

The Permissibility Of Security (Collateral) In Islamic Banking

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Abstract

Security (Collateral) also called Arrahnin Arabic has occupied a large space in the business of lending engaged by financial institutions considering its enormous role. This study is to examine the permissibility of collateral and its types under Islamic banking system. The study reveals that Shariah which is the basis on which the Islamic banks operate permits the acceptance of collateral for its lending and such collateral must not be prohibited by the Shariah. Arrahn in the parlance of Islamic banking can be used in two ways namely; as a marhun (pure security) or an instrument to facilitate the micro-financing. The study concludes that despite the clear position as regarding collateral, it should not be a primary criterion for lending as in the case of the conventional banking system in order to fit in to the economic reality so as to achieve the objectives of Islamic economies.

Key words: Islamic banking, Arrahn (Collateral), Sukuk, Fiqh Al-Mu'amalat

1. Introduction

Islamic banking as the name implies, got its pedigree from Islam and in lieu of that, it can be referred to as a financial institution whose statutes, rules and procedures expressly state its commitment to the principles of Islamic Shariah (Jurisprudence) and forbids the receipt and payment of interest on any transaction. This definition is well accepted by the General Secretariat of the Organization of Islamic Conference and the Islamic Development bank². It can also be defined as a model of non-interest banking that is consistent with the principles of Islamic Shariah which is also known as *Fiqh Al-Mu'amalat* (Jurisprudence of Commercial Transaction). The rules and practices of *Fiqh Al-Mu'amalat* emanated from the Quran and the Sunnah, and other secondary sources of Islamic law such as opinions collectively agreed among Shariah Scholars (*ijma*), analogy (*qiyas*) and personal reasoning (*ijtihad*).

1. Heritage Bank Maiduguri, Borno, Nigeria
2. Tajur Islam, "Mechanics of Islamic Banking", In Islamic Banking; How far Have we Gone. Edited by Pramanik H A, IUM Press, Malaysia. 2009: p. 126

Islamic Bank operates on the following principles; Prohibition of Interest, Gambling, Uncertainty (*Gharar*), Speculation (*Maysir*), Unethical Businesses and it is based on Profit and Loss Sharing. Islamic bank is considered as the major component of Islamic finance and it is the fastest- growing sector in the international financial system with a growth rate of 10-15% per annum with indication of consistent growth in the future. Furthermore, it is estimated that over \$1,041 Trillion worth of Shariah- compliant assets are managed worldwide as at end of 2009, 10% up from \$947bn in 2008. Islamic commercial banks accounted for 72% of the assets, investment banks 11%, sukuk issues also 11%, funds 5% and takaful& other assets 1%. Banks in aggregate therefore account for 83% of assets.³ Currently, the total assets that are Shariah Compliant worldwide as at the end 1H 2014 is estimated to be \$1.873 Trillion out of which \$1.476 Trillion representing more than 70% is banking asset⁴.

Islamic banks are regarded as financial intermediaries because they mobilizes funds from the surplus areas to deficit areas, and in undertaking such functions most especially mobilizing to deficit areas, they engage into the business of lending. Lending as a core function of Islamic Bank is a very relevant impetus for income generation and at the same time a crippling agent if not properly managed. Therefore, it is seen as a good servant and a bank master to banks. Lending is embedded in certain canon which is popularly called the 5C's of Credit- Character, Capacity, Cash, Collateral and Conditions⁵ and the PARTS- Purpose, Amount, Repayments, Tenor and Security⁶. In all the canons mentioned, security has been included which implies that security should be highly considered when lending.

Although, for Islamic banks to continue to be in the business of lending and to meet best practices, the Shariah Advisory Board has to continue to develop and review internal rules and regulations on lending and as well the lending products which is encapsulated in a documents called credit policy and such must be in consonance with the Shariah. This policy documents addresses key issues such as type of customer, credit size, quality of security, risk consideration, type of industry and business etc.

3. The City UK Islamic Finance Report, May 2011. Pp 1-12

4. IFSB Islamic Financial services Industry Stability Report, May 2015. P.7

5. <http://www.investopedia.com/terms/f/five-c-credit.asp>. Retrieved.25/12/2015. 5:26pm

6. Amateur Economist" Lending Mnemonic"(2011); Available at http://theamateurecom.blogspot.com/2011/10/Lending_mnemonic.html. Retrieved 13/07/2015. 4:53pm

But one fact remains that with all these measures put in place, one cannot absolutely resolve that no loan will go bad but the essence is to minimize rate of bad loan. In order to minimize the risk of loans going bad, the only life support system is security (collateral) which is also seen as a seat belt to lending vehicle because it is considered as the last resort towards recovering bad loans by banks.

However, this paper will be structured into five sections. Following this introduction, section two examines the conceptual framework. Section three looked into the literature review, features and benefits of a security (Collateral). Section four examines the position of security or collateral in Islamic banking and conclusion and recommendation in section five.

2. Conceptual Framework

The concept security has different meanings to different persons or professions. Literally, security is defined as thus;

- a. The activities involved in protecting a country, building or person against attack, danger etc.
- b. The state of feeling happy and safe from danger or worry.
- c. A valuable item such as house that you agree to give to somebody if you are unable to pay back the money that you have borrowed from them.
- d. Documents proving that somebody is the owner of shares etc in a particular company.⁷

From the above, definitions (c) best relates to our topic of study. Security, according to Afolabi (1990) is as an insurance against unforeseen developments and the last source through which the bank can get its money recouped should things turn sour⁸. Sykes (1972), sees security as a transaction whereby a person to whom an obligation is owed by another person called the debtor is afforded in addition to the personal promise of the debtor to discharge the obligations, rights exercisable against some property of the debtor in order to discharge the obligation⁹.

7. Hornby A. S. Oxford Advanced Learners Dictionary. Oxford University Press. USA 7th Edition, 2006: Pp. 1320, 1321

8. Afolabi, Layi. Law and Practice of Banking. Heinemann Educational books Nig. Ibadan 1999: P.210

9. Onyiriuba Leo. Analysing and Managing Risk of Bank Lending. NFS Data Bureau Ltd. Lagos Second Edition. 2008. P. 373

Relating same concept to Shariah, the term *Ar-rahn* cannot be relegated to the background. The term “*rahn*” is commonly used in *fiqh al-muamalah*. According to Shariah (Islamic law), the definition of *rahn* is: “To make an object with economic values in Islamic law perspective as a trust for the payment of debts, so that enabling mortgagee (*Murtahin*) to get all or a part of the debts from the object”¹⁰

Arrahn refers to a “possession offered as a security for a debt so that the debt will be taken from it in case the debtor failed to pay back the due money”¹¹ Imam Abu Zakaria al-Anshary defines *rahnas* “To make an economic object as a trust for the payment of debts, from which unsettled debts are paid”¹². *Arrahn* has been classified into two (2)¹³

- i. **Possessory Rahn:** - A *rahn* is said to be possessory if there is a transfer of possession in the subject matter of the security from the debtor (*al rahin*) to the creditor (*Al Murtahin*). For example, where a pledge or pawn is taken as security.
- ii. **Non- Possessory Rahn:** - A *rahn* is said to be non-possessory whereby the title in the subject matter of the security is passed from the debtor to the creditor. As in the case of a mortgage where the title in the landed property is passed to the mortgagee by the mortgagor. Thus it can be seen as a proprietary *rahn*.

3. Literature Review

In every research work, there is always the need to carry out the research hinged on an already existing literature. However, within Quranic exegesis Ibn Kathir is one of the scholars that explained very well about *Arrahn* regarding surah al Baqarah verse 283 (al Qurashi, 1999). Bukhari and Muslim alone have recorded at least ten to eleven text of various degree of hadiths about *ar-rahn* in their respective books¹⁴. Other great names such as Ibn Abidin, al Shaybani, al-Ḥaṣkafi and al- Shaybani arakhsi of Ḥanafi,

10. Maudila R. L “The optimizing of Rahn service for the Development of Islamic Banking in Indonesia”. *Journal of Islamic Economics*. Vol 4, No.2.(2003): Pp.170-171

11. Nasar S and Khan A.J, ” Collateral (Ar-Rahn) as practiced by Muslim funds of North India”. *J-KAU: Islamic Economics*. Vol 17, No. 1(2004): Pp.17-34

12. Abi Zakariya al-Anshari, *Fath al-Wahab*(Singapura: SulaimanMariy, n.d.), pp. 192.

13. Abd.Rahman A. Z, “Collateral and Security in the Islamic Commercial Law: The Concept and operation of Rahn. *Applied Shariah-Lecture 4*.(2009): P. 4

14. Ṣaḥīḥ Bukhari (al-Bukhari, 810-870M/194 – 256H) no. 2068, 2200, 2252, 2386, 2509, 2511, 2512, 2513 and Ṣaḥīḥ Muslim (al-Nisaburi) (1015-1016M). No: 1603/124-126, p.1226 & 1919.

al-Mawardi, al-Syirazi, al-Rafi'i and al-Nawawi of Shafi'i, al- Dasuqi, al- Dardir, al-Khalil and al-Qarafi of Maliki as well as Ibn Qudamah of Hanbali are indeed become "aliving legend" to the modern scholars in Islamic law. Their great collections on-*rahn* issues had flourished through their meticulous process and methodology developed by them.¹⁵

However, Khan and Nasir (2004) in their study concluded that Muslim Funds in Northern India are providing financial assistance to needy people, both men and women, Muslims and non-Muslims on the basis of strong collateral they obtain from the borrowers in the form of ornaments despite the non-recognition of *arrahn* under the Indian law. The collateral in fact constitutes the backbone of these institutions.

Shariff *et al* (2013), attempts to explore the potential of *arrahn* product and the need for its enhancement. They explore the features of the potential of *arrahn* taking into cognizance the suitability of concepts adopted in the product, the possibility of longer repayment's period, the minimization of the shariah and economic issue of *ujrah* fee, the possibility of offering more than RM10, 000 borrowing money and the expansion of receivable pledge item. They concluded that if eventually implemented it will become a good alternative product in the financial markets

Maulidia (2003) have argued that in practice, *rahn* appears as two different products. First, as a complementary product, that is additional transaction (guarantee/collateral) for other products such as *ba'i al-murabahah* financing. In this case, Islamic banks can detain debtors' mortgaged objects because of transaction. Secondly, as an independent product which serves as alternative to the conventional pawnshop. He concluded that in *rahn* debtors are not charged with interest. Instead, they are obliged to pay entrustment cost, conservancy cost, and custody cost, as well as appraisal cost.

Winton (1995) argue that collateral may serve as a contractual device to increase the lender's monitoring incentive, because collateral is likely to be effective only if its value can be monitored. Zakaria (2007) argues that financial institutions require security because lending is among the riskiest ventures. They lend to borrowers clients' funds. However, as they are lending, they experience a problem of borrowers not being able to pay back. So it is only through collateral that they are assured that their clients' funds are secured

15. Shariff, D, Shaharuddin, A, Muhamed, A.N, Pauzi, N. S, Mohammed, Z. M , " The improvement of Ar-Rahn (Islamic Pawn Broking) Enhanced Product in Islamic Banking System" Asian Social Science. Vol. 9, No.2.(2013):Pp 36-37

Hamid *et al* (2014) tries to explore and examines the theoretical frameworks of factors accepting on Islamic based pawn broking (*Ar-Rahn*) scheme in Malaysian using Descriptive analysis of the factors accepting *Ar-Rahn*. Seven factors are Shariah View, Pricing System, Pledge Assets, Customer Service, Locality, Social and Advertisement. The result showed that the Shariah view have the highest mean score indicate that it is key criteria that all customer emphasis when they choose the services of Ar-Rahn Scheme instead of others as they think that it is the most important factor in choosing the service.

Badagawa (2006) notes that, financial institutions require borrowers to present to them assets which would be in form of physical property, land and building titles, vehicle logbooks and other assets. In case of failure to repay by the borrowers, these are seized by the lending institutions and sold off to get back part of the borrowed funds.

3.1 Features of Security (Collateral)

There exist certain distinct features of security which serves as a first aid guide or information to Islamic banks when collecting securities from borrowers. However, the fact that such security pledged constitute a property, then it must have three (3) attributes according to Islamic law; it must have some value, it must be a thing the benefit is permitted, it must be possessed. The Hanafi Jurist have added the forth attribute namely; capability of been held in reserve¹⁶. Details of the features are as follows:-

- a. **Title:** Title refers as “the legal right to own something”¹⁷. There is no how one can discuss title without ownership. Ibn Rajab al Hanabali say ownership” *The owner of all things is the creator-God, Man possess only the benefit of them in a manner permitted by the law. He who posses all the benefit is the absolute owner, he who enjoys partial possession has limited ownership and hence is designated by a special name such as tenants or owner*¹⁸. As ownership is the right granted by law to the owner to benefit from, so the overt use of the benefit of the property is called possession. Possession is rightful if it is exercised

16. Khaddun, M and Liebsny, H, “Transaction in Sharia” Origin and Development of Islamic Law. Chapter VII.” 2008: P. 180

17. Hornby A. S. Oxford Advanced Learners Dictionary. Oxford University Press. USA 7th Edition, 2006. P. 1554

18. Ibn rajab, kitab al Qiwad. P. 195

by the person with the legal title. It is invalid if it is exercised by one who has no legal title¹⁹. Thus, a security must have good title which is free from encumbrances or encroachment. In order to authenticate such title, Islamic banks are to conduct an independent legal search on the documents of title submitted.

- b. Adequacy or Sufficiency in Value:** A good security must be adequate or sufficient to cover the bank exposure because accepting a security which is far below the facility amount is as good as creating some part of the facility unsecured. In lieu of this, most banks normally take the force sale value (FSV) or surrender value as against the market value. In Tafsir Al-Jalalayn “In addition, when the mortgagee has taken the mortgaging in his hand, this would then be something sufficient for him” Thus, the bottom line of this tafsir, is that what should be pledge as security should be sufficient enough to offset the loan.²⁰
- c. Stability in Value:** A good security must have a stable or increasing market value because accepting a security that has a decreasing value will jeopardize the facility. For instance accepting landed properties in urban areas is highly preferable than accepting same properties in a rural area because such properties in urban area has a stable and increasing value.
- d. Realizable:** This implies that a good security must be easily realizable without exorbitant cost or delay but this can be achieved if there exist a ready market. For instance, accepting landed properties in the rural areas, its realization will be delayed because no one will be interested in buying such properties in such location.
- e. Transferability or Assignment:** This means “that your property or rights now belongs to somebody else”²¹. i.e the security interest right of the collateral can be easily assigned and re-assigned during and after the performance of the obligation. However, the agreement of mortgage will be considered incomplete

19. Khaddun, M and Liebsny, H, “Transaction in Sharia” Origin and Development of Islamic Law. Chapter VII.” 2008: P. 180

20. Tafsir Al-Jalalayn. Vol 1. P.164

21. Hornby A. S. Oxford Advanced Learners Dictionary. Oxford University Press. USA 7th Edition, 2006. P.75

until the article pledge is taken over²² However, such mortgage object is a trusteeship held by the mortgagee (one who is lending debtors mortgaged property) and similar to other trusteeship, mortgagee needs not to compensate if the mortgaged object is damaged, as long as the case is not caused by his mistakes²³.

- f. Acceptable by law:** A good security must also be acceptable by the sharia law and not prohibited. Thus, the pledge of prohibited properties or the pledge of properties that cannot be possessed is not valid²⁴. In essence, all the dynamics involved in accepting a security must be legally binding and enforceable by law so that in situation where there is a breach of the terms and conditions of the contract because in such scenario, the court is the last option.

3.2 Benefits of Security (Collateral)

There is no gain saying that there exist no benefit in accepting or collecting security (*Arrahn*) against loans and advances because relying on the commitment of the promise to pay as when due which is the usual language of the debtor (borrower) is not enough as any default in such loans will lead to the depletion of share holders funds and invariably affects the profit position of such banks if such bad loans are to be written off but if there are security pledge the bank will at least recover substantial part of its exposure. The benefits of accepting security against loans and advances can be summarized as follows:-.

- a. **Minimization of Risks:** The fact that Islamic bank operates on the basis on Profit and Loss Sharing (PLS) scheme does not imply that it should not take measures to minimize its risk in order to reduce loss. However, taking security (*Arrahn*) against loans and advances will greatly reduce the risk the Islamic bank is bound to encounter be it credit risk, liquidity risk etc but if such loans are availed on the basis of mere promise to repay as at when due, the bank is at the mercy of the borrower as the risk of such will be high on the part of the bank in case of default.

22. Doi Abdur Rahman. Shariah: The Islamic Law. As-Noordeen Press. 7th Edition. Malaysia 2007: P.387

23. Hasbi Ash-Shiddieqy, Hukum-Hukum Fiqh Islam, 4th printing (Jakarta: Bulan Bintang, 1970), P. 376; In Maudila R. L "The optimizing of Rahn service for the Development of Islamic Banking in Indonesia". Journal of Islamic Economics. Vol 4, No.2. (2003): Pp.170-171

24. Saleem, M.Y. Islamic Commercial Law. John Wiley Publisher. Singapore. 2012: Pp. 8-94.

- b. **Increases borrowers commitment:** Taking security (*Ar-rahn*) by Islamic banks will further creates a high sense of commitment on the part of the borrower because he may not want to lose his or her property and that is why it is highly recommended for banks to accept property that are very key to the borrower which he cannot afford to lose. “*The prophet (SAW) purchased food grain from a jew on credit and mortgage his iron armour to him*”.²⁵ Deducing from the hadith, it is explicit clear that prophet would not like to lose his armour, thus, makes him to have commitment to repay the debt
- c. **Creditor’s interest highly safeguard in case of Bankruptcy:** The Arabic word *iflas* means bankruptcy. It covers both the modern senses of (i) balance sheet insolvency, when an entity’s assets are less than its liabilities; and (ii) income statement or cash flow insolvency, when an entity has insufficient liquid or monetizable assets to pay its debts as they come due. The Arabic word *mufli* means a bankrupt entity, And once one is a *mufli*, there are only two ways that status ends: full repayment of all unforgiving debts or death.²⁶ Creditors who have secured their debt through a pledge contract will be given priority over other unsecured creditors in case of Bankruptcy. Pledge also creates a secure right for the first creditor over subsequent creditors with whom the same property is pledged.²⁷
- d. **Minimizes inside related credits:** Inside- related credits are credit availed to directors, significant shareholders and employees. The fact that Security (*Arrahn*) is shariah compliant Islamic banks are expected to adhere to it and with such adherence loans and advances that are inside related will not be abused.
- e. **Gives Creditor the Right to Sue:** Security (*Arrahn*) taken against loans and advances gives the creditor the right to take legal action in case of default. This is seen considered as a recovery options available to the Islamic banks and that is why it is highly recommended in sharia that such security should be structured in a manner that it should be binding on both parties which must be supported by collecting, executing all the required documents before disbursement.

25. Sahih Bukhari, 48:4

26. Awad, A and Micheal, R. “Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy”. Pace University. Pace Law Faculty Publications. 2012: P. 980

27. Saleem, M.Y. Islamic Commercial Law.. John Wiley Publisher. Singapore 2012.: Pp. 8-94

- f. **Fulfils Psychological sense of Comfort:** Taking security against loans and advances fulfils the creditors' psychological sense of comfort. That is, it tends to fulfill the ego of the transactions as every parties involved will be a little bit fulfilled. Man by his nature has the fear of unknown and couple with the fact that life is full of uncertainty, collecting security against loans and advances such fear will be minimize to some extent and that is why Allah (SWT) has said that” *And if you are on a journey and cannot find a scribe, then let there be a pledge taken (Mortgaging).*²⁸

4. Position of Security or Collateral (ArRahn) in Islamic Banking

The position of *Arrahn* secured its support from the Quran and the Sunnah. The Holy Quran states that;

*“Every person is a pledge for what he has earned (Deed)”*²⁹.

In sharia law, it means holding something that has a value while giving something on debt. The Quran has laid down this condition in Quran 2: 283 which states that

“ And if you are on a journey and cannot find a scribe, then let there be a pledge taken (Mortgaging); then if one of you entrust the other, let the one who is entrusted discharge his trust (faithfully), and let him be afraid of Allah, his lord. And conceal not the evidence for he, who hides it, surely his heart is sinful. And Allah is All-knower of what you do”

The Prophet (SAW) says as narrated by Aisha that;

“The prophet (SAW) purchased food grain from a jew on credit and mortgage his iron armour to him”.³⁰

In a related hadith from Anas that;

*“The prophet mortgaged his armour to a jew in Madinah and bought barley bread from the jew for his family”*³¹

28. Quran 2: 283

29. Quran 73:38

30. Bukhari, 48:4

31. Sahih Bukhari No. 1927, Kitab al-Buyu- Ahmad, Nasai and ibn Majah. In Maudila R. L “The optimizing of Rahn service for the Development of Islamic Banking in Indonesia”. Journal of Islamic Economics. Vol 4, No.2. 2003:Pp.170-171

From the above narrations presented from the Holy –Quran and the Sunnah, it is explicitly clear that *Ar-rahn* is highly permissible in Shariah thus necessitate the need for its adoption by Islamic banks in doing the business of lending. *Arrahn* is built upon certain pillars and conditions which majority of the Islamic jurist has agreed upon.³² These are:-

1. Offer and acceptance (*sighah*)
2. Parties in the *rahn* contract (*rahin* and *murtahin*– the person who provides the collateral and the person who receives the collateral)
3. Collateral asset (*marhun*)
4. The debt itself (*marhunbih*)

In addition, for such a pledge to be valid, there exist other conditions which guide its operations³³;

- i. Both the mortgagor and the Mortgagee must have the legal capacity (*Ahliyyah*) to possess and dispose of the property. Thus, the mortgage of an insane person or a minor is not valid.
- ii. The agreement terms and conditions must be expressed in writing as supported by Quran 2:282 which states that
“When you deal with each other in transactions involving future obligations in a fixed period of time, reduce them into writing.....get two witnesses, out of your own two men.....”
- iii. The debt as well as the mortgaged property should not be unlawful commodities whose transactions are forbidden under the Shariah.
- iv. The indebted party cannot be coerced into putting collateral. Thus, it should be the debtor (*rahin*) that should enter the *rahn* contract voluntarily.
- v. An orphans property cannot be put up as a collateral by the trustee unless under exceptional circumstances.
- vi. The pledge property should be owned by the pledgor otherwise the contract cannot be executed.

32. Saleem, M.Y. Islamic Commercial Law. John Wiley Publisher. Singapore. 2012. Pp. 8-94

33. Doi A .Shariah: The Islamic Law. As-Noordeen Press. 7th Edition. Malaysia. 2007. Pp. 386-387; Saleem, M.Y. Islamic Commercial Law. John Wiley Publisher. Singapore (2012). Pp. 8-94; <https://cief.wordpress.com/2006/03/06/contract-of-ar-rahn-defination-and-conditions>. Retrieved 26/12/2015. 9:06am

- vii. The pledge property should be in existence at the time that the contract of pledge is concluded and it should be capable of being delivered because the creditor must take its possession.
- viii. The property held as collateral must be liquid. In other words, the property can be easily converted to cash.
- ix. A property conjoined with another property cannot be pledged separately. For instance a House cannot be pledge without the land because possession of a house is not possible without possession of a land nor can it be sold separately
- x. The ownership does not change, thus the owner is responsible for the cost of keeping the property even when it is pledge as collateral. Likewise the owner continues to enjoy any secondary benefit of the property.
- xi. If the property held as collateral is lost or damage while in possession of the trustee, without any negligence on his part there is no guarantee by the trustee.
- xii. The ownership of the property cannot be transfer until the debt settled or the debtor allows for such transaction.
- xiii. If the borrower cannot pay back at the expiry of the term, the judge will order the property pledge as collateral to be sold in the open market even if it is the residence of the borrower.

Ar-rahn is been applied in two different ways under the current practice of Islamic banking which is as follows; an instrument for Financing and a Complementary product. Firstly, *rahn* is considered as an instrument of financing most especially in micro financing and that is why it is been seen as an alternative to the conventional pawnshop. Under this arrangement the loan amount will depend on the value of the *marhun* (pledge asset such as gold, Jewelry etc) may be 70% of the pledged asset will be the loan amount and such pledge asset will be given to the pawn shop or known as “*kedaipajakgadai Islam*” as the *marhun* which will act as a trustee of the pledged asset during the facility period³⁴. A fee will be charge based on daily or monthly calculations for its service safe keep of the pledged item until it is reclaimed and the debt is settled

34. Maybank . “The Concept of al-Rahn from the Shariah Perspective....” [pdf]. Available at Retrieved 26/12/2015. 09:24am

Secondly, ar-rahn acts as a complementary product that is additional transaction (guarantee/collateral) for other products such as ba'i al-murabahah financing. In this case, Islamic banks can detain debtors' mortgaged objects because of transaction.³⁵ *For instance under house financing or car financing, the Bank (Creditor) normally financed the purchase of such property to enable the customer pays back over a given period of time. Under such arrangement the financed property becomes the marhun (Collateral) which the debtor cannot sell off without the permission of the bank. And in case of default, the bank has the authority to sell the house or car to settle the outstanding amount from the sale and credit debtor of the proceeds from the sale of the property if available.*

However, the usage of the above applications is in line with the growth of Islamic financial industry especially in regards of types of marhun used for rahn. Today, modern asset such as shares, sukuk certificates etc are being used as collateral in Islamic financing which is a shift from the previously used assets such as gold, jewellery etc.

5. Major Types of Acceptable Collateral by Islamic Banks

5.1 Land as a security

The Holy Quran says; “*Unto him belongeth whatsoever is in the heavens and whatsoever is in the earth and whatsoever is between them, and what so ever is beneath the sod*”³⁶ while it also observe that “*it is he who hath made the earth subservient unto you, so walk in the paths thereof and eat of his providence. And unto him will be the resurrection*”³⁷ Thus, land has been given to man to keep in trust, to be used wisely for his own benefit³⁸. Land as a security does not only refer to the surface of the land but to all gifts of nature such as rivers, oceans, climate, mountains, fishes, mines forest etc.³⁹ Accepting land as a form of security implies that a mortgage has to be created or taken on the property which is popularly called Mortgage of Real property. This can

35. Maudila R. L. “The optimizing of Rahn service for the Development of Islamic Banking in Indonesia”. Journal of Islamic Economics. Vol 4, No.2.(2003). Pp.170-171

36. Quran 20:6

37. Quran 67:5

38. Shattar, N. “Land Rights in Islam”. Dawn news. (2015); Available at www.dawn.com/new/1154522. Retrieved on 02/01/2015. 5:43pm

39. Marshal, A .Principle of Economics.Macmillan and Co Ltd.. London. 1890: P. 138.Available at www.agriinfo.in/?page=topic&superid=10&topicid=194. Retrieved on 26/12/2015. 4:28pm

either be a legal or equitable mortgage. There exist certain conditions or factors that is needed to be taken into consideration before accepting land as a security such as; borrowers title must be good and registered at the land registry, it must be free from any existing charge or encumbrances, it must be of commercial value etc

5.2 Debenture as a Security

Debenture refers to an instrument issued under a common seal of the company acknowledging its debt to the holder under the terms and conditions specified in the instruments⁴⁰. Thus, it serves as a proof of corporate indebtedness or borrowing. Debenture can be viewed from 2 types depending upon the availability or non availability of security for their repayment which is either Secured or non- secured debenture. Under the secured form of debentures, different types of debentures can be created/charge over the company's asset which can be; Floating charge, Fixed Charge.

Debentures issued by a company can be either convertible or Non-Convertible debenture which is expressed in a document or form called Deed of Debenture. Islamic banks like CIMB Islamic Bank Berhad, Malaysia have adopted such. However, it is pertinent to note that a debenture founded upon loan with interest is non-shariah compliant ⁴¹because interest has been prohibited in whatever form under the Shariah law because Allah says. *“O believers fear Allah and give up what is still due to you from interest (Usury), if you are true believers”*. (Q2:278) and the prophet (PBUH) has also prohibits riba as reported by Jabir bin Abdullahi *“The messenger of Allah (PBUH) cursed the recipient of usury and its giver, and the one who records it, and the two witness; and he said: “They are all equal (in sin & penalty)”* ⁴²

5.3 Shares as a Security

Shares can be defined as a part of the ownership of a company⁴³. Hartzell (2011) defines it as a unit of or reckoning investors interest in the contributed capital of a company⁴⁴.

40. Hartzell .D Dictionary of Management.Ogun. Melrose book and publishing Ltd.2011: Pp. 99

41. Abd. Rahman A. Z “Collateral and Security in the Islamic Commercial Law: The Concept and operation of Rahn. Applied Shariah-Lecture 4.(2009). P. 4

42. Sahih Muslim, Book of Bartering, Chapter 44. No.955. p.485

43. Black .J .Oxford Dictionary of Economics..Oxford University press.USA 2002. Pp 425

44. Hartzell .D .*Dictionary of Management*..Melrose book and publishing Ltd.Ogun2011.P. 343.

A share can also be seen as the interest of a shareholder in a company. Shares of a company can be broadly categorized as follows; the ordinary and preference shares. Share certificates of a company can be used or pledged as a security (*Arrahn*) for bank lending but one fact remains that the business activities of such company must be Shariah compliant. Under such arrangement, the charges that can be created are either equitable mortgage or Legal Mortgage. Other factors to be taken into consideration are type of share, valuation, margin, type of mortgage etc.

5.4 Takaful (Islamic Insurance) as a Security

Takaful is derived from an Arabic word that means joint guarantee, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risk. The Quran say “*And help one another in righteousness and piety, but do not help one another in sin and rancor*” (Q5:2). Anas ibn Malik reported that, A man said “*Oh messenger of Allah, should I tie my camel and trust in Allah or should I untie her and trust in Allah*” The messenger of Allah (PBUH) said, *Tie her and trust in Allah*⁴⁵. With the above necessitate the need for *takaful*. The Shariah Advisory Council (SAC), in its 24th meeting dated 24 April 2002, has resolved that the *takaful* business model based on *tabarru`* and *wakalah* is permissible⁴⁶ which also consistent with the resolution of OIC Fiqh Academy which recommends the *oftabarru`* concept in developing *takaful* institution.⁴⁷ *Takaful* is based on certain principle namely: *Tabarru* (Donation/Contribution) commitment, Ta’awun or mutual assistance, prohibition of *riba*, *ghaar* (Uncertainty) and *maysir* (Gambling or Speculation).

Takaful is classified into two; General and Family *takaful*. General *takaful* which is a short term policy renewable periodically according to the terms and conditions of the *takaful* contract. Eg. Motor, fire, employer liability, burglary, machine breakdown, health, fire consequential loss, and marine cargo etc) and family *takaful*. Family *takaful* is a situation whereby people come together to mutually indemnify one another against any disaster that may befall any member of their family such as sudden death or permanent disability. It is usually offered as a long term policy that cover that may

45. Tirmidhi, 2517

46. Central Bank of Malaysia. *Shariah Resolution in Islamic Finance*. Second Edition. (2010): P.63

47. OIC Fiqh Academy, *Majallah Majma` al-Fiqh al-Islami*, 1985, 2nd Convention, resolution no. 9 (2/9). In Central Bank of Malaysia. *Shariah Resolution in Islamic Finance*. Second Edition. (2010): P.63

span between 10 and 30 years depending on the structure of the product.⁴⁸

However, takafulis considered as a secondary security against the primary security in Islamic financing as it is used when the latter is faced with losses arising from specified risk. Thus, it is seen as a supporting security. For instance the HSBC Amnanah introduced the Home owner takaful specifically to provide Islamic insurance coverage for its Home Financing-I customers.

5.5 Guarantee as a Security

Guarantee which is called *Kafalah* in Arabic literally means surety, bail, guarantee, responsibility or amenability. Kafalah is of two types; *Kafalah bi al-nafs* (Physical) and *kafalah bi al-mal* (Financial). Physical guarantee is also called *Daman Wajh*- guarantee the safe delivery of another for a specific time. Financial guarantee refers to a pledge given to a creditor by the guarantor that the debtor will pay his debt, fine or any other personal liability thereby joining the latter liability to his principal debtor. Kafalah can be recourse or non recourse guarantee.⁴⁹ Contract of Guarantee is permitted in the shariah as obtained in Q12:72⁵⁰ and Q3:37⁵¹. Also the Prophet (pbuh) was reported to have gone for the funeral of a man to pray for his soul. He asked those present at the funeral: “did he leave any wealth?, they replied “No.” He asked further, “did he die with any debts outstanding?”, they replied “yes, he owed two *Dinār*” (in some narrations three *Dinār*). The Prophet (pbuh) was about to leave when he said “then pray on your companion.” Abu Qatadah interceded and said: “I guarantee his debt, Oh Messenger of Allah” and the Prophet (pbuh) then pray on his soul⁵². Guarantee is very essential for a flow of commercial dealings as it gives protection to the debtor and assurance and confidence about repayment to the creditor, thus considered as a security. Guarantee can be a personal or Corporate Guarantee.

48. Hassan, K.M, Kayed, N. R and Oseni, A. U *Introduction to Islamic Banking & Finance; Principles and Practice*. Pearson Educational Ltd. England. First edition. 2013: Pp. 216.

49. Abikan A. I, *Contract of Kafalah (Guarantee): A veritable product of Islamic Financing*. Pp.200-209.

50. *They said: “We have lost the (golden) bowl of the king and for him who produces it is (the reward of) a camel load; and I will be bound by it.”* The above verse relates the event of Prophet Yusuf and his brothers where the former feigned the loss of the King’s measure and stood guarantor for a reward for whoever retrieve it gave validity to the contract under the Islamic law.

51. *So, her Lord (Allah) accepted her with goodly acceptance. He made her grow in a good manner and put her under the care of Zakariyya (Zechariah)*

52. Sunanu Abu Dawud, hadith No.3343, vol. 3, p. 247

5.6 Goods as a Security

Goods refer to an economic asset taking a tangible physical form⁵³. Goods can also be defined as a personal possession other than land and building⁵⁴. Goods are acceptable forms of security provided that they are not subject to a sale contract and they are Shariah compliant. Islamic banks can also use pledges which are concluded through the offer and acceptance of a contract. Pledges give the right to possession of goods until the debt is repaid. However, only physical goods can be pledged, not intangible goods because of concern over valuation and repossession. In accepting goods as a form of security, there are certain features Islamic banks should take into cognizance, the goods must be non-perishable, tradable, ownership rights established and transferable.

5.7 Cash Deposit as a Security

Cash is considered as the safest security that can be pledged against borrowing by banks. Cash in this case refers to credit balance in an account. It could be a savings, current or fixed deposit account. Also, the conventional fixed deposit certificate can be used as a security for Islamic financing based on the ruling of the SAC, in its 9th meeting dated 25 February 1999, has resolved that conventional Fixed Deposit Certificate (excluding the amount of interest or *riba*) is a right or asset of the customer. Hence, it may be used as security for Islamic financing.⁵⁵

Under such arrangement, a lien will be placed on such account so that the borrower cannot have access to it until full payment of the debt. The lien and set off are often used in this case because the set off empowers the bank to use the cash or deposit to settle the loan in case of default. It can be mandatory or non-mandatory⁵⁶. Third party customers can also pledge such security on behalf of the borrower.

5.8 Domiciliation of Payment as a Security

In every facility granted by the Islamic banks there is a risk called credit risk under which possible diversion of funds by the borrower is an example but in order to

53. Black .J (2002). *Oxford Dictionary of Economics*. USA. Oxford University press. Pp. 199

54. Hornby(2006). *Oxford Advanced Learners Dictionary*. USA. Oxford University Press. 7th Edition. P.644

55. Central Bank of Malaysia .*Shariah Resolution in Islamic Finance*. Second Edition. 2010. P.57

56. Abd.Rahman A. Z. "Collateral and Security in the Islamic Commercial Law: The Concept and operation of Rahn. Applied Shariah-Lecture 4.(2009): P. 4

mitigate against such risk, domiciliation of is normally executed. Domiciliation of payment refers to a tripartite arrangement (bank, Borrower, third party) whereby the third party (Employer) undertakes to continue to pay the sum due to the borrower directly to the bank until the facility amount is fully redeemed⁵⁷. Individuals and corporate organization that engages in business that require facility in one way or the other do execute such undertaken to domicile their sales or contract proceeds. This type of security is usually considered as a supporting security in financing.

5.9 Negative Pledge as a Security

Negative pledge is an undertaken usually in written that prohibits the borrower from creating any security interest over its assets without the consent of the lender⁵⁸. The SAC, in its 6th meeting dated 26 August 1998, has resolved that “The consent to the second charge given by the first chargee shall not be construed as waiver of his claim towards the asset under the first charge. In addition, consent of the first chargee shall be given in writing to avoid any dispute”⁵⁹. This form of security is considered as a supporting security which is usually acceptable from borrowers with good credit history, payment history and exercise high level of integrity. It is mostly acceptable from blue chips companies.

5.10 Ijara Agreement as a Security

Ijarah as a concept refers to “rent out something”. This means selling the benefit of use or service for a fixed price or wage. Ijarah is applicable to two scenerios⁶⁰; employment of services and the use of asset/properties. Ijarah as applicable to services is seen as the employment of services of a person for a return (wages/salaries). Here, the employer of such services is called *Mustajir* while the employee is called *Ajir*. Whereas in the case of asset/properties it is refers to as Leasing; the usage of an asset/property for a time period in return for rent. Here the Lessor is called *Mujir* while the Lessee is called *Musta'ajir* and the rent payable is refer to as *Ujrah*. Ijarah is also splitted *Ijarah Thumma Al Bai* (Hire Purchase) and *Ijarah-Wal-Iqtina*

57. Afolabi L. *Law and Practice of Banking*. Heinemann Educational books Nig. Ibadan 1999:P.324

58. John E. I. “Practice of Banking” CIBN *Exam Distance Learning Pack*. PE III..Accountancy Training and Publication Ltd.Lagos2011.Pp. 125-147

59. Central Bank of Malaysia *.Shariah Resolution in Islamic Finance*.Second Edition.2010. P.56

60. Usmani T. M *An Introduction to Islamic Finance*..India Adam Publisher and Distributors.New Delhi. 2010. Pp.157, 158

Under this arrangement, there exist an ijarah agreement which refers to a document stating the terms and conditions of the ijarah. It normally contains the Parties involved, amount, duration, mode of repayment, rights of both parties etc. The fact that there exist no any other collateral apart from the property financed, the property lease agreement serves as the collateral to support the borrowing.

5.11 Sukuk Certificate as a Security

Islamic Sukuk refer to as a certificate of investment of same value of shares representing the ownership of tangible asset of the firm⁶¹. It is equivalent to bonds but since fixed income, interest bearing bonds are not permissible in Islam, it is structured in such a way to comply with the Islamic shariah. Sukuk is considered as debt securities which are valuable and tradable in the market, thus its certificates have satisfied the required features of acceptable securities in *rahn* for Islamic financing. The ruling of SAC can be used to buttress this fact “The SAC, in its 30th meeting dated 28 October 2002, has resolved that the Islamic debt securities may be charged in a *rahn* contract. The financing receiver is also allowed to identify the respective securities to be charged in the system without physical transfer of the charged securities to the financier⁶². Sukuks can be issued under different structures to accommodate the dynamics of different transactions. Some of these structures include: Salam: Ijarah, Mudaraba, Musharaka, Murabaha⁶³.

In addition, the Syafii scholars allow the security to be taken and used by the chargor as long as consent of the chargee is obtained. The Maliki scholars, on the other hand, allow “*rahnrasmī/hiyazi*” which is the submission of security through official notes in the registry of relevant authority. This may sufficiently represent the actual submission⁶⁴. These views are clearly consistent with the view of contemporary scholars who allow the utilization of debt securities and *sukukas* securities for *rahn*.

5.12 Assignment of Debt as a Security

Assignment of debt which is called *hiwalah* or *hawalah*. *Hiwalah* is a contract which caused the transfer of debt from one party to another. The participants involved in

61. AAOIFI SS17

62. Central Bank of Malaysia .*Shariah Resolution in Islamic Finance*.Second Edition.2010. P.58

63. Oladunjoye O. M .“Sukuk as a tool for infrastructural development in Nigeria”.*Journal of Islamic Banking and Finance*, Vol 2, No1.(2014).” Pp 338-339

64. Central Bank of Malaysia .*Shariah Resolution in Islamic Finance*.Second Edition.2010. P.59

this contract are the principal debtor, the creditor and the transferee. This contract is permissible as the prophet (SAW) “*The deferment (of paying debt) by the richer is an injustice. When there is one of you, get the offer from one other to transfer your debt to another person, just accept it.*”⁶⁵ Hiwalah can be *Hiwalah Muqayyadah* (Restricted Hiwalah) and *Hiwalah Mutlaqah* (Absolute hiwalah)⁶⁶. The borrower can assign debt to the bank as security for credit facility. Under this arrangement the debt in favour of the borrower from the third party is assigned to the bank for the obligation which the former has to the bank. Thus the borrower debtor is expected to settle his debt by paying the bank to which the debt is assigned.

5.13 Letter of Comfort/Awareness

Letter of comfort refers to a written formal letter written by a reputable company to a lending institution acknowledging support of its subsidiary borrowing from the bank.⁶⁷ This form of security only creates moral obligation on the part of the issuer rather than a legal obligation which implies that it does not serve as a guarantee to its subsidiary in case of default. Letter of comfort is usually prepared on the issuer letter headed paper duly signed under sealed by two directors or a director and the company secretary.

6. Conclusion

Taking collateral (Ar-rahn) against loans and advances by Islamic banks is highly permitted by the Shariah because the Quran, Hadith and as well as the fatawah amongst Muslim jurist permits the use of collateral to secure a loan. The application of *arrahn* in the business of lending is to safeguard the interest of the creditors (Islamic banks) majorly with regards to minimization of associated risks and by ensuring that the customers fulfil the duties of a debtor in the most efficient and secure manner. Under the current banking practice, the way and manner which *arrahn* is applied as earlier mentioned will enhance the economy thus ensuring that the core objectives of Islamic economies is achieved, but one issue of concern is that should it be a primary criteria against lending? Though, under the Islamic banking system they concentrate on the

65. <http://www.investment-and-finance-net/islamic-finance/h/hiwalah.html>. Retrieved on 16/12/2015

66. Sahih Bukhari Vol 3.No.487

67. Onyiriuba L (2008). *Analysing and Managing Risk of Bank Lending*. Lagos. NFS Data Bureau Ltd. Second Edition. Pp. 389

viability and profitability of the project or business to be financed and not the size of the collateral which is a clear deviation from the conventional banking system. This is further supported in the words of a non-muslim scholar Nwankwo (1991) that “*There should be no such thing as lending against security as the sole or primary criterion.... In the final analysis, when the crunch comes, the asset may have little resale value. Even then, collecting funds through liquidation of pledged security is an unpleasant business*”.⁶⁸

However, collateral arrangement is bedeviled with the issue of realization upon default by borrowers because of constraints such as unresolved fiqh issues, the existing legal framework guiding its processes, delayance in the administration of justice, lack of financial court etc all this has made Islamic banks and as well as the conventional bank toothless bull dog in realizing its Non Performing Loan (NPLs) that are secured with collaterals.

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68. Nwankwo, G.O. *Bank Management: Principles and practice*, Malthouse Press Limited. Lagos. 1991: P. 130. In Onyiriuba L. *Analysing and Managing Risk of Bank Lending*. NFS Data Bureau Ltd. Lagos. Second Edition. 2008. Pp. 373

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