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## Examining the Legality of Rahn Contracts in Malaysian Islamic Financial Institutions

### Meneliti Kesahihahn Akad Rahnu di Institutusi Kewangan Islam

Luqman Zakariyah,\* and Mohammed Kabiru Musah\*\*

#### Abstract

This study aims to investigate the legality of *rahn* contracts in Malaysian Islamic Financial Institutions. Specifically, it attempts to examine how *rahn* is used in these institutions as well as the *Shariah* issues related to it so as to ascertain the extent to which it has achieved the objectives for which it was legislated by the *Shariah*. To achieve these objectives, inductive method is used to gather information on *rahn* both from classical and modern books of Islamic Jurisprudence. Qualitative approach with interview as the instrument of data collection was also adopted to elicit data from the following Malaysian Islamic Financial Institutions: Bank Rajhi, Maybank, Bank Muamalat and Bank Islam. This research concludes that the *rahn* used in these Islamic financial institutions has achieved the objectives for which it was legislated. It is also used through several combinations of contracts such as *wadiah yad dhamanah* (savings with a protection guarantee), *ujrah* (fee), *qard hasan* (loan) among others. However, some transactions in which the *rahn* appears need to be reviewed, and amended to comply with the provisions of Islamic *Shariah*.

**Keywords:** Islamic Mortgage, Rahn, Islamic Contract, Islamic Home Financing, Islamic Financial Institutions.

#### Abstrak

Kajian ini bertujuan meneliti kesahihan Akad al-Rahnu di Institutusi Kewangan Islam di Malaysia. Secara khususnya, kajian ini cuba meneliti aplikasi al-Rahnu di institusi-institusi kewangan Islam Malaysia serta isu-isu *Shariah* yang berkaitan dengannya, demi memastikan akad tersebut mencapai objektif yang digariskan oleh *Shariah*. Demi mencapai objektif tersebut, metod induktif telah digunakan untuk mengumpul maklumat daripada buku-buku *Fiqh* klasik dan kontemporari. Pendekatan kualitatif

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dengan wawancara sebagai instrumen pengumpulan data juga diguna pakai untuk mendapatkan data dari Institusi Kewangan Islam Malaysia berikut: Bank Rajhi, Maybank, Bank Muamalat dan Bank Islam. Kajian ini menyimpulkan bahawa akad rahnu yang digunakan dalam institusi kewangan Islam ini telah mencapai objektif sebagaimana ditetapkan oleh Shariah. Ia juga digunakan melalui beberapa kombinasi kontrak seperti wadiah yad dhamanah (simpanan dengan jaminan perlindungan), ujarah (fee), qard hasan (pinjaman) dan lain-lain. Walau bagaimanapun, beberapa transaksi yang melibatkan rahnu perlu dikaji semula, dan dipinda supaya selari dengan Syariah.

**Kata Kunci:** Mortgage Islam, Rahnu, Kontrak Islam, Pembiayaan Rumah Islam, Institusi Kewangan Islam.

### Introduction

Saving money from risks is one of the most important purposes of Islamic law. *Rahn*, an Arabic term for pledge, mortgage or pawn, is one of the most efficient methods employed in Islamic financial institutions to protect money from risks or losses. When dealing in *rahn*, there is a manifestation of facilitation and the removal of hardships that might be encountered by either of the two parties to the contract in the conduct of financial transactions.

*Rahn*, considered as a means of documenting rights, has assumed a new dimension in different fields as a result of developments in products, especially in the Islamic financial institutions in Malaysia. This is what the present research seeks to address. This article attempts to achieve the following objectives:

1. Examining the Shariah issues related to rahn contracts in Islamic financial institutions in Malaysia.
2. Analyzing jurisprudentially, the various structures of rahn in Islamic financial institutions in Malaysia.

This research focuses on Al-Rajhi Bank Malaysia, Maybank Islamic Malaysia, Bank Muamalat Malaysia, and Bank Islam Malaysia as they are among the Islamic financial institutions in Malaysia that use *rahn* in their business activities and banking.

*Rahn* is a financial contract between the pledgor (*rāhin*) and the pledgee (*murtahin*) whereby an asset is pledged as collateral (*marhūn*) to the pledgee to give an assurance that the liability or obligation on the pledgor will be met.<sup>1</sup> The legitimacy of *rahn* contract is derived from the

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<sup>1</sup>Muhammad Yusuf Saleem, *Islamic Commercial Law* (Singapore: John Wiley and Sons Singapore Pte. Ltd, 2013), P24/ bank Negara, *Rahn (Shariah Requirements and Optional Practices)* Exposure Draft Issued on: 2 October 2015, P9.

Quran and founded on the Sunnah of Prophet Muhammad (peace be upon him), and further supported by the consensus of Muslim jurists (ijmā').

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

“And if you are on a journey and cannot find a clerk (to record the transaction), then (conduct your transactions on the security of) a pledge in hand. But if you do trust one another, then let the one who is trusted fulfill his trust, and he (the trusted one) should fear God, his Lord. Do not conceal evidence. Anyone who does so has a sinful heart, and God is fully aware of everything you do.”<sup>2</sup>

The permissibility of *rahn* is also corroborated by the Sunnah of Prophet Muhammad peace be upon him as reported by Bukhari as follows:

“On the authority ‘Aishah – may Allah’s pleasure be upon her – who narrated that the Prophet (peace be upon him) bought some food-stuff from a Jew on a deferred payment agreement, and he gave iron armour as a pledge (to the Jew)” (Bukhari and Muslim).<sup>3</sup>

Furthermore, Muslim jurists have reached a consensus (ijmā') among themselves on the permissibility of *rahn* in general, as cited by Ibn Qudāmah.<sup>4</sup> According to the majority of *fiqh* schools, the contract of *rahn* has four pillars which are:

1. The two parties to the contract; the pledger (*al-rāhin*), who is the debtor and owner of the pledged property, and the pledgee (*al-murtahin*), i.e. the creditor who takes and keeps the pledged property in his trust.
2. The pledged property (*al-marhūn*): This is the property that is kept as a security for the debt.
3. The debt (*al-marhūnu bihī*)
4. An expression that includes offer and acceptance.<sup>5</sup>

<sup>2</sup>Surah al-Baqarah (2), verse 283.

<sup>3</sup> Muhammad al-Bukhari, Saheeh al-Bukhari, by Muhammad Zubair Naser bin an-Naser (Dar Tauq an-Najaat, E1, 1422 A.H) The book of ar-Rahn, Chapter: The One who Pledges with his Shield, Vol.3, P. 142, No. 2509

<sup>4</sup> Abdullah bin Ahmed bin Qudaamah, *Almugni of Ibn Qudaamah*, (Cairo, Cairo Library, d., 1388 AH / 1968), C4, p. 245

<sup>5</sup>See, Muhammad Yusuf Saleem, p.125

**Rahn contracts in Malaysian Islamic financial institutions**

Interview Questions	Bank al-Rajhi Malaysia	Maybank Islamic	Bank Muamalat	Bank Islam
Does your financial institution use <i>rahn</i> ?	Yes	Yes	yes	yes
What types of <i>rahn</i> are being used by your institution for customers? (possession/official)	Official	possession/official	possession	possession
What is the <i>rahn</i> structure used by your institutions?	a combination of a <i>tawarruq</i> contract (through commodity <i>murabahah</i> ) and <i>rahn</i> contract	a combination of a <i>tawarruq</i> contract (through commodity <i>murabahah</i> ) and <i>rahn</i> contract	a combination of <i>wadiah yad dhamanah</i> (savings with a protection guarantee), <i>ujrah</i> (fee), <i>qard</i> (loan) and <i>rahn</i> (pledge).	a combination of <i>wadiah yad dhamanah</i> (savings with a protection guarantee), <i>ujrah</i> (fee), <i>qard</i> (loan) and <i>rahn</i> (pledge).
In which areas does your institution apply <i>rahn</i> ? (Home finance, personal finance, car finance, among others)	Al Rajhi Bank applies <i>rahn</i> in the following areas: mortgage finance, car finance, long term financing.	May Bank applies <i>rahn</i> in the following areas: (mortgage finance, cash line financing, long term financing)	Bank Muamalat applies <i>rahn</i> in <i>qard hasan</i> (interest-free loan).	Bank Islam applies <i>rahn</i> in <i>qard hasan</i> (interest-free loan).
Has it been approved by the <i>Shariah</i> Committee?	Yes	Yes	yes	yes
What types of property does your institution accept in pawn?	real estate, cars, and instruments.	We accept all type of collateral including property and financial assets like fixed deposit, shares etc.	Pure gold and jewelry, (from 24 carat to 20 carat).	Pure gold and jewelry, (from 24 carat to 18 carat).

Does your institution ever mortgage pledged items to repay the customer debt? (it happens sometimes- it happens a lot)	It happens sometimes.	It happens sometimes.	It happens sometimes.	It happens sometimes.
To what extent does the use of <i>rahn</i> contribute to the development and facilitation of the activities of the institution?	Secures the amount of financing and mitigates risks	It reduces risks incurred by the bank in dealing with financing assets.	It contributes to the bank income.	It contributes to the bank income.
What are the benefits derived by customers in using <i>rahn</i> instruments?	Get cash as fast as possible.	Get cash as fast as possible.	Get cash as fast as possible.	Get instant cash
What are the challenges facing customers in using <i>rahn</i> instruments?			Bring some precious stones such as diamonds or gold are not recognized by us,	Repayment of the loan according to the period specified.
Does your institution face problems while implementing <i>rahn</i> ?	Sometimes problems arise from the management, where the mortgaged may be less valuable than the amount of financing.			We do not have problems with the implementation of <i>rahn</i> , but the problem is that some customers try to mortgage fake gold.

What are the proposed solutions to address these problems in your opinion?	Get employees who have extensive experience on various items of pledge, be they real estate or other valuables to recognize its value.			The presence of sophisticated machines such as Decimeters and Gold Scanner will detected Gold quality.
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### Presentation of the Answers to the Interview Questions Above

**Question 1:** The answers are all in the affirmative from all the Islamic financial institutions that were interviewed, that is, all of them employed the instrument of *rahn* in rendering financial services to customers.

**Question 2:** The answers vary from one institution to another as follows:

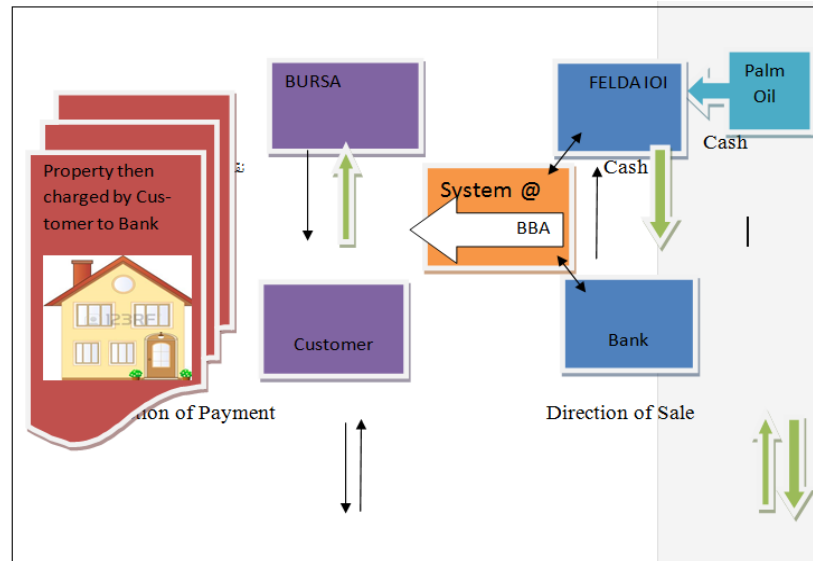
1. The answer from Al-Rajhi Bank in Malaysia suggests that it deals in official mortgage.
2. Maybank, on the other hand, deals in both types of mortgage system (possessory and official).
3. From Bank Muamalat and Bank Islam, the response is that they deal in possessory mortgage only.

**Question 3:** The answers to this question are also of varied dimensions from these financial institutions and they are as follows:

1. Al Rajhi Bank and May Bank use the *murabahah* instrument through *tawarruq* known as commodity *murabahah*. The customer submits a financing request to the financial institution, either for the purchase of a house or a car. Then the bank enters into a *tawarruq* transaction agreement with the customer through *murabahah* asking the customer to mortgage a house or a car as collateral for financing. Should the customer fail to meet the debt obligations, the bank will sell the house or the car. This process (commodity *murabahah*) is often carried out through the palm oil trade on the Malaysian Commodity Exchange.

An Explanation of the Structure of the *Rahn* Instrument in Home Financing in some of these Islamic financial institutions in Malaysia is presented in the following diagram below:



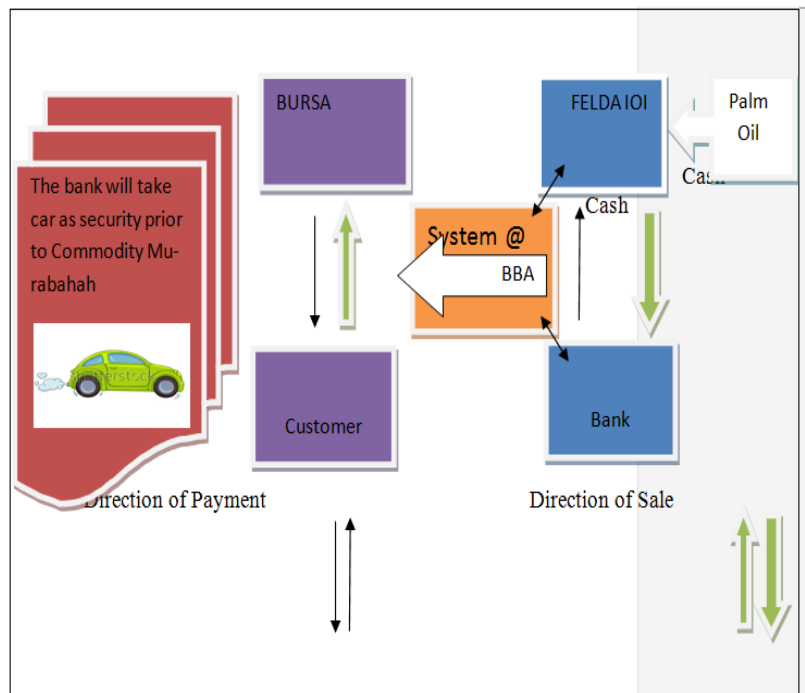


### Transaction Steps:

- 1- The client approaches the Islamic bank for home financing.
- 2- The Islamic bank buys palm oil from the Felda Foundation and offers cash through the system and procedures for selling on the Malaysian Commodity Exchange.
- 3- The Islamic bank sells the oil at a future price (Bai' BithamanAjil (BBA)<sup>6</sup> to the customer through the selling system and procedures on the Malaysian Commodity Exchange.
- 4- The customer sells the oil to the Malaysian Commodity Exchange and receives the sale amount in cash.
- 5- The customer uses the money to buy the house, and the Islamic bank maintains the house as collateral.

An Explanation of the Structure of the *Rahn* Instrument in Car Financing in some of these Islamic financial institutions in Malaysia is presented in the following diagram below:

<sup>6</sup> Refers to a sale and purchase transaction of an asset to be paid on later date (deferred payment) based on a price, which include a profit margin agreed to by both contracting parties.



### Transaction Steps:

- 1- The client approaches the Islamic bank for car financing.
- 2- The Islamic bank buys palm oil from the Felda Foundation and offers cash through the system and procedures for selling on the Malaysian Commodity Exchange.
- 3- The Islamic bank sells the oil at a future price (Bai' BithamanAjil (BBA)<sup>7</sup> to the customer through the selling system and procedures on the Malaysian Commodity Exchange.
- 4- The customer sells the oil to the Malaysian Commodity Exchange and receives the sale amount in cash.
- 5- The customer uses the money to buy the car, and the Islamic bank maintains the car as collateral.

This is the method adopted by Al Rajhi Bank and MayBank to finance the client to buy a house or a car. The contract is a sale and purchase transaction on the Malaysia Commodity Exchange. The commo-

<sup>7</sup> Refers to a sale and purchase transaction of an asset to be paid on later date (deferred payment) based on a price, which includes a profit margin agreed to by both contracting parties.

ty is often palm oil for easy handling and the need for it. The process involves the contract of agency and the client who will entrust the bank in the sale of the commodity to the other party in cash. The bank then transfers the amount to the customer's account. The customer, in turn, uses the money to buy the house or the car, and then begins to pay the amount in instalments or in a lump sum when the maturity is due. If he/she fails to repay the debt, the bank will sell the house or the car to fulfill its right.

Among the procedures that must be followed after the contract is concluded is that the bank sends the real estate document to the concerned government offices on real estate to reconcile it with their record in order to verify that it is mortgaged in favor of the bank in the specified amount. As for the car, the bank sends it to the road transport department to put the name of the bank on it, on the understanding that this car belongs to the customer but financed by Al Rajhi Bank. If eventually the customer pays up the full amount, the bank's name will be removed from the document and becomes fully owned by the customer.

As for Bank Muamalat and Bank Islam, they use *rahn* through several combinations of contracts, *wadiyah yad dhamanah* (savings with a protection guarantee), *ujrah* (fee), *qard hasan* (loan) and *rahn* (pledge). In this model, the customer offers his gold to the Islamic financial institution, on the basis of savings with a protection guarantee (*wadiyah yad dhamanah*), and the financial institution takes a fee for its protection of the gold. In the event of any damage or loss of the gold during the storage period, the financial institution shall be liable to pay compensation for damages or loss. The financial institution grants a loan (*qard*) to the client on an interest-free basis, and subsequently, the customer gives the gold as a pledge to the Islamic financial institution as collateral (*rahn*) for the period of time agreed upon in the contract.

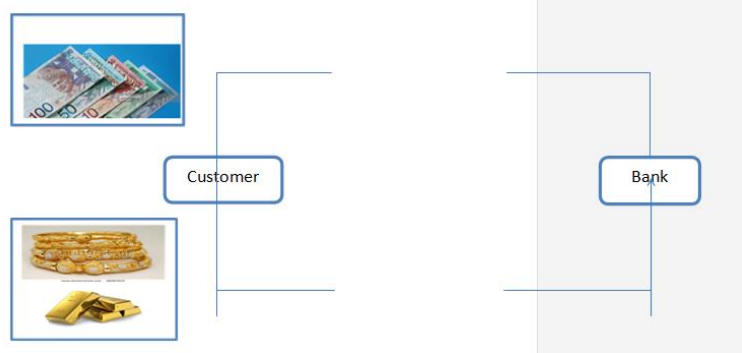
### Examining the Legality of Rahn Contracts in Malaysian Islamic Financial Institutions

The clarification of the steps of this transaction is as follows:

- 1) The customer keeps his/her gold with the bank under the principle of *wadiyah yad dhamanah* and pays *ujrah*.



- 2) In return, the bank provides custody service with a risk-protection guarantee.
- 3) The bank grants *qard* (loan) to the customer.



- 4) The customer pledges the gold under the principle of *rahn al-wadiyah*.

These are the procedures followed by Bank Muamalat and Bank Islam to lend customers a goodwill loan.

**Question4:** Answers to this question differ according to the individual financial institution as follows:

1. Al Rajhi Bank applies *rahn* in areas such as real estate finance, car financing and long term financing.
2. Maybank applies *rahn* in the areas of mortgage finance, cash line financing and long term financing.

3. As for Bank Muamalat and Bank Islam, the answers are compatible as they apply *rahn* in loan or personal finance.

**Question 5:** The answers to question five in all these financial institutions are in the affirmative. These transactions are not implemented until after the approval of the Sharia Authority of the financial institutions.

**Question 6:** The answers vary from one financial institution to another as specified below:

1. In Al-Rajhi Bank, the answer is that the property the bank accepts as mortgage is real estate, cars and *sukuk*.
2. Maybank accepts all types of collateral including property and financial assets, such as fixed deposit, shares etc.
3. The answer in the case of Bank Muamalat and Bank Islam, on the other hand, reveals that they accept pure gold and jewelry as mortgage.

**Question 7:** In response to this, an agreement is reached by both the financial institutions and their customers, that is, in case of default the pledged property is sold out to repay the customer's debt.

**Question 8:** Answers from these financial institutions to this question are close and they are as follows:

1. Al Rajhi Bank considers that the use of *rahn* secures the amount of financing and reduces risks.
2. The answer that Maybank gives shows that the use of *rahn* reduces the risks the bank incurs in dealing with asset financing.
3. The answer given by Bank Muamalat indicates that the use of *rahn* contributes to the bank's income.
4. For Bank Islam too, *rahn* also contributes to its source of income.

**Question 9:** There is virtual unanimity in the answer given by all these financial institutions to this question; the *rahn* system enables clients to obtain cash as quickly as possible.

**Question 10:** This question was answered by only two banks and the answer is as follows:

1. The answer from Bank Muamalat states that the challenges facing customers when using *rahn* are that some of them bring precious stones such as diamonds or gold which do not have which cannot be traced to a reliable source of purchase, and are therefore not acceptable to it. Only gold issued by known companies like Swiss Pamp, Public Gold, and other well-known shops are acceptable to it (Bank Muamalat). Otherwise, it will not accept it as long as the genuineness of its source remains unidentified. It could only be accepted after it has been tested and certified genuine by a jeweler.
2. In Bank Islam, the answer was that one of the challenges facing customers, when using *rahn* is the repayment of the loan, within the agreed period stipulated in the contract.

**Question 11:** As is clearly seen, only two of these banks provided answers to this question, viz. Al-Rajhi Bank and Bank Islam. Their submissions differ in this regard as can be observed below:

1. Al Rajhi Bank does not face any implementation problems. Therefore, it does not have problems in terms of *Shariah* compliance because all the products are not implemented without the approval of the *Shariah* department. For *rahn* contracts, however, the *Shariah* department must know everything related to the pledged property or item. But sometimes the problem lies in the area of management, where the bank may discover that the mortgaged item is less valuable after the transaction is completed.
2. As for Bank Islam, it does not face problems in the implementation of *rahn*, as well, but its main problem lies in the fact that some customers attempt to pledge fake gold.

**Question 12:** It was answered by the two previous banks (Al Rajhi Bank and Bank Islam), because the previous question relates to this question and with different answers as follows:

1. Al-Rajhi Bank's proposed solution to tackling this problem is to get those who have extensive experience on this mortgaged items, whether they are real estate or a piece of land, to evaluate them before the contract is concluded.
2. Bank Islam, on the other hand, proposes that this problem can be solved by acquisition of sophisticated machines such as

decimeters and gold scanners, through which the quality of gold could be verified.

### **Comparing the Application of *Rahn* in the Banks under Examination**

From answers to the first question, it is proven that all the Islamic financial institutions that have been interviewed use *rahn* in their business activities and their banking. This indicates that *rahn* plays a crucial role in Islamic financial institutions. It could also be deduced from the answers to the second question that these financial institutions deal in both types of *rahn* mortgage (possessory and official) in their financial transactions. While Al Rajhi Bank deals in official *rahn* mortgage only, Maybank, on the other hand, deals in both possessory and official *rahn* mortgages, whereas Bank Muamalat and Bank Islam deal in possessory *rahn* mortgage only. So, Maybank agrees with Al Rajhi Bank in dealing with the official *rahn* mortgage, and also agrees with Bank Muamalat and Bank Islam in dealing with possessory mortgage.

Looking at the answers to the third question about the *rahn* structure used by these financial institutions, Al Rajhi Bank and Maybank agree in using *rahn* structure in their financial transactions, which is *ta-warruq* through *murabahah* (commodity *murabahah* or BBA). This means that these two banks finance their clients in financial transactions which require *rahn* to secure the amount of funding needed. Bank Muamalat and Bank Islam agree in using the *rahn* structure, which is a combination of *wadiah yad dhamanah* (savings with a protection guarantee), *ujrah* (fee), *qard* (loan) and *rahn* (pledge). These two banks provide *qard hasan* -goodwill loan- to their clients in this transaction, whereby *rahn* is shown as collateral for the goodwill loan amount.

Answers to the fourth question revealed the areas in which *rahn* is applied in these financial institutions. Al Rajhi Bank applies *rahn* instrument in home financing, auto financing and long-term financing, but Maybank applies *rahn* mortgage in home financing, cash line financing, and long term financing, while Bank Muamalat and Bank Islam apply *rahn* mortgage system in personal financing or in the form of a goodwill loan, *qard hasan*. Maybank shares with Al Rajhi Bank in real estate financing and long-term financing, but Al Rajhi Bank is distinguished in the field of *rahn* application to auto financing. Moreover, Maybank also specializes in the application of *rahn* in the area of cash line financing. From the above analysis, we could find that Al Rajhi Bank and Maybank

utilize the *rahn* in their business activities more than Bank Muamalat and Bank Islam.

Answer to question five determines the kind of property or items accepted by these financial institutions in their *rahn* dealings are real estate, cars, securities, commercial papers, pure gold and jewelry. Al Rajhi Bank accepts real estate, automobiles, securities, while Maybank accepts all types of collateral including property and financial assets like fixed deposit and shares. In a similar vein, Bank Muamalat and Bank Islam accept pure gold and jewelry as collaterals, but they differ in their acceptance of gold quality and purity. Bank Muamalat also accepts gold whose quality ranges between 24 and 18 carats, but Bank Islam only accepts gold, whose quality ranges between 24 and 20 carats. As for the pledge of securities and commercial papers, they are considered contemporary issues in Islamic financial transactions. It is permissible to serve these instruments as a pledge according to Islamic law based on the jurisprudential rule which says: "All that is legally saleable can serve as a pledge."<sup>8</sup>

Responses obtained for questions six and seven revolve around the sale of mortgaged items by these financial institutions in case of a customer's default. This is the main objective for which a *rahn* contract is legislated, which is taking custody of a pledged property which can be sold out to settle customer's outstanding debt should there occur a situation of inability to repay the debt. It is a known fact, that if the client fails to repay his debt and there is no *rahn* (pledge) to guarantee easy recovery of the debt, this may lead these financial institutions to bankruptcy, and by extension, expose them to a liquidity deficit. This indicates that *rahn* is one of the most important means of hedging against risk.

With reference to answers received for question seven, it becomes crystal clear that foreclosure has a prominent role to play in mitigating the risks arising from financing. Al Rajhi Bank and Maybank, for instance, believe that *rahn* secures the amount of financing and reduces risk. As for Bank Muamalat and Bank Islam, they consider that the value of *rahn*'s contribution as increasing the income of the financial institu-

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<sup>8</sup>Ismail, Mohammad Bakr, *al-qawaid al-fiqhiyyah bayn al-asalah wa al-tawjih*, (Cairo: Egypt, Dar al-Mannar, 1997) p. 241/ Abd al-Rahman ibn Abi Bakr al-Suyuti, *al-Ashbah and al-Naza'ir* (Dar al-Kuttab al-Alami, 1411, 1 H / 1995), p. 457/ Muhammad Mustafa Al-Zuhaili, *al-qawa'id al-fiqhiyah wa tatbiqatuha fi al-madhahib al-'arba'ah*, (Dar Al-Fikr, Damascus, 1, 1437 AH2006), v. 1, p. 617.



tion, because they take fees for protection of the pledged property; this is in the form of gold and other pieces of jewelry.

Through answers received from question eight, it turns out that these financial institutions do not face problems in applying *rahn*, in terms of the *Shariah*, because all the products are implemented, only after the approval of the *Shariah* Board. For Al Rajhi Bank, problems may arise from the management for not knowing the value of the pledged property, and this requires the service of an expert in that area. Bank Islam faces problems of a different nature when some customers attempt to offer fake gold as collateral. However, with the use of sophisticated machines, the quality of such pieces of jewelry can easily be detected.

#### **Analysis of the Legality of *Rahn* Contracts**

Based on the above-discussed application of *rahn* in the financial transactions of the four banks in question, we have been able to uncover some *Shariah* issues related to these applications which need to be studied and analyzed from a *Shariah* perspective.

#### **The Issue of a Combination of Contracts in a *Rahn* Pledge**

We have seen from the above answers that (the value) of *rahn* in these financial institutions lies in the combination of contracts. Al-Rajhi Bank and Maybank deal in their financing through a complex contract of *tawarruq*, *murabahah* and *rahn*, known as commodity *murabahah* or BBA, whereas Bank Muamalat and Bank Islam deal with *rahn* through several complex contracts of *wadiah yad dhamanah* (saving with a protection guarantee), *ujrah* (fee), *qard* (loan) and *rahn* (pledge). This method of combining two or more contracts in a single transaction raises the question of the legality of such contracts.

#### **The Concept of Contract Combination in a Single Transaction**

According to the AAOIFI standard, “The combination of different contracts in a single contractual system with sequential parts and successive stages, according to a system governed by one transaction, is aimed at achieving a specific purpose on the part of the two contracting parties, as it is the case with contemporary financial transactions.”<sup>9</sup> The reason for this is that the fundamental basis as regards to the combination

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<sup>9</sup>See, Accounting and Auditing Organization for Islamic Financial Institutions, *Shari’ah Standards*, p.350.

of contracts is permissibility and not prohibition, except if otherwise proven by concrete evidence from the Quran and Sunnah. Though opinions on the legality of this type of transaction vary among scholars, the most correct view is that it is permissible to combine contracts in a single deal<sup>10</sup>, except if there is contradiction among these contracts. Then, there cannot be a combination of two opposing contracts in one single deal, as in the combination of gift and sale of the gift item to the beneficiary, or combining speculation and lending speculative capital to speculators. So if contracts are interrelated, they may be combined.<sup>11</sup> Ibn al-Qayyim contends that it is not forbidden to combine two contracts, each of which is permissible, such as if he sold him a commodity and rented his house to him for one month at one hundred dirham.<sup>12</sup> Moreover, as affirmed by Nazih, although the jurisprudential basis regarding this matter is the freedom to combine legitimate contracts in a single transaction, the combined contracts are adjudged based on their individual unit. Therefore, if the transaction includes several other contracts, each of which is permissible on its own, then the whole combination is deemed permissible. This is so because this principle has an exception indicated by the methods of *Shari'ah* rules and the principles of deduction from the detailed evidence.<sup>13</sup>

However, Muslim jurists have laid down specific rules for the permissibility of transactions in which contracts are combined. These are:

1. Contract combining should not include the cases that are explicitly banned by the *Shari'ah* like combining sale and lending in one contract.<sup>14</sup>
2. It should not be used as a trick to engage in *riba* such as agreement between two parties to practice *bay al-inah* (sale and buy-back) or *riba al-fadl*.<sup>15</sup>

<sup>10</sup> Abu Bakr ibn Mas'ud al-Kasani, *badaia al-sanai' fi tartib al-sharaia*, (Beirut: Dar al-Kuttab al-ilamiya, 2, 1406-1986), v 6, p. 58.

<sup>11</sup> Munther Qahaf, *Asasiyyaat at-Tamwil al-Islamiy*, (Kuala Lumpur: International Academy of Shari'ah Research, 2011), p. 153-157/, Accounting and Auditing Organization for Islamic Financial Institutions, *Shari'ah Standards* p.350.

<sup>12</sup> Muhammad Ibn Abubaker Ibn al-Qayyim al-Jawziyya, *I'laam al-Muwaqqi'in*, Reviewed by: Muhammad Abd al-Salam Ibrahim, (Beirut: Dar al-Kutb al-Ilmiyyah, 1<sup>st</sup> Edition, 1411 A.H, 1991 A.D), vol. 3, p. 265.

<sup>13</sup> Nazih Hammad, *al-Uquud al-Murakkabah fi al-Fiqh al-Islami* (Damascus: Dar al-Qalam, 1<sup>st</sup> Edition, 1426 A.H-2005A.D), p.9.

<sup>14</sup> See, Accounting and Auditing Organization for Islamic Financial Institutions, *Shari'ah Standards* p.350.

3. It should not be used as an excuse for practicing *riba*. The two parties could misuse, for instance, contract combining, when they conclude a lending contract in such a way that it attracts some benefits to one party at the expense of the other. For example, they could stipulate in the contract that the borrower should offer accommodation in his house to the lender, or should grant him a gift of value. Contract combining could also be misused by imposing excess repayment in terms of quantity or quality on the borrower.<sup>16</sup>
4. The combined contracts should not reveal disparity or contradiction to their underlying rulings and ultimate goals. Examples of contradictory contracts include granting an asset to somebody as a gift and selling/leasing it to him simultaneously, or combining *mudarabah* with lending the *mudarabah* capital to the *mudarib*, or currency exchange with *ju'alah*, or *salam* with *ju'alah* for the same contract value, or leasing with selling (i.e. hire-purchase in its traditional form).<sup>17</sup>

If we look at the contracts mentioned in the structure of Al-Rajhi Bank and Maybank, we would discover that there is no contradiction between these contracts, except when it is an organized *tawarruq* (*tawarruq munazzam*) where the contemporary jurists differed in its permissibility.

Organized *Tawarruq* is an agreement between an Islamic bank and someone who needs cash, on the understanding that the bank sells him a commodity at a price higher than its current price on deferred terms. The buyer then assigns the Islamic bank to sell the commodity for him at a lower price than the deferred price in which he bought the commodity, so that the muwarraq will get cash, while still owing the bank the deferred amount.<sup>18</sup>

Contemporary jurists differ on its *Shari'ah* ruling and there are two differing views which can be summarized as follows:

Some of the contemporary scholars<sup>19</sup> agree to the permissibility of organized banking *tawarruq*, based on the opinion of the majority of

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<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

<sup>18</sup> Ahmad Muhammad Lutfi, *al-Tawarruq wa Tatbeeqatuhu fi al- Masarif al-Islamiyyah*, (al-Mansourah: Dar al-Fikr wa al-Qanoun, 2013 Edition, vol.1, p.86, taken from Abdul Qadr al-Amariy, Bai' al-Wafaa' wa al-Ainah wa al-Tawarruq, p.22

<sup>19</sup> Such as Dr. Abdullah Al-Manea, Dr. Mohammed Abdul Ghaffar Al-Sharif, Dr. Musa Adam, Dr. Ali Mohiuddin QaraDaghi, Dr. Mohammad Taqi Othmani.

classical jurists who hold that *tawarruq* is permissible originally, and because it achieves the need of the bank to operate its money, as well as the need of customers to borrow cash without interest rather than interest-based loans. The process is not different from buying and selling which are legitimate. A trader who buys and sells goods and earns the difference between the selling and the buying prices or loses if he needs liquidity and sells it for less than he bought it.<sup>20</sup> Conversely, the second group of scholars believe that it is prohibited.<sup>21</sup> This is because the process involves engaging in usury by trickery. This type of sale and condition is forbidden by *Shari'ah*.<sup>22</sup>

Nevertheless, the Islamic financial institutions in Malaysia adopt the view of the scholars who subscribe to the permissibility of organized banking *tawarruq*, because they deal in *inah* (sale and repurchase) transaction due to necessity. This argument is based on the view of some *Shafi'i* scholars on this matter. As for the Islamic banks in Malaysia, dealing in it is avoided because of the suspicion of usury and fraud, but they deal in *tawarruq* which has been approved by the early jurists and was described as organized banking *tawarruq*.

Given the structure of the *rahn* mentioned previously, it appears that the *rahn* contract in this transaction achieves the basic objectives for which it was originally legislated by the *Shari'ah*, which means pledging property as security in respect of a right that can be satisfied, where the bank can reclaim its right out of the pledged property (home or car) if the customer fails to repay. Accordingly, the contract of *rahn* (pledge) in this transaction is permissible in *Shari'ah*, because the *rahn* (pledge) in this transaction is considered one of the most important means to hedge against the risks resulting from mortgage financing and car financing.

As for Bank Muamalat and Bank Islam, the structure of their *rahn* contracts is a combination of *wadiah yadh amanah* (savings with a protection guarantee), *ujrah* (fee), *qard* (loan) and *rahn* (pledge). This transaction is called "*ar-rahn*", and part of what is known as personal finance. It is a loan without any increase on the grounds that any increase on a loan is *riba*— usury - and is therefore forbidden.

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<sup>20</sup> See, Ahmad Muhammad Lutfi, p. 86.

<sup>21</sup> Some of these scholars are Dr. Ali Al-Salous, Dr. Sami Al-Suwailem, Dr. Abd Al-Jabbar Al-Samhani, Dr. Ahmed Mohiuddin and Dr. Hussein Hamed Hassan, the Fiqh Council of the Muslim World League, Dr. Rafik Younis Al Masri, and others.

<sup>22</sup> *Ibid.*

*Ar-rahn* Project is approved by many Islamic financial institutions in Malaysia, and we will discuss this model from a *Shariah* perspective as follows:

### **The Issue of Combining a *Rahn* Contract and *Wadiyah* Contract on the Same Subject Matter**

While there seems to be no contradiction between these contracts, as the depositor can use the deposit as mortgage, but there is something else that has to be considered. The most important difference is the time in which the pledged/custodial good must be handed back to its owner. For example, the original ruling of a *wadiyah* contract is to return it to its owner, whenever he/she requests for it. In contrast, the basic provision of pledge (*rahn*) contract is that the pledged property must be handed back to its owner, after the pledger has fulfilled his/her entire debt obligation. Therefore, in the contract of foreclosure, the mortgagee is permitted to hold the mortgagor until the debtor pays the debt, because the primary purpose of the mortgage contract is to secure the debt. If the mortgaged items must be returned to the owner at his request, as in the case of *wadiyah*, then the purpose of the mortgage contract legislation is defeated. This fact is supported by Al-San'ani when he contends that "the pledgee is permitted to retain the pledged item until he gets his money back, even if the owner of the *marhūn* (the object of pledge) dislikes it or asks for it."<sup>23</sup>

Conversely, in a *wadiyah* contract, if the depositor wants to take back his/her item, the custodian is obliged to return the consigned item to him. Ibn Hazm says that it is obligatory upon the trustee, who has been entrusted with a deposit (*wadiyah*) to keep it safe and return it to its rightful owner upon his/her demand.<sup>24</sup> This point is elaborated further by Ibn Arabi when he emphasizes that it is not compulsory to return *wadiyah* to the owner unless on demand, while in the case of *rahn* it is not compulsory to return it until the owner has settled his debt.<sup>25</sup>

The above argument indicates that the current practice of combining a *rahn* contract and *wadiyah* contract on the same item violates one of the essential features of *wadiyah*. The owner cannot claim his/her property

<sup>23</sup> Ahmad bn Qasim al-San'ani, *At-Taj al-Madh'ab li Ahkam al-Madh'ab* (Sana'a: Dar al-Hikmah al-Yamaniyyah, 1993 A.D-1414 A.H), vol.3, p. 234

<sup>24</sup> Ali bin Ahmed Ibn Hazm, *Al-Dhaheer, al-Muhalla* (Beirut: Dar al-Fikr, d., DT), 7 ج, p. 137.

<sup>25</sup> Muhammad bin Abdullah Abu Bakr ibn al-Arabi, *Ahkām al-Qurān*, (Beirut: Dar al-Kutub al-Ilmiyyah, 3<sup>rd</sup> Edition, 1424 A.H – 2003A.D), vol. 1, p. 571.

because it is not just a *wadiyah*, but also a pledge, which grants the pledgee the right of retention. Thus, the owner can only claim the good after repaying his/her debt to the creditor/trustee.<sup>26</sup>

**The issues of *Wadiyah Yad Dhamanah* (Savings with a Protection Guarantee), and *Ujrah* (fee)**

Literally, *wadi'ah* means deposit. Legally, however, it is a contract whereby a depositor leaves his property with another for the purpose of safekeeping. Operationally, *the word "wadi'ah" is a term for money deposited with a person who holds it for safekeeping without compensation.*<sup>27</sup> Regarding *wadi'ah* deposit, Ibn Quddama says:

“It is a non-binding contract executed by both parties. Whenever the depositor wants to take back the deposited item, it is compulsory for the guardian to return it, as stated by Allah – the Exalted in the Quran in verse 4:58”<sup>28</sup>

He goes further to maintain that any deposited item is held in trust (for the owner). If it gets damaged without negligence from its custodian, he cannot incur any liability for it.<sup>29</sup>

With the above explanations, it is obvious that there are three major characteristic features which makes deposit (*wadi'ah*) distinct from other transactions. Firstly, *wadiyah* is a trust (*amanah*) contract in which there is no liability for any damage except if the damage is caused by the custodian of the deposited item. Secondly, the custodian is responsible for the safekeeping of the deposited item and must return it to the depositor upon demand. Lastly, the owner of the item has the right to request for it whenever he wants.

If we consider the deposited items mentioned in the structure previously, it appears to be based on liability (*amanah*) rather than safekeeping, as well as charging the depositor a fee for the safekeeping of the item. This leads us to the statement of the scholars and their opinions on these two issues.

<sup>26</sup>See, Mohamed Fairouz Abdul khir, et al, *Critical Appraisal of the Rahn-based Islamic Microcredit Facility*, (International Shariah Research Academy for Islamic Finance Research Paper No: 45/2012). P19.

<sup>27</sup> Al-Mansour Al-Bahouti, *Al-Rawd Al-Murabah, fi Shar'h Zad Al-Mustanqaa*, (Dar Al-Moayyed), p. 437

<sup>28</sup> Abd Allah bn Ahmad bn Quddama, *Al-Mugni*, (Cairo: Maktabah al-Qahirah, 1388 A.H, 1968 A.D), vol.6, p.436

<sup>29</sup> See, Ibn Qudaamah.

As liability for the deposited item, the jurists are unanimous that the custodian is not liable unless he is negligent, even though they differ as to his liability for some other things.

Al-Sarakhsi said:

“This means that the custodian volunteers to keep the owner’s goods. Volunteering does not bind him to be liable for the item. Hence, any damage to the item under his custody is treated as though it is in the rightful owner’s custody. This is the interpretation of the jurist: “The custody of the custodian is like that of the owner. It makes no difference whether the damage is due to an avoidable or unavoidable cause. This is because the damage that is due to an avoidable cause is similar to a defect in safekeeping, but freedom from defect is required only in an exchange contract, not in a charitable contract.”<sup>30</sup>

With regard to charging fees for the safekeeping of deposited items, a *wadiyah* contract is originally a voluntary contract that does not require a return. However, if the depository (such as a bank) requires *uj-rah* (fee), this condition is valid and the contract becomes necessary in the opinion of the majority of jurists. This is because a deposited item is held in trust in the hands of its custodian. Based on this, if it is destroyed or lost without negligence on his part, no liability is incurred. But if it is deposited with a fee for protection and it gets destroyed due to something that is avoidable such as theft, then he is liable.<sup>31</sup> However, some Malikis argue that rent is not for safekeeping but rather for the place where it is placed.<sup>32</sup>

It is now clear from the above that taking rent on the *wadiyah* is permissible, but the problem lies in the financial institution lending the client and its requirement for him to deposit items like gold and then taking conservation fees for that. In this regard, Munther Qahaf says:

"This product is a loan with *ijarah*. While it is described as a goodwill loan with no increase, and the same amount is repaid at maturity, the rent in the lease contract includes an increase in the repayment, which is in fact an increase compensating for the loss of return on the money borrowed ... The prohibition of executing a loan contract (in combination) with a sale contract also includes *ijara* and advances. This is because the reason for forbidding sale and loan contracts combined is

<sup>30</sup> Abubakir Muhammad ibn Abi Sahl al-Sarkhasi, *al-Mabsut*, Review: Khalil Muhyi al-Din al-Mais (Beirut: Dar al-Fikr, 1<sup>st</sup> Edition, 1421 AH 2000A.D), vol. 11, p 197.

<sup>31</sup> Journal of Legal Judgments, p. 148, Article (777).

<sup>32</sup> Al-Sawiy, *Hashiyat al-Sawiy ala as-Shar'h as-Sagheer*, vol. 3, p. 566.

the possibility that the sale price includes a deliberate increase in the loan. It is clear that this contract involves a clear increase in the refund. In fact, it is an increase on the loan which is *riba* (usury)."<sup>33</sup>

Mohamed Omar Naim said in his research work that:

"Before the implementation of the idea of Islamic *rahn* (pledge) as an alternative to the traditional mortgage which allows interests, there arose a dispute among the executors of the idea of Islamic mortgage on the type of loan which does not incur the bank an additional amount. And in response to that, there were several suggestions: *Al-Qard Al-Hassan* (goodwill loan), *albaya bi al-thamn al-ajili* (BBA Selling at a deferred price), *bay al-wafa* (redemption sale), *ujratalkhidmati*, (service fees), *uj-rat hi fz al-marhuna* (safekeeping fee for the pledged property)."<sup>34</sup>

This view can be elaborated as follows:

1. As long as the financial institution has entered into a new contract with the customer, which is the loan contract, and the customer has pledged gold to the financial institution, and the mortgaged (gold) is in the possession of the financial institution, and when the customer fails to fulfill his obligation, the bank has the right to sell the gold to recover its debt. But if the contract of paying the rent is still valid, then this indicates suspicion of *riba*.
2. On the other hand, it can be said that as long as the financial institution does not benefit from the gold (mortgaged), but takes a fee in exchange for its protection, with the price of safekeeping being legitimate, the transaction may be free from *riba*. But the problem lies in the requirement to pledge the deposited item and taking the price for safe keeping, before obtaining the loan as this would be tantamount to a kind of fraud.
3. As long as the financial institution needs liquidity in the running of its business and capital in the development of its enterprise, scholars differ concerning this transaction. They differ as to whether it is permissible or forbidden. To some scholars it is not clear as to whether there is no difference between the safekeeping fee and interest in the conventional

<sup>33</sup> Munther Qahaf, *Fundamentals of Islamic Finance*, p. 116

<sup>34</sup> Mohamed Omar Naeem, *ahkam alrahn al-hiazii wa al-rasmi: dirasatan fiqhiyah muqaran bi al-qanun al-malizi*, (Master's thesis, Islamic Law, Cairo University, 1420 AH / 1999), p. 253.



mortgage. It is possible that once the financial institution stabilizes and gets liquidity, it can abandon this type of transaction and this based on the difference between the scholars as to the permissibility or otherwise of this transaction. This is consistent with the maxim that: "Anything that is allowed for a reason becomes disallowed when the reason is lifted."

In order to avoid and eliminate this illegal violation, researchers suggest as follows:

### **Conclusion:**

The Islamic financial institutions in Malaysia which have been the focus of this study, namely, Al Rajhi Bank, Maybank, Bank Muamalat and Bank Islam, use *rahn* in their banking and business activities. *Rahn* is often used through a combination of contracts, and its use varies from bank to bank. Some banks use it in home financing, car financing, and long-term financing. The house and the car are pledged to guarantee the repayment of the amount of financing. On the other hand, other banks use it when they give their customers a loan and when they use *Ar-rahnu*. The bank provides a goodwill loan to the client, and in order to secure the loan amount, the bank asks the customer to pledge his/her gold as collateral for it, and the bank will charge a fee for the preservation of the gold.

The *rahn* used in these Islamic financial institutions has achieved the objectives for which *rahn* serves. was legitimate. However, some transactions in which the *rahn* appears needs to be reviewed and amended to comply with the provisions of Islamic law.

However, some structures of *Ar-rahnu* transactions, which are used by some Islamic financial institutions in Malaysia, through which the financial institutions grant their client good loans, requires further study, consideration and modifications, because there are dubious strategies that are contrary to the *Shari'ah* rules. And the researchers have referred to some of the proposed solutions, including: (1) investing gold if the financial institution is trading in gold,(2) or the financial institution takes service fees for administrative expenses, (3) or via combination of *Tawarruq* contract (through commodity *Murabahah*) and *Rahn* contract. The explanation of this structure is that the bank will enter into a *tawarruq* transaction through a commodity *murabahah* arrangement. The bank then requires the customer to pledge his/her gold as collateral (*rahn*). In the event of the customer's failure to meet his/her debt obligation, the

bank will sell the gold at the market price and refund the surplus, if the market price exceeds the financing amount.

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