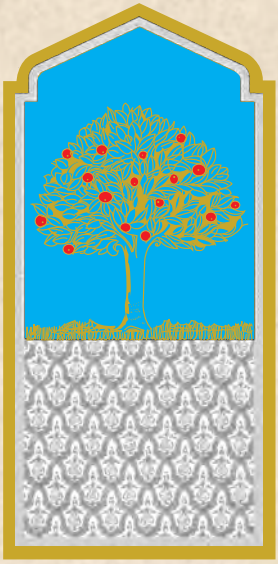

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THE USE OF FLOATING CHARGE AS AN ISLAMIC COLLATERAL INSTRUMENT: A SHARIAH COMPATIBILITY ANALYSIS[1]

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Abstract

The provision of collateral or security is imperative in modern banking as it serves as a significant form of risk mitigation against customer's default in financing activities. One of the most common security instruments utilized by financial institutions is a charge. In the context of a client which is a body corporate, it may create either a fixed or a floating charge. A floating charge has some unique features whereby it constitutes a charge on a class of a company's present and future assets. From the Shari'ah perspective, an Islamic financial institution's collateral arrangements must primarily comply with the Shari'ah. The unique feature of a floating charge where the charged assets may constantly change from time to time may require thorough Shari'ah deliberation to determine its Shari'ah status. This paper specifically analyses floating charge from the Shari'ah perspective juxtaposing the discussion with the known legal characteristics of a floating charge under the law. The paper evaluates the compatibility of floating charge with the Shari'ah, using rahn contract and requirements as the benchmark framework. From the assessment, it is observed that a floating charge does not fulfil the rahn requirements as stipulated by the majority of jurists (Hanafi, Shafi'i and Hanbali). Nonetheless, the Maliki opinion tolerates the features of floating charge involving uncertain or unknown assets. In this regard, Maliki jurists are generally of the view that rahn is a secondary contract, hence, it remains valid even when there are gharar elements in the rahn asset. Another issue in a

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floating charge is the possibility of the charged assets becoming Shari'ah non-compliant or mixed with Shari'ah non-compliant assets in the future. The Malikis along with the majority of classical jurists do not allow rahn on impermissible assets. However, the paper finds some contemporary Shari'ah opinions arguing that they can still be used as marhun, provided that the prohibited elements are external and can be eliminated/excluded.

Keywords: floating charge, collateral, *rahn,* Islamic law, Islamic banking and finance

1.0 Introduction

The provision of collateral or security is an imperative tool for credit assessment in modern banking as it serves as a significant form of risk mitigation against customer's default in financing activities[2]. It is quite common that customers, both individuals and corporate or business entities, are required to provide some form of assurance for satisfaction of the debt when applying for financing facilities from a financial institution. The financial institution may require the assurance to be provided by the debtor by putting aside or providing an asset as security. In the context of a financing arrangement, financial institutions normally will require that the customer provides an amount of assets in the form of money, securities (such as shares and bonds) or other tangible and intangible property as the subject matter of the security instrument.

As business entities sharing similar functions with conventional banks, Islamic banks also employ collateral as an important credit and risk mitigation tool for their financing facilities. From the *Shari'ah* perspective, an Islamic financial institution's collateral arrangements must primarily comply with the *Shari'ah* and that the assets used as collateral must be *Shari'ah* compliant. Collateral / security instruments under the *Shari'ah* is governed under the Islamic security contracts or *'uqud al-tawthiqat*, which is a

[2] Javed Ahmed Khan & Shariq Nisar, *Collateral (Al-Rahn) As Practiced by Muslim Funds of North India*, J.KAU: Islamic Econ., Vol.17, No.1, (2004), 21.

broad concept. In general, the term *tawthiq* can be defined as the act of strengthening the right to preserve it upon failures or default of one's event to fully ensure its' result is acheived[3]. Ahmad Zuhayli[4] and Hammad[5] have stated that in the financial or commercial context the role of Islamic security contracts is to strengthen and establish the rights and to safeguard both the creditor or debtor from disagreement or non-awareness or inconsistency of debt amount (higher or lower) and can be used as evidence should the matter be raised to the court to address the dispute. The commonly acknowledged Islamic security contracts (uqud tawthiqat) can be in the form of *rahn, hawalah, kafalah*, or *daman* contracts. Each of these contracts has their own nature and requirements that need to be adhered to and complied with from the *Shari'ah* perspective[6].

However, most of the security instruments and the underlying assets used and accepted within the Islamic financing sphere mirror the conventional practices as there is no clear governing guideline issued on the same[7].

Under the common law, a collateral or security is provided in relation to an obligation to pay, so that if the obligation is not met, the collateral may be sold and the proceeds be applied to pay the obligation[8]. It involves the grant of a right in an asset, which the

[3] Mahmud Ismail, Nidhar Abd Qader, *Nizam al-Tawthiq fi al-Shariah al-Islamiyyah (Al-Tawthiq bi al-Kitabah fi al-Shariah)*, (n.p: 1993), 2.

[4] Muhammad Al-Zuhayli, *Wasail al-Ithbat fi al-Shariah fil Mu'amalat al-Madaniyyah wal-Ahwal al-Shakhsiyyah*, (Beyrut: Maktabah Dar al-Bayan, n.d), vol.1, 31.

[5] Nazih Hammad, "*Rahn al-Duyun wa Sanadat fi al fiqh al-Islami* (Contract of *Rahn* on Debt and Bond from Islamic Law Perspective)", *Dirasah Ta'siliyyah wa Tatbiqiyyah*. Paper presented for 14th *Shari'ah* Conference for AAOIFI, Bahrain, (22-23 March 2015).

[6] Tawfeeq Ibrahim Musa Abu Aqeel, *Ahkam al-Rahn fi Al-Shari'ah Al-Islamiyyah Bayna Nazariyyah wa al-Tatbiq* Unpublished thesis, (Paletsine: University of Hebron Al-Khalil, 2008), 3.

[7] This information is obtained from a focus group discussion (FGD) conducted at INCEIF on 19 September 2017. The FGD comprised of 25 participants from industry practitioners, experts, selected *Shari'ah* scholars and legal advisors, which generated invaluable inputs from the participants.

[8] Lynn M. LoPucki, Arvin I. Abraham and Bernd P. Delahaye, "Optimizing English and American Security Interest", *Notre Dame Law Review*, vol.88

grantor owns or has an interest in, for an advance or debt so that if the total assets of the debtor are insufficient to pay all the creditors, the grantee or financier will be able to use the asset to obtain total or partial payment[9]. The common law recognises four types of collateral instruments, i.e. mortgages, charges, pledges and lien[10]. Essentially each of these instruments grant a legal or equitable security interest in the assets of the borrower to a creditor, who then has the right to appropriate those assets if the borrower fails to perform its underlying obligations. However, each type of security has different elements and grants different types of rights to creditors.

Within the common law legal system, including Malaysia, one of the most common security instrument utilized by financial institutions as a credit and risk mitigation tool is a charge. In the context of a client which is a body corporate, a company may create either a fixed or a floating charge. A floating charge has some unique features whereby it constitutes a charge on a class of a company's present and future assets. In this arrangement, the debtor or chargor of the asset can still deal or dispose of the asset in the ordinary course of business, without requiring consent of the creditor (chargee). In the event of default or if the debtor goes into liquidation, the floating charge attaches into its then current assets, thus, '*crystallizing*' into a fixed charge and according a priority status to the creditor. The unique feature of floating charge where the charged assets may constantly change from time to time may require thorough *Shari'ah* deliberation to determine its *Shari'ah* status. In order to address the above concerns, a more detail scrutiny must be made to the relevant specific issues, so that the *Shari'ah* status of a floating charge can be more conclusively determined. Thus, this paper specifically analyses floating charge from the *Shari'ah* perspective juxtaposing the discussion with the known legal characteristics of a floating charge under the law.

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(4), (2013), 1785.

[9] Louise Gullifer, "The Reforms of The Enterprise Act 2002 and The Floating Charge as A Security Device", *Can. Bus. L.J.*, 46, (2008), 399-400.

[10] Asian Development Bank, *Unlocking Finance for Growth, Secured Transactions Reform in Pacific Island Economies,* Manila, Philippines: Asian Development Bank, (2014), 6; Louise Gullifer, *Goode & Gullifer on Legal Problems of Credit and Security*, (Sweet & Maxwell, 2013), 31.

The paper starts with an introduction of the problem. Section 2 gives an overview of charge and its types under the civil law, followed by a discussion on the compatibility of charge with the *Shari'ah* contract of *rahn* in section 3. Section 4 then discusses the compatibility of floating charge with the *Shari'ah*, using *rahn* contract and requirements as the benchmark framework for assessment. The paper then provides some concluding remarks and recommendations in Section 5.

2.0 An Overview of Charge and Its Types under Civil Law

A charge entitles a creditor to seize an asset upon a condition, such as, failure to pay an obligation. Goode provides a very comprehensive definition of a charge, i.e., an agreement between the creditor and the debtor by which a particular asset or class of assets is appropriated to the satisfaction of the debt, so that the creditor is entitled to look at the asset and its proceeds to discharge the indebtedness in priority to the claims of other unsecured creditors and junior encumbrances; and it does not transfer ownership of the asset but merely creates an encumbrance or impediment[11].

An important feature of a charge is that if there is default, the creditor is entitled to sell the collateral assets without having to obtain the consent of the debtor. When a charge is created, it creates a right to have access to judicial process enabling the chargee to seize the charged property and to sell it to pay off the debt[12]. The charge can be divided into two types which are fixed and floating. Under a fixed charge, the debtor may not dispose of the charged asset without the consent of the creditor. Another type of charge is the floating charge, which can be created over a class of assets and enables the debtor to deal with the collateral assets in the ordinary course of business without any interference from the creditor until the floating charge crystallises[13]. Therefore, fixed charges enable equipment finance, but are not useful for inventory finance, because inventories

[11] Roy Goode, *Goode & Gullifer Legal Problems of Credit and Security*, (Sweet & Maxwell, 2003), 36.
[12] *Re Cosslett (Contractors) Ltd*, (1998), ch.495.
[13] *NGV Tech Sdn Bhd (receiver and manager appointed) (in liquidation) v Rammstech Ltd*, MJLU, (2015), 671.

are constantly changing. A floating charge is perhaps more suitable as it may be created over a changing pool of assets, rather than one particular asset.

2.1 Fixed Charge

A fixed charge is a security interest that gives a lender the greatest priority against competing claimants. However, to enjoy the benefits of this security instrument, a creditor is required to have a high degree of control over the collateral. This would include the requirement that consent of the creditor must be obtained for any disposition of the collateral, even for dispositions of inventory and other collateral in the ordinary course of the debtor's business[14]. In addition, the creditor must receive and have control of the proceeds. Under a fixed charge, the subject matter or the charge are usually the debtor's more permanent assets such as land and fixtures; and the charge immediately attaches to the assets. The chargee is given control over the chargor's ability to deal with the charged assets. This means that the chargor cannot dispose of or have any dealings on the asset(s) without the consent of the chargee[15].

2.2 Floating Charge

Since a fixed charge does not allow the debtor to use the assets without the creditor's consent, it would be burdensome for a debtor to carry on with its ordinary course of business if all its assets were subjected to such a charge. Thus, the common law allows the creation of a floating charge. A floating charge is a security interest applied to constantly changing assets of the debtor. A floating charge hovers over the assets which the chargor currently owns or afterwards acquires provided the after acquired assets fall within the same asset class. The debtor is allowed to use, collect or dispose of the covered assets in the ordinary course of business; and the floating charge automatically covers any new items of similar nature. Floating charges remain over the property they are intended to affect, while leaving the debtor free to sell, buy and vary the assets under the charge until the debtor defaults at which time the floating charge

[14] *Re Yorkshire Woolcombers Association*, (1903), 2, ch.284.
[15] Ibid.

'fixes' on the existing asset or assets. This process of fixing on an asset or group of assets is called "crystallization" of the charge. When a floating charge crystallizes, it attaches to all the assets that the debtor/chargor currently owns within the charged asset class. After crystallization, the creditor can deal with any of the assets then existing under the charge and the debtor-company is no longer able to deal with the assets in the ordinary course of the company's business[16].

Under a floating charge, attachment over specific assets in the asset class is deferred. The chargee's rights "attach" in the first instance not to specific assets but to a shifting class of assets, including future assets. The chargor is left free to manage and dispose off assets in the class of assets under the charge, in the ordinary course of business, until an event occurs which causes the floating charge to crystallise[17].

The most important characteristics to determine whether a charge is a fixed charge or a floating charge are: (i) whether the asset subject to the charge is under the control of the chargee/creditor; and (ii) whether the asset is of a type that is constantly changing and needs to be disposed of in the company's ordinary course of business. In *Re Cosslett (Contractors) Ltd*[18], it was stated that:

> *"The essence of a floating charge is that it is a charge, not on any particular assets, but on a fluctuating body of assets which remain under the management and control of the chargor, and which the chargor has the right to withdraw from the security."*

The charge is a floating charge where the assets are under the control of the debtor-company even though the charge document described the charge as a fixed charge or the charge document used a different term[19]. It is clear that a charge over land or factory or building is a

[16] *Illingworth v Houldsworth*, (1904), AC 355.

[17] LexisNexis. "Types of Security – Overview" Lexis Nexis, https://www.lexisnexis.com/uk/lexispsl/bankingandfinance/document/391289/55KB-65S1-F185-X1PM-00000-00/Types_of_security_overview#, accessed on August 31, 2018

[18] *Re Cosslett (Contractors) Ltd*, op. cit.

[19] *National Westminster Bank Plc v Spectrum Plus Ltd & Ors* [2005] 4 All

fixed charge because these assets are clearly identified and not part of a class of assets. However, in *Re Lin Securities (Pte)*[20], it was stated that a "fixed charge" created over the company's entire assets and undertaking is actually a floating charge. This is because, where the reference is made to the company's entire assets, it will most likely be a combination of specific assets which do not change and also other assets which the company can use or dispose of in its ordinary course of business. In this instance, the charge is treated as a floating charge because only a floating charge will allow the secured assets to be used by the company in its ordinary course of business during the term of the charge. Nonetheless, if the specific asset is the only property or asset owned by the company, for example, a building or a ship, a fixed charge may be created over it[21]. A charge, purportedly a fixed charge, was created over all the company's assets excluding the company's lands and trading stock of goods held for resale. The court nevertheless held this to be a floating charge as it would have included office equipment, tools and book debts[22]. The key differences between fixed and floating charges are summarised in Table 1:

Table 1: Summary of key differences between fixed and floating charges

Key Differences	Floating Charge	Fixed Charge
Definition	a charge on an asset that constantly changes in quantity and/or value from time to time (such as an inventory, stock in-trade), to secure the payment of a financing.	a charge on a specific fixed asset (such as a parcel of land) to secure the payment of a financing.

ER 209.

[20] *Re Lin Securities (Pte),* (1988), 2, MLJ 137

[21] *Re Panama, New Zealand and Australian Royal Mail Co* (1870) LR 5 Ch App 318.

[22] *Re G E Turnbridge Ltd* [1995] 1 BCLC 34.

Key Differences	Floating Charge	Fixed Charge
Type of assets	A floating charge usually covers all current and future assets of the company such as stock-in-trade, plant and machinery, vehicles, etc.	A fixed charge usually covers all of a particular property, e.g. land and buildings, a ship, piece of machinery, shares, intellectual property such as copyrights, patents, trademarks, etc.
Asset Utilization and Disposal	Under this arrangement, the debtor (chargor) of the asset can deal or dispose off the asset in the normal course of business, without requiring consent from the creditor (chargee). In the event of default, OR the debtor goes into liquidation, the floating asset freezes into its then current state, 'crystallising' the floating charge into a fixed charge and making the financier a priority creditor.	Under this arrangement, the asset is assigned as a charge to the creditor and the debtor (chargor) would need the creditor's permission to deal in or dispose it off. The financier also registers a charge against the asset which remains in force until the financing is paid.

Source: Authors' own

3.0 Charge and Its Compatibility with *Rahn* Contract?

In the previous section, the study has deliberated on the features of both fixed and floating charges from a legal standpoint. As for the *Shari'ah* point of view, a charge, especially a fixed charge, can be said to be closest to a *rahn* contract. Literally, *rahn* is an Arabic word which means permanency and constancy[23].

Technically, Hanafi scholars define it as holding a valuable item in lieu of debt obligation that may be satisfied from that item in case of default[24]. According to Maliki scholars, *rahn* is defined as: an act of a person who has an authority to perform sale transaction in

[23] Fayruz al-Abadi, al-Majid al-Din Muhammad ibn Ya'kub. *Al-Qamus al-Muhit*. (Beyrut: Mu'assah Al-Risalah, 2005), vol.2, 250.
[24] Muhammad Amin ibn 'Umar ibn Abd 'Aziz Ibn 'Abidin, *Hashiyah Radd al-Muhtar ala al-Durr al-Mukhtar*. (Beyrut: Dar al-Kutub al-'Ilmiyyah, 2003), vol.10, 68-72.

making something that can be sold or something with ambiguity (*gharar*) - even if it is spelled out as a condition in the contract - as a security to a right[25]. Shafi'i scholars define *rahn* as placing an item as security to a debt obligation whereby it can be recovered from it in the case of default[26]. Likewise, Hanbali scholars define *rahn* as a property that is made as security to a debt whereby it can be recovered from its price in case of the debtor's default[27].

It can be observed that Muslim scholars use different expressions in defining *rahn*. However, all of them agree that it is a kind of security against a debt, whereby the secured property can be utilised to repay the debt in the case of default. In short, Muslim jurists define the contract of *rahn* as involving assets offered as security for a debt in case the debtor fails to pay back the money due[28]. However, it is observed that Hanafi scholars emphasize the act of holding in their definitions, which may be construed to mean taking control of the security or possessing it; while other scholars do not mention this as part of their definition of *rahn*. It is also noted that the Maliki scholars have included asset with ambiguity (*gharar*) as eligible for the purpose of collateral.

Contemporary literature such as, AAOIFI defines *rahn* as a financial asset or so, tied to a debt so that the asset or its value is used for repayment of the debt in the case of default[29]. *Rahn* also means to charge or lodge a real or corporeal property of material value, in

[25] ´Abu 'Abdullah Muhammad ibn Muhammad ibn Abdul Rahman al-Maghribi Al-Hattab, *Mawahib al-Jalil li Sharh Mukhtasar Khalil*. (Beyrut: Dar Alim al-Kutub, n.d). vol.6, 538; Muhammad ibn Abdullah Al-Khurashi., *Sharh al-Khurashi ala Mukhtasar SidiKhalil*, (n.p: n.d) vol.5, 236.

[26] Shams al-Dīn Muhammad ibn Muḥammad al-Khatib Al-Sharbini, *Mughni al-Muḥtāj ila Ma'rifah Ma'ani Alfaz al-Minhaj*. (Beyrut: Dar al-Kutub al-Ilmiyyah, 2000), vol.2, 122-123.

[27] Abī Muḥammad 'Abdullah ibn ´Aḥmad ibn Muḥammad Ibn Qudāmah, *Al-Mughni,* (Riyadh: Dar al-'Alim al-Kutub, 1997), vol.4, 234.

[28] Al-Dusuqi, *Hashiah al-Dusuqi 'ala al-Sharh al-Kabir*. (Beyrut: Dar al-Fikr, n.d), vol.3, 231.

[29] Accounting and Auditing for Organization of Islamic Financial Institutions (AAOIFI). *Shari'ah Standards for Islamic Financial Institutions*. (Bahrain: AAOIFI, 2017), *Sharī'ah* Standard no.39: *Mortgage and Its Contemporary Applications,* 968.

accordance with the law, as security for a debt or pecuniary obligation, so as to make it possible for the creditor to recover the debt or some portions of the goods or property[30]. In fact, the essence of *rahn* is to provide backing or security for a loan (*qard*) or other forms of indebtedness (*dayn*)[31]. It is also noted that the nature of *rahn* is a voluntary and charitable contract (*tabarru*'), where the charged property is given without any financial consideration[32].

Admittedly, the above definitions of *rahn* are wide enough to cover various forms of common law security instruments such as, pledge, charge and mortgage. However, it is worth mentioning that the *rahn* contract does not match with some of the characteristics of the other three types of common law security instruments, i.e., mortgage, pledge and lien. This is because: (i) mortgages involve the transfer of ownership of the mortgaged assets from the debtor to the creditor, which is not a criterion of *rahn*; (ii) pledges require delivery and possession of the pledged assets by the creditor, which is not mandatory in *rahn*; and (iii) liens involve holding the lien assets without having the right to dispose it, which is not necessarily the case for *rahn*.

Comparing the above definitions of *rahn* with that of a charge, it can be said that they are very similar. This is in line with the description of the charge where the creditor has the right to recover from the charged property should the debtor fail to meet or pay his debt obligation whereby the ownership of the charged property is not transferred to the creditor during the financing tenure[33]. The features

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[30] Abdullah Alwi Hj Hassan, *Sales and Contracts in Early Islamic Commercial Law*, (Islamabad: Islamic Research Institute, 2000), [Sales and Contracts in Early Islamic Commercial Law], 146.

[31] Ida Madieha Azmi & Engku Rabiah Adawiah Engku Ali, "Legal Impediments to the Collateralization of Intellectual Property in the Malaysian Dual Banking System", *Asian Journal of Comparative Law*, Vol.2, No.1, (2007), Article 8, 8.

[32] *Majallah*, no.706: the pledge becomes a concluded contract by the offer and acceptance of the pledgor and pledgee. But, until it is received, it is not complete and irrevocable. Therefore, the pledgor before delivery can go back from the pledging.

[33] Louise Gullifer, "The Reforms of The Enterprise Act 2002 and The Floating Charge as A Security Device", op. cit.

of *rahn* are closely identical with a charge, making it an appropriate translation of choice for the term *rahn*. Therefore, for the purpose of this paper, although the word *rahn* has been variably translated in the literature as pledge, mortgage or charge, this paper will translate it as a charge to provide consistency and avoid confusion with the meanings associated with the other security instruments under common law.

4.0 Floating Charge and Its Compatibility with the *Shari'ah*

As discussed earlier, a floating charge is a charge on a class of assets (present and future) of a company where these assets may be dealt with by the company in the ordinary course of its business. This floating charge will continue until it is crystallised into a fixed charge when any of the crystallization events or conditions as set out in the debenture occur. Until then, the assets remain under the full control of their owner, i.e. the debtor, even to the extent of selling them off, further charging them or acquiring new assets of the same class to be automatically included under the floating charge. These features of a floating charge contain some elements that may make it incompatible with the general features of a *rahn* contract.

In order to address the above concerns, a more detail scrutiny must be made to the following specific issues, so that the *Shari'ah* status of a floating charge can be more conclusively determined. For this purpose, *rahn* contract is used as a benchmark framework to determine the *Shari'ah* compatibility of a floating charge. This section begins with a brief discussion on the legality of *rahn* contract from the *Shari'ah* perspective, followed by a detailed discussion on the *Shari'ah* requirements under *rahn* contract, particularly, the requirements related to the taking possession (*qabd*) of *rahn* asset, as well as issues of uncertainty (*gharar*), ignorance (*jahalah*) and non-existence (*ma'dum*) of the *marhun*.

4.1 Legality of Rahn

The permissibility of *rahn* under the *Shari'ah* is derived from various Quranic verses, prophetic sayings as well as *ijma*' of the Muslim scholars. For example, the term *rahn* has been mentioned in the

following Quranic verse: "if you are on a journey and cannot find a scribe, then a security [should be] taken"[34].

Ibn Jarir al-Tabari[35] (v.3, 1988) and Al-Qurtubi[36] are among the scholars who clarified further the concept of *rahn* as stated in the above verse 283 of al-Baqarah. This verse indicates the permissibility of taking *rahn* when the debt transaction takes place whilst one or both parties are travelling. This practice also applies to any contracting parties who are not travelling. Nevertheless, the discussion on permissibility of taking security as discussed by the jurists here is only confined to the contract of *rahn* and does not involve any other *uqud al-tawthiqat*.

In addition, there are various narrations of *hadith* that discussed *rahn* as reported by al-Bukhari, Muslim and some other narrators. The following are among the well-known *ahadith* with regard to the practice of *rahn*. In a *hadith* from Anas, he said that: "The Prophet charged his armour to a Jew in Madinah and bought barley bread from the Jew for his family"[37]. Also Aisyah (r.a), said: "The Prophet bought some foodstuff on credit from a Jew and charged an iron armour to him"[38].

The Muslim scholars have also unanimously agreed (*ijma'*) that *rahn* contract is permissible from the *Shari'ah* perspective[39]. Based on the Qur'ānic verse, the prophetic traditions and *ijma'* mentioned above, it is established that the contract of *rahn* is allowable from the point of view of *Shari'ah*.

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[34] *Al-Baqarah*: 283.

[35] Al-Hurastani Al-Tabari, *Tafsir al Tabari min Kitabihi Jami' al-Bayan an Ta'wil al Qur'an*, (Beyrut: Mu'assasah al-Risalah, 1994) vol.2.

[36] Abu 'Abdullah Muhammad ibn Ahmad Al-Ansari Al-Qurtubi, *Al-Jami' li Ahkam Al-Qur'an*, (Beyrut: Dar al-Mu'assasah, 2006) vol.3.

[37] Abi 'Abdullah Muhammad ibn Isma'il Al-Bukhari, *Sahih Al-Bukhari*. (Riyadh: Maktabah al-Rushd, 2006). *Hadith* no.1963, *Kitab al-Buyu'*, Vol.2, 729.

[38] Ibid, *hadith* no.1990, *Kitab al-Rahn*, vol.2, 738.

[39] Ibn Qudamah. *Al-Mughni,* vol.4, 234; Al-Sharbini, *Mughni al-Muḥtaj ila Ma'rifah Ma'ani Alfaz al-Minhaj*. vol. 2, 121; Shihab al-Din Abu al-'Abbas Al-Qarafi, *Al-Dakhirah fi Furu' al-Malikiyyah.* (Beyrut: Dar al-Gharb al-Islami, 1994) vol.8, 75; Abi Bakr Muhammad ibn Ahmad ibn Abi Sahl Syams Al-Sarakhsi, *Al-Mabsut*. (Beyrut: Dar al-Kutub al-'Ilmiyyah, 2001), vol.21, 64.

4.2 General Requirements of Rahn

Muslim scholars differ on the key requirements of a *rahn* contract. Majority of Muslim jurists (Maliki, Shafi'i and Hanbali jurists) were of the view that a valid *rahn* contract shall contain the following elements[40]:

a) Contracting parties, i.e. chargor (*rāhin*) and chargee (*murtahin*),
b) The charged asset (*marhūn*)
c) Debt obligation (*marhun bihi*)
d) *Sighah* – offer and acceptance (*Ījāb* and *qabūl*).

On the other hand, the Hanafi jurists differ from the majority's view, where they only regard *sighah* i.e. the offer and acceptance as the only essential element of a *rahn* contract.[41]. Nevertheless, although the Hanafi opinion limits the essential element of a *rahn* contract to *sighah* (offer and acceptance), it is still subject to the existence of the contracting parties, the collateral assets and the debt obligation. Thus, it can be submitted that the difference of view here is merely in form and not in substance.

Generally, each of the above elements of *rahn* has its own conditions. These elements and conditions are discussed by the jurists[42] as the following;

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[40] ´Abi al-Walid Muhammad ibn Ahmad Ibn Rushd, *Bidayah al-Mujtahid wa Nihayah al-Muqtasid*. (Beyrut: Dar al-Fikr, n.d), vol.2, 272; Al-Qarafi, *Al-Dakhirah fi Furu' al-Malikiyyah*. vol.8, 78-79, Al-Sharbini, *Mughni*, vol.2, 121, Alauddin Abi Hasan ibn Ali Sulayman Al-Mardawi, *Al-Insaf fi Ma'rifatul Rajih min al-Khilaf*, (n.p: nd), vol.5, 137; Mansur ibn Yunus ibn Idris Al-Buhuti, *Kashshāf al-Qinā' an Matan al-Iqnā* ', (Beyrut: Dar al-Kutub, 1997), vol.3, 321, 323.

[41] Ala' al-Din Abi Bakr ibn Mas'ud Al-Kasani, *Bada'i' al-Sana'i' fi Tartib al-Shara'i'*, (Beyrut: Dar al-Kutub al-Ilmiyyah, 2003), vol.6, 204; Muhammad ibn 'Abd al-Wahid al-Siwasi al-Sikandari Kamal al-Din Ibn al-Humam, *Sharh Fath al-Qadir 'Ala al-Hidayah Sharh Bidayah al-Mubtadi'*, (Beyrut: Dar al-Kutub al 'Ilmiyyah, 2003), vol.9, 66; Ibn 'Abidin, *Hashiyah Radd al-Muhtar ala al-Durr al-Mukhtar*. Vol.10, 68; Ali ibn Abu Bakr Al-Maghinani, *Al-Hidayah Sharh Bidayah al-Mubtadi',* (Maktabah Kaherah: Dar al-Salam li al-Taba'ah wa al-Nashir wa tauzi' wal tarjamah, 2000), 1555.

[42] Ibn Rushd, *Bidayah*, vol.2, 272; Muhammad ibn Shihab al-Din Al-Ramli, *Nihayah al-Muhtaj ila Sharh Minhaj*, (Beirut: Dar al-Fikr, n.d), vol.3, 375;

a) Contracting parties (chargor and chargee): The parties must be eligible to execute a contract by having attained the age of prudence and having full control over the subject of the contract. By having satisfied these conditions, both parties reduce the risk of being cheated and mitigate undue influence that could possibly violate their rights and consequently annul the contract.
b) The charged asset (subject matter): The majority of jurists maintain that the charged item must be something that is legal, permissible, valuable, existent and owned by the chargor (debtor) or an authorised agent or a third party who has allowed or authorised the use of the said asset.
c) *Sighah* (offer and acceptance): The contractual expression (*sighah)* of the *rahn* contract must satisfy the general terms of the contract and the phrasing must be clear, concise and free from any ambiguity.

4.3 Requirements of Rahn Asset (Marhun)

The requirements of the *rahn* asset (*marhun*) involve the following criteria;

a) The *marhun* shall be a **property**: Most of Muslim scholars agreed that the *marhun* in a *rahn* contract can be in the form of property/assets that are either movable (vehicle, inventory, stocks, cash etc) or immovable (land, building, trees etc).[43] Assets that are fungible (*mithliyyat*) such as gold, silver or other assets that can be weighed or measured; or valuable (*qimiyyat*) such as trade stocks, animals, etc. can also can be use as *marhun*. Premised on the above, it is clear that the *marhun* must be a property, thus, things that are not recognised as property, such as, carcass, blood, etc. shall not be eligible to be used as *marhun*.[44]

Alauddin Abi Hasan ibn Ali Sulayman Al-Mardawi, *Al-Insaf*, vol.5, 139; Ibn Qudamah, *Al-Mughni,* vol.4, 380.

[43] Al-Sarakhsi, *Al-Mabsut*. vol.21, 64; Ibn Rushd, *Bidayah,* vol.2, 272, Al-Hattab, *Mawahib,* vol. 6, 542-543; Ibn Qudamah, *Al-Mughni*, vol.4, 239.

[44] Al-Kasani, *Bada'i',* vol.6, 205; Al-Qarafi, *Al-Dakhirah fi Furu' al-Malikiyyah,* vol.8, 92-93; Abi Hasan Ali ibn Muhammad Al-Mawardi, *Al-Hawi al-Kabir fi al-Fiqh Mazhab al-Imam Al-Shafi'i*, (Beirut: Dar al-Kutub al-Ilmiyyah, n.d), vol.7, 102; Ibn Qudamah, *Al-Mughni*, vol.4, 242.

b) The *marhun* shall be under **valid ownership**: This is one of the conditions for a *marhun* to be valid under a *rahn* contract. Muslim jurists unanimously agreed that in order to be permissible, the *marhun* shall be subject to a valid ownership (either physical or usufruct) by the chargor (*rahin*) or another owner (in the case where the *marhun* is obtained from a third party with his/her consent) .[45] The Muslim jurists further discuss the permissibility of using a *marhun* that is owned by a third-party owner but the consent is yet to be obtained. The jurists have different opinions on this matter. According to the Hanafi [46] and Maliki [47] jurists, the status of *rahn* is unconfirmed until permission is obtained from the asset owner and this arrangement is also known as *rahn fudhuli.* On the other hand, the Shafi'i[48] and Hanbali[49] jurists hold that it is not permissible to use a third-party asset as *marhun* without his/her consent. In addition, it is argued that since a third-party asset cannot be sold without the owner's permission, the same principle also applies in prohibiting the use of a third-party asset as *marhun* without the owner's permission.

c) The *marhun* shall be recognised as a **valuable asset** from the *Shari'ah* perspective: The *marhun* shall be in the form of recognised and valuable assets from the perspective of *Shari'ah*, so that they can be utilised to settle the debt accordingly. Muslim jurists unanimously agree that it is forbidden for a Muslim either to use or accept *marhun* in the forms of liquor or swine from another Muslim or non-Muslim, even when it has been stipulated in the contract that it would be placed under the possession of a non-Muslim.[50] Generally, the main purpose of *rahn* is to secure

[45] Al-Kasani, *Bada'i',* vol.6, 204-205; Ibn Rushd, *Bidayah,* vol.2, 273; Al-Sharbini, *Mughni,,* vol. 2,125; Ibn Qudamah, *Al-Mughni*, vol.4, 247.

[46] Al-Kasani, *Bada'i',* vol.6, 204-205; Ibn 'Abidin, *Hashiyah* vol.10, 115-116.

[47] Ibn Rushd, *Bidayah* vol.2, 273; Al-Qarafi, *Al-Dakhirah,* vol.8, 89-80.

[48] Al-Sharbini, *Mughni*, vol.2, 125; Al-Mawardi, *Al-Hawi*, vol.7, 383.

[49] Sham al-Din ibn Muhammad Ibn Muflih, *Al-Furu'*, (Beyrut: Dar al-Alim al-Kutub, 1985), vol.4, 160; Ibn Qudāmah, *Al-Mughni,* vol.4, 242.

[50] Al-Kasani, *Bada'i',* vol.6, 205; Ibn 'Abidin, *Hashiyah,* vol.10, 105; Al-Qarafi, *Al-Dakhirah,* vol.8, 87-88; Al-Mawardi, *al-Hawi,* vol.7, 210; Ibn

the debt by using the *marhun* to satisfy the outstanding debt in the case of default. As such, the use of both liquor or swine for that purpose is prohibited, due to the clear-cut prohibition for a Muslim to deal with both assets under the *Shari'ah*. According to the majority of Muslim scholars, if a Muslim places such kind of assets as collateral to a non-Muslim, in the case of such assets being damaged or lost under the possession of the non-Muslim, there is no requirement for him to compensate the value of the assets as they are non-valuable assets from the *Shari'ah* standpoint. The same treatment applies even in the case of the chargor (*rahin*) being a non-Muslim. However, the Hanafi scholars took a different view, where, in the case of the *rahin* is a non-Muslim and he uses such prohibited assets as *marhun* to a Muslim creditor (chargee), the Muslim creditor is liable to compensate the value of the *rahn* assets if they are damaged or lost under his possession due to his negligence or wrongdoing.[51] Finally, in the case of *rahn* between non-Muslim contracting parties, there is no restriction of the types of assets to be used as *marhun*. Thus, they can agree to use even the prohibited assets since these assets are recognised as valuable assets among the non-Muslims.

d) The *marhun* shall be **in existence** at the inception of *rahn* contract: The Muslim jurists discuss thoroughly on the permissibility or otherwise of *rahn* for non-existent assets or assets that may exist or become available, such as, *rahn* of crops that have yet to mature during the year; or foetus in its mother's womb; or any production of flour or wheat for the current season; etc. According to the majority of Muslim jurists (Hanafi, Shafi'i and Hanbali), the *marhun* shall exist at the inception of *rahn* contract as it is not permissible to sell a non-existent asset, thus, the same rule applies to *rahn* contract too. Based on this view, it is not permissible to use non-existent assets as *marhun*.[52] On the

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Qudāmah, *Al-Mughni,* vol.4, 257; Al-Buhuti, *Kashshaf,* vol.3, 349-350.

[51] Al-Kasani, *Bada'i',* vol.6, 205; Ibn 'Abidin, *Hashiyah,* vol.10, 105; Al-Sarakhsi, *al-Mabsut*. vol.21, 89, 115.

[52] Al-Kasani, *Bada'i',* vol.6, 204-205; Muhammad ibn Idris Al-Shafi'i, *Al-Umm*, (Beyrut: Dar al-Ma'rifah, n.d), vol.3, 153; Ibn Qudāmah,

other hand, the Maliki jurists took a different position in relation to *rahn* of non-existent assets. Some of the Maliki jurists allow for the *rahn* of non-existent assets whether it is stipulated or not stipulated in the contract. They argue that originally the debt obligation exists without any requirement of having *rahn*, thus, it is better to have one rather than having nothing[53].

e) The *marhun* shall be **deliverable** at the point of *rahn*: According to majority of Muslim jurists, the *marhun* shall be capable of delivery as it must fulfil the requirement of sale that requires the asset to be capable of delivery, otherwise the sale contract will be void. The same ruling applies to *rahn* contract. Thus, it is not permissible for assets that are not capable of delivery at the time of contract to be used as *marhun*, such as, escaped animals or birds in the sky.[54] On the other hand, the Maliki jurists have a different view, where they rule that *rahn* of non-deliverable assets even if it is stipulated or non-stipulated in the contract is permissible, as deliverability is a requirement of sale which may not necessarily apply to a *rahn* contract[55]. They argue that delivery of the *rahn* asset remains within the responsibility of the chargor and if the chargor managed to do so, then the chargee will benefit from the ability to recover any outstanding debt from the sale of the assets in the event of default.

f) The *marhun* shall be **known and specified** at the point of *rahn* contract: The jurists differ on the permissibility to use unknown asset (*majhul*) as *marhun*. According to the Hanafi jurists, Al-Kasani[56] and Ali Haidar[57], it is permissible to accept any type of *jahalah* element for *marhun* that is acceptable in a sale contract; and decline any type of *jahalah* that is deemed as not permitted in a sale contract. They even classify the element of

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Al-Mughnī. vol.4, 272.

[53] Al-Qarafi, *Al-Dakhirah,* vol.8, 92; Al-Hattab, *Mawahib,* vol. 6, 538-539.

[54] Al-Kasani, *Bada'i',* vol.6, 204-205; Al-Sharbini, *Mughni,* vol. 2, 122; Ibn Qudamah. *Al-Mughni*, vol.4, 50.

[55] Al-Qarafi, *Al-Dakhirah,* vol.8, 87, 92; Al-Hattab, *Mawahib,* vol. 6, 538-539.

[56] Al-Kasani, *Bada'i',* vol.6, 204, 207.

[57] Ali Haidar, *Durar al-Hukkam fi Sharh Majallah al-Ahkam*, (Beyrut: Dar alim al-Kutub, 2003), vol.5, 79-80.

jahalah that are accepted in sale and *rahn* as follows: i) *al-Jahalah al-yasirah* (minor ignorance): The element of *jahalah* is minor and may not lead to a dispute between the contracting parties, which is accepted in both sale and *rahn*; ii) *al-Jahalah al-Fahishah* (major ignorance): The element of *jahalah* is major and may lead to a dispute between the contracting parties, which is not accepted in both sale and *rahn.*

On the other hand, the Maliki jurists view that *rahn* of something with any element of *jahalah* is permissible as the requirement of sale may not necessarily apply to a *rahn* contract. They also compare the arrangement of *rahn* to the concept of witness (*shahadah*). Since there is no requirement to specify a particular witness, similarly, there is also no requirement to specify a particular asset for *rahn* purpose. In addition, both *rahn* and witness share a similar purpose, i.e. to support and provide security (*tawthiq)* to the transaction.[58]

Contrary to the above opinions, the Shafi'i[59] and Hanbali[60] jurists hold a more restrictive approach where they do not allow the use of unknown and unspecified assets as *marhun* since it will invalidate both sale and *rahn* contracts.

g) The *marhun* shall be **physical assets** *('ayn*): According to majority of Hanafi jurists, it is not permissible to use rights or usufructs as *marhun*.[61] Examples of such rights or usufructs are residential right or right to use of transportation within a specified period, etc. Such prohibition by the Hanafi jurists is due to their non-recognition of rights and usufructs as mal (asset), accordingly, they cannot be used as *rahn* assets.

Whereas, the Shafi'i[62] and Hanbali jurists[63] (prohibit rights from being used as *marhun*, arguing that rights are non-deliverable assets because they are not available physically during the contract, which, result in the inability to liquidate the same in the event of

[58] Al-Qarafi, *Al-Dakhirah*, vol.8, 82, 83, 93.
[59] Al-Mawardi, *al-Hawi,* vol.7, 290-291.
[60] Ibn Qudāmah. *Al-Mughnī.* vol.4, 250.
[61] Al-Kasani, *Bada'i',* vol.6, 204; Ali Haidar, *Durar,* vol.5, 79.
[62] Al-Mawardi, *al-Hawi,* vol.7, 381; Al-Sharbīnī, *Mughnī,* vol. 2, 123.
[63] Ibn Qudamah, *Al-Mughni*. vol.4, 250; Al-Buhuti, *Kashshaf,* vol.3, p 321.

default to satisfy the debt. To the contrary, the Maliki jurists[64] allow the use of rights as *marhun*, taking into consideration that it is permissible to use rights as the object of sale.

4.4 Shari'ah Ruling on Possession (Qabad) of The Rahn Assets

The crux of the dispute is whether receipt or possession of the *rahn* asset by the chargee is a condition of contract completion or a condition for the enforceability of the contract. There are two opinions among the Muslim scholars on the issue of taking possession (*qabad*) or delivery of the collateral to the chargee. They are as follows:

a) Majority of Muslim scholars are of the view that taking possession of *marhun* is a condition for a valid *rahn* contract. This is the opinions of the Hanafi[65] Shafi'i[66], and Hanbali[67] (Ibn Qudamah: vol.4, 364) scholars. This opinion is supported by the following evidences:

   Allah says in His Holy Book:

   (وإن كنتم علي سفر ولم تجدوا كاتبا فرهان مقبوضة)

   "And if you are on a journey and cannot find a scribe, a pledge with possession [may serve the purpose]"[68].

   The above opinion is also supported by the following *hadith*: "The Prophet charged his armour to a Jew in Madinah and bought barley bread from the Jew for his family"[69]. This tradition indicates that the armour had been delivered to the Jew in the *rahn* contract.

b) On the other hand, some Muslim scholars, primarily from the Maliki school of thought view that taking possession of the

[64] Al-Qarafi, *Al-Dakhirah,* vol.8, 79, 92, 93.
[65] Al-Sarakhsi, *al-Mabsut*. vol.21, 68.
[66] Al-Ramli, *Nihayah,* vol.3, 253.
[67] Ibn Qudamah, *Al-Mughni*, vol.4, 364.
[68] *Al-Baqarah*: 283
[69] Al-Bukhari, *Sahih al-Bukhari*. *Hadith* no.1963, *Kitab al-Buyu'*, vol.2, 729.

> *marhun* is not required as a condition of conclusion, validity or enforceability of a *rahn* contract, but merely a condition to fulfill the best practice of the contract.[70] In other words, a *rahn* contract will remain a valid contract even without delivery of the *marhun* by the debtor to the creditor. The contract is valid and the chargee may later demand delivery of the collateral[71].

In arriving at this opinion, this group of Maliki jurists also relied on the same verse of Surah Al-Baqarah: 283 but using a different interpretation. According to this line of interpretation, the verse has already regarded the *marhun* as a valid collateral (referring to it as *rihan*) before adding the phrase "that is possessed" as a description to it. The description comes on an item that is already recognised as collateral. In other words, a valid *rahn* contract has already existed first, then only the description comes to merely explain the best practice to fulfil the purpose of *rahn* contract, i.e. by taking possession of the *marhun*[72].

On this issue, it is submitted that the preferred opinion is this view of the Maliki scholars that taking possession of *marhun* is merely to fulfill the best practice of a *rahn* contract. This is also implied by the AAOIFI *Shari'ah* Standard No.39, where item 3/1/1 of the Standard provides: "The mortgage contract is binding on the mortgagor once it is concluded, and the mortgagor does not have the right to revoke it from his own side, whereas the mortgagee has the right to do so" [73].

Based on above, AAOIFI views that the contract of *rahn* is binding once it is concluded, and possession is not mentioned as one of the primary conditions for a valid *rahn* contract. The AAOIFI *Shari'ah* Standard further elaborates that possession may take place in several forms, i.e., actual possession or legal possession, as provided in the same Standard under item no 3/1/2[74]: "Possession of

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[70] Al-Qarafi, *Al-Dakhirah,* vol.8, 100-101; Ibn Rushd, *Bidayah,* vol.2, 274.
[71] Muhammad ibn Ahmad Ibn Juzay, *Qawanin al-Ahkam al-Shar'iyyah wa Masail al-Furu' al-Fiqhiyyah*, (Beyrut: Dar al-Fikr, 1979), 231; Ibn Qudamah, *Al-Mughni*. vol.4, 364.
[72] Tawfeeq Ibrahim Musa Abu Aqeel, *Ahkam al-Rahn,* 95.
[73] AAOIFI. *Sharī'ah Standards for Islamic Financial Institutions*, 968.
[74] Ibid.

the mortgaged asset takes place on the basis of the same requirements for possession of a sold property. It could be actual possession by putting a hand on the property, which is known as seizure mortgage; or possession could be legal through registration and documentation, which is known as security or formal mortgage. Both types of mortgages are subject to the same rulings"

4.5 Shari'ah Status of Taking Possession (Qabd) of Marhun in a Floating Charge

The discussion on the status of taking possession of the *marhun* under *rahn* has been discussed in detail in the preceding sub-section. Based on the deliberation, it is concluded that majority of Muslim jurists, other than the Malikis, were of the view that taking possession of the *marhun* is a requirement for a valid *rahn* contract. On the other hand, the Maliki jurists view it as merely to fulfill the best practice of *rahn* contract instead of being a main requirement of the contract.

In relation to the status of possession of collateral under a floating charge arrangement, it can be argued that the possession of the collateral can be achieved through registration of the company's assets under the floating charge arrangement with the relevant authority. This operates by categorizing the assets that are subject to the floating charge and assigning to the creditor a legal right to claim over any assets registered under such charge in the specific event of crystallization. In this regard, the rights and interests of the creditor in the assets under a floating charge are protected by law even if the assets are not in the creditor's physical possession.

However, to some extent, such an argument can still be refuted since it is hard for the creditor to claim possession of specified assets, either physical or constructive, upon registration of a floating charge as the company's assets may still change or be unavailable from time to time. In addition, registration of a floating charge only provides specification of the chargor's current assets but not the future assets to be acquired by the chargor. In this sense, the possession of such assets (future assets) does not occur upon creation of the charge as it is on a floating basis, but rather at the time of crystallization when the charge turns into a fixed charge and attaches to specific assets.

4.6 The Issue of Uncertainty (Gharar) In Floating Charge

The issue of *gharar* is very much relevant in determining the *Shari'ah* status of a floating charge. By its unique nature, a floating charge may include present and future assets of a company. The present assets are subject to constant change from time to time as the debtor is given the right to utilize the company's existing assets in its ordinary course of business. The same goes for the future assets, where any future acquired assets by the company (debtor) will be regarded as assets under the floating charge and the rules governing existing assets will be applied to the new assets once they are acquired by the company. In summary, the issue of *gharar* may arise in a floating charge due to the following three factors:

a) Uncertainty of Assets: The nature of the assets which are constantly changing raises the *Shari'ah* issue of uncertainty (*gharar*) of the subject matter i.e. of the assets placed under the floating charge. The uncertainty here refers to the changing nature of the assets, arising out of the lack of control by the chargee over the assets under the floating charge, where they remain in the control of the chargor. This leads to uncertainty in specifying and identifying the assets to be delivered to the creditor upon occurrence of liquidation event.

b) Future Assets or Newly Acquired Assets: Under a floating charge, the future assets of the company are among the assets used as collateral even though they are not yet available at the time of creation or registration of the charge.

c) Absence of Asset Specification Under the Floating Charge: Under a floating charge, the assets listed will comprise of current assets and future assets of the company (debtor). Even though the current assets exist at the time of registration of the charge, the future acquired assets are unknown and unidentified when the charge is created. The current assets may also attract the element of *jahalah* as they may change from time to time due to the flexibility given to the debtor to use the existing assets in the ordinary course of the company's business.

The *Shari'ah* issues arising from these three factors are interrelated and therefore will be dealt with together in the following.

4.7 Shari'ah Analysis of the Issue of Uncertainty (Gharar) in a Floating Charge

The discussion on the requirement of certainty for collateral under *rahn* contract has been made in sub-section 4.3 (f) of the study. From the said discussion, it is observed that the majority of Muslim jurists were of the view that the charge of an asset which contains uncertain (*gharar*) element is prohibited. However, despite the majority's view, it is proposed that the view of the Maliki school that allows for some tolerance towards *gharar* element in *rahn* contract be adopted. By adopting the Maliki's position, the existence of *gharar* in the *marhun* is no longer an issue as long as the *gharar* does not lead to a dispute or to consume other's wealth unjustly.

In the case of a floating charge, registration requirement with the authority reduces the possibility of ambiguity and dispute as the specification and details of the assets are determined upon creation of the charge,[75] although they may change from time to time due to dealings made by the debtor or acquisition of new asset. Nevertheless, as the specification of the assets are done on the basis of asset class, rather than each individual asset, it is worth mentioning that the ability of the debtor to deliver the exact assets registered upon creation of the charge in the event of liquidation is still questionable as the assets are constantly changing and will only be individually determined upon crystallisation.

Despite some elements of uncertainty in the asset specification under the current arrangement of floating charge, this can still be tolerated by adopting the opinion of the Maliki scholars, which allows the charge of assets that consist of elements of *gharar*. This flexibility takes into consideration that the *rahn* contract is supplemental in nature, thus it is not necessary to apply the same requirements of a primary sale contract to a *rahn* contract. Thus, the requirements of *rahn* can be less restrictive in nature compared to the sale contract. In addition, the main objective of the *rahn* contract is to

[75] The specification is on the asset as a class, rather than each individual asset.

secure or give comfort to the creditor over the debt obligation of the debtor in the event of non-performance of debt payment. This is in line with opinion of some of the Maliki jurists[76] where they allow for the *rahn* of non-existent assets whether it is stipulated or not stipulated in the contract. They argue that since the debt obligation exists without any requirement of having *rahn*, it is therefore better to have one rather than having nothing.

Regarding the absence of asset specification under a floating charge, the majority of Muslim jurists, i.e., Hanafi, Shafi'i and Hanbali Schools hold that the detail specification of *rahn* assets must be made, known and clear in a *rahn* contract.

Al-Kasani of the Hanafi School in his work Badai'e al-Sanai'ie stated that:

(ولا يجوز رهن المجهول ولا معجوز التسليم ونحو ذلك مما لا يجوز بيعه. والأصل فيه : أن كل ما لا يجوز بيعه لا يجوز رهنه)

"It is not permissible to use an unknown item as a subject matter of rahn, as well as item that cannot be delivered and the like, which are not permissible to be used for sale; the principle here is: "what is not permissible to be sold shall not be allowed to be a collateral" [77].

Al-Shirazi of the Shafi'i School in his book *Al-Muhazzab* said that:

وما لا يجوز بيعه من المجهول لا يجوز رهنه، لأن الصفات مقصودة في الرهن للوفاء بالدين، كما انها مقصودة في البيع للوفاء بالثمن، فإذا لم يجز بيع المجهول وجب أن لا يجوز رهن المجهول

"and whatever is not permissible to be sold from unknown item, shall not be used as an object of rahn contract;

[76] Al-Qarafi, *Al-Dakhirah,* vol.8, 92; Al-Hattab, *Mawahib,* vol. 6, 538-539.
[77] Al-Kasani, *Bada'i',* vol.6, 137.

because the main objective of rahn is to fulfill debt obligation similar to the main objective of sale contract which is to pay the price. Thus, the prohibition of selling of an unknown item will indicate the same prohibition to use marhun which is unknown in nature" [78].

Ibn Qudamah of the Hanbali School in *Al-Mughni* said that:

(ولا يصح رهن ما لا يجوز بيعه ... ولا المجهول الذي لا يجوز بيعه، لأن الصفات مقصودة في الرهن لإيفاء الدين، كما تقصد في البيع بالوفاء بالثمن)

"It is not permissible to create rahn on an asset which is not permissible to be sold; ...and (the same applies to) unknown item that is not allowed to be sold; as the objective of rahn contract is to settle debt obligation similar to the objective of sale contract which is to pay the price" [79].

To the contrary, the Maliki[80], some Shafi'i[81] jurists and a dominant opinion of the Hanbali scholars[82] are of the view that the sale of an asset which is not present during the contract session is valid subject to the determination of the characteristic and specification of the same upon execution of the contract.

The preferred view: Although the majority of Muslim scholars are of the view that a *marhun* must not be an unknown asset, the context of unknown element (*jahalah*) refers to that type of *jahalah* which leads to dispute and injustice among contracting parties. Thus, it is submitted that, should the reasons for *jahalah* being prohibited, i.e., strong probability of dispute and injustice

[78] Abi Ishaq Ibrahim ibn 'Ali ibn Yusuf Al-Shirazi, *Al-Muhadhdhab Fi Fiqh al-Imam al-Shafi`i*. (Kaherah: Matba'ah 'Isa al-Babi al-Halabi, 1995), vol.1, 309.
[79] Ibn Qudamah, *Al-Mughni*., vol.6, 467.
[80] Al-Dusuqi. *Hashiah,* vol. 3, 25.
[81] Abi Zakariya Yahya ibn Sharif Al-Nawawi, *Rawdat al-Talibin*, (Beyrut: Dar al-Kitab al-'Arabi, 2003), vol.9, 365.
[82] Al-Buhuti, *Kashshaf,* vol.3, 165.

among contracting parties are eliminated, the *jahalah* alone shall not invalidate the contract.

In the context of *rahn*, following the views of the Maliki's jurists, some Shafi'i jurists, and a dominant opinion of the Hanbali scholars, it is submitted that *rahn* of an unknown asset, despite it not being present or not yet acquired at the time the contract, is valid, provided that its essential features have been adequately described and characterized in the *rahn* contract. The essential features here include the nature or type of the asset, such as the asset class, and do not necessarily require specific tagging of individual assets. In addition, *rahn* is not an exchange contract, but a supplementary and supporting contract. Since the purpose of *rahn* is only to secure the debtor's debt obligation, the strict requirements on the subject matter of contract as applied in exchange contract need not be stringently applied to a *rahn* contract and can be made more flexible for the purpose of *rahn*.

In relation to the *jahalah* element in a floating charge, it is believed that the registration of the charge with the respective authority is adequate to eliminate any potential dispute and unfairness between the contracting parties. Although the creditor only has knowledge about the current assets and not the future acquired asset, the creditor's rights are protected by the law due to the registration of the charge, together with the explanation of the class of assets covered by the said charge. Moreover, the main objective of *rahn* can be achieved even if the *rahn* assets are not fully determined and specified individually upon creation of the charge. The general description of the asset covered or to be covered by the charge, by reference to the asset class or groups of assets, is deemed to be adequate certainty for the parties, capable of preventing any probable dispute on the matter. Hence, it can be considered as a valid arrangement for the purpose of *rahn*.

4.8 Underlying Assets in a Floating Charge and Possibility of Shari'ah Non-Compliance

There might be a possibility that the assets used in a floating charge consist of *Shari'ah* non-compliant elements[83]. This could arise in the

[83] A focus group discussion (FGD) was conducted at INCEIF on 19

following instances:

a) The current assets under the floating charge are *Shari'ah* non-compliant from the beginning upon the assets being charged; or
b) The asset status changes from *Shari'ah* compliant to *Shari'ah* non-compliant due to the ordinary business activities conducted by the company such as the change in the status of *Shari'ah* compliant shares to non-compliant; or
c) The acquisition of new *Shari'ah* non-compliant assets in the future.

The question that arises is whether the charge would be invalid due to the use of *Shari'ah* non-compliant assets as collaterals in all or any of the above circumstances? In order to address this issue, the status of using *Shari'ah* non-compliant assets as collateral will first be discussed.

4.8.1 The Use of Shari'ah Non-Compliant Assets as Collateral

The Muslim scholars have deliberated on the issue of using *Shari'ah* non-compliant assets as collateral. Generally, the majority of Muslim scholars ruled that *rahn* of *Shari'ah* non-compliant assets such as alcohol or swine is not allowed.[84] The reason being, wine or pork are not recognised as property for Muslims, thus, it is unlawful for a Muslim to sell or charge such asset(s).

In the case of non-Muslim creditors and debtors; the jurists discuss the issue in a different context since the non-Muslims recognise such prohibited items as valued properties. According to the Hanafi jurists[85], it is valid for both non-Muslim contracting parties to place *Shari'ah* non-compliant assets such as swine, liquor

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September 2017. The FGD comprised of 25 participants from industry practitioners, experts, selected *Shari'ah* scholars and legal advisors, which generated invaluable inputs from the participants.

[84] Al-Kasani, *Bada'i',* vol.5, 205; Al-Hattab, *Mawahib,* vol.6, 538; Al-Ramli, *Nihayah,* vol.4, 238; Ibn Qudamah, *Al-Mughni*, vol.4, 374; Al-Nawawi, *Rawdat al-Talibin*, vol.13, 178; Abu Daud Sulayman ibn Al-Ashash Al-Zarqani, *Sharh Al-Zarqani ala al-Muwatta wa bihamisihi Sunan Abi Dawud,* (Beyrut: Dar al-Kutub Ilmiyyah, n.d), vol.5, 235.

[85] Al-Sarakhsi, *al-Mabsut*, vol.21, 89.

or other *Shari'ah* prohibited items as *rahn* assets because these assets are considered as valuable from their perspective as non-Muslims.

From the above discussion, it is worth noting that the discussion of the classical Muslim scholars above applies only to the *Shari'ah* non-compliant assets, which fundamental elements and external attributes are impermissible in nature. The prohibitions of dealing in these prohibited items are based on a number of Quranic verses and Prophetic *ahadith*. As such, the majority of Muslim jurists do not recognise such items as *mal*. Thus, they are not eligible to be used as collateral.

However, the discussion on the status of *Shari'ah* non-compliant collateral in the context of modern financial assets may require a more thorough discussion since the behavior and nature of the financial assets may be distinguished from ordinary assets. In addition, the categorization of *Shari'ah* non-compliant financial assets seems to be quite different from the categories already discussed by the early Muslim jurists.

For ease of understanding, the discussion of early Muslim jurists has always been on specific assets which are clearly prohibited by the *Shari'ah*, either by way of commandments in the Quran or in the hadith of the Prophet s.a.w. Examples are: swine, wine, carcass, blood and other prohibited items. These assets are *Shari'ah* prohibited by their very own nature (*haram li zaatihi*). However, for financial assets, they are quite different in term of their definition of *Shari'ah* non-compliant status. The nature and characteristics of financial assets such as fixed deposits, shares, bonds and other relevant assets are commercially defined. However, the existence of some external factors and the parameters as determined by modern *Shari'ah* scholars may cause those financial assets to be classified as *Shari'ah* non-compliant. These parameters may differ from one scholar to the other. Among the widely used parameters for evaluation of financial assets in the form of shares and stocks are: the nature and activities of the business entity; and certain financial benchmarks as determined by the respective *Shari'ah* authority. Since there is no clearly ruling made by the early jurists on these modern financial assets, the modern Muslim scholars made their own rulings based on their own/collective *ijtihad*.

4.8.2 Shari'ah Discussion on the Use of Shari'ah Non-Compliant Financial Assets as Collateral in a Floating Charge

There are several *Shari'ah* resolutions issued by contemporary *Shari'ah* scholars related to using *Shari'ah* non-compliant financial assets as collateral. Among others are AAOIFI (2017: 973) which prohibits IFIs from accepting any *Shari'ah* non-compliant shares as collateral for Islamic financing in its S*hari'ah* Standard No.39 (Mortgage and Its Contemporary Application): *(4/3) "It is impermissible to mortgage the financial papers and Sukuk that should not be issued or transacted according to Shari'ah … Such financial papers include also traditional investment certificates, certificates of traditional investment deposits, and shares of the companies that pursue impermissible activities like manufacturing of alcohols, swine trade and dealing in Riba…"*[86].

The above ruling which among others prohibits *Shari'ah* non-compliant shares is in line with the main requirement of *rahn* contract, i.e., that the *marhun* must be a *Shari'ah*-permissible asset. This is important as the main purpose of a *rahn* contract is to settle the debtor's outstanding debt in the event the debtor fails to meet the debt payment or defaults, by way of selling the charged assets. Thus, if the status of the charged asset is *Shari'ah* non-compliant, then it cannot be sold as the main principle governing *rahn* is: "any item which is permissible as the subject matter of sale is also permissible as collateral"[87].

In addition, there are also resolutions issued by the *Shari'ah* Advisory Council (SAC) of BNM in its 160th meeting on 30th June 2015 that discussed the issue of *rahn* which comprised of both *Shari'ah* compliant and *Shari'ah* non-compliant assets. Their ruling is in the context of the shares of companies which consist of mixed assets (both permissible and impermissible). The SAC ruled that these shares may be accepted as collateral provided that the following conditions must be fulfilled:

the core business of the company is recognized as *Shari'ah* compliant; and

[86] AAOIFI. *Shari'ah Standards for Islamic Financial Institutions*, 974.

[87] Al-Jaziri, *Al-Fiqh ala al-Madhahib al-Arba'ah*, (Beyrut: Dar al-Kutub Ilmiyyah, 2003), vol.2, 226.

the mixed asset can be used as collateral provided that the *Shari'ah* compliant assets and *Shari'ah* non-compliant can be segregated and the value of the collateral is limited only to the portion of the assets that are *Shari'ah* compliant.

The SAC of BNM in the same meeting also resolved that a similar ruling also applies to interest bearing debt-based assets such as conventional fixed deposits, bonds and *Shari'ah* non-compliant unit trusts where the collateral value is limited to the principal amount of the fixed deposits and bonds; whereby for unit trusts the collateral value is limited to the value of the investor's initial and subsequent/additional investment. Based on this ruling by the SAC of BNM, there are two conditions for acceptance of mixed financial assets, as follows:

a) The *Shari'ah* compliant asset and *Shari'ah* non-compliant asset within that instrument can be segregated; and
b) The collateral is accepted only up to the value of the portion of the assets that are *Shari'ah*-compliant

There is also another resolution in relation to acceptance of *Shari'ah* non-compliant assets as collateral issued by the *Shari'ah* Advisory Council (SAC) of Securities Commission Malaysia in its 188th meeting held on 25 August 2016. This resolution was made in the context of holding the shares which were later reclassified into *Shari'ah* non-compliant status during the tenure of financing. In this case, the SAC resolved that it is permissible to maintain the initially *Shari'ah*-compliant securities, which have later been reclassified into *Shari'ah* non-compliant securities, as collaterals until the end of the financing tenure.

Based on above discussions, it is submitted that there are several opinions on the treatment of *Shari'ah* non-compliant financial assets, shares in particular, when they are used as security for financing. As a starting point, as suggested by Mukarrami and Afiqah, it is best to consider the classification of *Shari'ah* non-compliant assets into two types[88]:

[88] Ahmad Mukarrami Ab Mumin and Afiqah Nur Yahya, *Research on Acceptability of Shari'ah Non-Compliant Asset As Collateral,* paper

a) The asset which form and substance is *Shari'ah* non-compliant in itself such as pork, wine and the like. This type of asset is not permissible for *rahn* purposes from the *Shari'ah* perspective.
b) The asset that becomes *Shari'ah* non-compliant due to other elements or external factors. This is illustrated in the case where the *rahn* asset is *Shari'ah* compliant but changes its status to non-compliant due to external elements such as *riba* (interest) in conventional fixed deposits and bonds. This type of asset is permissible for *rahn* purposes provided that the element of haram is excluded.

Thus, it is recommended that in relation to floating charges:

a) For current assets that already exist upon inception of the charge, if they are in the category of assets that are *Shari'ah* non-compliant by themselves, then they cannot be used as collateral. However, if the current assets are recognised as *Shari'ah* non-compliant due to the existence of other external elements that are prohibited, they can be used as collateral, provided that the prohibited (*haram*) element is eliminated/excluded.
b) As for assets that are initially *Shari'ah* compliant but may become *Shari'ah* non-compliant either due to future acquisition, or changes in the status of the asset to *Shari'ah* non-compliant; they can remain as collateral because it is difficult to control the possibilities of future changes to the assets. It is also difficult to identify the respective possible future *Shari'ah* non-compliant assets. The status of *Shari'ah* non-compliant assets can only be determined upon the event of crystallisation when the floating charge turns into a fixed charge and attaches to all the assets available under the charge at that point of time. At that point of crystallisation, the *haram* element in the *Shari'ah* non-compliant assets shall be excluded from the collateral.

5.0 Conclusion and Recommendation

In the context of a floating charge, it is observed that it does not fulfil the *rahn* requirements as stipulated by the majority of jurists (Hanafi,

presented in Kuala Lumpur Islamic Finance Forum, (KLIFF, 2017).

Shafi'i and Hanbali). Nonetheless, the flexibility of the Maliki opinion regarding *rahn* requirements allows the features of floating charge involving uncertain or unknown assets to be tolerated in a *rahn* contract.

It is observed that the differences of opinions among the jurists on the *rahn* requirements are due to several factors including their perspective on the nature of security contracts (*'uqud al-tawthiqat*). In this regard, Maliki jurists are generally of the view that *rahn* contract is a secondary contract, hence, it is not necessary to fulfil the requirements of a sale contract in a *rahn* arrangement. According to this view, the *rahn* contract remains a valid contract even without fulfilling the sale requirements. The sale requirements are merely to perfect the *rahn* contract, and not prerequisites for its validity. This perspective is markedly different from that of the majority of Muslim jurists who hold that *rahn* contract must follow the requirements of a sale contract. According to the majority's view, the principle of "what is permissible for sale is also permissible for *rahn*" applies strictly, such that, all requirements of a valid sale also apply equally to a *rahn* contract. Nevertheless, for the purpose of our discussion on the floating charge, the preferred view is that of the Maliki school that tolerates elements of uncertainty and *jahalah* of the *marhun* in a floating charge.

There are, however, further issues in a floating charge, particularly with regard to the possibility of the charged assets becoming *Shari'ah* non-compliant or mixed with *Shari'ah* non-compliant assets in the future.[89] The reason being, in a floating charge, the chargor has the right to employ the assets in its ordinary course of business, even though the assets had been charged to the charge. In short, the chargor is free to buy or sell the assets under the floating charge prior to the event of crystallisation without the need to get consent of the chargee. This will open up the possibility of the future acquired asset being *Shari'ah* non-compliant. The Malikis along with the majority of Muslim jurists do not allow *rahn* on

[89] As identified in a focus group discussion (FGD), which was conducted at INCEIF on 19 September 2017. The FGD comprised of 25 participants from industry practitioners, experts, selected *Shari'ah* scholars and legal advisors, which generated invaluable inputs from the participants.

impermissible assets. However, as discussed in the preceding sub-section, if the impermissibility of the assets is due to external elements, they can still be used as *marhun*, provided that the prohibited elements are eliminated/excluded.

Finally, it may be alternatively submitted that a floating charge may not fit into the normal features of *rahn* contract. It may be deemed as a new contract that is akin to *rahn* in some ways, but with a number of different features and legal consequences. It is alternatively recommended that a floating charge may be viewed as a form of *wa'd* to *rahn* (promise to charge) rather than a *rahn* contract per se. Initially, the chargor will make a *wa'd* to create *rahn* on its current and future assets with an undetermined value as the business continues as usual, until a crystallisation event occurs. Should the crystallisation occurs at any point within the debt period, the *rahn* contract shall take place at that point of time. The *rahn* assets will be identified and valued accordingly at the moment of crystallisation. In contrast, should crystallisation do not take place, then the *rahn* will not come into effect. Nevertheless, this analysis still requires further study and deliberation on its applicability from the practical as well as from the *Shari'ah* perspective.

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