006/7th Muharram 1427 resolved that the financing product structured based on *musharakah mutanaqisah* contract is permissible. This is because the *musharakah mutanaqisah* is a contract recognized in Islamic muamalat. In implementing *musharakah mutanaqisah* contract, it is permissible for the contracting parties to:
- (i) Combine the two contracts of *musharakah* and *ijarah* in one document of agreement, as long as both contracts are concluded separately and clearly not mixed between each other; and
 - (ii) Impose a pledge on the shares owned by the customer because the right of beneficial ownership is recognized by Shariah.

TAWARRUQ³

Background

37. Previously, the common Shariah concepts adopted in Islamic finance is *wadiah*, *qardh*, *mudharabah* and others. However, since there is a need to address the contemporary issues and subscribe to the majority opinion of Shariah scholars, the *tawarruq* concept is now introduced. Even though the concept has long been discussed by the Shariah scholars, only recently such concept was being practically implemented. This concept is regarded as an alternative to *bai` `inah* concept and is used in product financing, deposits and financial liquidity management.

Issues

Deposit Product and Financing based on *Tawarruq*

38. Islamic financial institution made a proposal to offer deposit product and financing based on the concept of *tawarruq* or commodity *murabahah*. In brief, the mechanism of deposit *murabahah* commodity involves the following transactions:
- (i) The customer (depositor) appoints bank as an agent to purchase metal commodity from metal trader A seller on cash basis in an established metal commodity market;
 - (ii) The bank will thereafter purchase the metal commodity from the customer on a deferred sale at a cost price plus profit margin;
 - (iii) Next, the bank will sell back the metal commodity to metal trader B in the metal commodity market.

³ *Tawarruq* means purchasing a commodity on a deferred price either in a form of musawamah or murabahah, later selling it to a third party with the objective of obtaining cash.

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39. As an agent to purchase the metal commodity on behalf of the customer, the bank receives cash from the customer for the price of commodity which is deemed as deposit in the bank's account. As a result of the transactions (ii) above, the bank assumes liability (the cost price of the commodity plus profit margin) to be paid to the customer on maturity. The price of commodity purchased by metal trader A and the commodity's price when sold to the metal trade B are same.
40. With respect to financing mechanism on the other hand, the sequence of transactions would be as follow:
- (i) The bank purchases metal commodity from metal trader B on cash basis;
 - (ii) Thereafter, the bank sells the metal commodity to customer on deferred price (cost price plus profit margin);
 - (iii) The customer may appoints the bank as his agent to sell the metal commodity to metal trader A on cash basis in the metal commodity market.
41. While the cash sale price by the customer to metal trader A enables the customer to obtain cash for financing, while deferred sale price from the bank to the customer enables customer to pay back the financing facility to the bank within an agreed term. The issue is whether the above mechanism of transactions complies with Shariah.

Resolution

42. The Council in its 51st meeting held on 28th July 2005 / 21st Jamadil Akhir 1426 resolved that deposit product and financing based on the concept of *tawarruq* is known as commodity *murabahah* is permissible.

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***Ijarah Sukuk* and Shariah Compliant Securities as Underlying Asset in *Tawarruq* Transaction.**

43. There is a proposal to use *ijarah sukuk* and Shariah-compliant securities as underlying asset in *tawarruq* transaction or *murabahah* to manage liquidity in Islamic financial system. The proposed characteristics of *ijarah sukuk* include *ijarah sukuk* which is backed by tangible asset, financial asset and a combination of both tangible asset and financial asset. For Shariah-compliant securities, the proposed characteristic is that the securities must be endorsed as Shariah compliant. The issue here is whether the use of financial asset like *sukuk* and securities instead of commodity in *tawarruq* transaction is permissible in Shariah.

Resolution

44. The Council in its 58th meeting held on 27th April 2006/ 28th Rabiul Awal 1427 resolved that the use of *ijarah sukuk* and Shariah-compliant securities as underlying asset in *tawarruq* or *murabahah* to manage liquidity in Islamic financial system is permissible. However, such *ijarah sukuk* must be backed by tangible asset and not financial asset.

***BAI` INAH*⁴**

Background

45. *Bai` Inah* concept is used in Malaysia Islamic banking system and capital market to facilitate the needs of market players when Islamic financial industry was first pioneered in the country. Even though the majority of Shariah scholars disallow this concept, some of them are of the opinion that it is acceptable as long as all the pillars and conditions of the contract are complied with. Based on this

⁴ *Bai` Inah* means a seller sells an asset to client and then buy back that asset from the same client at a different price in which the deferred price is higher than the cash price.

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opinion, *bai` inah* concept is accepted to be practiced in Malaysia to ensure that Islamic finance is as competitive as its conventional counterpart. Among others, this concept is applied in money market transaction, bond issuance, debt securitization and credit card facility.

Issue

***Bai` Inah* Transaction in the Money Market**

46. *Bai` inah* transaction is perceived as a suitable contract to be introduced in Islamic Inter-bank money market. In this transaction, Shariah-compliant asset (for example Government Investment Issues) will be sold by a financier (for example central bank) to the recipient bank at X price on deferred terms. Then, recipient bank will sell back the asset to the financier on cash basis at Y price. The deferred price of X is higher than the cash price of Y, hence the difference is regarded as profit to the financier. Both sale contracts are executed separately. The question is whether the application of *bai` inah* as explained above is compliant with the concept of *bai` inah* which is acceptable in Shariah.

Resolution

47. The Council in its 8th meeting held on 12th December 1998/ 23 Syaaban 1419 resolved that *bai` inah* transaction in the Islamic Inter-Bank Money Market is permissible based on the following conditions:
- (i) *Bai` Inah* transaction must follow the mechanism which is accepted by Syafii school; and
 - (ii) The transacted good is not a ribawi item.

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Islamic Credit Card Based on *Bai` Inah*

48. Islamic banking institution proposed to offer Islamic credit card based on the combination of *bai` inah* and *wadiah* concepts. The proposed mechanism is as follows:
- (i) The customer purchases an asset from the bank on deferred terms (the purchase price comprise cost plus profit); for example, for example, RM11, 800 (RM10, 000 + RM1, 800) to be paid within one year by the customer;
 - (ii) The customer thereafter will sell back the asset to the bank on cash basis (at cost value); for example, RM10,000. The selling price of the asset is lower than the purchase price. This is the amount which will be credited into a marginal *wadiah* account of the bank for customer's use.
49. The above mechanism of Islamic credit card was proposed to the Council for deliberation to determine whether it is in compliance with Shariah.

Resolution

50. The Council in its 18th meeting held on 12th April 2001/ 22 Muharram 1422 resolved that the mechanism of Islamic credit card which applies *bai` inah* concept to generate funds for credit purposes by a customer who requests for the Islamic credit card is permissible.

Revisiting the Rulings on *Bai` Inah*

51. The Regional Shariah Dialogue which was held on 28th and 29th June 2006 aims at harmonising and promoting understanding amongst the Shariah scholars who are involved in Islamic finance. The dialogue had specifically focused on finding the best solution to resolve the issue of the use of *bai` inah* and *tawarruq* in

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Islamic financial system. The Council and the participating Shariah scholar had taken a comprehensive approach with regard to *bai` `inah* and *tawarruq* transactions.

Resolution

52. The Council in the Regional Shariah Scholars Dialogue on 29th June 2006 or 3 Jamadil Akhir 1427 resolved that:

- (i) The permissibility of *bai` `inah* and *tawarruq* is still a matter of juristic disagreement among the Shariah scholars backed by their own basis of justifications;
- (ii) The basis relied upon to justify the permissibility of *tawarruq* is similar with the basis to justify the permissibility of *bai` `inah*. Therefore, both concepts shall be ruled similarly;
- (iii) *Bai` `inah* concept is still necessary in the context local Islamic finance development. However, the market players are required to strengthen and enhance the operational process and documentation to comply with the features of *bai` `inah* as permitted; and
- (iv) Since *ba` `inah* concept is still regarded as a matter of juristic disagreement among the Shariah scholars, it is more desirable that Islamic financial institutions to limit its use in products which face difficulty in structuring them based on other consensually accepted contracts.

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HIBAH⁵

Background

53. Islamic banking Industry normally applies *hibah* concept to award *wadiah* depositors and *qardh*. In certain cases, there are instances of giving *hibah* to customers who make timely payment as scheduled. In takaful industry, *hibah* concept is used in several family takaful products in which participants could give *hibah* in the form of assigning the takaful benefit to the nominee or *hibah* recipient.

Issue

Hibah in the Contract of Al-Ijarah Thumma Al-Bai`

54. There are customers of Islamic financial institution who make their monthly payment according to the prescribed schedule. To encourage the good conduct in managing their financing, Islamic financial institutions would take initiatives to credit certain amount as *hibah* to customers of *al-ijarah thumma al-bai`*. The issue is whether this kind of initiative is permissible under Shariah.

Resolution

55. The Council in its 13th meeting held on 10th April 2000/5th Muharram 1421 resolved that *hibah* concept used in *al-ijarah thumma al-bai`* contract as an initiative to the customer who pay on schedule is permissible.

⁵ *Hibah* means transfer of ownership of a property or usufruct to another without any compensation during the life of the donor.

***Hibah* in Takaful Industry**

56. Generally, assets in its tangible form or in the form of its benefit (*usufruct*) can be given as *hibah* to other parties. The issues that arise are:
- (i) Whether takaful benefit qualifies as an asset for *hibah*?
 - (ii) Whether the status of *hibah* changes to will (*wasiah*) if the participant dies since the transfer of the asset ownership would take place after the death of the donor?
 - (iii) Whether a participant can revoke the *hibah* before the maturity of takaful the certificate?
 - (iv) What is the implication should the recipient of the *hibah* die before the maturity of the takaful certificate?

Resolution

57. The Council in its 34th meeting held on 21st April 2003/ 19 Safar 1424 resolved the following:
- (i) Takaful benefit can be used for *hibah* since it is the right of the participants. Therefore, participants should be allowed to exercise their rights according to their choice as long as it does not contradict with Shariah;
 - (ii) The status of *hibah* in takaful plan does not change into a will (*wasiah*) since this type of *hibah* is a conditional *hibah*, in which the *hibah* is an offer to the recipient of *hibah* for a specified period. In the context of takaful, the takaful benefit is both associated with the death of the participant, as well as the maturity of the certificate. If the participant remains alive on maturity, the takaful benefit is owned by the participant but if he dies within such period, then *hibah* shall be executed;

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- (iii) A participant has the right to revoke the *hibah* before the maturity date because conditional *hibah* is only deemed to be completed after delivery is made (*qabdh*);
- (iv) Participant has the right to revoke the *hibah* and transfer it to other parties or terminate the takaful participation if the recipient of *hibah* dies before maturity;and
- (v) The takaful nomination form has to be standardized and must stipulate clearly the status of the nominee either as a beneficiary or an executor (*wasi*) or a trustee. Any matter concerning distribution of takaful benefit must be based on the contract. Participants should be clearly explained on the implication of every contract being executed.

***Hibah* for Loan Contract (*Qardh*)**

58. *Qardh* contract is one of the contracts used to manage liquidity in Islamic finance. The contract obliges a borrower to return the loan amount to the lender without contracting to pay any additional return. However, in normal practice a borrower sometimes give *hibah* at his own discretion when paying off the debts. The issue is whether the practice of giving *hibah* complies with Shariah.

Resolution

59. The Council in its 55th meeting held on 29th December 2005/ 27th Zulkaedah 1426 resolved that the practice of giving unconditional *hibah* in a loan contract is permissible. Nevertheless, the Council advised that such practice should be implemented wisely so as to avoid it becoming a norm (*`urf*) which can make it a condition attached to the loan contract.

***Hibah* in Inter-Bank *Mudharabah* Investment Contract**

60. Inter-bank *Mudharabah* investment is one of the transactions used by participants in the Islamic Inter-Bank Money Market. Banks that are in need of funds normally offer competitive returns to attract investors. However, there are banks that can only manage to offer returns lower than the market rate of return. To attract more investors, there is a proposal to introduce *hibah* in the Inter-bank *Mudharabah* Investment contract. Based on this concept, it is suggested that the receiving banks that have lower rate of returns offer *hibah* as a gesture of consolation gift to the investing banks that are willing to invest with the former. The issue here is whether the approach of giving *hibah* in the *mudharabah* contract is permissible in Shariah.

Resolution

61. The Council in its 8th meeting held on 12th December 1998/ 23rd Syaaban 1419 resolved that the practice of offering *hibah* in *mudharabah* contract by the receiving banks to the investing banks in Islamic Inter-bank Money Market using *mudharabah* contract is not permissible. This is because *mudharabah* contract is based on profit sharing. If the practice of offering *hibah* is allowed, it can affect the nature of the *mudharabah* contract.

KAFALAH⁶

Background

62. The banking system became more robust and stronger with the existence of deposit insurance scheme and credit guarantee facilities, introduced through the *riba-based* conventional banking. Based on the similar needs, the Islamic

⁶ *Kafalah* means a guaranteed contract on certain asset, usufruct and/or services provided by a guarantor to the parties involved.

financial system has to device similar facilities based on approaches and mechanisms which are in line with Shariah. These facilities can be structured based upon the principle of *kafalah* or *dhaman*. This principle has been used in deposit insurance scheme and credit guarantee facility.

Issue

Deposit Insurance Scheme

63. The public confidence factor is paramount to protect deposits and ultimately ensure stability of any banking institution. One of the safety net arrangements to protect the banking system is through the deposit insurance scheme. The main objective of deposit insurance scheme in the banking system is to minimize depositors' risk of losing their deposit.
64. In Islamic banking, the implementation of deposit insurance scheme is equally important to ensure that the Islamic banking deposits are able to compete with the conventional deposits in attracting customers. The main issue here is whether Islamic banking institution can the same facility.

Resolution

65. The Council in its 26th meeting held on 26th June 2002/ 15th Rabiul Akhir 1423 resolved that deposit insurance scheme in Islamic banking is permissible based on the concept of mutual guarantee among the Islamic financial institution as participants to the scheme. The implementation of deposit insurance scheme does not contradict with the Shariah principles since its objective is to protect the public interest especially the depositors and the banking industry as a whole. Nevertheless, there is a need to separate the funds in the operation of deposit insurance scheme for Islamic banking to ensure that the fund of Islamic deposit insurance scheme are invested in Shariah compliant instrument.

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Credit (Debt) Guarantee

66. Credit guarantee company, which provides guarantee scheme for Islamic banking, proposed to offer Islamic Direct Access Guarantee Scheme (Skim Jaminan Laluan Terus Secara Islam). The characteristics of this Scheme are as follows:
- (i) Amount of financing is within the prescribed limit by the guarantee company;
 - (ii) Limit of guarantee period is prescribed between 5 to 8 years;
 - (iii) The amount of fees is prescribed by the company;
 - (iv) Guarantee coverage ranging from 30% to 100% from the total amount of financing;
 - (v) Processing charge (once) will be imposed; and
 - (vi) Renewal charge will be imposed
67. The credit guarantee will only cover Islamic financing offered by Islamic financial institutions to their customers. One of the Shariah issues in credit guarantee facility as explained above is whether the guarantee mechanism in which the guarantor charges fee for the guarantee service provided is permissible in Shariah.

Resolution

68. The Council in its 54th meeting held on 27th October 2005/ 23rd Ramadan 1426 and in its 55th meeting held on 29th December 2005/27th Zulkaedah 1426, resolved that the above Islamic guarantee (by charging guarantee fee) mechanism provided by credit guarantee company to the Islamic financial institutions offering Islamic financing products to customers is permissible.

QARDH⁷

Background

69. In the early stage of Islamic banking development in this country, several products were introduced based on *qardh hasan*, such as government investment certificate and benevolent loan. Now, the application has been expanded to include other products such as *rahn*, credit card and charge card. It has also been used to structure liquidity management instrument for Islamic banking institution.
70. Since *qardh hasan* concept is essentially benevolent in nature, it is improper to implement it in commercial transaction with profit orientation. Thus, the Council has made in-depth scrutiny on the terminology to modify it according to the current needs.

Issue

Qardh Hasan Terminology

71. The use of *qardh hasan* concept in a correct manner and acceptable by Shariah would definitely benefit contracting parties. However, if it is used inappropriately used, it would potentially create problems which may tarnish the image of Islamic financial system. Among others:
- (i) Whether or not *qardh hasan* in its true meaning implies the need to be repaid or otherwise.
 - (ii) Since Islamic banking institution provides financing by utilizing customer's deposits who expect returns, the use of *qardh hasan* as a mode of

⁷ *Qardh* means a debt or borrowing contract between two parties in which repayment of the borrowed amount must be of the same.

financing is deemed to be inappropriate. This is because *qardh hasan* is not meant to generate profits rather it is benevolent or *tabarru`at* by nature.

Resolution

72. The council in its 51st meeting held on 28th July 2005/ 21st Jamadil Akhir 1426 resolved that the word "*hasan*" should be taken out after the word *qardh* implying that *qardh* is an obligation for borrowers to pay back their loan to lenders.

Liquidity Management Instrument based on *Qardh*

73. Liquidity management instrument is an instrument used to ensure that the level of liquidity of banking institutions is at an optimum level. It is specifically used to absorb liquidity surplus in the market. Using this instrument, Islamic banking institutions able to channel its liquidity surplus to the Bank Negara Malaysia. Previously, the Islamic liquidity management instruments were based on *mudharabah* and *wadiah* concepts.
74. *Qardh-based* instrument is proposed to be offered as an additional instrument for liquidity management in Islamic financial system. The mechanism of *qardh-based* liquidity management instrument is as follows:
- (i) Bank Negara Malaysia will issue a tender through FAST (Fully Automated System for Issuing/Tendering) system disclosing the amount of loan to be borrowed;
 - (ii) The tender is based on uncompetitive bidding whereby bidders are required to bid for total nominal amount that they are willing to loan to Bank Negara Malaysia;

- (iii) The successful bidders will provide the loan based on period of tenure until maturity ;and
- (iv) On maturity, Bank Negara Malaysia will pay back the loan in total. *Hibah* may be given at the discretion of Bank Negara Malaysia.

Resolution

75. The Council, in its 55th meeting held on 29th December 2005/ 27th Zulkaedah 1426, resolved that the liquidity management instrument based on *qardh*, which is a contract of interest free loan between Islamic financial institution and Bank Negara Malaysia to facilitate the need of short-term loan, is permissible. Nevertheless, Bank Negara Malaysia as the borrower can pay back more than the borrowed sum in the form of *hibah* provided it is at sole discretion of borrower and there is no pre-condition clause.

TA`WIDH⁸

Background

76. Islamic banking operation exists when there is a relationship between a financier and a recipient of finance. This relationship creates obligations for both parties in which the financier is obliged to provide financing to the financee (customer) as stipulated in the contract. On the other hand, the financee is under obligation to pay total financing received within the stipulated period. If the payment is not made within the specified period, it would inevitably affect the financial activity of the financier.

⁸ *Ta`widh* means giving compensation for loss incurred as a result of harm occurring.

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77. For a conventional bank, the issue of default is dealt with by imposing interest (*riba*). Since interest is apparently against the principle of Shariah, Islamic bank need to have a proper mechanism to overcome the issue of default.
78. The absence of a proper mechanism to overcome the issue of default may trigger moral hazard on the part of the customer who may take such opportunity to deliberately delay payment. Therefore, *ta`widh* has since been the best approach to overcome the issue of default in payment by the customer.
79. The discussion on the application of this mechanism in Islamic financial activities in Malaysia cover various aspects such as default on financing repayment, judgement debt, *mudharabah* investment and early settlement of debt.

Issue

Imposition of *Ta`widh* in Islamic Finance

80. The conventional banking handles default in payment by charging interest on customers. Since charging interest is against the principle of Shariah, Islamic banking is not allowed to emulate this mechanism to resolve the issue of default. This requires a Shariah compliant mechanism to deal with the issue and it was brought to the attention of the Council for its resolution.

Resoultion

81. The Council in its 4th meeting, held on 14th February 1998/16th Syawal 1418 resolved that *ta`widh* (compensation) may be imposed on the defaulting customer who fails to meet his obligation to pay the financing based on the following conditions:
- (i) The amount of *ta`widh* cannot exceed the actual loss suffered by the financier;

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- (ii) The determination of compensation is made by a third party, that is Bank Negara Malaysia;and
- (iii) The default or delay of payment is due to negligence on the part of the customer.

Ta`widh on Debt Judgement

- 82. The existing procedural law provides that the court has the power to order payment of interest (*riba*) on the judgement debt as decided by court. This interest is ordered on the judgement debtor at a rate of 8% per annum of the total judgement, to be calculated from the date of the judgement is made until the judgement debt is settled by the judgement debtor to the judgement creditor.
- 83. With respect to Islamic financial cases, such a claim also exists but the court normally exercise its discretion not to impose the interest since it is based on *riba* mechanism. If the claim is made in court for fixed rate financing cases such as *murabahah* and *bai` bithaman ajil*, the claimant (judgement creditor) will make a claim on the total balance of outstanding selling price, subject to the deduction of rebate (*ibra`*), if any.
- 84. Since the mechanism to avoid delay in paying judgement debt for Islamic financial cases had never been introduced, this issue was posed to the Council for its resolution.

Resolution

- 85. The Council in its 50th meeting, held on 26th May 2005/17 Rabiul Akhir 1426 and 61st meeting on 24th august 2006/30th Rejab 1427 resolved that the court may impose late payment penalty charges on judgement debt as decided by the court on Islamic banking and takaful cases. The imposition of late payment penalty charge is based on the combination of *gharamah* (penalty) and *ta`widh*

(compensation) mechanisms. The Council also resolved that the mechanisms for implementing late payment penalty charge should be as follows:

- (i) The court may impose penalty charges at the rate of 8% per annum. However, from this rate of 8% per annum, the judgement creditor (bank) is only allowed to be compensated for the actual loss (*ta`widh*);
 - (ii) To determine the compensation rate of actual loss (*ta`widh*) that may be taken by the judgement creditor, the Council agreed to adopt “annual average for overnight weighted rate” of Islamic money market of the preceding year as a reference; and
 - (iii) The total compensation based on actual loss must not exceed the principal debt. If the rate of actual loss is less than 8% per annum, the balance shall be channelled by judgement creditor to charitable organisation as may be determined by Bank Negara Malaysia.
86. If the judgement creditor is an individual, (for example the payment of takaful benefits by takaful provider to participant), judgement debtor shall only be obliged to pay *ta`widh* to the judgement creditor in addition to the judgement debt. Judgement debtor needs to pay the balance of the late payment penalty charge directly to charitable organisation as may be determined by Bank Negara Malaysia.
87. For judgement debt which involves payment of takaful benefit by takaful provider to the participant, the total late payment penalty charge shall be paid from the shareholder’s fund.

⁹ *Ibra`* means surrendering one’s right to a claim on debt either partially or fully.

Background

88. In the conventional system, customer has to pay only the outstanding principal amount and earned interest at the time when early settlement is made. The unearned interest is normally waived by the financier. Contractually, customer in Islamic financial system has to settle total outstanding selling price in the case of early settlement. However, Islamic bank normally give rebate to its customer who made early settlement. This practice of rebate is important to maintain the competitiveness of Islamic banking. Therefore, the concept of *ibra`* which resembles the rebate payment is introduced. The concept of *ibra`* is more suitable for the financier who wants to surrender its right over the debt to customers.

Issues

***Ibra`* Clause in Financing Agreement**

89. In the beginning, *ibra`* was practiced in Islamic banking institution based on a financier's discretion to grant it to a customer who settles his debt earlier than the stipulated period. However, since the practice of giving rebate is solely discretionary on part of an Islamic banking institution; the customer may cast doubt whether they are eligible to receive *ibra`* when they make an early settlement. Furthermore, they are also in the dark about the formula for the *ibra`* computation by the bank. As a result, customers shift to conventional financing instead.

90. To overcome confusion in the granting and computation of *ibra`* by Islamic banking institution, it was proposed that a clause on promise to provide *ibra`* to customers who settle their debts earlier than the stipulated period be introduced. Therefore, it is important to resolve the issue of whether the incorporation of such clause on promise to give *ibra`* to customers in the Islamic financing agreement is permissible by Shariah.

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Resolution

91. The Council in its 24th meeting, held on 24th April 2002/11 Safar 1423 resolved that Islamic banking institution may incorporate the clause on undertaking to provide *ibra`* to customers who make early settlement in the Islamic financing agreement on the basis of public interest (*maslahah*). This clause shall be stipulated under the method of payment.
92. With the inclusion of *ibra`* clause in the financing agreement, the bank is bound to honor that promise. This approach mirrors the concept of giving discount on price or reducing the debt of the customers who make early settlement based on the concept of *dha` wa ta`ajjal* which is acceptable in Shariah. The confusion on the issue of uncertainty in price (*gharar*) does not arise if the clause on promise to give *ibra`* is stated clearly in the financing agreement.

***Ibra`* in Variable Rate *Bai` Bithaman Ajil* Product**

93. One of the latest innovative Islamic financing product is *bai` bithaman ajil* product based on variable rate. The main features of this product are as follows:
- (i) The contract used is deferred payment or *bai` bithaman ajil*. This contract would not change throughout the financing period except for the effective profit rate which may vary depending on the current market rate by modifying the rate of *ibra`* (rebate) on monthly basis;
 - (ii) The bank and the customer would execute an asset sale contract based on a selling price. This selling price comprises cost plus and agreed ceiling profit rate. The ceiling profit rate would normally be higher than the current profit rate in the market since the bank needs to provide a buffer to cater for the increases in market rate;

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- (iii) The bank will give monthly rebate to the customer to make it equivalent to the market rate if the current profit rate is lower than the agreed ceiling profit rate. In any circumstances, the effective profit rate will not exceed the stipulated ceiling profit rate.
94. Based on the characteristics of variable rate *bai` bithaman ajil* product, there are several Shariah issues that need to be resolve. These Shariah issues include:
- (i) Whether a clause of *ibra`* can be included in the financing agreement document;
 - (ii) Whether two forms of *ibra`* can be incorporated in one single agreement: one clause on *ibra`* for early settlement and another clause on *ibra`* for monthly basis to correspond the current profit rate in the market;
 - (iii) In the event the effective profit rate is increased with the monthly instalment payment to remain unchanged, whether a clause on rescheduling to extend the financing period can be provided for in the agreement without the need to execute a fresh contract.

Resolution

95. The Council in its 32nd meeting on 27th February 2003/25th Zulhijjah 1423 resolved that granting of *ibra`* in a variable rate *bai` bithaman ajil* product is permissible. In this context, the bank is the party who offered the *ibra`* (unilaterally promise to give *ibra`*) to the customers and the bank may decide to give *ibra`* in any manner it feels appropriate. If the bank has promised (binding promise) to give *ibra`* to its customers, the bank bound to fulfill its promise.
96. Based on the mutual agreement in the contract, the financing period for the customer can be extended without the need to execute fresh contract provided that both parties fulfill all conditions in the agreement and the final price charged on the customers shall not exceed the original selling price (based on the ceiling profit rate) contracted earlier.

WA`D¹⁰**Background**

97. Generally under the shariah principles, a “contract” is different from a “promise”. Each of them has its own legal implications. In a contract, the parties are bound by the terms of the contract, thus they may be obliged to compensate for the breach of the contract. On the other hand, in a promise it is not binding on the promisor to fulfill his promise. As such, no compensation could be imposed on him if he breaches of the promise.
98. In the current financial practices however, there are a number of promissory elements, such as the sale and buy-back agreement (repo), *When Issue* transaction and forward foreign currency transactions. Thus, such a promissory mechanism in practice must be carefully examined to avoid any potential breach of promise by promisor, which would result in losses to the promisee.

Issues**Sale and buy-back Agreement (Repo)**

99. Sale and buy-back agreement (repo) refers to sale and purchase of an asset (in the forum of Shariah compliant financial instrument) whereby both contracting parties promise to buy or re-sell the asset in future. This arrangement is essential for cash line financing in inter bank money market. It raises two Shariah issues:
- (i) What is the status and legal effect of a promise in a contract?
 - (ii) Whether it is permissible to stipulate a condition to buy or re-sell the same asset in a contract of sale?

¹⁰ *Wa`d* in Islamic transaction means promise.

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Resolution

100. The Council in its 13th meeting held on 10th April 2000/ 5th Muharram 1421 resolved that *wa`d* in the sale and buy-back agreement is permissible provided that *wa`d* is not stipulated as a condition for the sale and purchase of the asset.

"When Issue" Transaction

101. *When Issue* is a promise made by both contracting parties (vendor and purchaser) in order to secure a transaction in debt securities, at certain price, which will usually be issued approximately in a week. Although it is merely a promise, its relevant to be recorded in the "Bond Information Dissemination System" in order to ensure market transparency for all market participants. This *When Issue* arrangement is meant to facilitate the participants to forecast an accurate price for bidding on the issuing date.
102. The actual sale and purchase of the securities take place upon the delivery of the securities and the price settlement, after the issuing date. Should the issuer cancel the issuance of the securities, the promise too will be automatically terminated. This raises a Shariah issue on the permissibility of a promise to sell and buy in future.

Resolution

103. The Council in its 22nd meeting held on 26th February 2002/ 13th Zulhijjah 1422, resolved that *When Issue* transaction in Islamic securities market is permissible based on the permissibility of promise to sale and promise to buy.

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Forward Foreign Currency Transaction

104. Transactions in foreign currency, either on the basis of spot or forward, are among the necessary transaction for an Islamic banking institution. In the current banking practices, delivery and settlement in foreign currency transactions do not take place on spot at the same time and date of the conclusion of the contract.
105. In a foreign currency spot transaction, delivery and settlement will normally take place on T+2 (two days after transaction day), whereas, in a forward transaction, settlement will be made on a pre-determined future date, for example, after one month or three months according to the terms of the contract. A similar arrangement, which is based on the concept of promise, is introduced by Islamic banking institution, whereby both parties promise to sell and buy currency at an agreed rate. As such, the actual contract takes place on T+2 for a spot transaction and on a predetermined future date for a forward transaction.
106. In its actual operation, an Islamic banking institution will immediately secure a contract booking number after both parties reach an agreement and promise each other. This booked contract will be marked to the market. In addition, there will be no actual signing of agreement on the settlement date. The issue from the Shariah point of view is whether this practice, which is based on promise, is permissible or not.

Resolution

107. The Council in its 49th meeting held on 28th April 2005/ 19th Rabiul Awal 1426 resolved that an Islamic banking institution is allowed to enter into forward foreign currency transaction based on unilateral binding promise (binding only on the promisor) and the compensation for breaching of promise could be implemented. This permissibility is only applicable for currency hedging purposes. Such a transaction may be arranged between the Islamic banking

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institution and its customers, or between the Islamic banking institutions, or between the Islamic banking institutions and conventional banking institutions.

ACCEPTING OF FUND FROM UNLAWFUL SOURCES

Background

108. Among the main functions of Islamic banking institution in Malaysia are accepting deposits, providing financing facilities and investments. All of these activities are carried out in accordance with Shariah principles as endorsed by their own Shariah Advisory Committees and supervised by Bank Negara Malaysia. Through these Shariah compliant activities, Islamic banking institutions manage to generate profits and the benefits are shared with the investors and shareholders.
109. Even though Islamic financial activities have been closely regulated and supervised, the financial institutions can not avoid accepting deposits whose sources may be non-Shariah compliant or a mixture of Shariah compliant and non-Shariah compliant activities. The compliance status of the sources may probably be unknown and uncertain. Sometimes, the institutions may also receive a request from customers who take Islamic financing facility but choose to have it insured under conventional insurance.

Issues

Customers' Deposit

110. In relation to Islamic banking deposits, is it permissible for the Islamic banking institution to accept every deposit without the need to screen its source?

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Resolution

111. The council in its 58th meeting held on 27th April 2006/ 28th Rabiul Awal 1427 resolved that Islamic banking institutions may, generally, accept any application for placement of deposit or investment fund from individual or corporate customers without the need to investigate the status of the sources of fund; either Shariah compliant, non-Shariah compliant or a mixture between the two.

Islamic Financing Insured by Conventional Insurance

112. Taking into account the co-existence of Islamic financial system along the conventional financial system, customers have the freedom to choose the most suitable financial service according to their needs. Thus, there is possibility that the customers may choose to subscribe to a conventional insurance to insure their Islamic financing facility. This situation raises an issue of whether accepting conventional insurance policy money by an Islamic banking financier upon the death of the customer is permissible in Shariah.

Resolution

113. The Council in its 5th meeting held on 30th April 1998/ 3rd Muharram 1419 resolved that an Islamic banking institution may accept the conventional policy claim payment should the deceased customer had taken up a conventional insurance policy to insure the Islamic financing facility.